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Zero Seller Recourse Deals and Other Emerging Trends: The Latest Developments in Representation and Warranty Insurance

By John McDonald and Chad Warpula

As the representation and warranty (R&W) insurance industry continues to mature and new carriers enter the market, some important trends in R&W insurance policies are emerging. These trends are quickly becoming generally-accepted norms, which will have ramifications for buyers and sellers of companies and R&W insurance carriers. Private equity firms, strategic buyers and sellers of companies, as well as their attorneys, investment bankers and other advisors, need to be aware of these trends.

R&W Insurance

R&W insurance is insurance obtained in connection with merger and acquisition (M&A) transactions. In a typical M&A transaction, the seller has the sole responsibility for indemnifying the buyer for losses resulting from breaches of the seller's representations and warranties in the purchase agreement (typically relating to undisclosed or inaccurately disclosed issues with the company being sold), subject to highly negotiated caps, thresholds and baskets. In an R&W-insured M&A transaction, the buyer obtains recovery for some or all such losses from the R&W insurance policy, up to the policy's coverage limit.

In the late 1990s, R&W insurance emerged as a method to shift some or all indemnification risk from the seller to an insurer. Today, coverage is available across all industry sectors. The increase in R&W insurance usage over the last several years has been exponential. So much so that, as competition has increased, premiums have declined to two percent to four percent of the coverage limit for R&W insurance policies. With the growing pervasiveness of R&W insurance premiums, coverage and other terms have

settled, however, this is still a developing trend and more changes in premiums, coverage and other terms may come.

Attractiveness to Strategic Buyers, Sellers and Private Equity Sponsors

R&W insurance is attractive to sellers of companies because it increases the amount of sale proceeds that they receive at closing and reduces or eliminates the possibility that they will be required to return sale proceeds to the buyer, either directly or through release of sale proceeds placed into escrow. That is particularly attractive to private equity sellers of companies, as they typically want to return funds to their limited partner investors as quickly as possible after closing of the sale to maximize their internal rate of return from the investment and their carried interest compensation.

R&W insurance is also attractive to buyers in competitive auction processes because it can improve the competitiveness of their bids by increasing the amount of sale proceeds that the seller receives at closing, as compared to non-R&W insurance transactions in which the customary 10 to 20 percent of transaction proceeds are placed into escrow for 12 to 18 months after closing to act as a source of recovery for the buyer relating to undisclosed issues. Buyers submitting an auction bid letter that includes R&W insurance have a marked advantage over other buyers because, other than a standard seller retention (or basket) if required by the R&W insurance policy, any buyer claims covered by the policy will be asserted against the insurance company instead of the seller.

Security and Structure of R&W Insurance

R&W insurance can provide buyers with protection where there is concern over the ability to collect on the seller's indemnification obligation. This can be extremely useful in bankruptcy sales, take-private transactions, distressed sales and ESOP transactions. R&W insurance policies can be either buy-side (procured by the buyer) or sell-side (procured by the seller) policies. Today, buy-side policies are the dominant form of R&W insurance, comprising at least 80% of policies issued annually in the U.S., according to major insurers and market data. The security that R&W insurance provides is structured to limit the seller's indemnity obligation to escrow of 0.5 percent to 2.5 percent of the purchase price (the "retention") – which, as discussed below, is fading away – supplemented with a buy-side R&W insurance policy to achieve a 7.5 percent to 10.0 percent effective indemnity cap/recourse for the buyer. As the market has matured, the process of obtaining R&W insurance has become increasingly more efficient. However, obtaining R&W insurance can still take weeks from start to finish; therefore, buyers should contact the insurance broker or carrier early in the deal cycle. Like all insurance, the premium for a R&W insurance policy will vary based on many factors, including the size of the transaction, the level of risk involved, the deductible and the cap. However, the investment can be fruitful because R&W insurance extends survival of the reps and warranties/buyer's recourse beyond the typical 12-18-month escrow period to as long as six years after closing.

