

# 2017 Insights

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Skadden

A collection of commentaries on the critical legal issues in the year ahead.

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# Capital Markets

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# Volatility and Uncertainty Continue in the US Capital Markets

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The U.S. capital markets experienced continued volatility throughout much of 2016, as the bond and equity markets were affected by a series of significant events: the November U.S. presidential election; the June Brexit vote; fluctuating oil prices over the course of the year; the Federal Reserve's December increase in interest rates, only the second since 2006; and a variety of geopolitical events throughout the year, most notably with respect to China and Russia.

How the U.S. capital markets perform in 2017 will largely depend on how and whether the Trump administration implements its proposals, and how those policies complement or contradict one another in their impact. Until there is some clarity on these issues, the markets may again experience volatility related to the new administration.

**High-Yield Debt Market.** The U.S. high-yield market in 2016 ended the year approximately 15 percent lower by dollar volume and 23 percent lower in number of issuances than 2015, the third consecutive year of decline.<sup>1</sup> U.S. high-yield bond issuances totaled \$245 billion (486 issuances) in 2016 compared to \$288 billion (634 issuances) in 2015. Acquisitions and refinancing activity continued to drive volume last year; however, M&A issuances (including leveraged buyouts) decreased to approximately 19 percent of total volume in 2016, compared to approximately 33 percent in 2015. In addition, energy sector issuers remained active in the market, with exchange offers and other restructurings and — particularly with stronger oil prices in the fourth quarter — traditional refinancings. (See [“Oil and Gas Industry Seeks Steady Ground Following Year of Restructurings, Restrictive Lending.”](#)) December 2016 was the busiest December for high-yield issuances since 2013, with refinancings accounting for 69 percent of dollar volume.

**Investment-Grade Debt Market.** The U.S. investment-grade debt market in 2016 once again had record dollar volume — approximately \$1.35 trillion (1,881 issuances) — exceeding the previous record of \$1.32 trillion (2,177 issuances) set in 2015 and marking the sixth consecutive year of dollar volume increase. The total dollar volume was driven in part by several large acquisition financings, including: \$46 billion by Anheuser-Busch InBev NV to finance its acquisition of SABMiller Plc (the second-largest bond offering ever behind Verizon's \$49 billion offering in 2013), \$20 billion by Dell Inc. to finance its acquisition of EMC Corp., and \$15 billion by Abbott Laboratories to fund its acquisition of St. Jude Medical. In addition to M&A issuances, the investment-grade volume in 2016 was driven by issuers refinancing debt in anticipation of interest rate increases as well as potential volatility and uncertainty associated with the implementation of President Donald Trump's campaign proposals. Banks and financial issuers represented the largest total number of issuances by sector in 2016 (almost 50 percent) and approximately 42 percent by dollar volume, as banks issued new bonds both to replace maturing debt and to prepare to meet total loss-absorbing capacity rules adopted by the Federal Reserve in December 2016. The rules, which go into effect January 1, 2019, require banks identified as global systemically important banks to maintain a minimum level of long-term debt that could be used to recapitalize critical operations upon failure. They also set a new minimum level of total loss-absorbing capacity, which can be met with both regulatory capital and long-term debt. Strong investment-grade issuance volume — dominated by banks and financial issuers — continued into early 2017, with a record \$44 billion of dollar volume in the first two days of the year. Year-to-date 2017 investment-grade issuance is nearly \$150 billion, a record high for January.

<sup>1</sup> Sources for the data in this article are: Dealogic, Debtwire, [highyieldbond.com](#), S&P Capital IQ LCD, Bloomberg and Thomson Reuters.

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**Equity and IPO Markets.** The U.S. equity markets reached record levels, starting in December 2016 and continuing into 2017. Toward the end of January 2017, both the Standard & Poor's 500 index and the Nasdaq composite set new all-time highs, and the Dow Jones industrial average topped the 20,000 milestone. The records were driven by strong fourth-quarter earnings and executive orders from President Trump that provided some clarity on infrastructure policies, including accelerating the completion of the Keystone XL and Dakota Access pipelines and easing the regulatory burden for domestic manufacturers.

Despite the recent positive tone in the markets, volatility in the first half of 2016 depressed the initial public offering (IPO) market throughout most of the year, with only 105 IPOs raising approximately \$20 billion, compared to 174 IPOs raising over \$34 billion in 2015, representing the lowest dollar and issuance volumes since 2003 and 2009, respectively. The five largest IPOs in 2016 accounted for over one-quarter of the dollar volume, and the leading sectors by dollar volume were financial services and health care. Financial services and health care companies also had the greatest number of issuances, followed by technology issuers. Several companies that filed for IPOs in 2016 or were considered candidates for IPOs in 2017 (including Dollar Shave Club and Centennial Resource Development Inc.) instead consummated a sale process, which can provide a quicker path to liquidity, particularly for private equity firms looking to exit older investments. Special purpose acquisition companies (SPACs) continued to access the IPO market in 2016, with 13 SPAC IPOs raising \$3.5 billion (down from 20 SPAC IPOs raising \$3.9 billion in 2015, but still well above dollar levels in 2008-14).

Follow-on volumes in 2016 also were down materially from prior years, particularly with respect to marketed transactions. Despite the decline in overall follow-on activity, however, 2016 was a record year for block trades (which represented 57 percent of total follow-on proceeds raised), as issuers sought execution certainty and a transfer of risk to underwriters.

