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THE JOURNAL OF FEDERAL AGENCY ACTION

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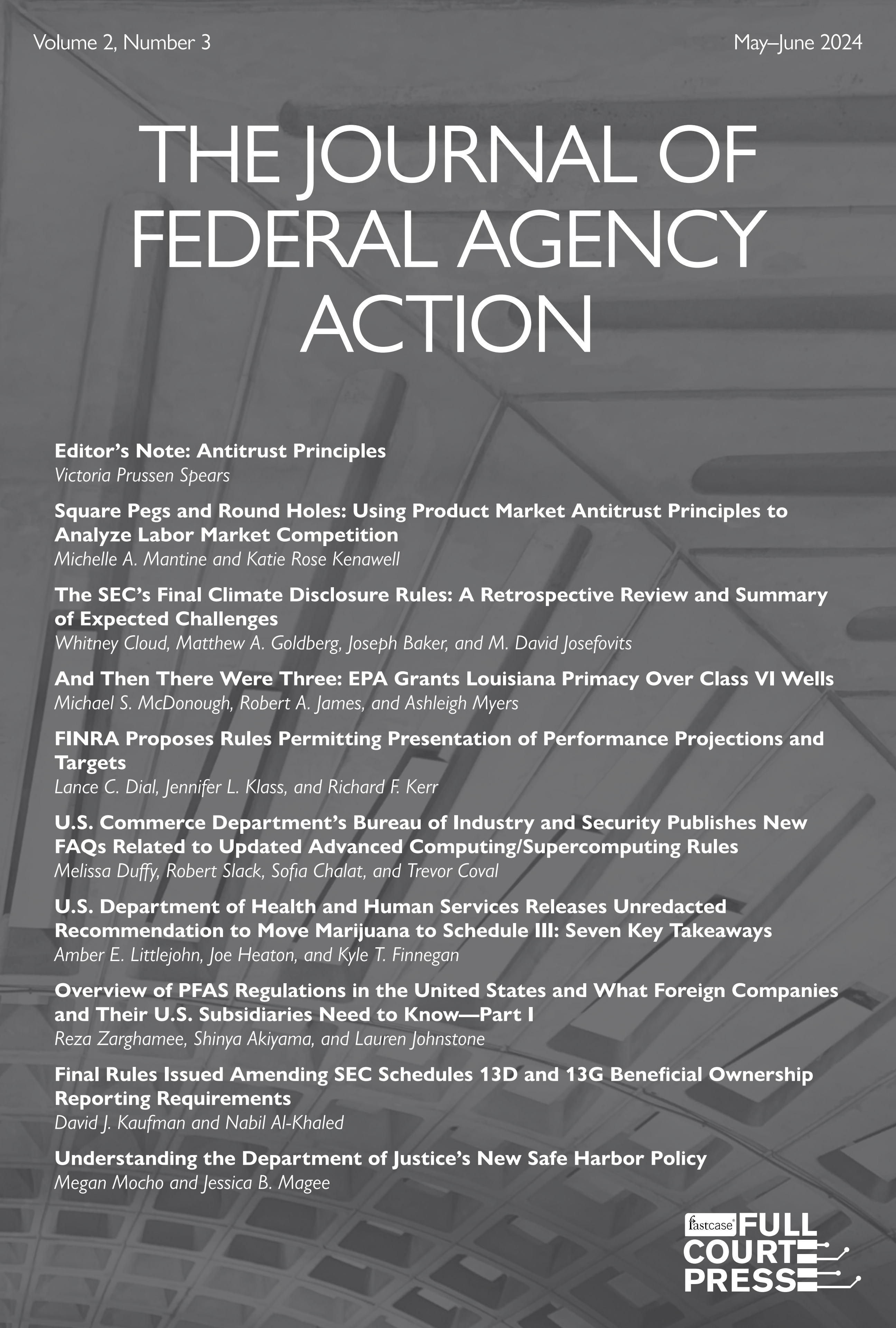

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Articles and Submissions

Direct editorial inquiries and send material for publication to:

Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway, #18R, Floral Park, NY 11005, smeyerowitz@meyerowitzcommunications.com, 631.291.5541.

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Morgan Morrissette Wright, Publisher, Full Court Press at mwright@fastcase.com or at 202.999.4878

For questions or Sales and Customer Service:

Customer Service
Available 8 a.m.–8 p.m. Eastern Time
866.773.2782 (phone)
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Sales
202.999.4777 (phone)
sales@fastcase.com (email)

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Editor's Note
Antitrust Principles

Victoria Prussen Spears*

Articles in this issue of *The Journal of Federal Agency Action* focus on a broad range of federal regulatory activity, beginning with an analysis of merger guidelines recently released by the Federal Trade Commission and the Department of Justice. Other pieces cover developments by the Securities and Exchange Commission, the Environmental Protection Agency, the Financial Industry Regulatory Authority, and more!

The FTC and DOJ

The first article in this issue, titled "Square Pegs and Round Holes: Using Product Market Antitrust Principles to Analyze Labor Market Competition," is by Michelle A. Mantine and Katie Rose Kenawell of Reed Smith LLP.

In this article, the authors discuss merger guidelines released recently by the Federal Trade Commission and the Justice Department's Antitrust Division.

The SEC

Then, in "The SEC's Final Climate Disclosure Rules: A Retrospective Review and Summary of Expected Challenges," Whitney Cloud, Matthew A. Goldberg, Joseph Baker, and M. David Josefovits of DLA Piper explore potential legal challenges to the rules on climate disclosures recently adopted by the U.S. Securities and Exchange Commission.

The EPA

Michael S. McDonough, Robert A. James, and Ashleigh Myers of Pillsbury Winthrop Shaw Pittman LLP are the authors of the next

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piece, titled "And Then There Were Three: EPA Grants Louisiana Primacy Over Class VI Wells." In this article, the authors review the decision by the U.S. Environmental Protection Agency to grant authority to Louisiana to permit and regulate Class VI underground injection control wells.

FINRA

The article that follows is titled "FINRA Proposes Rules Permitting Presentation of Performance Projections and Targets." Here, Lance C. Dial, Jennifer L. Klass, and Richard F. Kerr of K&L Gates LLP discuss amendments proposed recently by the Financial Industry Regulatory Authority to Rule 2210, governing broker-dealer communications with the public.

BIS

In "U.S. Commerce Department's Bureau of Industry and Security Publishes New FAQs Related to Updated Advanced Computing/Supercomputing Rules," Melissa Duffy, Robert Slack, Sofia Chalat, and Trevor Coval of Fenwick & West LLP provide background on the Commerce Department's Bureau of Industry and Security's semiconductor controls and discuss newly issued guidance.

HHS

Amber E. Littlejohn, Joe Heaton, and Kyle T. Finnegan of Ice Miller LLP are the authors of the article titled "U.S. Department of Health and Human Services Releases Unredacted Recommendation to Move Marijuana to Schedule III: Seven Key Takeaways." In this article, the authors offer key takeaways from newly unredacted U.S. Department of Health and Human Services documents.

PFAS

Next is the first part of a two-part article titled "Overview of PFAS Regulations in the United States and What Foreign Companies and Their U.S. Subsidiaries Need to Know," by Reza Zarghamee, Shinya Akiyama, and Lauren Johnstone of Pillsbury Winthrop Shaw Pittman LLP.

This first part describes poly- and perfluoroalkyl substances (PFAS), the types of products that include it, and the recent wave of litigation involving PFAS contamination, which has involved settlements above $10 billion. The conclusion of this article, to be published in the next issue of *The Journal of Federal Agency Action*, will discuss developments in federal and state regulation of these chemicals and specific scenarios in which these developments may affect foreign corporations. The article will end with the recommendation that businesses that manufacture, distribute, use, or dispose of PFAS or products containing PFAS should stay abreast of these developments and develop proactive strategies to minimize their potential liability.

Schedules

In "Final Rules Issued Amending SEC Schedules 13D and 13G Beneficial Ownership Reporting Requirements," David J. Kaufman and Nabil Al-Khaled of Thompson Coburn LLP discuss final beneficial ownership reporting rules adopted recently by the Securities and Exchange Commission.

Safe!

"Understanding the Department of Justice's New Safe Harbor Policy" is the title of the article by Megan Mocho and Jessica B. Magee of Holland & Knight LLP. Here, the authors discuss a new policy that applies to companies that voluntarily self-disclose criminal misconduct discovered in connection with mergers and acquisitions.

Enjoy the issue!

Note

* Victoria Prussen Spears, Editor of *The Journal of Federal Agency Action*, is senior vice president of Meyerowitz Communications Inc. A graduate of Sarah Lawrence College and Brooklyn Law School, Ms. Spears was an attorney at a leading New York City law firm before joining Meyerowitz

Communications. Ms. Spears, who also is Editor of *The Journal of Robotics, Artificial Intelligence & Law*, *The Global Trade Law Journal*, and *The Global Regulatory Developments Journal*, may be contacted at vpspears@meyerowitz communications.com.

Square Pegs and Round Holes: Using Product Market Antitrust Principles to Analyze Labor Market Competition

Michelle A. Mantine and Katie Rose Kenawell*

In this article, the authors discuss merger guidelines released recently by the Federal Trade Commission and the Justice Department's Antitrust Division.

The Federal Trade Commission (FTC) and the Antitrust Division of the U.S. Department of Justice (DOJ) (together, the Agencies) have released the 2023 Merger Guidelines (the guidelines), which, in the Agencies' view, modernize the merger guidelines to reflect the realities of the modern economy.[1] These guidelines memorialize the factors the Agencies have been focusing on when reviewing recent mergers and acquisitions. The FTC and DOJ published a draft of the guidelines for public comment in July 2023, after an 18-month process to develop them. The approval followed a six-month public comment period and was passed by the Commission in a 3-0 vote.[2] While not legally binding, the guidelines provide transparency into the Agencies' decision-making process.

The guidelines are part of the renewed federal effort to limit high concentration in certain markets by preventing already powerful firms from merging with one another. Attorney General Merrick B. Garland explained that "[u]nchecked consolidation threatens the free and fair markets upon which our economy is based on. . . . These updated Merger Guidelines respond to modern market realities and will enable the Justice Department to transparently and effectively protect the American people from the damage that anticompetitive mergers cause."[3]

Theoretically, the guidelines should help to increase competition and, therefore, lower prices for consumers. Most people, when they envision antitrust enforcement, picture just that: more robust competition that keeps product prices from skyrocketing. However, the new guidelines (as well as the proposed revisions to

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filings pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR), as amended)[4] tackle far more than traditional product markets, as they focus on labor competition and mobility.

The Analogy

The traditional principles of competition are applicable to labor markets. In this analogy, firms are the buyer instead of the seller, because they are paying salaries to purchase labor from workers. Therefore, instead of monopolies, the employer firms are characterized as creating a monopsony, which is when there are very few buyers who have a lot of concentrated power.[5]

There are three main sources of monopoly power, which can be roughly analogized to the labor markets, as shown in Table 1.

Monopolies in product markets are more likely to form when product markets are highly concentrated, have a lot of product differentiation, and when there are high search frictions. This usually results in higher prices.

Labor markets are similar, but the result is compressed wages for employees. If all the employers in a labor market can collude to set wages, they will not need to compete with one another and

Table 1

Traditional Product Markets	**Labor Markets**
Market Concentration	A market with very few employers relative to the number of workers.
Product Differentiation	Jobs with particularized amenities, which makes it harder to compare jobs to one another.
Search Frictions	The difficulty of finding, applying, and being hired for a comparable job. The Merger Guidelines describe search frictions as “the process of finding, applying, interviewing for, and acclimating to a new job. Switching costs can also arise from investments specific to a type of job or a particular geographic location.”[a]

[a] 2023 Merger Guidelines, p. 27.

they can pay their employees considerably less.[6] By the same token, if all the firms in a labor market merge into one firm, they do not even need to collude to compress wages. They will just decrease because competition for employees will decrease.

Antitrust in the labor context is making its way into the government's enforcement rhetoric.[7] The new merger guidelines and proposed HSR rules take aim at these issues, consistent with the FTC and DOJ's investigatory focus. Specifically, Guideline 10 reads:

> When a Merger Involves Competing Buyers, the Agencies Examine Whether It May Substantially Lessen Competition for Workers, Creators, Suppliers, or Other Providers.
>
> A merger between competing buyers may harm sellers just as a merger between competing sellers may harm buyers. The same—or analogous—tools used to assess the effects of a merger of sellers can be used to analyze the effects of a merger of buyers, including employers as buyers of labor. Firms can compete to attract contributions from a wide variety of workers, creators, suppliers, and service providers. The Agencies protect this competition in all its forms.