Zero Seller Recourse Deals

Skin in the Game and Moral Hazard

R&W insurance has not traditionally exculpated sellers from all liability to buyers. As a way of ensuring that sellers have some "skin in the game" and addressing the "moral hazard" risk of a seller failing to provide full and accurate disclosure to the buyer concerning the company being sold because the R&W insurer, rather than the seller, will bear the risk of losses relating to undisclosed issues, R&W insurance policies have traditionally provided for the retention described above, after which

buyer losses for undisclosed issues are covered by the R&W insurance policy, up to its coverage limit. Although the retention amount is significantly less than the 10 to 20 percent of transaction proceeds placed into escrow in non-R&W insurance M&A transactions to act as a source of recovery for the buyer, it provides some assurance to R&W insurance carriers that the seller will be vigilant in preparing the disclosure schedules to the purchase agreement and otherwise ensuring complete disclosure to the buyer concerning the company being sold.

However, as new carriers have entered the R&W insurance market, competition among them has increasingly resulted in R&W insurance policies being underwritten in which there is no recourse to the seller. The buyer absorbs losses for the deductible/basket amount and the R&W insurance policy covers any losses in excess of that amount, up to the coverage limit. Some brokers active in the R&W insurance market have estimated that 50 percent or more of R&W insurance policies now being underwritten provide for no-seller-recourse, up significantly from prior years.

Convergence in Premiums

Although there have always been no-seller-recourse R&W insurance policies, the premiums for those policies have historically been meaningfully higher than for R&W insurance policies with seller recourse, due to the additional risk to the R&W insurance carrier, which has tended to reduce their prevalence. However, with the rise in competition among R&W insurance carriers, some of which may be new entrants focused on increasing market share, potentially at the expense of ultimate profitability, the spread between premiums for policies with seller recourse and those without seller recourse has compressed substantially. This has made R&W insurance policies in which there is no recourse to the seller much more attractive to buyers, which typically bear the cost of the policy's premium. A notable trend in no-seller-recourse R&W insurance policies is for the seller to be required to pay a portion (sometimes up to half) of the policy's premium, to help offset any increase in the premium resulting from the elimination of seller recourse.

Other Incentives for Full Disclosure

The compression in the premium spread between recourse and non-recourse R&W insurance policies could be interpreted as indicating that fears of moral hazard are overblown and sellers will be vigilant in providing full disclosure to buyers, regardless of whether they retain post-closing indemnification liability to buyers. Consequently, continuing this argument, there may not be sufficient incremental risk associated with no-seller-recourse R&W insurance policies, as compared to policies in which there is seller-recourse, to justify a large spread in premiums. There is anecdotal evidence to support this argument, as some industry participants underwriting R&W insurance policies have not noticed a substantial difference in the thoroughness of disclosure in no-seller-recourse R&W insurance policies, as compared to seller-recourse policies. Some incentives for sellers to provide full disclosure, regardless of whether they retain liability, include the reputational harm that would come from incomplete disclosure and resulting indemnification claims, as well as the fact that sellers always retain liability for failure to disclose issues that amounts to fraud. In addition, sellers have ample motivation to provide full disclosure in M&A transactions in which the buyer is a private equity firm and the sellers are management team members who will continue to manage the acquired company after the acquisition, because the sellers will essentially become partners with the private equity firm and undisclosed issues coming to light after closing could damage that relationship.

An Unsustainable Trend?

Some more seasoned R&W insurance market participants feel that this is an unsustainable trend that will reverse over time, as carriers incur losses from no-seller-recourse R&W insurance policies and either exit the R&W insurance market entirely or increase the premiums that they charge for such policies to more accurately compensate them for the additional risk. Because of the 12 to 18-month "tail period" between when an R&W insurance policy is underwritten upon closing of an M&A transaction and when indemnification claims are typically made by buyers, usually after completion of audited financial statements and filing of consolidated tax returns including the acquired company surface issues that become the subject of claims, it is probably too early to determine the effect of the recent trend toward the increased use of no-seller-recourse R&W insurance policies. If the widely-watched AIG R&W insurance claims survey expected to be released in the summer of 2018 shows substantial additional claims being made on no-seller-recourse R&W insurance policies, as compared to policies in which there is seller recourse, it could have a meaningful impact on carriers' underwriting practices and their pricing of premiums for no-seller-recourse policies.