### Looking Ahead

Implementation of President Trump's campaign proposals has the potential to significantly impact the U.S. capital markets throughout 2017, as do a wide variety of exogenous political and global macroeconomic events. As in recent years, repeat issuers and companies with strong fundamentals, especially those in sectors that stand to benefit from President Trump's stated policies, are likely to continue to have the best access to capital if volatility returns. More highly leveraged or distressed companies may need to seek alternative financing solutions and creative structures, as evidenced in recent years in the energy sector. In a positive sign for the IPO market, a healthy backlog continues to build, and investors have begun to rotate their portfolios back into equities, reversing a multiyear trend. So far, 2017 is off to

a strong start, with a number of companies having launched or priced their IPOs in the first month of the year. However, some private companies may continue to delay IPO plans in favor of private capital raises, particularly with the increased number of shareholders allowed before a company is required to become a Securities and Exchange Commission reporting company.

**M&A and Refinancing.** A more favorable M&A environment under President Trump could positively impact both the debt and equity capital markets. Many of President Trump's cabinet appointments have made careers in leveraged buyouts, which could further impact the M&A environment. The expectation is that a robust M&A market (see "[Mergers and Acquisitions: 2016 Update](#)") will drive significant acquisition financing. Similarly, at the beginning of 2017, issuers likely will continue to take advantage of the still relatively low interest rate environment to effect opportunistic financings or refinance existing near-term debt before interest rates rise.

**Fiscal Stimulus.** President Trump's policy statements, including the promise of a large infrastructure investment, are expected to stimulate the economy if they come to fruition. Fiscal stimulus, together with corporate tax cuts, could improve corporate profits and result in higher stock prices and a stronger equity market. However, more protectionist trade policies could have the opposite effect. In addition, policies that are favorable for the equity market often have the opposite impact on the bond market. Growth-oriented fiscal policies could increase the threat of inflation and result in a faster pace of Federal Reserve interest rate increases, which would negatively impact the bond market. (See "[Significant Changes Likely for US Trade Policy and Enforcement](#).")

**Corporate Tax Reform.** Corporate tax reform, if enacted, is expected to have a significant positive impact on the equity markets but could negatively affect the bond markets. (See "[Business Tax Reform All but Certain in US, Europe](#).") An inability to deduct interest on bonds or a reduced corporate income tax that makes deductibility less valuable could make bonds, particularly high-yield bonds, less attractive. However, an ability to expense capital investments could benefit the bond market if companies issue debt to finance these investments. Similarly, if repatriation of corporate cash held abroad is facilitated with a lower tax rate, companies that benefit — including investment-grade technology and pharmaceutical companies — may need to raise less cash in the bond markets for share buybacks, dividend recaps, M&A and other purposes. Yet share buybacks and M&A activity, combined with higher capital spending and additional hiring that likely will occur with repatriation, are bullish indicators for the equity markets.

**Financial Deregulation.** The possible repeal of the Volcker Rule and the loosening of other Dodd-Frank Act regulatory standards could strengthen the bond market, particularly the high-yield

market, by allowing banks to once again provide trading liquidity for high-yield bonds and underwrite bonds for more highly leveraged issuers. (See “[The Trump Impact: Key Issues in Financial Services Reform for 2017.](#)”) Deregulation also could positively impact the equity markets, particularly financial stocks, and encourage additional issuances.

**Equity Backlog.** Following consecutive years of below-average issuance levels (by volume), a significant pent-up backlog exists across industry verticals. Conditions look ripe for issuance activity to pick up in 2017, fueled in large part by a recent recovery in corporate earnings, improved performance of the 2016 IPO class as compared to 2015 and an investor base that is underweight in its equity investment allocations by historical standards. The IPO of Snapchat’s parent, Snap Inc., is expected as early as March with a valuation in excess of \$20 billion according to some sources. While the overall IPO market may be less focused on these so-called unicorns, the technology sector is poised for at

least a modest recovery, and successful IPOs in the early part of 2017 could lead to greater offering activity during the year. In addition, the financial, energy and industrial sectors are expected to see significant upticks in equity issuances given prevailing pro-growth, anti-regulation and protectionist themes, combined with a recovery in oil prices and rising interest rates. These trends clearly favor domestic issuers, whereas foreign issuers or those with significant overseas exposure likely will be viewed more skeptically by investors, given geopolitical uncertainty, a strong dollar and fears around global trade. Overall optimism surrounding the equity markets is balanced between IPO and follow-on activity. One of the big unknowns, however, is the way in which the sponsor backlog will play out, with private equity shops largely pursuing dual-track processes. But with a target-saturated environment in many verticals and a sense that the bull run is in or nearing its final phase, the bias may be toward near-term IPO exits.

### Strength Across Sectors in Equity Markets

Based on views of equity capital markets and syndicate bankers across Wall Street, the prevailing expectation is that most sectors should be active in the equity markets in 2017.

**Technology.** There is a consistent sense on Wall Street that technology companies will help lead the charge in the recovery of the IPO market. Smaller-scale, high-growth companies with high revenue visibility, such as software companies, are likely to form the initial wave, though significant pent-up supply of internet and e-commerce companies exists, which could generate larger deals. Snapchat’s plans to launch an IPO as early as the first quarter of 2017 may be the catalyst the tech market needs.