Traditionally, antitrust laws were applied to protect consumers specifically. However, this guideline reflects the government's interest in protecting other market participants too—namely, workers. Notably, the drafters reference just two cases to support this guideline.

The first is *Mandeville Island Farms, Inc. v. Am. Crystal Sugar Co.*,[8] which the Agencies rely on for the proposition that the Sherman Act "'does not confine its protection to consumers, or to purchasers, or to competitors, or to sellers. . . . The Act is comprehensive in its terms and coverage, *protecting all who are made victims of the forbidden practices* by whomever they may be perpetrated.'"[9]

The case held that sugar refiners were liable under the Sherman Act for agreeing to make certain demands to upstream sugar growers. While the holding established Sherman Act liability for sellers, it is technically not limited to sellers: "protecting all who are made victims of the forbidden practices," does include workers. However, this case did not involve a merger or acquisition, only distinct firms colluding with one another.

Next, Guideline 10 references *NCAA v. Alston*,[10] where the Supreme Court applied the Sherman Act to protect workers from an employer-side agreement to limit compensation.[11] This decision prevented the NCAA from limiting benefits available to student athletes as compensation, which is roughly analogous to the issues of the larger labor markets. However, just like with *Mandeville Island Farms*, this case did not include a merger or acquisition.

These scarce and somewhat tangential references are notable because, as the name suggests, the merger guidelines are not law. The Agencies have "issued and revised [the guidelines] to enhance transparency and promote awareness of how the agencies carry out that charge with respect to mergers and acquisitions."[12] Therefore, the Agencies use these guidelines to decide whether to bring antitrust charges against merging firms, but courts are not bound to follow them.

Where the Analogy Falters

Some scholars have criticized the drafters for ignoring the differences between the labor market and product market. For example, Cornerstone Research, a consulting company with a focus on economic and financial consulting, published a comment ("A Comment on Labor Market Definition") about these differences, which notes that "[t]he temptation here is to take wages to be analogous to prices in a product market. However, compensation may often be more complex than prices in a product market; for many workers, their compensation is multidimensional and more complex than simply W-2 income."[13] Many employees care more about their economic benefits than they do about the number on their pay stub, including everything from health insurance to pension or retirement plans. Other employees might place more value on less tangible benefits, like the flexibility to set their schedule, workplace safety, or other preferences surrounding a workplace culture.[14]

The new guidelines fail to account for the intrinsic value of these benefits, tangible or not.

The Comment explains that this

> is flawed economic logic. If workers explicitly prefer the firm's compensation package of slightly lower wages but higher non-wage benefits (e.g., remote work, flexible hours), then the firm is not suppressing the worker's total compensation. In fact, the

> firm is competing for workers by offering a bundle of benefits that are more valuable to the worker; this is equivalent to higher total compensation and is procompetitive. Thus, any assessment of market power needs to account for all components of compensation that workers value.[15]

Also, the Agencies rely heavily on defining relevant markets when evaluating a merger. For instance, the FTC's challenge to Whole Foods transaction with Wild Oats Markets in 2008 sparked debate over whether there was a submarket for premium, natural, and organic supermarkets, as compared to the larger grocery store product market.[16] If people are likely to substitute one product for another when the prices increase, then they generally are considered to be in the same market (calculated by the SSNIPT (small but significant and non-transitory increase in price) Hypothetical Monopolist Test).[17]

A narrow market often exists if consumers would not substitute the product no matter the price increase. In the above example, a narrow market existed if consumers would keep going to Whole Foods instead of a non-organic grocery store, even if the prices for premium, natural, and organic groceries skyrocketed. The Agencies have a hard time bringing antitrust claims when the market is defined broadly; conversely, when the market is defined narrowly, it is easier for the Agencies to prove that one or two firms are dominate. Market definition is critical for the government's antitrust case against a firm and experts believe the new Merger Guidelines will give the agencies more flexibility to define markets.[18]

However, defining the labor market is becoming increasingly more complex. While there may be some natural logical constraints to decide what products are competing with one another, they are not always applicable for labor markets. For instance, the court might have considered how far the average person would travel to buy premium, natural, and organic products in the case of Whole Foods before they would simply revert to a non-organic grocery store. There are plenty of consistent factors that courts can use to determine what a product market is based on how consumers choose between competing products.

Picking a job, however, is not so simple. After the COVID-19 pandemic, many more workers are opting for entirely remote jobs. While a geographic market used to be an important part of a traditional merger analysis, it loses meaning in the face of available remote work for labor markets.

Workers also consider intangible benefits, including:

- Commute times,
- Physical office space,
- Workplace culture and coworkers, and
- Nearby dining/ shopping options.

Workers also consider the absence of so-called dis-amenities, or the absence of uncomfortable qualities. This can include:

- Safety (as opposed to occupational hazards),
- Regular daytime shifts (as opposed to unusual hours or night shifts), and
- Year-round employment (as opposed to seasonal jobs).

Amenities and dis-amenities may make labor markets unlike any traditional product markets. Most job seekers cannot compare jobs one-to-one the way they might compare prices of two grocery stores. As a result, it will be difficult for the FTC and DOJ to know what jobs are comparable and therefore should be included in the same labor market.[19]

Despite the difficulties, the DOJ did succeed in their suit to prevent the merger of Penguin Random House LLC and Simon & Schuster. After a grueling three-week trial, the district court Judge Florence Pan wrote an 80-page opinion affirming the government's stance: the merger would have the effect of "substantially" lessening competition among authors.[20]

"The decision is also a victory for workers more broadly," said AAG Kanter of the Penguin House success story. "It reaffirms that the antitrust laws protect competition for the acquisition of goods and services from workers."[21]

Consequences

The proposed HSR rules likely will require merging firms to include far more data than ever before, including data related to labor markets described above. To combat increasing concentration in the employer's (and therefore buyer's) market, the proposed HSR rules require the merging firms to supply data related to merging parties' top-five categories of workers as classified by the Bureau of Labor Statistics' Standard Occupational Classification system. The proposed HSR rules also require additional geographic information in the case of overlapping labor markets between the merging parties.

The proposed HSR rules go even further, requiring firms to also report whether they have had any adverse penalties or findings issued in the past five years by either the National Labor Relations Board, Occupational Safety and Health Administration, or the Department of Labor's Wage and Hour Division.[22]

There are some meaningful benefits as well as drawbacks to using traditional antitrust analysis to help mitigate anticompetitive effects in labor markets. As Eric Posner's book on the topic suggests, antitrust law could be a useful way to improve labor and wages conditions across the country if pursued effectively.[23] However, the analytical approach underlying the new merger guidelines and proposed HSR rules may lead to inconsistent results. Expect to see more court decisions on the subject and an unclear path forward for prospective merging firms.

Notes

* Michelle A. Mantine, a member of the Board of Editors of *The Journal of Federal Agency Action*, is a partner in the Pittsburgh office of Reed Smith LLP. Katie Rose Kenawell is an associate in the firm's Pittsburgh office. The authors may be contacted at mmantine@reedsmith.com and kkenawell@reedsmith.com, respectively.

1. 2023 Merger Guidelines, https://www.ftc.gov/system/files/ftc_gov/pdf/2023_merger_guidelines_final_12.18.2023.pdf.

2. FTC and DOJ Release 2023 Merger Guidelines, https://www.ftc.gov/news-events/news/press-releases/2023/12/federal-trade-commission-justice-department-release-2023-merger-guidelines.

3. FTC and DOJ Seek Comment on Draft Merger Guidelines, https://www.ftc.gov/news-events/news/press-releases/2023/07/ftc-doj-seek-comment-draft-merger-guidelines.

4. FTC and DOJ Propose Changes to HSR Form for More Effective, Efficient Merger Review, https://www.ftc.gov/news-events/news/press-releases/2023/06/ftc-doj-propose-changes-hsr-form-more-effective-efficient-merger-review.

5. Eric A. Posner, How Antitrust Failed Workers, Oxford University Press, 2-6 (2021).

6. *Id.*

7. *See* Assistant Attorney General Jonathan Kanter Delivers Remarks at the Fordham Competition Law Institute's International Antitrust Law and Policy Conference, https://www.justice.gov/opa/speech/assistant-attorney-general-jonathan-kanter-delivers-remarks-fordham-competition-law. AAG Kanter explains that a McDonald's manager was being prevented from taking a pay raise a different franchise location: "An anticompetitive agreement took her power to choose where to work and to earn a fair return for her skills and labor." *See also* Deputy Assistant Attorney General Michael Murray Delivers Remarks at the Santa Clara University School of Law, https://www.justice.gov/opa/speech/deputy-assistant-attorney-general-michael-murray-delivers-remarks-santa-clara-university. DAAG Murray brings this up as early as 2019, saying, "[t]he Department has been active in this area for many years, perhaps most prominently several years ago with a series of settlements concerning no-poach agreements and technology companies."

8. Mandeville Island Farms, Inc. v. Am. Crystal Sugar Co., 334 U.S. 219, 235-36 (1948).

9. 2023 Merger Guidelines, p. 26, n.49 (emphasis added).

10. NCAA v. Alston, 141 S. Ct. 2141 (2021).

11. 2023 Merger Guidelines, p. 26, n.50.

12. FTC and DOJ Seek Comment on Draft Merger Guidelines, https://www.ftc.gov/news-events/news/press-releases/2023/07/ftc-doj-seek-comment-draft-merger-guidelines.

13. Kavan Kucko, Justin McCrary, Bryan Ricchetti, and Rainer Schwabe, A Comment on Labor Market Definition, Cornerstone Research (Sept. 15, 2023).

14. *Id.* at p. 4.

15. *Id.* at p. 6.

16. FTC v. Whole Foods Mkt., 548 F.3d 1028 (2008).

17. 2023 Merger Guidelines, p. 42.

18. For instance, the Chief Economist of the Antitrust Division and the Director of the Federal Trade Commission's Bureau of Economics wrote that this "gives the Agencies the option to focus on the loss of competition between the parties rather than fight over how narrowly a market could be properly defined." Susan Athey and Aviv Nevo, DOJ and FTC Chief Economists Explain the Changes to the 2023 Merger Guidelines, https://www.promarket.org/2023/12/19/doj-and-ftc-chief-economists-explain-the-changes-to-the-2023-merger-guidelines/.

19. This difficulty is highlighted by the challenge Agencies face when bringing labor cases. *See* Press Release, U.S. Dep't of Just., Justice Department Sues to Block Penguin Random House's Acquisition of Rival Publisher Simon & Schuster, https://www.justice.gov/opa/pr/justice-department-obtains-permanent-injunction-blocking-penguin-random-house-s-proposed.

20. In Written Opinion, Judge Florence Pan Delivers Knockout Blow to PRH, S&S Merger, https://www.publishersweekly.com/pw/by-topic/industry-news/publisher-news/article/90880-in-written-opinion-judge-florence-pan-shreds-blocked-prh-s-s-merger.html.

21. *Id.*

22. Proposed Amendments to HSR Rules Form Instruction, https://www.federalregister.gov/documents/2023/06/29/2023-13511/premerger-notification-reporting-and-waiting-period-requirements.

23. Eric A. Posner, How Antitrust Failed Workers, Oxford University Press (2021).

The SEC's Final Climate Disclosure Rules: A Retrospective Review and Summary of Expected Challenges

Whitney Cloud, Matthew A. Goldberg, Joseph Baker, and M. David Josefovits*

In this article, the authors explore potential legal challenges to the rules on climate disclosures that were adopted by the U.S. Securities and Exchange Commission.

The U.S. Securities and Exchange Commission (SEC) has adopted its highly anticipated final rules on climate disclosures. And now, the also highly anticipated legal challenges will assuredly follow. This article explores those potential legal challenges after situating the new rules within the SEC's past climate-related disclosure requirements. It also offers takeaways for navigating the new rules given an uncertain future.