Broadened Scope and Reduced Exclusions

Another prominent recent trend in R&W insurance has been toward broadened scope of coverage and reduced exclusions from coverage. This trend is the result of buyers' desire to reduce "gaps" in coverage under the R&W insurance policy, as compared to the protection from losses resulting from undisclosed issues that they would obtain from the seller in a non-R&W insurance M&A transaction. That is the case because liability resulting from matters excluded from coverage under the R&W insurance policy is typically either effectively borne by the buyer or becomes the subject of a negotiation process among the buyer and the seller, which can slow down the transaction process and weaken the buyer's competitive position versus other bidders in auction scenarios. Sellers have put pressure on carriers to eliminate these gaps to further reduce their residual risk and prevent negotiation with buyers over treatment of excluded issues.

Broadened Scope

The scope of coverage under R&W insurance policies has broadened through reduction of the scope of the stated exclusions to coverage under the policies. Historically, R&W insurance policies have excluded certain categories of issues involving heightened risk – environmental and government payments-related liabilities are some prominent examples – which R&W insurance carriers have viewed as either more appropriately being the subject of a stand-alone insurance policy or presenting such an outsized, unmeasurable risk, as compared to the premium received for the R&W insurance policy, that it cannot be responsibly underwritten. However, increased competition among R&W insurance carriers has led to reduced use of broad categories of exclusions and instead to exclusion only of specific issues relating to the acquired company that are identified by the carrier during its due diligence process.

Reduced Exclusions

Competitive dynamics in the R&W insurance marketplace have also manifested themselves in a reduction in the number of issues that are listed in the exclusion schedules to R&W insurance policies. Carriers want to appear reasonable and market-friendly to R&W insurance brokers, which are increasingly gatekeepers for deal flow for new R&W insurance underwritings, when proposing exclusions from coverage. In situations in which there are several carriers competing

for an underwriting, a carrier that proposes a long list of exclusions from coverage under the R&W insurance policy may knock itself out of contention, particularly if the issues proposed to be excluded are perceived as not being material as compared to the size of the transaction.

Consistent with the fundamental premise of insurance as insuring only against unknown liabilities, R&W insurance carriers have customarily excluded issues known by the buyer from coverage under policies. Known issues can be excluded from coverage under an R&W insurance policy either by listing them on the exclusions schedule to the policy or by operation of the provisions in the policy that exclude issues that are known to the buyer's transaction team from coverage under the policy. This results in pressure from buyers to reduce the number of issues included in the exclusions schedule to the R&W insurance policy. Carriers have responded by conducting thorough due diligence in connection with underwriting R&W insurance policies and seeking to put the buyer's transaction team on notice of the matters that they identify during underwriting calls, thereby excluding them as known issues under the policies' terms. This forces buyers to not turn a "blind eye" to issues that should have been known. From the carriers' perspective, however, this is an imperfect solution, as memories can fade from the time when underwriting calls occur and the time, often one or more years later, when claims are made under the policies, potentially creating factual issues about what exactly was known to the buyer's transaction team that lead to disputes over coverage under the policies. Most buyers, however, do not rely on R&W insurance to employ a "blind eye" approach to due diligence, as they would prefer to "turn over the rock" and deal with the consequences square on, rather than ignore issues and pursue claims on the policies later.

Conclusion

As discussed above, the emerging trends in R&W insurance policies discussed in this article have important ramifications for buyers and sellers of companies utilizing R&W insurance policies and R&W insurance carriers, which will continue to play out over the coming years. While many established R&W insurance providers view new market entrants skeptically as short-term players in the industry, the increased competition among carriers is creating a dynamic and constantly evolving market and resulting in more favorable R&W insurance terms for both buyers and sellers of companies.

Please do not hesitate to contact the authors with any questions that you may have about these trends or about R&W insurance more broadly.