**Health Care.** While uncertainty around the fate of the Affordable Care Act may be disruptive to certain subsectors such as hospitals and services, a healthy rebound in life sciences issuance is expected. There are a significant number of biotechnology and pharmaceutical companies in the near- and medium-term pipeline, and already there have been a number of launches and public filings, including five IPOs and eight follow-ons launched as of January 27, 2017, on the back of a historically well-attended health care conference for investors and pharmaceutical executives.

**Industrials.** Industrials have rallied significantly on the prospects of increased infrastructure spending and protectionist trade policies. A number of capital markets professionals expect

this to lead to significant equity issuance as well as debt refinancing activity. Pitch activity has been robust in recent months, and a few near-term public filings and launches are expected. Much of the supply remains sponsor-backed, with a number of longer-held positions ripe for exit. Companies in the building products and materials space could be particularly active, as could issuers tied to the steel market.

**Energy.** The trend toward consolidation, particularly in the exploration and production (E&P) space, is projected to continue, as players maintain their focus around the Permian Basin in Texas and New Mexico. That likely will drive a significant need for acquisition financing. However, many targets believe that oil price stability and a positive outlook for the industry will finally thaw the IPO market, and they have begun to engage in discussions with banks. A clearing of the E&P backlog would pave the way for issuances in the midstream space, where many master limited partnerships (MLPs) have been delaying capital spending as they wait for the equity markets to reopen.

**Financial Institutions.** The promise of decreased regulation, rising interest rates and a steepening yield curve have improved the outlook for the sector, resulting in expectations that significant post-election follow-on activity will continue and the market will see a reinvigorated IPO pipeline (including many IPOs that have been on hold for long periods). Banks are likely to be among the most active issuers, both in the IPO and follow-on markets, though there

are a handful of insurers and reinsurers in the pipeline. In the specialty finance and business development company (BDC) space, many issuers are starting to trade back at or above book value. If that trend holds, there is likely to be a decent number of new issuances.

**Consumer.** The near-term IPO pipeline of sponsor-backed companies is relatively moderate, as much of the supply in this sector has been brought public in the last couple of years. However, there remain concentrated positions in a number of these companies, and sponsors may look to monetize those holdings aggressively if the market remains open. In addition, a number of nonsponsor-owned, high-growth retail names are starting to engage in IPO discussions. Investors currently seem to favor hard goods retailers, particularly those with a strong e-commerce platform, and the food and beverage sector is expected to remain strong.

**Real Estate.** Real estate investment trusts (REITs) struggled in 2016, underperforming the S&P 500 and suffering from elevated trading volatility as investors have rotated out of the space. The recent interest rate hike and the promise of more have not helped. However, certain areas such as hotels and residential- and consumer-driven sectors have the potential to outperform the broader sector, leading to potential equity issuances. Overall, the IPO pipeline is moderate, with a couple of large potential debuts expected and a number of midsized hotel and multifamily operators that may choose to test the market.

# Trump's Focus on Deregulation Could Shape SEC Priorities in 2017

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In his statement announcing the appointment of Jay Clayton to run the Securities and Exchange Commission (SEC), President Donald Trump said that “we need to undo many regulations which have stifled investment in American businesses, and restore oversight of the financial industry in a way that does not harm American workers.” Taken together, President Trump’s emphasis on deregulation, his statement in connection with Clayton’s appointment and Clayton’s professional experiences indicate a clear intention to shift the SEC’s agenda in terms of both regulation and enforcement priorities.

Leadership changes throughout the SEC will position the agency to implement these changes this year. In addition to selecting Clayton to replace Mary Jo White, who stepped down as SEC chair on January 20, 2017, President Trump is expected to nominate two additional commissioners whose seats were left vacant in 2016. Assuming confirmation, Clayton also will have a number of division directors and other key SEC leadership positions to fill.

## Regulation Reform

The Dodd-Frank Act most likely will not survive 2017 intact. Many of the act’s provisions have been the subject of debate and calls for repeal since their inception. In the fall of 2016, the House Financial Services Committee approved the Financial CHOICE Act, which provides a potential road map for the future of Dodd-Frank, specifically, and financial regulation, in general. (See [“The Trump Impact: Key Issues in Financial Services Reform for 2017.”](#)) The Financial CHOICE Act proposes significant changes to Dodd-Frank, including repeal of the Volcker Rule, the Department of Labor’s fiduciary duty rule and the CEO pay ratio rule. (See [“Trump’s Proposed Changes to Tax, Dodd-Frank, DOL Could Impact Executive Compensation.”](#))

If Congress does not repeal certain provisions of the Dodd-Frank Act outright, it may look to the SEC to revise those provisions, giving Clayton a say in how those rules are finalized. Clayton will inherit a number of other rulemaking matters that have been on the SEC’s agenda, including efforts resulting from congressional mandates to ease capital formation rules in the Jumpstart Our Business Startups Act (JOBS Act) and Fixing America’s Surface Transportation Act (FAST Act).