The Past, Proposed, and Present Shape of the SEC's Climate Disclosure Rules

The SEC has a long history of requiring disclosures of environmental- and climate-related risks in SEC reports. Beginning in 1971, the SEC issued Release No. 33-5170, which stated that the SEC requirements "call for disclosure, if material, when compliance with statutory requirements with respect to environmental quality, e.g., various air, water and other anti-pollution laws, may necessitate significant capital outlays, may materially affect the earning power of the business, or cause material changes in registrant's business as done or intended to be done."[1]

About a decade later, in 1982, the SEC issued Release No. 33-6383, which required the disclosure of information relating to

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litigation and other business costs arising out of compliance with "federal, state, and local laws that regulate the discharge of materials into the environment or otherwise relate to the protection of the environment."[2]

Then, in 2010, the SEC issued Release No. 33-9106, which "remind[ed] registrants . . . that [certain climate-related] disclosure[s] . . . should be clear and communicate to shareholders management's view of the company's financial condition and prospects."[3]

More than a decade after the last update, on March 21, 2022, the SEC proposed new rules designed to make climate disclosures more "consistent, comparable, and reliable."[4] According to the SEC, the purpose of the new rules is to improve the disclosure requirements currently required under Release No. 33-9106 by standardizing the location and substance of information.[5] They required registrants to include certain climate-related disclosures in their registration statements and periodic filings, including information about climate-related risks that are reasonably likely to have a material impact on their business. This specifically included:

- Information about greenhouse gas emissions, including Scope 1 and Scope 2 greenhouse gas emissions and carbon intensity, and Scope 3 greenhouse gas emissions and carbon intensity, if those figures are material;[6]
- Climate-related costs, capital expenditures and reserves;
- Material risks related to climate change, including whether such risks are likely to manifest in the short, medium, or long-term; and
- Board and management oversight of climate-related risks, as well as the processes for identifying, assessing, and managing those risks.

On March 6, 2024, nearly two years after issuing its proposed rules, the SEC adopted its final climate disclosure rules.[7] The final rules were largely a win for issuers, as they scaled back many of the more controversial aspects of the proposed rules. Those changes include:

- Removing the requirement that issuers disclose Scope 3 greenhouse gas emissions;

- Requiring only large-accelerated and accelerated filers to disclose Scope 1 and Scope 2 greenhouse gas emissions—as opposed to the universal requirement in the proposed rules—and these companies need only disclose material Scope 1 and Scope 2 emissions;
- Modifying and lessening required climate-related risk disclosures; and
- Limiting governance disclosure requirements, including eliminating the requirement that companies identify relevant expertise of board members, the specific board members responsible for managing climate-related risk, and how the board sets climate-related goals.

In many respects, the SEC's final rules are a less-toothy version of California's climate disclosure rules and the European Union's Corporate Sustainability Reporting Directive (CSRD). Given the pro-ESG political climates in California and the European Union, those jurisdictions have pursued more aggressive climate-related policymaking, now reflected in the resulting regulations. For example, both California law and the EU's CSRD impose more stringent Scope 3 emission disclosure requirements and both mandate disclosures from a broader group of entities than those covered by the SEC's final climate rules. Both the CSRD and California's climate disclosure rules are set to go into effect in 2026.

The changes between the proposed and final climate rules were more significant than those to other recent SEC rules. For example, last year, the SEC issued final rules concerning cybersecurity[8] and "greenwashing," which is when an investment fund overstates the environmentally-friendly nature of its financial products.[9] In both instances, the final rules were largely consistent with their proposed version with minor changes focusing primarily on lessening compliance and monitoring requirements.[10] In contrast, the changes between the SEC's proposed and final climate rules are more significant. This is likely a result of the nearly 24,000 public comments to the proposed climate rules, at least in part.

Anticipated Legal Challenges

Although the SEC's final climate disclosure rules are not as stringent as their proposed version, they will still undoubtedly face legal challenges stemming from a fractured political climate. The three most likely challenges are discussed in turn below.

Ultra Vires—An Unauthorized Expansion of the SEC's Statutory Rulemaking Authority

Opponents of the SEC's ESG agenda are likely to attack the SEC's statutory authority to mandate the disclosures in the final climate disclosure rules. The SEC's rulemaking powers are constrained by the express terms of Section 13(a) of the Exchange Act, its enabling statute. That section provides that the SEC's authority is limited to mandating public reporting that is "necessary or appropriate for the proper protection of investors and to insure fair dealing in the security."[11] In response to the proposed and final rules, opponents argued that the SEC exceeded this authority. Following publication of the proposed rules, sixteen state attorneys general wrote a letter to SEC Commissioner Gary Gensler, arguing that "legitimate mandatory disclosures [under Section 13(a)] are those required to protect investors from inflated prices and fraud, not merely helpful for investors interested in companies with corporate practices consistent with federally encouraged social views."[12] Representatives from ten of those states sued to block the SEC's final climate rules the same day they were adopted.[13]

The States' position is consistent with the position the SEC took during the Trump administration, when in 2016, the SEC noted that without specific congressional direction, it lacked the authority to require ESG-related disclosures.[14]

The SEC's position on its authority to promulgate ESG-related disclosure rules changed with the Biden administration. In 2022, the SEC posited that its proposed rules satisfy the requirement of its enabling statute because "this information can have an impact on public companies' financial performance or position and may be material to investors in making investment or voting decisions."[15] The SEC also underscored the new rules' link to materiality in its press release on March 6.[16] These references demonstrate the SEC's intent to situate its authority to promulgate rules mandating climate disclosures with its authority to promulgate Rule 10b-5, which prohibits buying or selling securities while concealing "a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."[17]

It remains to be seen whether framing the final rules in this light will convince federal courts that the SEC acted within the bounds of its authority as provided by Section 13(a). Either way, this question will likely be a source of significant litigation.

The Major Questions Doctrine—The Issue's Importance Compels Congressional Direction

The SEC's final climate disclosure rules may also be challenged under the "major questions doctrine." This doctrine is used by courts to unwind agency action where "the history and breadth of the asserted authority and the economic and political significance of the agency's rule give courts reason to doubt that Congress meant to confer the authority in question." The Supreme Court has relied on the major questions doctrine twice in the past two years to invalidate administrative agencies' actions as outside their historical purview without clear direction by Congress.[18] Following the Court's recent invocation of the major questions doctrine, challenges to agency authority are expected to proliferate.

Challengers to the SEC's final climate disclosure rules will likely argue that they run afoul of the "major questions doctrine" by diverging from the SEC's historical practice of requiring disclosures only of financially material information. Even within the SEC, opponents of the rules have argued that, in contrast to prior disclosure rules, the rules "force[ ] investors to view companies through the eyes of a vocal set of stakeholders, for whom a company's climate reputation is of equal or greater importance than a company's financial performance."[19] Litigants undoubtedly will seize on this perspective to argue that the SEC does not have the authority to dictate what issues beyond financials are (or should be) important to investors.

Notwithstanding the recent developments in this area, there are good reasons to believe the SEC's final climate disclosure rules will survive a "major questions doctrine" challenge. To start, a court may not view climate disclosures as having the same economic and political significance as mandating actions, such as transitioning power plants away from natural gas and coal. Further, there is longstanding acceptance of the breadth of the SEC's rulemaking authority. While the outcome of a major questions doctrine challenge is uncertain, its assertion by private litigants is almost guaranteed.

A First Amendment Violation—Impermissibly Compelled Speech

Lastly, First Amendment limitations on compelled speech may present another potential hurdle for the SEC's final climate disclosure rules. The "compelled speech" doctrine began in *West Virginia State Board of Education v. Barnette*,[20] when the Supreme Court held that a state board of education could not require school children to recite the Pledge of Allegiance because the government "cannot enforce unanimity of opinion on any topic." The Supreme Court addressed the application of the compelled speech doctrine to corporations in *Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio*.[21] Although corporations enjoy protections under the First Amendment, the Supreme Court has held that the "compelled speech" doctrine is not violated by government requirements that corporations disclose "purely factual and uncontroversial information" in their commercial speech as long as the disclosures are reasonably related to a legitimate government interest and are not "unjustified or unduly burdensome." Thus, historically, SEC disclosure requirements aimed at informing and protecting investors were viewed as compatible with First Amendment protections.

If faced with a compelled speech challenge, the SEC undoubtedly would argue that the climate disclosure requirements, like traditional financial reporting requirements, satisfy the *Zauderer* test.

First, the SEC's final rules would arguably seek only "purely factual and uncontroversial" information about the climate risks associated with an offered security.

Second, the required climate disclosures could be construed as reasonably related to the government's interest in providing investors with investment-relevant information.

Finally, the SEC's final rules may not be unduly burdensome because they do not prevent companies from expressing any climate-related message, and therefore do not chill protected speech.

There are, however, non-frivolous arguments that the climate disclosure rules are different in kind than mandatory financial disclosures and therefore run afoul of the compelled speech doctrine. In particular, challengers could argue that the rules compel companies to adopt the SEC's policy views as to climate change and the importance of climate-related risks to investors. This politically charged challenge in the context of climate disclosures might land differently than compelled disclosures of other information. There could easily be variation by federal courts in applying the *Zauderer* test to the SEC's final climate disclosure rules.

Conclusion

Market participants will need to be agile and thoughtful about their climate-related disclosures in the coming months and years. While many market participants are well positioned to comply with the SEC's climate rules given their compliance with the European Union's climate disclosure laws and parallel preparations to comply with California's new climate-related rules, some are not. Those market participants should begin such preparations in earnest. This includes evaluating current climate-related risks, public-facing disclosures, and budgeting to ensure there are sufficient investments and resources available to comply with the new requirements. This may also include hiring third-party consultants to advise and implement compliance standards and governance models. But no matter the current level of preparation, market participants should not rely on a successful legal challenge to the SEC's final climate rules to excuse compliance. And all market participants, no matter their current level of preparation, should consider hiring experienced regulatory counsel to help them navigate what is certain to be a shifting legal landscape as state, federal, and international guidelines evolve.

Notes

* The authors, attorneys with DLA Piper, may be contacted at whitney.cloud@us.dlapiper.com, matthew.goldberg@us.dlapiper.com, joseph.baker@us.dlapiper.com, and david.josefovits@us.dlapiper.com, respectively.

1. *See* S.E.C. Release Nos. 33-11042; 34-94478, The Enhancement and Standardization of Climate-Related Disclosures for Investors (Mar. 21, 2022) at 15 (hereinafter, the Proposed Rules) (citing S.E.C. Release No. 33-5170 (July 19, 1971)) (footnote omitted).
2. Proposed Rule at 16 (quoting Release No. 33-6383 (Mar. 3, 1982)).
3. S.E.C. Release No. 33-9106.
4. *See* SEC Release No. 33-11042 at 7.
5. *Id.* at 29-33, 293 (explaining that fragmented disclosure standards undermine transparency and that "[t]he primary benefit [of the new rule] is that . . . [it] is expected to enable investors to make more informed investment or voting decisions.").

6. Scope 1 emissions are "are direct [greenhouse gas] emissions that occur from sources owned or controlled by the Company." Proposed Rule at 39. Scope 2 emissions are "are those emissions primarily resulting from the generation of electricity purchased and consumed by the company." *Id.* Scope 3 emissions "are all other indirect emissions not accounted for in Scope 2 emissions," i.e., emissions that are "a consequence of the company's activities but are generated from sources that are neither owned nor controlled by the company." *Id.*

7. Securities and Exchange Commission, Final Rule The Enhancement and Standardization of Climate-Related Disclosures for Investors, 17 CFR 210, 229, 230, 232, 239, and 249, at https://www.sec.gov/files/rules/final/2024/33-11275.pdf.

8. *See* S.E.C. Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure Guide, https://www.sec.gov/corpfin/secg-cybersecurity.

9. *See* Press Release: SEC Adopts Rule Enhancements to Prevent Misleading or Deceptive Investment Fund Names, U.S. Securities and Exchange Commission (Sept. 20, 2023), https://www.sec.gov/news/press-release/2023-188.

10. For example, the SEC's final cybersecurity rule no longer requires disclosure of the name(s) of directors with cybersecurity expertise; allows incident disclosures on Forms 10-Q and 10-K, instead of a Form 8-K, as previously proposed; and no longer requires disclosure of "policies and procedures" for assessing, identifying, and managing material risks, as previously proposed, but rather a registrant's "processes" for doing so. *See* SEC Fact Sheet: Public Company Cybersecurity Disclosures; Final Rules, U.S. Securities and Exchange Commission, https://www.sec.gov/files/33-11216-fact-sheet.pdf. Similarly, like the final cybersecurity rule, the final greenwashing rule was largely consistent with its proposed version, with minor changes that lessened compliance and monitoring requirements. This included, for example, increasing the compliance period from 30 to 90 days in the event a fund's investment portfolio veers below the rule's prescribed limits. *See* Gensler Statement on Updates to the Names Rule, U.S. Securities and Exchange Commission (Sept. 20, 2023), www.sec.gov/news/statement/gensler-statement-names-rule-092023.

11. 15 U.S.C. § 78m(a).

12. Letter from Patrick Morrisey, Attorney General of West Virginia, to Gary Gensler, Chair of the U.S. Securities and Exchange Commission (June 14, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8915606-244835.pdf.

13. *See* State of West Virginia et al. v. U.S. Securities and Exchange Commission, No. 24-10679, Dkt. No. 1 (11th Cir.) (Petition for Review filed by ten states requesting that the Court of Appeals "declare and vacate the Commission's final action" because "the final rule exceeds the agency's statutory authority and … [is] not in accordance with law.").