A Bank's Guide to SBA Fintech Investing; Compliance with the Volcker Rule

By Gerald Francese and Felicia Xu

In second quarter 2017, global investments in fintech companies reached $8.4 billion across 293 deals.[1] The rise of fintech continues to dramatically change the landscape of the financial sector, as financial institutions recognize the need to reduce operating costs and provide customers with easier access to services. In response to the disruptive nature of fintech, 30 percent of large financial institutions have invested in artificial intelligence and 77 percent are expected to adopt blockchain as part of an in-production system by 2020.[2] However, as the number of financial institutions interested in the fintech industry continues to grow, they are faced with regulatory barriers to invest in these businesses.

The Volcker Rule prohibits financial institutions from engaging in "proprietary trading," acquiring or retaining any equity, partnership or other ownership interest in a hedge fund or private equity fund and sponsoring a hedge fund or private equity fund. As a result, financial institutions that seek a stake in the fintech industry must either develop their own technologies in-house, invest in individual fintech companies or find other regulatory authorities to make a permissible investment. The options are especially challenging for smaller financial institutions that are not financial holding companies or do not have the resources to independently develop new technology.

One alternative is that financial institutions can invest in fintech companies without acquiring ownership in a hedge fund or private equity fund by forming or investing in a Small Business Investment Company (SBIC). Investment in an SBIC is exempt from the Volcker Rule. This article provides an overview of the SBIC program and discusses some benefits to financial institutions to invest in fintech via an SBIC program.

The SBIC Program

The SBIC program is designed to assist small businesses in securing long-term capital for growth. Qualified investors, including financial institutions, may apply to the Small Business Administration (SBA) for a license to provide access to low-cost, government-guaranteed capital (SBA leverage) to make investments in U.S. small businesses.[3] Launched in 1958, the SBIC program has deployed more than $84 billion of capital, made more than 174,000 investments in small businesses, and licensed more than 2,100 funds.[4]

Investment Criteria

Small Business. SBICs may only invest in "small businesses." A portfolio company qualifies as a small business by having, with its affiliates, (i) tangible net worth of less than or equal to $19.5 million and (ii) an average net income of less than or equal to $6.5 million after federal income taxes (excluding any carry-over losses) over the previous two years, at the time of investment.[5]

A business may also be deemed "small" under the SBA's North American Industry Classification System codes.[6]

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[1] KPMG Pulse of Fintech Q2-2017.

[2] PwC Global FinTech Report 2017.

[3] SBIC OVERVIEW

[4] SBIC Overview: U.S. Small Business Administration Office of Investment and Innovation

[5] 13 C.F.R. § 121.301(c). The size standards were adjusted for inflation in 2014, according to the interim final rule in 79 Fed. Reg. 113 (June 12, 2014).

[6] 13 C.F.R. § 121.201.

Smaller Business. Twenty-five percent of an SBIC's capital must be invested in "smaller businesses," defined as a business that, together with its affiliates, has (i) tangible net worth of less than or equal to $6 million and (ii) an average net income of less than or equal to $2 million after federal income taxes (excluding any carry-over losses) over the previous two years, at the time of investment.[7]

Form of Investment. SBICs can provide financing to small businesses in the form of equity securities,[8] loans,[9] debt securities,[10] and guarantees.[11] Additionally, SBICs may purchase securities of a small business through or from an underwriter.[12] Loans may be secured and amortizable but generally must have a minimum one-year term and maximum twenty-year term.[13]

Investment Size. A financial institution's total investments in SBICs may not exceed five percent of its capital and surplus.[14] Further, an SBIC may not invest an amount greater than 10 percent of its total capital (private and SBA leverage), and 30 percent of its private capital, in any single portfolio company.[15]

Other Investment Restrictions

- An SBIC may not invest in businesses with more than 49 percent of their employees located outside the United States.[16]
- An SBIC may not invest in other SBICs.[17]
- An SBIC may not invest in industry sectors deemed contrary to the public interest nor may they invest in: (i) re-lenders or re-investors, (ii) passive businesses, (iii) real estate businesses, (iv) project finance, (v) farm land purchases, (vi) associated suppliers or (vii) financing licensees.[18]
- An SBIC can control its portfolio companies for up to seven years[19] and may qualify for an extension upon pre-approval by the SBA.[20]

The Volcker Rule

As discussed above, the Volcker Rule, a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, generally prohibits banking entities[21] from engaging in proprietary trading and investing in hedge funds or private equity funds.[22] However, the final Volcker Rule implementing regulations excludes portfolio companies controlled by a SBIC from the definition of banking entity.[23] Thus, SBICs are not subject to the Volcker Rule's prohibition on sponsoring or investing in covered funds.