Among the matters that could be high on Clayton’s agenda is the drive to modernize and simplify SEC disclosure requirements. The SEC and its staff have long pursued the idea of a comprehensive re-evaluation of the mandated disclosure requirements for U.S. public companies. If the SEC decides to move forward with this undertaking, companies can expect to see significant changes to information they are required to disclose regarding their businesses and financial results. A number of redundant, overlapping and outdated SEC rules also likely would be eliminated. Such disclosure changes would not be universally welcomed; critics see these initiatives as anti-disclosure and seeking to curtail information available to investors. However, Clayton likely would see these initiatives as in line with the new administration’s general push toward less regulation.

Two rulemaking matters on which former Chair White focused in 2016 — universal proxy cards and board diversity disclosures — are less likely to remain on the SEC’s agenda this year. In October 2016, the SEC proposed amendments to its proxy rules that would require the use of universal proxy cards in contested board of director elections. If adopted, the proposed changes would allow shareholders to choose from among all board candidates regardless of who nominated them, rather than voting for a particular slate of candidates as is the current practice. These proposals received a fairly negative reaction from a number of key market participants, including the U.S. Chamber of

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Commerce. Considering that Republican Michael S. Piwowar, who was named acting chairman of the SEC on January 23, 2017, voted against the proposal, it is unlikely that the SEC will move to finalize these rules. Likewise, former Chair White's drive to amend the SEC's rules to increase the required disclosures regarding the diversity of board members and nominees likely will end with her departure.

### **Enforcement Priorities**

During the Obama administration, a key focus of the SEC's enforcement efforts was high-profile matters against major financial institutions stemming from the 2008 financial crisis. In part, there was a perception that these aggressive cases were in response to the public outcry that the SEC's enforcement laxity contributed to the financial crisis. These cases were often pursued using the SEC's administrative proceeding process. Many market participants questioned the fairness and impartial-

ity of the SEC's use of that process in pursuing these cases and whether the basis for the focus on financial institutions was the underlying facts or a desire to punish them.

Under new leadership, the SEC may return its enforcement attention to traditional securities violations such as insider trading, and accounting and financial fraud. It also may focus its enforcement efforts on individual violators as opposed to high-profile companies. The use of the SEC's administrative proceeding process, which has attracted strong criticism, will likely change. Finally, the SEC staff's process for considering and granting waivers to the automatic disqualification provisions of a number of the SEC rules that are triggered by certain enforcement matters, such as the WKSJ status and the Regulation D "bad actor" provisions, may revert to the traditional approach followed prior to the recent highly public and unprecedented commission debate on these matters.

# Trump Infrastructure Plan May Open Opportunities for Projects

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After nearly two decades of widening concern over the declining state of U.S. infrastructure, it was not surprising that infrastructure became a central theme in the 2016 election cycle. Improving our nation's transportation, water and energy infrastructure was one of the few issues to garner strong bipartisan support in the campaign, and President Donald Trump's infrastructure platform was notable in two key ways. First, it focused heavily on private investment, which President Trump sees as a key funding source for domestic infrastructure projects, and second, it set an ambitious target — \$1 trillion of new infrastructure investment. If the Trump administration realizes its infrastructure-related objectives in any significant way, there should be a wave of new opportunities for capital providers, contractors and private developers in the infrastructure sector.

## Navarro-Ross Tax Credit Proposal

During the campaign, the centerpiece of the administration's infrastructure plan was an aggressive use of tax credits to attract private investment. The most detailed proposal in this area was set forth prior to the election in a white paper authored by Peter Navarro, a business professor at the University of California, Irvine, whom President Trump selected to chair the White House National Trade Council, and Wilbur Ross Jr., a noted private equity investor and President Trump's nominee for secretary of Commerce. The Navarro-Ross plan calls for enacting federal legislation to establish an investment tax credit (ITC) for U.S. infrastructure projects sized at 82 percent of the invested equity. According to the Navarro-Ross analysis, President Trump's proposed \$1 trillion infrastructure plan would require \$167 billion in equity, which would give rise to approximately \$137 billion in tax credits. The plan calls for the tax credits to be offset by increased tax revenues from project construction activities — specifically, through taxes on additional wage income and contractor profits — resulting in revenue neutrality for the federal government.

The Navarro-Ross tax credit proposal has been met with some skepticism as to its viability. Deficit hawks in Congress, many of them Republican, are not convinced that the plan is revenue-neutral. Industry analysts have expressed concern that many of the currently active investors in the infrastructure sector (*e.g.*, pension funds) are tax-exempt entities and would be unable to utilize the credits. Moreover, if Congress lowers corporate tax rates, it is unclear whether there will be sufficient tax capacity to absorb the full amount of the available investment tax credits. Perhaps in response to these critiques, infrastructure advisers to President Trump suggested in the days following his inauguration that the administration's infrastructure proposal may be cut nearly in half, to \$550 billion.

There also is a more fundamental question: Are there a sufficient number of infrastructure projects that can benefit from the Navarro-Ross proposal? The ITC-based model, like other nonrecourse project financing structures, relies on an underlying project that generates a stream of revenue sufficient to service the project debt and provide the private investor with a return of and on its capital (supplemented by the benefits it receives from the tax credit). Widespread realization of the Navarro-Ross plan likely would require a significant increase in the use of public-private partnerships (P3s) — or analogous development and procurement models — in the infrastructure sector. While variations on the model exist, P3 transactions typically involve a private investor being granted the right, and undertaking the obligation, to design, build, finance, operate and maintain a public infrastructure project pursuant to a long-term concession arrangement. In return, the private investor receives demand-based revenues (*e.g.*, tolls) or, in some cases, an availability payment from the public authority for performance (regardless of demand). Approximately three dozen significant P3s have been financed in the U.S. over the last 30 years, including surface transportation, public utility and social infrastructure

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projects. Major recent P3 projects include the \$4 billion rebuild of the central terminal at LaGuardia Airport in New York City, the \$3.4 billion Vista Ridge water pipeline project in Texas and the recently announced commercial closing for the \$2.3 billion managed toll lanes project on Interstate 66 in northern Virginia.