14. *See* 81 Fed. Reg. at 23,970 ("The Commission, however, has determined in the past that disclosure relating to environmental and other matters of social concern should not be required of all registrants unless appropriate to further a specific congressional mandate or unless, under the particular facts and circumstances, such matters are material.").

15. The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21,335 (Apr. 11, 2022).

16. SEC.gov, SEC Adopts Rules to Enhance and Standardize Climate-Related Disclosures for Investors.

17. 17 C.F.R. § 240.10b-5.

18. *See* Biden v. Nebraska, 600 U.S. 477 (2023) (embracing the "major questions doctrine" and holding that the EPA lacked authority to implement the Clean Power Plan, a plan promulgated to reduce carbon dioxide emissions in coal and natural gas power plants by forcing the plants to reduce or change their energy source).

19. Statement from Commissioner Hester M. Peirce, We Are Not the Securities and Environment Commission—At Least Not Yet (Mar. 21, 2022), https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321.

20. West Virginia State Board of Education v. Barnette, 319 U.S. 1178 (1943).

21. Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio, 471 U.S. 626, 651 (1985).

And Then There Were Three: EPA Grants Louisiana Primacy Over Class VI Wells

Michael S. McDonough, Robert A. James, and Ashleigh Myers*

In this article, the authors review the decision by the U.S. Environmental Protection Agency to grant authority to Louisiana to permit and regulate Class VI underground injection control wells.

Louisiana recently became the third state granted authority by the U.S. Environmental Protection Agency (EPA) under the Safe Drinking Water Act (SDWA) to permit and regulate Class VI underground injection control (UIC) wells—that is, wells permitted specifically for long-term, deep geological storage of carbon dioxide (CO_2) and which are critical to the full-scale development of commercial geological carbon sequestration.[1] Until now, only North Dakota (2018) and Wyoming (2020) had been granted primacy, and Louisiana becomes the first state to receive this "primacy" status under the Biden administration.

The approval comes as Class VI permit applications have ballooned over the past couple of years. The interest in these wells is driven largely by increased political support and corporate commitments for growing carbon capture and sequestration projects to meet climate targets and by generous tax incentives.

Class VI Wells

The EPA protects underground sources of drinking water by regulating the underground injection of fluids for storage or disposal through the UIC program within the SDWA's regulatory framework. In 2010, the EPA established a new class of UIC well, the Class VI well, specifically to regulate the injection of CO_2 into deep subsurface rock formations. While many states have long been granted primacy to permit other classes of UIC wells, Class VI wells have largely been the sole authority of the federal government. With primacy, the EPA delegates to states the primary authority

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to regulate and permit these injection wells within their borders to be used as safe, permanent repositories for captured carbon.

Unlike when the Class VI UIC wells were first established, demand for permanent underground CO_2 storage has surged in recent years, from the carbon removal industry and from a clear political directive supporting carbon capture and sequestration to achieve climate goals. Yet, progress has been constrained by regulatory delays. The EPA has permitted only two Class VI wells[2] to date and expects to complete permitting on only a handful of others this year, with average expected permitting times exceeding two years.

State primacy is generally thought to speed up approval processes (illustrated by North Dakota's four- to eight-month turnaround time). However, projects still must meet standards at least as rigorous as federal standards for environmental health and safety to ensure that injection wells do not contaminate underground sources of drinking water. Indeed, as part of its primacy application process, Louisiana promulgated its own Class VI regulations that are largely consistent with federal regulations established in 2021.

Louisiana's Class VI Program

Granting primacy to Louisiana will almost certainly help the EPA address the logjam of Class VI applications—22 of which are located in Louisiana, with many more projects in development. But the regulatory efficiencies to be gained from granting primacy are only realized after a multiyear application process—one that has deterred many states from seeking primacy.

Louisiana submitted its original primacy application in spring of 2021 and amended it in September 2021 to add primacy over Class VI injection wells. Following four public hearings across 2021 and 2023 and the review of over 45,000 public comments, the EPA determined in December 2023 that Louisiana's Class VI UIC program is consistent with the SDWA and meets all requirements for approval.

One unique component of Louisiana's Class VI program is the environmental justice (EJ) analysis, which intertwines safety and environmental considerations to ensure the protection of all communities. This feature is perhaps unsurprising given the Biden administration's focus on EJ. Memorialized in the Memorandum of Agreement between the EPA and Louisiana, the EPA cites

Louisiana's EJ commitments as "a clear benchmark for any state that seeks Class VI primacy in the future." These requirements include:

- Enhanced, inclusive public participation processes;
- EJ impacts analysis in permitting, including environmental hazards, exposure pathways, and susceptible subpopulations;
- Mitigation measures to ensure Class VI projects do not increase environmental impacts and public health risks in EJ communities; and
- Measures to protect residential areas, potentially including carbon dioxide monitoring and release notification networks and installation of enhanced pollution controls.

This is consistent with the December 9, 2022, letter EPA Administrator Michael Regan sent to governors, detailing the EPA's expectation that all new primacy applications will contain how the state proposes to address EJ and equity concerns and EPA's August 18, 2023, "Environmental Justice Guidance for UIC Class VI Permitting and Primacy" memorandum.

Now that primacy has been granted, all Class VI permit applications currently pending with the EPA will be transferred to the Louisiana Department of Natural Resources, and all future Class VI applications will be submitted to the Louisiana Department of Natural Resources rather than the EPA.

Primacy Beyond Louisiana

The EPA's approval of Louisiana's primacy application could serve as a model for other states seeking and planning to seek primacy. This includes Texas, which, like Louisiana, is situated in EPA Region 6, a state with extensive oil and gas industry presence, favorable geology, and the heart of the U.S. energy transition. Texas is in the "pre-application phase," having submitted a formal primacy application on December 19, 2022.

In September 2023, the Texas Railroad Commission amended its Class VI regulations to further align its existing Class VI regulations with federal requirements, taking advantage of lessons learned from Louisiana, North Dakota, and Wyoming's primacy application processes. Among other changes, the Texas Railroad Commission amendments clarified the definition of anthropogenic sources of

CO_2 that can be sequestered, revised the evidentiary requirements for establishing pore space ownership, instituted new test well and mechanical integrity requirements, and mandated financial assurances. This step was largely favored by industry and viewed with optimism as an important step in moving Texas's primacy application forward and clearing the backlog of eight Class VI permit applications currently pending with the EPA. States such as Arizona and West Virginia are similarly positioned.

EPA officials have sought to speed Class VI permit approvals and encouraged states to obtain primacy in recent years. Supporting those efforts, the 2021 bipartisan infrastructure law gave the EPA, in addition to $25 million over five years to address the current backlog of permit applications, a further one-time award of $50 million in grants to support 25 states that had indicated their interest in developing Class VI UIC programs and applying for primacy. Still, the EPA estimates it will take 24 months to approve federal primacy applications from the date the application is deemed complete, which in itself can take many months to achieve.

Leading up to approval of Louisiana's primacy application, the EPA Office of Inspector General (OIG) launched an evaluation into the EPA's Class VI permit program in November 2023. The OIG says its goal is "to determine whether the EPA has used available resources, including [the infrastructure law funding], to improve permitting of Class VI wells under its Underground Injection Control Program."

Takeaways

- Louisiana is the third state granted authority to permit and regulate Class VI UIC wells, marking a significant step forward for these projects.
- The EPA established the Class VI well to regulate the injection of CO_2 into deep subsurface rock formations.
- Large-scale deployment of carbon capture and sequestration projects is necessary to meet climate goals but has been hindered by delayed processing times.

Conclusion

Large-scale deployment of carbon capture and sequestration projects is necessary to meet climate goals but has been hindered by delayed processing times. The EPA's approval of Louisiana's application to seek primacy is a significant step in moving projects forward in a state with relatively robust carbon capture and sequestration interest and activity, providing industry with planning certainty. It simultaneously serves as a benchmark for other states seeking primacy. The final rule was published in the Federal Register on January 5, 2024.

Notes

* The authors, attorneys with Pillsbury Winthrop Shaw Pittman LLP, may be contacted at michael.mcdonough@pillsburylaw.com, rob.james@pillsburylaw.com, and ashleigh.myers@pillsburylaw.com, respectively.

1. https://www.federalregister.gov/documents/2024/01/05/2024-00044/state-of-louisiana-underground-injection-control-program-class-vi-primacy.

2. https://www.epa.gov/uic/current-class-vi-projects-under-review-epa.

FINRA Proposes Rules Permitting Presentation of Performance Projections and Targets

Lance C. Dial, Jennifer L. Klass, and Richard F. Kerr*

In this article, the authors discuss amendments proposed recently by the Financial Industry Regulatory Authority to Rule 2210, governing broker-dealer communications with the public.

The regulation of broker-dealer communications is delegated to the Financial Industry Regulatory Authority (FINRA), while investment adviser advertisements are regulated directly by the U.S. Securities and Exchange Commission (SEC). FINRA and the SEC have historically taken very different approaches to the use of performance projections and performance targets. FINRA rules specifically prohibit the use of projections (subject to certain narrow exceptions), while the SEC generally allowed such metrics, historically subject to general antifraud requirements and since the adoption of the recently revamped investment adviser marketing rule, Rule 206(4)-1 (SEC Marketing Rule), pursuant to specific requirements regarding the use of "hypothetical performance."

FINRA recently proposed amendments to Rule 2210[1] (governing communications with the public) that would narrow the differences between the two regulatory frameworks related to use of projections. Specifically, FINRA filed proposed amendments to Rule 2210 (the Proposed Amendments) that borrow heavily from the approach adopted by the SEC in the SEC Marketing Rule and that would permit FINRA members to include performance projections and return targets in their communications, subject to certain limitations and conditions.

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Summary

If adopted, the Proposed Amendments would allow FINRA member firms to project the performance or provide a targeted return with respect to a security or asset allocation or other investment strategy in a communication to "institutional investors" or in a communication distributed solely to qualified purchasers (QPs) that promotes or recommends specified nonpublic offerings.

This permission would be subject to three primary conditions:

- The FINRA member adopts policies and procedures reasonably designed to ensure that the communication is relevant to the likely financial situation and investment objectives of the investor receiving the communication;
- The FINRA member has a reasonable basis for the criteria and assumptions used in calculating the projections or targets; and
- The communication includes certain disclosures and information regarding the criteria and assumptions used for—and the risks and limitations of—the performance projections and targets.

FINRA also notes that the while the Proposed Amendments have several key differences from the SEC Marketing Rule, FINRA would expect to interpret the Proposed Amendments consistent with the SEC's interpretations of the SEC Marketing Rule.

Scope

As an initial matter, the Proposed Amendments would permit the use of projections and targets only with a limited audience of investors: "institutional investors" (as defined in FINRA Rule 2210(a)(4)) and QPs. Communications with institutional investors could include performance projections and targets for any securities, including individual securities, private funds, mutual funds, and exchange-traded funds. On the other hand, the Proposed Amendments would only permit performance projections and targets in communications to QPs that relate to private placements sold only to QPs (e.g., private funds). This limitation is different from the SEC Marketing Rule, which requires consideration of the audience's sophistication but does not impose a specified minimum level of sophistication.

Another key distinction between the Proposed Amendments and the SEC Marketing Rule is that the Proposed Amendments would be limited to projections and targets, while the SEC Marketing Rule covers hypothetical performance more broadly, including "back-tested performance." Back-tested performance, as discussed in more detail below, is excluded from the scope of the Proposed Amendments.

Policy and Procedures

The Proposed Amendments would require policies and procedures be "reasonably designed to ensure that the communication is relevant to the likely financial situation and investment objectives of the investor receiving the communication and to ensure compliance with all applicable requirements and obligations." These policies and procedures requirements in the Proposed Amendments largely align with the SEC Marketing Rule.

The policies and procedures required by the Proposed Amendments would relate to the "investor receiving the communication" rather than, as in the SEC Marketing Rule, the "intended audience," although it is not immediately clear the significance of this change. In adopting the SEC Marketing Rule, the SEC included the phrase "intended audience" in a change from its original proposal to clarify that advisers can group investors into categories or types rather than evaluating each investor individually. Even though the Proposed Amendments do not include the same term (i.e., intended audience), FINRA explains in its proposal that FINRA members can rely on past experience with particular types of institutional investors or QPs. That said, the fact that the Proposed Amendments do not use the broader language raises the question of whether FINRA members would need to evaluate the financial situations and investment objectives of the particular recipients of any communication containing projections or performance targets.