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[7] 13 C.F.R. § 107.710.

[8] Pursuant to 13 C.F.R. § 107.800(b), "equity securities" are defined as stock of any class in a corporation, stock options, warrants, limited partnership interests in a limited partnership, membership interests in a limited liability company, or joint venture interests.

[9] Pursuant to 13 C.F.R. § 107.810, a "loan" is defined as a transaction evidenced by a debt instrument with no provision for the SBIC to acquire equity securities.

[10] Pursuant to 13 C.F.R. § 107.815, "debt securities" are defined as instruments evidencing a loan with an option or any other right to acquire equity securities in a small business or its affiliates, or a loan which by its terms is convertible into an equity position, or a loan with a right to receive royalties that are excluded from the cost of money pursuant to §107.855(g)(12).

[11] 107.50

[12] 107.825

[13] §4.3 Permitted loans and investments

[14] 15 U.S.C. § 682(b).

[15] *Program Overview*, U.S. SMALL BUSINESS ADMINISTRATION (April 7, 2017, 11:00 AM), https://www.sba.gov/sbic/general-information/program-overview.

[16] *Id.*

[17] BANK SUBSIDIARIES KEY LEGAL AND OPERATIONAL ISSUES- 15 USC CH 14A

[18] *Id.*

[19] The Small Business Investment Company (SBIC) Program

[20] Pursuant to 13 C.F.R. § 107.50, "control" is defined as the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a corporation, limited partnership or other concern, whether through the ownership of voting securities, by contract, or otherwise.

[21] Pursuant to 12 C.F.R. § 44.2, a banking entity means (i) any insured depository institution; (ii) any company that controls an insured depository institution; (iii) any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (12 U.S.C. 3106); and any affiliate or subsidiary of any entity described above.

[22] 12 C.F.R. § 44.10(a)(1).

[23] 12 C.F.R. § 44.10(c)(11).

Additional Incentives

Investment Performance

In addition to using its own private capital, SBICs can issue debentures up to three times the amount of their private capital.[24] Such capital is provided at a significantly lower cost than traditional limited partner equity investments. Furthermore, the concentration of a large portion of funding from one source reduces fund managers' fundraising burden and administrative and reporting requirements.[25]

CRA Consideration

Financial institution investments in SBICs may meet the definition of qualified investments under the Community Reinvestment Act (CRA).[26] Financial institutions qualify for CRA consideration under the investment test for investments in SBICs when the investment benefits its assessment area. In addition, financial institutions may receive CRA consideration under the community development test when investments in SBICs benefit a broader statewide or regional area that includes its assessment area.[27] In essence, CRA credits provide an additional source of private funds to SBICs that they would not otherwise receive.

Gramm-Leach-Bliley Act (GLB Act)

Financial institutions are also exempt from certain regulations that govern regulatory capital treatment for certain equity investments held by banks, bank holding companies and financial holding companies under the GLB Act. Under the regulations:

- An eight percent Tier 1 capital deduction applies on covered investments that in the aggregate are less than 15 percent of an organization's Tier 1 capital;
- A 12 percent deduction applies to investments aggregating 15 to 24.99 percent of Tier 1 capital; and
- A 25 percent deduction applies to investments aggregating 25 percent and above of Tier 1 capital.[28]

SBIC investments are exempt from the above regulations so long as their value is less than 15 percent of Tier 1 capital.[29]

In addition, ownership of a 15 percent equity interest in a portfolio company by a bank-affiliated SBIC will not give rise to a presumption that the portfolio company is an Affiliate under Sections 23(a) and (b) of the GLB Act.[30]

SBIC Advisers Relief Act

The SBIC Advisers Relief Act amends provisions of the Investment Advisers Act of 1940 (Advisers Act) that relate to an exemption from investment adviser registration for advisers to SBIC funds and state regulatory authority with respect to such SBIC fund advisers. Under the SBIC Advisers Relief Act:

- Advisers whose only clients are SBICs will not be required to register at the federal or state level;
- SBICs will be considered to qualify as a "venture capital fund" for purposes of the VC fund adviser exemption (note this is applicable only to the federal exemption); and
- The "private fund adviser exemption" is expanded to include advisers with non-SBIC private funds that have gross assets of less than $150 million.