However, P3 transactions require complex and lengthy planning and structuring efforts and, in many cases, a major shift both in strategic thinking by public sector agencies (which have developed projects without private involvement, for example, via tax-exempt bond financings) and in public sentiment regarding the delivery of essential services (where, as an example, members of the public face new or increased charges that accrue to a private investor). Consequently, P3 projects undergo several years of planning and permitting before the investment community is invited to submit qualifications and proposals. Without significant changes in the way P3 projects are structured and financed, only a handful of well-structured and “shovel ready” P3 projects may reach financial close in any given year. While new federal incentives may spur greater private sector interest in infrastructure, the use and success of P3s ultimately depends on projects that produce predictable revenue streams over the long term. Given the scale and complexity of these projects, implementing P3 procurement models on a large scale nationwide will take time.

### **Federal Credit Programs in the Trump Era**

Infrastructure investors in the U.S. will need to monitor how the specific policies and legislative agenda advances in the coming months support or sideline federal credit programs that provide low-interest-rate financing to infrastructure projects, including P3s. Oversight of the primary credit programs has been consolidated under the Build America Bureau, which was established within the Department of Transportation in 2016 to provide a one-stop shop for federal financing for P3s and other significant transportation projects. The bureau’s mandate is to streamline approvals of loans under two credit programs that provide long-term, low-interest-rate loans to surface transportation and rail projects, respectively, and to administer the private activity bond program, through which tax-exempt financing is made available to support P3s. The bureau also will manage the \$800 million Fostering Advancements in Shipping and Transportation for the Long-Term Achievement of National Efficiencies (FASTLANE) grant program, established in December 2015 pursuant to the Fixing America’s Surface Transportation (FAST) Act.

Investors also should be aware of new opportunities in the U.S. water infrastructure sector. The Water Infrastructure Finance and Innovation Act of 2014 (WIFIA) established a federal credit program administered by the Environmental Protection Agency for eligible water and wastewater infrastructure projects. WIFIA

was further amended by the Water Infrastructure Improvements for the Nation Act of 2016, which included \$20 million in budget authority (\$17 million of which is available for loans and other credit support) to allow the WIFIA program to commence lending operations. This amount, which has been appropriated to the program, represents a credit subsidy cost, similar to a loan loss reserve. The actual credit assistance capacity of the program is expected to exceed \$1 billion in credit facilities, with loans for private and public sector borrowers, supporting up to 49 percent of eligible project costs for water infrastructure projects.

### **Democrats’ ‘Blueprint to Rebuild America’s Infrastructure’**

Democrats in Congress, who are advocating for increased public sector spending, have responded to President Trump’s plan with their own competing infrastructure proposal. On January 24, 2017, Senate Minority Leader Chuck Schumer, D-N.Y., and several Senate Democratic colleagues released “A Blueprint to Rebuild America’s Infrastructure,” which matches President Trump’s vision of a \$1 trillion investment in U.S. infrastructure over a 10-year period. Unlike President Trump’s plan, funding under the Democrats’ proposal would come entirely from taxpayer dollars at the federal level. The proposal would expand the use of popular federal grant and loan programs, such as Transportation Investment Generating Economic Recovery (TIGER) grants, the Transportation Infrastructure Finance and Innovation Act (TIFIA), Railroad Rehabilitation and Improvement Financing (RRIF) and WIFIA, and would lead to the creation of a national infrastructure bank to promote innovative infrastructure financing solutions. In this regard, the Democrats’ plan carries on several Obama administration initiatives that failed to garner approval from the Republican-controlled Congress. The plan also proposes to reform the current system of energy tax incentives by consolidating a number of targeted incentives for renewable and clean energy into broader categories and by making those tax incentives permanent (*i.e.*, not subject to phase-outs).

### **Conclusion**

It is still too early to gauge how the new administration’s infrastructure agenda will incorporate specific facets of any prior policy proposal, including the Navarro-Ross plan. Any infrastructure legislation actually passed by Congress will bear the imprint of significant bipartisan negotiations. However, we expect that President Trump and his advisers’ emphasis on private investment and more frequent use of P3s will significantly increase opportunities for private sector participants and spur financial innovation in the area of infrastructure project delivery.

# Mexican Energy Sector Restructuring: New Opportunities for Renewables

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The ongoing effort to restructure the power sector in Mexico, together with Mexico's strong policy on combating climate change, have created compelling opportunities for investors in renewable energy projects that likely will persist this year. As Mexico continues to transition its electricity sector from a vertically integrated, state-owned and -controlled structure to an unbundled one with private and public ownership, investors will be required to bear more market and investment risks than before. However, these risks are familiar to investors in other mature electricity markets and do not represent insurmountable obstacles to capitalizing on new Mexican renewable energy opportunities.