Reasonable Basis for Projections/Targets

In its most significant deviation from the SEC Marketing Rule, the Proposed Amendments include a specific requirement that the

FINRA member using performance projections or targets have—and document—a reasonable basis for the criteria and assumptions used in connection with the projections or targets. The intent of this requirement is to ensure projections are not "wildly optimistic" and are made in good faith. FINRA notes that the reasonable basis requirement follows existing precedent set forth in FINRA Rules 2210 and 2241 (requiring price targets in a research report to have a reasonable basis) and in SEC Regulation S-K (requiring management projections to have a reasonable basis). FINRA also proposed new Supplementary Material to Rule 2210 that would provide a list of some, but not all, of the factors FINRA members should consider in forming their reasonable basis. This Supplementary Material also clarifies that back-tested performance cannot serve as the "reasonable basis" for projected performance or performance targets.

Although the SEC Marketing Rule lacks a specifically analogous requirement, the SEC Marketing Rule includes other requirements that effectively reach the same result (with the exception of the exclusion of back-tested performance as a basis for performance targets or projections). Specifically, the SEC Marketing Rule requires advertisements to be fair and balanced, and not misleading, and requires advisers to be able to substantiate any statements of material fact, including performance targets.

Disclosures

Finally, the Proposed Amendments would require FINRA members to make certain disclosures when delivering performance projections and targets. First, the communication would be required to prominently disclose that the projections or targets are hypothetical in nature and that there is no guarantee that the projections or targets would be met. In addition and similar to the SEC Marketing Rule, the Proposed Amendments would require FINRA members to disclose the criteria and assumptions and risks and limitations associated with the projections or targets. As with the SEC Marketing Rule, FINRA members would not be required to disclose the specific formulas used or other proprietary information and would be permitted to provide general descriptions so long as such descriptions are sufficient to allow the recipient to understand the risks and limitations and reasons why actual performance may not match the projections or targets.

Implications for FINRA Members

The Proposed Amendments are a welcome step in harmonizing the regulatory requirements applicable to broker-dealers and investment advisers with respect to use of performance advertising. If approved by the SEC, FINRA members would be able to use performance projections and targets in a manner similar to investment advisers, which should allow for more consistency in the promotion of private funds. The proposed rule would also go a step further for FINRA members communicating with institutional investors, allowing the FINRA member to provide projections or targets relating to single securities (including mutual funds and exchange-traded funds).

Another potential implication relates to how the Proposed Amendments would relate to existing FINRA guidance. Specifically, FINRA has noted that unrealized holdings have no actual performance experience and therefore the presentation of related return metrics would constitute a prohibited projection under FINRA Rule 2210. Given that the Proposed Amendments would permit performance projections, it would seem that unrealized holding performance would be permitted, subject to the limitations and conditions of the proposed rule.

Similarly, this proposal could have implications for FINRA member firms who seek to present internal rate of return (IRR) metrics for private funds. FINRA has previously expressed its concerns that the use of IRR for incomplete investment programs in retail communications could be a prohibited forecast or projection; however, FINRA also noted that, for firms with ongoing operations, IRR calculated in accordance with the Global Investment Performance Standards would be permitted. The Proposed Amendments could allow FINRA member firms additional latitude in presenting IRR metrics to institutional investors or QPs calculated in different methodologies, so long as the FINRA members comply with its conditions.

What's Next?

The Proposed Amendments will be reviewed by the SEC. The SEC may request that FINRA make amendments to its proposal or may publish the proposed rule for public comment. The comment period would last 21 days following the publication of the proposed rule in the Federal Register. After the comment period, the SEC and FINRA would consider comments and, ultimately, issue a final set of amendments.

Notes

* The authors, attorneys with K&L Gates LLP, may be contacted at lance.dial@klgates.com, jennifer.klass@klgates.com, and richard.f.kerr@klgates.com, respectively.

1. https://www.finra.org/rules-guidance/rule-filings/sr-finra-2023-016.

U.S. Commerce Department's Bureau of Industry and Security Publishes New FAQs Related to Updated Advanced Computing/ Supercomputing Rules

Melissa Duffy, Robert Slack, Sofia Chalat, and Trevor Coval*

In this article, the authors provide background on the Commerce Department's Bureau of Industry and Security's semiconductor controls and discuss newly issued guidance.

The U.S. Commerce Department's Bureau of Industry and Security (BIS) has released two interim final rules that expanded export controls related to advanced computing and semiconductors, aimed at China and other national security concern countries: (1) the Advanced Computing/Supercomputing Interim Final Rule (AC/S IFR),[1] and (2) the Semiconductor Manufacturing Equipment Interim Final Rule (SME IFR).[2] These new rules both modify and expand the October 7, 2022, semiconductor export controls. The two interim final rules went into effect on November 17, 2023. Corrections and changes to the rules are expected to be published.

BIS recently published frequently asked questions (FAQs)[3] that offer guidance on the new:

1. Export license exception and its advance notification requirement for certain advanced chips and products containing them;
2. Controls on U.S. person activities in support of advanced chip production;
3. Scope of its end-use controls relating to advanced computing and semiconductors; and
4. Clarified directions for electronic export information filers.

Within the FAQs, BIS also provided a preview of at least one export control revision that is expected to be made, and detailed

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several export scenarios where a license may be required under these interim final rules. More clarifications and revisions are expected to be published by the agency.

This article provides background on the semiconductor controls, followed by a discussion of the newly issued guidance from BIS.

Background on the Updated Advanced Computing/Supercomputing Rules

Advanced Computing/Supercomputing Interim Final Rule

The AC/S IFR makes significant changes to the October 2022 rule related to advanced computing items and advanced-node integrated circuits (ICs).

ECCN 3A090

The AC/S IFR makes significant changes to Export Control Classification Number (ECCN) 3A090, which controls advanced computing ICs subject to the Export Administration Regulations (EAR)—the criteria for that ECCN have been overhauled from the initial version of the ECCN released in October 2022. The revised ECCN 3A090.a captures high-performance ICs that could be particularly useful in data center processing, with a total processing performance of 4800 or more, or a total processing performance of 1600 or more and a performance density of 5.92 or more. The newly created ECCN 3A090.b captures less-advanced ICs that are nonetheless useful in data center chip training, with a total processing performance of 2400 or more, but less than 4800, with a performance density of 1.6 or more, but less than 5.92; or a total processing performance of 1600 or more and a performance density of 3.2 or more, but less than 5.92. A carve-out exists under Note 2 to ECCN 3A090, by which ICs are not subject to ECCN 3A090 if they have a total processing performance of below 4800, but otherwise meet the performance density criteria, and are not designed or marketed for use in data centers.

Items that are subject to the EAR and meet the criteria of ECCN 3A090 are subject to the regional stability (RS) controls described below.

New Paragraph .z for Additional ECCNs

The AC/S IFR extends the performance criteria of ECCN 3A090 to items otherwise described by other ECCNs. These performance criteria are captured in a ".z" paragraph in the following ECCNs: 3A001, 4A003, 4A004, 4A005, 4A090, 5A002, 5A004, 5A992, 5D002, and 5D992. In other words, items normally controlled in those ECCNs that also meet the performance criteria of 3A090 are controlled in the new paragraph .z of their respective ECCNs. These items are also subject to the RS controls described below, as well as standard antiterrorism controls.

Expanded Geographic Scope

The new rule substantially expanded the geographic scope of the restrictions on these advanced ICs controlled under ECCN 3A090 and the items that incorporate them. The restrictions previously applied to only China (including Hong Kong) and Macau. The most recent amendment expanded the restrictions on ICs controlled by ECCN 3A090, computers and electronic assemblies controlled by ECCN 4A090, and items otherwise controlled by other ECCNs that meet the performance criteria of ECCNs 3A090 or 4A090 to all destinations listed in Country Groups D:1, D:4, and D:5 (excluding destinations also specified in Country Groups A:5 or A:6, currently Cyprus and Israel). These destinations include China and other countries subject to national security, missile technology, and arms embargo controls. These controls are imposed under a new RS policy found at 15 C.F.R. § 742.6(a)(6).

Accordingly, the new RS controls impose a licensing requirement on exports, reexports, and in-country transfers of the above items for this expanded group of countries. License applications for these items to a destination specified in Country Group D:5 (such as China) or Macau will be reviewed under a presumption of denial. License applications for these items to destinations specified in Country Groups D:1 or D:4 (excluding Macau) will be reviewed under a presumption of approval, unless the export, reexport, or in-country transfer is to an entity headquartered in, or whose ultimate parent company is headquartered in, a destination specified in Country Group D:5 or Macau. In this case, a license application would be reviewed under a presumption of denial.

New License Exception Notified Advanced Computing

The AC/S IFR created a new License Exception Notified Advanced Computing (NAC), found at 15 C.F.R. § 740.8, that authorizes exports, reexports, and in-country transfers of ICs that meet the criteria of ECCN 3A090 (excluding items that both meet the performance criteria of ECCN 3A090.a and are designed or marketed for data center use) and items controlled in other ECCNs that also meet the criteria of ECCN 3A090 (e.g., the ".z" paragraphs). Where an item meets the performance criteria of ECCN 3A090.a and is designed or marketed for use in a data center, License Exception NAC may not be used for the export, reexport, or in-country transfer of the item. Where an item meets the performance criteria of ECCN 3A090.b, License Exception NAC is available for items designed or marketed for use in a data center.

The export or reexport under License Exception NAC must be made pursuant to a written purchase order (with a narrow exception for commercial samples). License Exception NAC cannot be used for export, reexport, or in-country transfer to or for a prohibited end user or prohibited end use, except for a license required under § 744.23(a)(3)[4] in limited cases.

Where the exporter seeks to use License Exception NAC for exports or reexports (not required for in-country transfers) to Macau or Country Group D:5, the exporter must provide BIS with a minimum of 25 days' advanced notice and receive approval from BIS prior to the export or reexport occurring.

Temporary General License

The AC/S IFR creates a new temporary general license (TGL), found at Supplement No. 1(d)(2) to Part 736 of the EAR, for the export, reexport, and in-country transfer of items described under ECCNs 3A090 or 4A090, or items controlled under other ECCNs that meet the performance criteria of ECCNs 3A090 or 4A090 that would otherwise require a license under this new rule. The TGL authorizes the export, reexport, and in-country transfer to destinations specified in Country Groups D:1, D:4, and D:5 where the recipient entity is not headquartered or whose parent is not headquartered in Country Groups D:1, D:4, or D:5 (excluding destinations also specified in Country Groups A:5 or A:6). The items must be for ultimate end use outside of Country Groups D:1, D:4, and D:5 (excluding destinations also specified in Country Groups

A:5 or A:6), and by end users that are not D:5 or Macau entities. The recipient may only use the TGL for limited activities, including integration, assembly (mounting), inspection, testing, quality assurance, or distribution. Other activities, including product research and development (R&D) and engineering, are not authorized under the TGL. The TGL is valid through December 31, 2025.

U.S. Person Restrictions

In addition to restricting the movement of hardware, software, and technology subject to EAR, U.S. export controls also restrict certain activities of U.S. persons related to advanced-node ICs that are not otherwise subject to EAR. The AC/S IFR clarifies and expands the restrictions on activities of U.S. persons related to advanced semiconductors implemented in the October 2022 rule. Under the October 2022 rule, a license was required for any U.S. person to ship, transmit, transfer, or service specified end items or services to Advanced IC development or production facilities in China or Macau.

Under the new AC/S IFR, restrictions on the activities of U.S. persons are broadened to encompass U.S. person support for development or production of advanced-node ICs at any facility where the entity or its parent company is headquartered in Country Group D:5 or Macau (excluding destinations also specified in Country Groups A:5 or A:6). These restrictions are found at 15 C.F.R. 744.6(c)(2)(i)-(ii).

Advanced Computing Foreign Direct Product Rule

The AC/S IFR expands the country scope of the Advanced Computing Foreign Direct Product Rule (FDPR), found at 15 C.F.R. § 734.9(h). The original Advanced Computing FDPR controlled items subject to the advanced computing ECCNs if destined for China or Macau, or for incorporation into items (excluding EAR99 items) destined for China or Macau. The revised Advanced Computing FDPR captures all of Country Groups D:1, D:4, and D:5 (excluding destinations also specified in Country Groups A:5 or A:6). The Advanced Computing FDPR country scope extends to any country worldwide where the foreign-produced item is destined for an entity headquartered in or whose parent is headquartered in Country Group D:5 or Macau. This worldwide end use restriction applies when companies headquartered in Country Group D:5 or

Macau are a party to the transaction involving the foreign-produced item, including as a purchaser, consignee, or end user.

Semiconductor Manufacturing Equipment Interim Final Rule

The SME IFR makes significant changes to the October 2022 rule related to semiconductor manufacturing items.