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[24] Typically, SBICs can only issue debentures up to two times private capital.

[25] https://www.sbiclaw.com/faqs/

[26] *Id.*

[27] 12 C.F.R. § 25.23 & 12 C.F.R. § 25.26(c).

[28] FEDERAL RESERVE SYSTEM. 12 CFR Parts 208 and 225. [Regulations H and Y; Docket No. R–1055] Dec. 10, 2001

[29] *Id.*

[30] http://www.jdsupra.com/legalnews/description-of-the-small-business-71461/

U.S. Securities and Exchange Commission Issues Guidance on Cybersecurity Risks and Incidents

By Mark Mao, Dave Meyers and Jason Norinsky

On February 21, 2018, the U.S. Securities and Exchange Commission (the "Commission") issued guidance in a report titled "Commission Statement and Guidance on Public Company Cybersecurity Disclosures"[1] to assist public companies in preparing disclosures on cybersecurity risks and incidents. The Commission notes that its 2011 guidance led to increased general disclosures, typically in the form of risk factors. Considering the increasing significance of cybersecurity incidents however, the Commission believes it is important to provide further guidance to public companies. In addition to reinforcing and expanding upon the Commission's 2011 guidance on cybersecurity disclosures, the Commission addressed new topics, including the importance of cybersecurity policies and procedures and the application of insider trading prohibitions in the context of cybersecurity. A close analysis of the new guidance shows that the Commission is becoming increasingly aggressive regarding cybersecurity risks and the potential for significant incidents to occur.

Material Disclosures

The Commission's guidance requires public companies to consider the materiality of cybersecurity risks and incidents when preparing disclosures under the Securities Act of 1933, as amended (the "Securities Act") and the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Commission indicates that cybersecurity risks and events may require timely and ongoing disclosure in periodic reports, including annual reports on Form 10-K and quarterly reports on Form 10-Q. Additionally, because Securities Act and Exchange Act registration statements and Exchange Act periodic reports must disclose all material facts required to be stated therein or necessary to make the statements therein not misleading, public companies should consider the adequacy of their cybersecurity-related disclosures. To maintain the accuracy and completeness of shelf registration statements with respect to the consequences and costs of material cybersecurity incidents, public companies that are active public market participants may wish to consider providing disclosures related to cybersecurity risks and incidents in current reports on Form 8-K. The Commission Statement urges public companies to continue to use these forms to disclose material information pertaining to cybersecurity matters promptly.

In determining disclosure obligations regarding cybersecurity risks and incidents, public companies generally must weigh the potential materiality of any identified risk and, if an incident occurs, the importance of any compromised information and the impact of the incident on ongoing operations. The materiality of cybersecurity risks or incidents depends upon the scope of potential or actual harm to a public company's reputation, financial performance, and customer and vendor relationships, as well as the possibility of litigation or domestic or foreign regulatory investigations or actions. Although the Commission indicates that it understands that public companies may require time to discern the implications of a cybersecurity incident and that companies may need to cooperate with law enforcement, such ongoing internal

[1] 17 CFR 229 and 249; SEC Release No. 33-10459; 34-82746, available at: https://www.sec.gov/rules/interp/2018/33-10459.pdf.

or external investigations would not provide a basis for avoiding disclosure of a material cybersecurity event. If a prior disclosure is incomplete or inaccurate, the Commission suggests that public companies consider making an update or correction.