## Electricity Sector Restructuring

The "Secretaría de Energía," or Energy Ministry (SENER), is overseeing the restructuring of the electricity sector pursuant to the August 2014 "Ley de la Industria Eléctrica" (Electric Industry Law) and related legislation (Reform Legislation). The intention of the reform is to lower prices by shifting to a more competitive market and promoting renewable energy generation.

Prior to the Reform Legislation, the "Comisión Federal de Electricidad," or Federal Electricity Commission (CFE), was the state-owned enterprise responsible for operating the electricity sector. CFE controlled power purchasing, planning and transmission and was the primary generator that owned most of the total installed capacity and electricity production in the country. Opportunities existed for private entities to participate in generation but were mostly limited.

Under the new regime and for the near term, CFE continues as the primary retail supplier of electricity, but it has become a holding company with separate generation, transmission, distribution, supply and marketing subsidiaries that operate semi-independently. As a result, parties doing business with CFE must look to the specific credit profile and assets of the CFE entity with which they are contracting, and such parties can no longer rely on the asset and credit profile of the consolidated/integrated energy company. In addition, system operations have been transferred to the "Centro Nacional de Control de Energía," or National Energy Control Center (CENACE). This independent system operator (ISO) for the new wholesale power market plays a similar role to that performed by ISOs in the U.S., with responsibility for ensuring access to the grid, operating the system in a reliable manner and assuring availability of sufficient supplies to meet customer demand. This year, CENACE will introduce new market components, including the real-time wholesale market, the balancing capacity market and financial transmission rights. With these changes, the electricity sector will transition to a structure akin to markets such as the California ISO, which will be very familiar to independent power producers and financiers in the U.S. electricity market.

## Power Contract Auctions

The Mexican government made an aggressive commitment to renewable energy with the 2012 General Law on Climate Change, requiring 35 percent of electricity production to come from renewable sources by 2024. A key component of that commitment is power supply solicitations in which CENACE auctions long-term (15-year) power contracts with CFE to renewable energy generators.

Two auctions have been held to date. At the first, 11 winning bids were selected for wind and solar projects totaling 1,720 megawatts (MW) of generating capacity with an

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average bid price of US\$41.80 per megawatt-hour (MWh). The winning bids in the second auction represented 2,871 MW with an average bid price of US\$33.47 per MWh. Each auction received bids from approximately 60 to 70 local and international prospective suppliers. A third auction is planned for April 2017.

The CENACE auctions are governed by the “Bases de Licitación de la Subasta de Largo Plazo,” or Bid Rules for Long-Term Auction, which are published before each auction. Pursuant to these rules, bidders must provide a detailed construction schedule with specific milestones, including a fixed commercial operation date, certify their technical expertise and identify their contractor, among other details. The rules include a form of non-negotiable power purchase agreement (PPA) that winning bidders must execute with CFE. The new PPA contains terms that generally have been included in project financings in the U.S. and elsewhere but not some of the protections that benefited generators in previous power purchase agreements with CFE in Mexico.

### **New Terms of Agreement**

The new PPA between a CFE subsidiary and the generator has a 15-year term that runs from the fixed commercial operation date. However, the uncertainty around pricing in the new wholesale electricity market is hampering developers’ efforts to secure long-term financing extending into the period following expiration of the 15-year PPA. Under the PPA, the CFE counterparty makes payments in accordance with the actual amount of energy delivered each month and performs year-end reconciliations that aggregate the monthly amounts delivered to determine compliance with contracted quantities. Because ownership was a material consideration in securing the bid, there are some limitations on changes to generator ownership. However, CFE’s restructuring and the new regime present credit, curtailment, construction and operational risks that were mitigated under the old regime.

### **CFE Credit Risk**

Under the old regime, CFE’s obligations were guaranteed by the government. Given this guarantee and CFE’s formidable balance sheet, it enjoyed a favorable international credit rating that made the former PPA with CFE an attractive and bankable contract for investors and lenders alike. Under the new regime, while the government continues to own the CFE counterparty, it no longer guarantees the subsidiary’s obligations. In addition, the CFE counterparty’s balance sheet reflects the fact that it owns only a subset of the assets that its predecessor entity held, and it must be responsible for its respective share of long-term liabilities and obligations.

Anticipating concerns about credit, the Reform Legislation requires the CFE counterparty to post a guarantee equivalent to one year of its contractual obligations. It is unclear whether the

government would ultimately backstop CFE through an implied guarantee if the market assigns a high-risk premium to project financings under the new arrangements. Also, in the event that a CFE counterparty default causes generator termination, the CFE counterparty must fund the full amount of the contract into a trust in order to cover the difference between spot market and contract prices. However, the CFE counterparty’s contractual obligation does not eliminate the risk that the CFE counterparty may fail to comply with this funding obligation, either because it lacks the necessary financial resources or for other reasons.

The Reform Legislation contemplates further restructuring CFE, which could result in a CFE counterparty no longer being a subsidiary or affiliate of CFE. In that scenario, the CFE counterparty would be required to increase its posted guarantee, but the generator would still take the risk that the CFE counterparty might not post the requisite guarantee.