Removal of ECCN 3B090 and Expansion of ECCNs 3B001 and 3B002

Semiconductor manufacturing items previously described in ECCN 3B090 have been moved to ECCNs 3B001 and 3B002, which were expanded to capture that equipment. These RS-controlled SME items described in ECCNs 3B001 and 3B002 require a license for export, reexport, or in-country transfer to Country Group D:5 and Macau.

Clarification of U.S. Person Restricted Activities

The SME IFR clarifies the U.S. person support restrictions related to semiconductor manufacturing, found at 15 C.F.R. § 744.6(c)(2)(iii). The U.S. person restrictions apply to facilities where advanced-node semiconductor production occurs, even where the production does not necessarily amount to fabrication. This includes early-stage manufacturing and late-stage product engineering, but does not include back-end steps, such as assembly, testing, or packaging. The U.S. person restrictions do not restrict the activity of U.S. persons employed by an entity headquartered in the United States or Country Groups A:5 or A:6 where the entity is not majority owned by an entity headquartered in Country Group D:5 or Macau.

Temporary General License

The SME IFR creates a new TGL for semiconductor manufacturing equipment producers headquartered in the United States or Country Groups A:5 or A:6, found at Supplement No. 1(d)(1) to Part 736 of the EAR. Under this TGL the qualifying SME producer may continue to send items to manufacturing facilities in Country Group D:5 or Macau for the development or production of certain

Category 3B items on the Commerce Control List. The TGL is valid until December 31, 2025.

Newly Published FAQs

The FAQs issued on January 4, 2024, address industry inquiries and feedback received in response to the AC/S IFR and SME IFR.

License Exception NAC

In the FAQs, BIS highlighted that it will review NAC notifications for national security concerns and "require a license application for any notifications that raise concerns." This means that even if the chip meets all technical parameters for the license exception, a license application may still be required if the type of item, quantity, and the end user/end use raises a concern for the agency.

BIS also confirmed that because the NAC review process considers additional factors such as end users, uses, and volume, the agency does not plan to publish a list of advanced computing chips that are eligible for the License Exception NAC.

BIS noted that it plans to revise ECCN 4A090.b to clarify an issue that was raised concerning the scope of the requirements related to the License Exception NAC. BIS explained that exporters should "assess all computers, 'electronic assemblies,' and 'components' containing integrated circuits, any of which meets or exceeds the limits in 3A090.b, against the requirements of License Exception NAC notwithstanding ECCN 4A090.b currently being reserved."

BIS also stated that in situations where the exporter is not the designer/manufacturer of the chip, the NAC notification submissions should provide authorization to allow BIS to contact the chip designer or manufacturer on the exporter's behalf to obtain information on the chip's performance density.

Additionally, BIS stated that it expects to receive "duplicative" NAC notifications related to the same chip but submitted by different exporters. However, BIS made clear that an approval of one notification does not mean all other exporters shipping that item are similarly approved. License Exception NAC approvals are only valid for the exporter who submitted the approved application.

U.S. Person Controls

The FAQs clarified that certain exclusions for controls on activities of U.S. persons under the chip restrictions apply to only "natural" U.S. persons—not a U.S. entity. BIS explained that the exclusion of "natural" U.S. persons from the controls was intended to prevent discrimination against U.S. person employees of non-U.S. person entities headquartered in allied countries.

In response to a comment asking for clarification on whether the exclusion in § 744.6(d)(5) impacts what type of facilities are covered under § 744.6(c)(2)(iii), BIS stated that since § 744.6(c)(2)(iii) states, "regardless of end use or end user," the type of facility is not relevant to the application of paragraph (c)(2)(iii). The U.S. person restrictions related to semiconductor manufacturing equipment apply more broadly than those relating to advance-node ICs and are implicated whenever the equipment is destined for the restricted countries.

Clarification on Status of Cyprus

BIS clarified that while it has not yet removed Cyprus from Country Group D:5, it is effectively removed because the restrictions under 22 C.F.R. § 126.1 of the State Department's International Traffic in Arms Regulations do not apply to Cyprus. Accordingly, Cyprus has been excluded under these rules from restrictions on destinations specified in Country Group D:5, per the carve-out for countries also listed in Groups A:5 or A:6.

Regional Stability Controls and .z ECCNS

The Electronic Export Information (EEI) filing to the Automated Export System (AES) is used by BIS to gather information from exporters for compliance purposes. EEI filings are generally required for exports of hardware and software where the value is over $2,500. However, BIS confirmed that the mandatory AES EEI filing for ".z" category items applies to transactions below the $2,500 threshold and licenses are required for any items that fall under ECCNs 3A090/4A090 and another ECCN on the Commerce Control List.

BIS explained that the .z paragraphs were created to retain the original license requirements for that item plus the new RS-related license requirements from the October 17 AC/S IFR, as well as related license exceptions. Accordingly, the exporter must ensure the export, reexport, or in-country transfer of .z items complies with the new RS license requirements in addition to the preexisting requirements of the applicable ECCN, irrespective of the applicability of License Exception NAC. BIS provided the example that ECCN 4A003.z "controls items that meet both ECCN 4A003.b and ECCN 4A090." Therefore, it requires a license to the same destinations as 4A003.b items plus the additional restrictions on ECCN 4A090 items; and outside of Country Group D:1, D:4, and D:5 countries, it is eligible for the same license exceptions as an ECCN 4A003.b item.

Clarification of Facility Definition in SME IFR

The SME IFR implements several end-use restrictions related to facilities where the development or production of advanced-node ICs occur. BIS confirmed that its definition for "facility" in the SME IFR includes:

- Facilities where "production" may occur beyond a fabrication facility, including "beyond the clean room or production floor";
- Facilities where important late-stage product engineering or early-stage manufacturing steps (among others) may occur; and
- "[D]evelopment" and product engineering activities at R&D fabrication "facilities" that may not engage in volume manufacturing.

Key Takeaways

The AC/S IFR and the SME IFR expanded the scope of semiconductor export controls and clarified provisions of the October 2022 rule. Businesses that engage with semiconductors and related items should take care to ensure their activity complies with the new semiconductor export controls, including:

- Conducting export classifications to determine whether their items and related technology are captured under the new controls;

- Developing alternative production and export channels for items captured under the new controls, including relocating manufacturing activities outside of restricted destinations;
- Updating internal compliance policies and programs, including red flag indicators of diversion into restricted destinations; and
- In making representations and warranties to foreign buyers and investors, scrutinizing whether the business is a "critical technology" company and whether the transaction is subject to review by the Committee on Foreign Investment in the United States.

Notes

* The authors, attorneys with Fenwick & West LLP, may be contacted at mduffy@fenwick.com, rslack@fenwick.com, schalat@fenwick.com, and tcoval@fenwick.com, respectively.

1. https://www.federalregister.gov/documents/2023/10/25/2023-23055/implementation-of-additional-export-controls-certain-advanced-computing-items-supercomputer-and.

2. https://www.federalregister.gov/documents/2022/10/13/2022-21658/implementation-of-additional-export-controls-certain-advanced-computing-and-semiconductor.

3. https://www.bis.doc.gov/index.php/documents/policy-guidance/3434-2023-frequently-asked-questions-003-clean-for-posting/file.

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U.S. Department of Health and Human Services Releases Unredacted Recommendation to Move Marijuana to Schedule III: Seven Key Takeaways

Amber E. Littlejohn, Joe Heaton, and Kyle T. Finnegan*

In this article, the authors offer key takeaways, including the recommendation that marijuana should be rescheduled from a Schedule I to a Schedule III controlled substance, from newly unredacted U.S. Department of Health and Human Services documents.

The U.S. Department of Health and Human Services (HHS) recently released over 250 pages of documents in response to a Freedom of Information Act (FOIA) request, including the recommendation that marijuana should be rescheduled from a Schedule I to a Schedule III controlled substance, and the results of the HHS's analysis. While industry and advocates have seen heavily redacted copies, the release of the recommendation infused excitement and hope into an industry strained by tensions between federal law and the laws of 38 states that have legalized cannabis for medical or adult use.

In 2022, HHS was tasked by President Biden with reviewing the status of marijuana under the Controlled Substances Act, using an eight-factor test[1] to assess:

1. The abuse potential compared to other drugs,
2. Whether there is a currently accepted medical use, and
3. The relative safety or ability to produce physical dependence compared to other drugs.

This article offers key takeaways from the newly unredacted HHS documents.

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HHS Determined Marijuana Poses Less Risk Than Other Scheduled Substances

After decades of prohibition and stigma rooted in fear about the dangers of marijuana, HHS took the historic step of acknowledging the relative safety of marijuana compared to other substances. HHS concluded that the "risks to the public health posed by marijuana are low compared to other drugs of abuse (e.g., heroin, cocaine, benzodiazepines), based on an evaluation of various epidemiological databases for emergency department (ED) visits, hospitalizations, unintentional exposures, and most importantly, for overdose deaths." Marijuana also proved far less harmful than alcohol when measuring adverse health events, overdoses, and the prevalence of driving under the influence.

HHS Recognizes That Cannabis Has Accepted Medical Uses

Almost two decades after the passage of the first state medical cannabis law, the federal government has recognized the accepted medical uses of cannabis in the treatment and management of disease. Unlike HHS's 2015 review, the widespread medical use of cannabis through state medical programs provided the breadth and depth of evidence needed to satisfy this criterion. As more states legalize, the body of research on medical cannabis will continue to grow, giving medical professionals more information on how medicinal cannabis can impact diseases.

Moving to Schedule III Does Not Diminish the Food and Drug Administration's Authority to Regulate Cannabis

News of HHS's recommendation to reschedule cannabis was not met with universal excitement from industry and advocates. Many fear the move to Schedule III would facilitate a takeover by the pharmaceutical industry and mean the end of state cannabis programs. Rescheduling would not change existing Food and Drug Administration (FDA) authority to regulate cannabis, nor would it change current incentives or pathways for the development of cannabis pharmaceuticals. Rescheduling does not make cannabis an approved drug. Like hemp products, the FDA would likely step in where a cannabis product is marketed as an FDA-regulated product, including drugs, dietary supplements, or pet medicines, and the product or marketing presents a risk to public health or safety.

Moving to Schedule III Wouldn't Fully Legalize Cannabis, But It Could Reduce Business Risk and Increase Market Stability

Rescheduling marijuana does not decriminalize cannabis. Cannabis decriminalization, even with de-scheduling, would require an act of Congress. However, the move would end the application of Internal Revenue Service code section 280(e) to the legal cannabis industry. Code Section 280(e) presently taxes legal cannabis businesses like cartels with effective tax rates commonly ranging between 70 and 90 percent. The Congressional Research Service has affirmed that if the Biden administration reschedules cannabis, then 280(e) would no longer apply. Ending 280(e) for legal cannabis businesses could significantly lower their tax burden. This would help stabilize the industry, especially small businesses, and infuse the industry with resources to reinvest in research, infrastructure, and workforce. Additionally, the recognition of medical value and the shift in legal status from an illicit substance will likely soften the risk environment that increases business costs from real estate to banking.

This Action by the Biden Administration Should Increase the Pressure on Congress to End Federal Prohibition

Despite a significant majority of American voters favoring federal cannabis legalization, Congress has remained unwilling to progress with legalization. With HHS now acknowledging the relative safety and the acceptance of cannabis as medicine, this could mean some members of Congress evolve on their legalization stance. With bipartisan proposals on the table including the STATES Act, PREPARE Act, and incremental reforms such as the SAFE Banking Act, advocates and the industry should be prepared to help lawmakers move past old thinking and find solutions to end the disconnect between state and federal governments to update antiquated criminal penalties and promote a safe and sensibly regulated cannabis industry.

HHS Reminds Us That CBD Does Not Have Meaningful Abuse Potential

HHS cited the FDA's review of the new drug application for Epidiolex, as well as its own eight-factor analysis that found, "Based on the totality of the available scientific data, cannabidiol (CBD) does not have meaningful abuse potential." While HHS has asserted that CBD lacks meaningful abuse potential, it remains stuck in a federal regulatory gray area that has limited industry growth and viability and led to inconsistent regulation in the states. Hemp and CBD companies should examine shifts in the federal government's position on cannabis products to help inform strategies to change the policy necessary to create a federal regulatory pathway for hemp consumer products.

Industry Focus on Responsible Use Initiatives and Education Is Critical to Protecting the Public and Ending Federal Prohibition

The safety concerns cited in the documents primarily relate to cannabis abuse—not use. While marijuana fared better than other controlled substances in many of the measures of safety, HHS's findings underscore the fact that even substances with less risk must still be used responsibly. Investment in internal responsible use policies, the promotion of responsible industry marketing practices, and advocating for policies to educate patients, consumers, and the public on responsible use, including abstinence and the dangers of intoxicated driving, is necessary to create a safe and sustainable regulated industry.