The Commission's guidance also discusses risk factor disclosures, which require public companies to disclose the most significant factors that make investments in their securities speculative or risky. Notably, the Commission suggests that public companies should consider the following issues in evaluating cybersecurity risk factor disclosures: (i) the occurrence of prior cybersecurity incidents, including their severity and frequency; (ii) the probability of the occurrence and potential magnitude of such incidents; (iii) the adequacy of preventative measures undertaken to reduce cybersecurity risks and costs (including limits or the ability to prevent or mitigate cybersecurity risks); (iv) the aspects of business and operational functions that contribute to material cybersecurity risks and the potential costs of such risks; (v) the costs of cybersecurity protections (including any insurance coverage relating to cybersecurity incidents and payments to third-party service providers); (vi) the potential for reputational harm; (vii) existing or pending laws and regulations relating to cybersecurity that may affect the requirements to which public companies are subject and their associated costs; and (viii) litigation, regulatory investigation, and remediation costs associated with cybersecurity incidents.

Importantly, the Commission clarified that general discussions of these topics in risk factors alone may not be sufficient, stating that public companies should consider disclosing previous or ongoing cybersecurity incidents or other past events to place discussions of these risks in the appropriate context.

Board Risk Oversight

The Commission also discussed how disclosure of a board's involvement in the oversight of the risk management process should provide important information to investors about how a public company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company.[2] To the extent that cybersecurity risks are material to the business, these disclosures should include the board's role in overseeing and managing material cybersecurity risks and a description of how the board administers its risk oversight function. Disclosures regarding a public company's cybersecurity risk management program and how the board engages with management allow investors to assess how a board is discharging its risk oversight responsibility.

Management's Discussion and Analysis of Financial Conditions and Results of Operations ("MD&A")

The Commission's guidance also discusses MD&A disclosures. The Commission's guidance provides that the cost of ongoing cybersecurity efforts, the costs and other consequences of cybersecurity incidents, and the risks of potential cybersecurity incidents could inform a public company's analysis of the events, trends or uncertainties that are reasonably likely to have a material effect on such company's results of operations, liquidity or financial condition. In addition, the Commission states that public companies should consider the array of costs associated with cybersecurity issues, including loss of intellectual property, immediate costs of the incident, as well as the costs associated

[2] Final Rule: Proxy Disclosure Enhancements, Release No. 33-9089 (Dec. 16, 2009) [74 FR 68334 (Dec. 23, 2009)]

with implementing preventative measures, maintaining insurance, responding to litigation and regulatory investigations, and preparing for and complying with proposed and current legislation.

Description of Business and Legal Proceedings

Public companies are required in their periodic reports and registration statements to discuss their products, services, relationships with customers and suppliers, and competitive conditions. If cybersecurity incidents or risks materially affect any of these factors, a public company must provide appropriate disclosure of such incidents or risks. With respect to required disclosures of material pending legal proceedings, the Commission's guidance notes that this requirement includes any material pending legal proceedings related to cybersecurity issues, such as a customer lawsuit due to the theft of customer intellectual property related to a cybersecurity event.

Disclosure Controls and Procedures

The Commission's guidance encourages public companies to adopt comprehensive policies and procedures related to cybersecurity and to assess their compliance regularly. A public company must assess whether it has sufficient disclosure controls and procedures in place to ensure that relevant information about cybersecurity risks and incidents is processed and reported to the appropriate company personnel. When making the required certifications and disclosures regarding the design and effectiveness of disclosure controls and procedures, a company's principal executive officer and principal financial officer should consider the adequacy of controls and procedures for identifying cybersecurity risks or incidents and assessing and analyzing their impact.

Insider Trading

As noted above, information about a public company's cybersecurity risks and incidents may be material non-public information for which directors, officers and other corporate insiders would violate the antifraud provisions of Rule 10b-5 of the Exchange Act if they make transactions in a company's securities while in possession of that material non-public information. The Commission's guidance encourages public companies to consider how their code of ethics and insider trading policies take into account and prevent trading based on material nonpublic information related to cybersecurity risks and incidents.

Regulation FD and Selective Disclosure

The Commission's guidance notes that companies may have disclosure obligations under Regulation FD in connection with cybersecurity matters. In cases of selective disclosure of material non-public information related to cybersecurity, public companies should ensure compliance with Regulation FD, and the Commission expects public companies to have policies and procedures to ensure that any disclosures of material non-public information related to cybersecurity risks and incidents are not made selectively. Accordingly, public companies may wish to review their Regulation FD policies to determine whether they appropriately address information relating to cybersecurity risks and incidents.