### **Curtailment Risk**

Generators also are subject to certain curtailment risks under the new PPA. To be accepted and remain active in the market, generators must acquire and maintain their status as a market participant, which includes executing a market participant agreement with CENACE. Both this agreement and the new PPA require that the generator abide by CENACE’s operational instructions. While the regulations governing CENACE indicate that dispatch decisions will be based on impartial criteria, the process for determining dispatch and curtailment priorities is not plainly defined, and it is unclear what factors might affect these decisions beyond reliability.

Under the new PPA, generators that are instructed not to deliver energy by CENACE are not compensated, and generators are allowed to terminate the agreement only after six months of curtailment. This change is a significant departure from the former PPA with CFE, where CFE generally was required to pay in the event of curtailment.

### **Construction and Operational Risks**

Similar to the curtailment risk, projects developed under the new PPA will be subject to other construction and operational risks. For construction, generators are responsible for strictly meeting the schedule set forth in the auction bid rules and annexed to the PPA. While certain extraordinary events, such as civil disturbance or the occurrence of a *force majeure*, allow for a schedule delay, project holdups due to other factors will result in the developer incurring penalties per milestone missed. Furthermore, the CFE counterparty can terminate the PPA if commercial operation is not reached within 12 months of the fixed commercial operation date.

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In addition, the PPA does not provide compensation in the event of project delays or other missed milestones resulting from government actions or inactions. For delays brought on by issues such as permitting or an inability to interconnect on time because of grid construction, the fixed commercial operation date may be delayed with no penalty to the generator; however, the generator is not compensated for the delay. The generator has the right to terminate the agreement after six months of delays due to government actions that affect the project schedule.

### **Conclusion**

The restructuring of the electricity sector and Mexico's commitment to renewable energy present investors with attractive, long-term opportunities in renewable energy projects. However, changes to the market structure and regime remove important investment protections afforded to project owners under the previous regime. Investors will need to undertake careful diligence of curtailment and other risks that might not have been a focus previously.



# Corporate Restructuring

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**16** Oil and Gas Industry Seeks Steady Ground Following  
Year of Restructurings, Restrictive Lending

# Oil and Gas Industry Seeks Steady Ground Following Year of Restructurings, Restrictive Lending

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Crude oil and natural gas prices reached multiyear lows of approximately \$26 per barrel for crude oil (as of January 2016) and \$1.50 per million British thermal units (mmbtu) for natural gas (as of March 2016). This represented a 75 percent decline in the price of oil from its peak of approximately \$105 per barrel in mid-2014 and an 80 percent decline in the price of natural gas from its early 2014 peak of over \$8 per mmbtu. At the time, many industry observers predicted that depressed commodity prices would result in numerous bankruptcy filings and an uptick in M&A activity.

Most oil and gas companies responded with heavy job and capital expense cuts. A slow but steady increase in prices during the past year — to over \$50 per barrel for oil and over \$3.50 per mmbtu for natural gas as of the end of 2016 — allowed many companies to avoid formal restructurings. However, the increase in oil prices arrived too late and was not enough for many others. Oilfield services companies and exploration and production (E&P) companies experienced more acute levels of distress — and accounted for the highest number of in-court restructurings in 2016.

Looking ahead, heavy debt loads among oil and gas companies are likely to slow the recovery of the industry as a whole, but if oil prices remain stable or increase, we expect far fewer restructurings this year. Opportunities for consolidation through acquisitions exist within the oil and gas space. Opportunistic buyers, including companies that recently have delevered through bankruptcy, may look to add attractive assets to their portfolios.

**Oilfield Services.** Beginning in mid-2014, oil prices began to fall sharply, decreasing 50 percent over the following six-month period and worsening in 2015. The prolonged, depressed oil prices meant that E&P companies reduced spending on oilfield services work, such as repairs and maintenance, putting pressure on oilfield services companies. When E&P companies did hire service companies, competitive pricing among the service providers added to that pressure. In 2016, 70 oilfield services companies filed for bankruptcy. Now that oil prices have risen, E&P companies are moving forward with deferred maintenance work, leading to higher demand for oilfield services companies and likely far fewer oilfield services bankruptcies this year.

**Upstream.** In response to declining oil prices, E&P companies substantially reduced their existing production operations and implemented severe cutbacks in capital spending. Moreover, because most companies use reserve-based loans (RBLs) to fund their drilling activities, they are subject to revaluation and redetermination of the value of their reserves twice annually — in the spring and fall (in addition to “wildcard” redeterminations under certain RBLs). The significant decline in prices, together with regulators’ concerns about bank lenders’ exposure to the oil and gas sector, constrained banks’ ability to work with their borrowers during the redetermination process. Consequently, the spring 2016 redeterminations resulted in many E&P companies experiencing significant decreases in their borrowing bases and credit lines as banks took a more conservative approach to their price decks. This led to banks further lowering the forward-pricing curves they use to determine the borrowing bases.

Banks took additional steps to limit their exposure to the oil and gas sector, or to provide greater certainty regarding the ability of their E&P borrowers to repay their loans. Specifically, many lenders amended their credit agreements to tighten some of the covenants to which their borrowers are subject. For example, a number of banks imposed minimum liquidity requirements, effectively limiting their exposure to certain companies without reducing those companies’ borrowing bases. Banks also added so-called anti-hoarding provisions in response to situations in which borrowers drew down the

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maximum amount available under their facilities and later filed for bankruptcy. The severe decline in oil prices reduced the value of many E&P companies' assets and constrained their liquidity, forcing a number of companies to restructure. In 2016, approximately 69 E&P companies filed for bankruptcy, though the trend appears to be tapering off, with fewer E&P companies declaring bankruptcy in the past several months of the year. For 2017, while we expect continued activity for offshore drillers, the tapering should otherwise continue for E&P bankruptcies.