Conclusion

HHS rescheduling recommendation represents a historic shift in the federal government's position on marijuana. With the ball now in the Drug Enforcement Administration's court, we anticipate more forward movement on rescheduling before the election in November. With rescheduling would come the need for substantial legislative fixes and federal agency engagement to align law and policy with marijuana's new status. Rescheduling would represent a giant step toward federal legalization. Advocates from industry to social justice will need to increase government engagement, especially with lawmakers in Washington, D.C., to ensure a seat at the table.

Notes

* The authors, attorneys with Ice Miller LLP, may be contacted at amber.littlejohn@icemiller.com, joe.heaton@icemiller.com, and kyle.finnegan@icemiller.com, respectively.

1. The factors are: Actual or relative potential for abuse; scientific evidence of pharmacological effect, if known; state of current scientific knowledge regarding the drug; history and pattern for abuse; scope, duration, and significance of abuse; public health risk, if any; psychic or physiological dependence liability; and whether the substance is an immediate precursor of a substance already controlled.

Overview of PFAS Regulations in the United States and What Foreign Companies and Their U.S. Subsidiaries Need to Know—Part I

Reza Zarghamee, Shinya Akiyama, and Lauren Johnstone*

This two-part article overviews the status of poly- and perfluoroalkyl substances (PFAS) regulation in the United States. This first part describes PFAS, the types of products that include it, and the recent wave of litigation involving PFAS contamination, which has involved settlements above $10 billion. The conclusion of this article, to be published in the next issue of The Journal of Federal Agency Action*, will discuss developments in federal and state regulation of these chemicals and specific scenarios in which these developments may affect foreign corporations. The article will end with the recommendation that businesses that manufacture, distribute, use, or dispose of PFAS or products containing PFAS should stay abreast of these developments and develop proactive strategies to minimize their potential liability.*

Poly- and perfluoroalkyl substances (PFAS) are a class of approximately 15,000 synthetic fluorinated organic compounds (by the U.S. Environmental Protection Agency's (EPA's) most recent reckoning).[1] The carbon-fluorine bond is among the strongest in organic chemistry and gives PFAS their physical properties: fire-, water-, and grease resistance. Due to these properties, PFAS exist in a wide array of industrial and commercial products, including:

- Aqueous fire-fighting foam (AFFF);
- Paper and packaging products;
- Plastics;
- Surfactants;
- Surface coatings for textiles, utensils, electronics, automobile parts, etc.;
- Lubricant and oil formulations;
- Cosmetics;

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- Nonstick cookware; and
- Textiles.

Additionally, PFAS are used in a vast array of industrial processes and critical applications, including the manufacture of circuit boards and semiconductors.

The combined market for PFAS chemicals is estimated to exceed at least $28 billion annually.[2] Foreign businesses interface with PFAS in different capacities, as manufacturers, processors, distributors, and users of PFAS-containing products. Additionally, foreign businesses active in the mergers and acquisitions market may have to decide whether to take on other businesses' PFAS-related liabilities as a part of a transaction.

PFAS have been subject to heightened regulatory scrutiny[3] since the 1990s. In the early 2000s, the EPA (and other environmental and public health agencies around the world) classified certain PFAS chemicals as "persistent, bioaccumulative, and toxic." The term "persistent" refers to the fact that PFAS do not naturally biodegrade in the environment. PFAS are "bioaccumulative" in that they remain and, over time, accumulate in the bloodstream and organ tissue. They are "toxic," inasmuch as exposure to certain PFAS has been reported to be linked to developmental defects, chronic illnesses, and death. In particular, PFAS are reported to cause thyroid disease, pregnancy issues, and cancer, though opinions vary about the degree of risk and at what concentrations such risks become acute. This classification stands at the heart of the increasing litigation risks associated with PFAS and the attention paid to PFAS by U.S. regulators. As explained below, PFAS are a "hot topic" in U.S. environmental law, as was the case in the 1980s and 1990s with asbestos and in the early 2000s with dioxins and polychlorinated biphenyls (PCBs).

The PFAS Supply Chain

To date, three types of entities in the PFAS supply chain have incurred the bulk of the liability:

1. *Primary Manufacturers*. These are typically specialty chemical companies that produce and distribute PFAS either in bulk or in commercial- or industrial-grade formulations that also contain other chemicals. Thus far,

2023 has witnessed the two largest PFAS settlements of all time, both arising in connection with the water contamination cases in multidistrict litigation, with various Dupont entities entering into a proposed settlement for $1.185 billion and 3M for between $10.3 and $12.5 billion.

2. *Secondary Manufacturers or Processors*. These companies, which are significantly more numerous than primary manufacturers, obtain PFAS or other fluorinated compounds for use in their own industrial processes (e.g., textile manufacturers that treat their products with waterproofing agents made by principal manufacturers). These liabilities stand to be significant, potentially up to several hundreds of millions of dollars.
3. *End Users*. These can be businesses that use PFAS-containing formulations and products produced by businesses in categories 1 and 2 (e.g., the aviation industry, which both outfits planes with PFAS-coated seats and other equipment because of their fire-resistant qualities and uses PFAS-containing AFFF to quench fires or perform firefighting drills).

Each of the three business types mentioned above is theoretically capable of introducing PFAS to the environment—and consequently incurring liability—through accidental spills and releases, permitted discharge, disposal, and, in the case of products such as AFFF, product usage. In terms of the nature of the liability exposure, primary and secondary manufacturers (including those that are overseas and knowingly arrange to place their chemicals in U.S. commerce) are exposed to product liability suits, while any entity that introduces PFAS into the environment has exposure for toxic tort liability (i.e., exposure to environmental claims made pursuant to common law causes of action, such as negligence, nuisance, trespass, personal injury, etc.) and, depending on the laws and policies of a given state, statutory liability.

In addition to these three types of businesses, other entities that are part of the supply chain or that interface with it may incur liability. For example, depending on the degree of control that they exert over PFAS products and the types of claims being brought, trading companies and warehousing and storage facilities also have potential liability exposure. The same holds for waste disposal and treatment facilities (e.g., landfills, incinerators, wastewater treatment plants, and publicly owned treatment works), which are technically not part of the supply chain, but which accept wastes from businesses that are, and public water systems, which may distribute potable water impacted by PFAS-contaminated groundwater and thus incur liability.

Although the majority of liabilities and judgments have been issued in the context of environmental contamination and injury to human body, recent years have witnessed a flurry of activity involving PFAS-related consumer action claims against different businesses, including some operating in the food and beverage and cosmetics industries. Under other consumer protection laws, businesses producing PFAS-containing products may be liable for false advertising if the businesses make claims such as the products are "clean," "organic," and "harmful chemical free," for example.

"Good PFAS" Versus "Bad PFAS"

It is fair to state that PFAS have entered the public consciousness. Recent years have witnessed a proliferation of news articles and media stories pertaining to "forever chemicals"—a nickname given to PFAS because of their persistence. Because such publications and broadcasts do not distinguish between the various types of PFAS, which have different health and safety profiles, the general public has been accustomed to treating all PFAS as identical. This attitude has carried over to environmental advocacy groups, who stress the fact that most of the 15,000 or so PFAS chemicals have not been rigorously studied from the standpoint of environmental fate and transport, ecotoxicity, and human toxicity. Many lawmakers, too, are unattuned to the nuanced differences between PFAS chemicals—this is especially true at the state level. On the other hand, industry and members of the scientific community have pointed out that not all PFAS should be regulated in the same way. For example, fluoropolymeric PFAS are less likely to present adverse health effects[4] than non-fluoropolymeric long-chain PFAS.

Until now, the EPA has seemed to be taking a phased approach to PFAS regulation, in the sense that it is gradually expanding the scope of PFAS subject to proposed or final regulation. Moreover, the EPA seems to differentiate between the different classes of PFAS is its June 2023 "Framework for Addressing New PFAS and New Uses of PFAS."[5] This policy document imposes different requirements for the health and safety information necessary to support pre-market approvals under the Toxic Substances Control Act based on the type of PFAS involved and the likely exposure scenarios. Nevertheless, the EPA consistently speaks of expanding the scope of PFAS regulation, so it is difficult to anticipate where or how it will draw the line.

A similar uncertainty exists in the European Union, though the circumstances differ. In February 2023, the European Chemicals Agency proposed a universal ban on the PFAS production, to be implemented over a period of more than 13 years. However, it seems doubtful that this regulation will survive in its current form, given the 4,000+ comments that have been received as of the close of the public comment period in September 2023.

Difficulties of Destroying PFAS

Once PFAS enter the environment, new exposure pathways are created. PFAS are among the most dispersible chemicals in the environment. PFAS' chemical and physical properties make PFAS remediation challenging, particularly in groundwater or surface water. To date, treatment techniques have proven effective only on a limited basis. The most effective strategy has been to isolate and capture PFAS using membrane filtration (e.g., ion exchange, granular activated carbon, and reverse osmosis or nanofiltration). Even then, disposing of PFAS captured from remediation systems—or of unused commercial stocks of PFAS-containing products—can be problematic, as older commercial waste incineration facilities do not operate at the necessary temperatures to break the carbon-fluorine bonds that give rise to PFAS substances.

For this reason, companies are increasingly considering more costly, energy-intensive remediation strategies, including super-critical water oxidation, electrochemical oxidation, and in situ thermal remediation.[6]

* * *

Editor's note: The conclusion of this article will be published in the next issue of *The Journal of Federal Agency Action*.

Notes

* The authors, attorneys with Pillsbury Winthrop Shaw Pittman LLP, may be contacted at reza.zarghamee@pillsburylaw.com, shinya.akiyama@pillsburylaw.com, and lauren.johnstone@pillsburylaw.com, respectively.

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3. https://www.epa.gov/assessing-and-managing-chemicals-under-tsca/risk-management-and-polyfluoroalkyl-substances-pfas.

4. https://www.americanchemistry.com/chemistry-in-america/chemistries/fluoropolymers.

5. https://www.epa.gov/system/files/documents/2023-06/PFAS%20Framework_Public%20Release_6-28-23_Final_508c.pdf.

6. Examples would include supercritical water oxidation (involves oxidation at temperatures and pressures exceeding the thermodynamic critical point), electrochemical oxidation (involves the application of an electrical chemical and is similar to the process that some wastewater treatment plants use), and in situ thermal remediation (involves heating the source areas to eradicate contaminants).

Final Rules Issued Amending SEC Schedules 13D and 13G Beneficial Ownership Reporting Requirements

David J. Kaufman and Nabil Al-Khaled*

In this article, the authors discuss final beneficial ownership reporting rules adopted recently by the Securities and Exchange Commission.

In an effort to modernize beneficial ownership reporting under Section 13(d) and 13(g) of the Securities Exchange Act of 1934, the Securities Exchange Commission (SEC) recently adopted final rules (the Final Rules).[1] The Final Rules significantly depart, in many respects, from the rules the SEC originally proposed in February 2022 (the Proposed Rules).

Background

To provide market participants notice of significant acquisitions or potential changes in control of reporting companies, the SEC requires certain public filings. These Schedule 13D or Schedule 13G filings are required under Section 13(d) and 13(g) of the Exchange Act, and Regulation 13D-G for holders who beneficially own more than five percent of any class of securities registered under the Exchange Act. The reporting requirements apply to classes of four different types of equity securities as well as security-based swaps for which any of the four types of equity securities is the underlying security (each, a Covered Class).

Final Rules

Revised Filing Deadlines

- The initial Schedule 13D will be due five business days (previously ten days) after the date on which a person

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acquires beneficial ownership of more than five percent of a Covered Class of securities;

- The initial Schedule 13D will be due five business days (previously 10 days) by certain persons who become ineligible to report on Schedule 13G after the event that causes the ineligibility;
- The initial Schedule 13G for Qualified Institutional Investors (QIIs)[2] and "Exempt Investors"[3] will be due 45 days after the end of the calendar quarter in which beneficial ownership first exceeds five percent of a Covered Class;
- The initial Schedule 13G for "Passive Investors"[4] in lieu of Schedule 13D will be due five business days (previously 10 days) after the date on which they acquire beneficial ownership of more than five percent of a Covered Class;
- The deadline for filing amendments to Schedule 13D pursuant to Rule 13d-2(b) is now two business days (from promptly after the triggering event) after the date on which a material change occurs;
- The deadline for Schedule 13G amendments will be 45 days after the end of the calendar quarter in which a reportable change occurs (previously 45 days after the end of the calendar year in which the reportable change occurs);
- The deadline for Schedule 13G amendments filed by QIIs will be five business days (previously ten days) after the end of the month in which beneficial ownership first exceeds ten percent of a Covered Class, and thereafter upon any deviation by more than five percent of the covered class, with these requirements applying if the thresholds were crossed at any time during a month; and
- The deadline for Schedule 13G amendments filed by Passive Investors will be two business days after the date on which beneficial ownership exceeds ten percent of a Covered Class (previously promptly after the triggering event), and thereafter upon any deviation by more than five percent of such Covered Class.

Additionally, under the Final Rules, only a "material change" will trigger an amendment obligation to Schedule 13G filed under Rule 13d-2(b) (rather than "any change" under the current rules).

Further, the Final Rules extend the time-of-day deadline for Schedule 13D and 13G filings, and amendments thereto, to

10:00 p.m. eastern standard time (rather than 5:00 p.m. eastern standard time).

Guidance on Group Formation

In a departure from the Proposed Rules, the SEC did not adopt certain Rule 13d-5 amendments that would have tracked the statutory text of Section 13(d)(3) and (g)(3) to specify that two or more persons who "act as" a group for purposes of acquiring, holding, or disposing of securities are treated as a "group." Instead, the SEC elected to issue guidance in the adopting release on certain common types of investor engagement activities that scope of activities that could give rise to group formation.

The adopting release recognized that neither the statutory language nor the SEC rules define the term "group." According to the adopting release, the determination of whether two or more persons are acting as a group "depends on an analysis of *all the relevant facts and circumstances* and *not solely on the presence or absence of an express agreement*, as two or more persons may take concerted action or agree informally."[5]

The adopting release presented the related guidance in question and answer format, listing the below situations where a Section 13(d) group would not be formed:

- Communications between two or more shareholders concerning a particular issuer, including topics relating to the improvement of the issuer's long-term performance, changes in issuer practices, submissions, or solicitations in support of a nonbinding shareholder proposal, a joint engagement strategy (that is not control-related), or a "vote no" campaign against individual directors in uncontested elections.
- Shareholders engaging in discussions with an issuer's management, without taking any other action.
- Shareholders jointly making recommendations to the issuer regarding the structure and composition of its board of directors, if (1) no discussion of individual directors or board expansion occurs, and (2) no communications are made, or agreements or understandings are reached, among the shareholders regarding the potential withholding of

their votes to approve, or voting against, management's director candidates (so long as the issuer does not take steps to implement the shareholders' recommendations).

- Shareholders jointly submitting a nonbinding shareholder proposal for presentation at a shareholders' meeting.
- Communications between a shareholder and an activist that is seeking for its proposals to an issuer's board or management, if the shareholder does not consent or commit to a certain course of action.

On the other hand, the guidance states that a group is likely formed if a beneficial owner of a substantial block of a Covered Class that is or will be required to file a Schedule 13D intentionally communicates to other market participants (including investors) that such a filing will be made (to the extent this information is not yet public) with the purpose of causing such persons to make purchases in the same Covered Class, and one or more of the other market participants make purchases in the same Covered Class as a direct result of that communication.

Effective Dates

The Final Rules will become effective 90 days after their publication in the Federal Register. Compliance with the revised Schedule 13G filing deadlines will be required beginning on September 30, 2024. Compliance with the structured data requirement for Schedules 13D and 13G will be required beginning on December 18, 2024. Compliance with the other rule amendments, including the deadlines for initial and amended Schedule 13D, will be required upon their effectiveness.

Implications

All market participants should welcome these changes as they reflect increased information symmetry among issuers and investors market alike. The Final Rules also better comport with changes in technology and developments in the financial markets, including reduced settling times of equity transactions.

Additionally, the shortening of the Schedule 13D and Schedule 13G filing deadlines will likely increase the burdens of beneficial ownership reporting. The new reporting deadlines may be more challenging to meet in some instances, especially with respect to Schedule 13D filings. Investors that could be potential filers should adopt best practices that ensure proper systems are in place to ensure compliance with the new filing requirements.

However, the five-business-day Schedule 13D reporting deadline is a relatively moderate departure from the current 10-calendar-day reporting deadline, and is thus unlikely to cause a major shift in the broader beneficial ownership reporting paradigm.

Notes

* The authors, attorneys with Thompson Coburn LLP, may be contacted at djkaufman@thompsoncoburn.com and nalkhaled@thompsoncoburn.com, respectively.

1. https://www.sec.gov/files/rules/final/2023/33-11253.pdf.

2. QIIs generally include registered brokers or dealers, banks, insurance companies, investment companies registered under Section 8 of the Investment Company Act of 1940, investment advisers registered under Section 203 of the Investment Advisers Act of 1940, a parent holding company or control person (if certain conditions are met), employee benefit plans and pension funds that are subject to the provisions of the Employee Retirement Income Security Act of 1974, savings associations, certain church plans, and certain non-U.S. institutions that are regulated by substantially comparable schemes as their U.S. counterparts, and related holdings and groups. *See* 17 C.F.R. 240.13d-1(b)(1)(ii). To be eligible to report on Schedule 13G, QIIs must have acquired a Covered Class in the ordinary course of business and not with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect. 17 C.F.R. 240.13d-1(b)(1)(i).

3. The adopting release uses the term "Exempt Investor" to refer to "persons holding beneficial ownership of more than five percent of a Covered Class, but who have not made an acquisition of beneficial ownership subject to Section 13(d)" (e.g., persons who acquire their securities prior to the securities being registered under the Exchange Act, or persons who acquire no more than two percent of a Covered Class within a 12-month period).

4. The adopting release defines the term "Passive Investors" as beneficial owners of more than five percent but less than 20 percent of a Covered Class who can certify under Item 10 of Schedule 13G that the subject securities were not acquired and are not held for the purpose or effect of changing or influencing the control of the issuer of such securities and were not acquired in connection with or as a participant in any transaction having such purpose or effect.

5. Emphasis added.

Understanding the Department of Justice's New Safe Harbor Policy

Megan Mocho and Jessica B. Magee*

In this article, the authors discuss a new policy that applies to companies that voluntarily self-disclose criminal misconduct discovered in connection with mergers and acquisitions.

Continuing its focus on incentivizing prompt and voluntary self-disclosure of criminal misconduct, Deputy Attorney General Lisa Monaco recently announced a new U.S. Department of Justice (DOJ) Safe Harbor Policy promising a presumption of prosecutorial declination for voluntary self-disclosures of criminal conduct discovered in the course of a merger or acquisition.

Under the new department-wide policy, the DOJ will decline to prosecute "acquiring companies that promptly and voluntarily disclose criminal misconduct within the Safe Harbor period, and that cooperate with the ensuing investigation, and engage in requisite, timely and appropriate remediation, restitution, and disgorgement." The DOJ noted that "any misconduct disclosed under the Safe Harbor Policy will not be factored into future recidivist analysis for the acquiring company."

Application

The policy, as stated, applies only to the acquiring company. Application of the policy can, however, extend to the acquired entity as well, provided there are no aggravating circumstances. The lack of aggravating factors—such as significant profit from the conduct, recidivism, or pervasiveness of the conduct within the company—may shield the acquired company from criminal prosecution as well.

As a threshold matter, the Safe Harbor will be available only for acquirors in arm's-length deals and will not be available where conduct was already required to be disclosed or known to the

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DOJ or the public. Companies engaged in merger and acquisition (M&A) activities and the professionals who steward them through such transactions need to understand the key elements of the new policy pertaining to timing, cooperation, remediation, and monetary payment.

Timing

To qualify for the Safe Harbor, self-disclosure must occur within six months after the M&A transaction closes, regardless of whether the misconduct was discovered pre- or post-acquisition (and it must be remediated within one year, as discussed below). Monaco warned, "Companies that detect misconduct threatening national security or involving ongoing or imminent harm can't wait for a deadline to self-disclose."

This period may prove to be unfeasibly short for many transactions. Internal investigations are often slow, cumbersome activities that can take more than six months before the full scope of misconduct is apparent. For many acquiring companies, early hints of misconduct do not even come out of the woodwork until many months after acquisition, typically following turnover of existing personnel or full integration of the acquired company into the acquiring company's culture and practices. Evidence of misconduct may go unnoticed for years after a transaction where the acquired company continues to operate as a subsidiary with a level of independence from the acquiror.

Recognizing this conundrum, the DOJ is "placing an enhanced premium on timely compliance-related due diligence and integration. Compliance must have a prominent seat at the deal table if an acquiring company wishes to effectively de-risk a transaction." For companies negotiating a deal, a perfunctory compliance diligence process will not satisfy this requirement and will likely prevent the acquiring company from later obtaining voluntary self-disclosure benefits if criminal misconduct is identified. Diligence in key risk areas—the Foreign Corrupt Practices Act (FCPA), accounting practices, export controls, anti–money laundering, cybersecurity, supply chain integrity, and procurement practices—must occur throughout the life cycle of a transaction, both pre- and post-closing. Companies that invest time and resources to conducting a thoughtful and robust compliance diligence review of M&A targets are now also investing in potentially vastly better future outcomes—including complete declination—if that diligence process identifies evidence of a crime. Of course, thoughtful and thorough compliance diligence also secures a would-be acquiror important data points for considering whether to negotiate different terms or potentially discontinue negotiations. On this point, Monaco noted, "[t]he last thing the Department wants to do is discourage companies with effective compliance programs from lawfully acquiring companies with ineffective compliance programs and a history of misconduct. . . . Instead, we want to incentivize the acquiring company to timely disclose misconduct uncovered during the M&A process."

Failure to take compliance diligence seriously could result in even harsher sanctions, with Monaco noting companies that do "not perform effective due diligence or self-disclose misconduct at an acquired entity" will be "subject to full successor liability for that misconduct[.]"

Cooperation

Lisa Monaco noted the importance of cooperation in connection with the new Safe Harbor Policy, providing an example of the DOJ's decision to decline to charge an FCPA case following a company's timely and voluntarily self-disclosure of the misconduct, remediation, and cooperation in DOJ's investigation, which included identification of individual wrongdoers. Over the past several years, the DOJ has consistently highlighted the importance of cooperation during the investigation phase as a mitigating factor in both criminal and civil cases. Paramount to the concept of cooperation is the identification and appropriate discipline of individual wrongdoers—including potential compensation clawback or termination—regardless of their status or seniority at the company.

Cooperation also includes timely capture, disclosure, and highlighting of all facts relevant to the DOJ's investigation, providing access to witnesses and assistance in interpreting key documents. Again, this can pose a challenge to companies that may still be assessing the full scope and impact of wrongdoing but that want to voluntarily self-report within the Safe Harbor's six-month deadline. Companies that identify evidence of a crime in connection with M&A activity will want to consider self-reporting even in the midst of an ongoing internal investigation and position themselves as engaged in ongoing cooperation through frequent, proactive updates to the government.

Remediation

To qualify for the Safe Harbor, the conduct must not only be self-reported within six months, it must also be "fully" remediated within one year from the date of closing. Recognizing this may be an unworkable time period, Monaco noted in her speech that this deadline was a "baseline" that can be extended by prosecutors to take into account the "specific facts, circumstances, and complexity of a particular transaction[.]" Suffice to say, the DOJ will expect to see companies focused on designing a tailored and effective remediation plan and then taking steps to promptly implement and complete that plan.

This timeline might be difficult even in less-complex transactions. For smaller companies, a relative lack of financial, people, and technological resources may hinder their ability to create the necessary sea change in internal controls at the acquired company. This concern cannot be ignored; the majority of criminal prosecutions of corporations are of small, privately held organizations.

Monetary Payment

The DOJ's new Safe Harbor Policy will require the acquiring company to disgorge profits gained from the misconduct. Although not a significant departure from past DOJ policies, this is a consideration that may wipe out the value of the investment, depending on the breadth and duration of the misconduct.

Notably, treatment of civil or other regulatory enforcement actions is not contemplated by the DOJ's policy. With increasing parallelism in criminal and civil investigations—and the Securities and Exchange Commission and other agencies' own focus on incentivizing and crediting voluntary self-disclosure, cooperation, and remediation—certain industries may find themselves saddled with coordinating reporting to and cooperation with multiple agencies with different internal policies and proof requirements, along with lingering risk of enforcement and civil or monetary penalties following a self-disclosure to non-DOJ agencies.

Next Steps

Note that the DOJ's own press activity, which can occur even if a company self-discloses, was not discussed in statements announcing the Safe Harbor. Companies that are eligible and want to take advantage of the policy should consider that the DOJ may later publicly disclose the investigation and its decision to decline prosecution of the company, and plan for potential financial and reputational impact therefrom, as well as possible future private class action and other claims stemming from the DOJ's public disclosure after a company seeks to do the right thing by coming forward.

Note

* The authors, partners in Holland & Knight LLP, may be contacted at megan.mocho@hklaw.com and jessica.magee@hklaw.com, respectively.