**Midstream and Downstream.** Many oil and gas companies are fully integrated (either directly or through their subsidiaries and affiliates) in E&P, midstream and downstream activities. However, in the last several years, some companies spun off their midstream and downstream businesses to focus solely on E&P, believing that establishing their midstream and downstream businesses as separate entities would enhance focus on the objectives of those businesses and their capital needs, with greater value for shareholders.

Midstream and downstream companies are involved in the gathering, transporting, processing, marketing or storing of oil or natural gas. (Downstream is sometimes defined to refer only to the sale and distribution of oil and gas and their by-products, with the refining, storing and transportation activities defined as midstream.) Produced oil and natural gas are transported to the end user through an extensive network of pipelines and gathering systems. New pipelines are constructed continually in high-growth regions, which is time-consuming and capital-intensive but integral to oil and natural gas production because hydrocarbons are difficult and expensive to transport by vehicle or vessel. The availability of adequate pipeline infrastructure and the cost to transport such crude oil and natural gas directly impact the profitability of any given crude oil and natural gas property. Accordingly, upstream E&P companies are dependent on seamless interaction with hydrocarbon gatherers, transporters and processors — participants in the midstream sector of the oil and gas industry — to maintain both profitable and environmentally compliant operations.

To date, the midstream sector has not suffered the same level of financial distress experienced by E&P or oilfield service companies. Midstream companies typically charge fees to use their pipelines and equipment (rather than drilling wells and operating rigs to produce oil and gas), and therefore are typically more

insulated from commodity price cycles than E&P companies. In 2016, 12 midstream companies filed for Chapter 11 bankruptcy. Similarly, downstream companies did not experience nearly the level of distress as oilfield services and E&P companies, with only a handful of nonintegrated downstream companies filing for bankruptcy last year.

The midstream segment of the oil and gas industry seems likely to benefit from the Trump administration's change of course on the development of the Keystone XL and Dakota Access pipelines, as well as the administration's potential change of course on other major pipeline projects, providing opportunities for midstream oil and gas companies. If midstream infrastructures are improved, that should enhance economics for upstream operators as well — in particular, fully integrated oil and gas companies.

**Factors to Consider in 2017.** In November 2016, in an attempt to reduce record global oil inventories, the Organization of the Petroleum Exporting Countries (OPEC) agreed to its first production cuts in eight years. The agreement was broader than expected, extending beyond OPEC to include Russia and other non-OPEC countries. While the strength of the deal will depend on whether all parties deliver on their commitments, it seems unlikely oil prices will return to the \$30-per-barrel levels seen in early 2016.

If the Trump administration opens more federal lands to drilling activities, which would be consistent with its emphasis on expanding U.S. oil and gas production, that could counterbalance OPEC's decision to cut production and may act as a downward pressure on oil and gas prices.

With higher energy prices, the need for financial restructuring decreases. Looking ahead, we see the need for additional restructurings in the oil and gas space even at current price levels, particularly for E&P offshore drillers who continue to experience insufficient demand for offshore rigs given the continued oversupply of oil. Even with fewer restructurings, we expect a significant amount of post-reorganization M&A activity, as credit-oriented hedge funds that now own equity of reorganized E&P companies look to monetize their investments and take advantage of increased oil prices.



# M&A / Governance

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# Mergers and Acquisitions: 2016 Update

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Global mergers and acquisitions volume in 2016 declined from the record levels set in 2015, but activity was nonetheless strong by historical standards. Value of global deals was approximately \$3.7 trillion, an annual total behind only 2015 and 2007, according to Thomson Reuters. The value of U.S. transactions was approximately \$1.7 trillion. Despite unexpected political and economic developments, M&A activity in 2016 reflected many of the trends of 2015.

## Market Drivers

Mergers and acquisitions volume in 2016 again was dominated by strategic activity driven by fundamental forces — the need to grow revenues and earnings in a low-growth environment and to be competitively positioned in the global marketplace. Given these conditions, M&A has provided corporations a means to grow revenues faster than would be possible organically, and synergies resulting from transactions have provided opportunities to expand margins and drive more rapid earnings growth. Deal activity also has allowed strategic players to enhance geographic or portfolio footprints, or to position themselves as industry disruptors through the acquisition of new technologies.

These fundamental imperatives driving corporations' rationale for pursuing mergers and acquisitions were coupled with a continued benign environment conducive to M&A, particularly in the United States. Favorable factors included stable equity markets, strong corporate balance sheets and the availability of acquisition financing at historically attractive rates. Importantly, C-suite and boardroom confidence about long-term opportunities continued, supporting deal initiatives. Additionally, shareholder support for deals in 2015, while not universal, in large part continued in 2016.

One noteworthy development was an increase in inbound U.S. M&A activity to record levels. The United States consistently has been an attractive destination for M&A due to factors including large market size, a growing (albeit slow-growth) economy, relatively stable capital markets and the rule of law. With actual or potential economic dislocations and political uncertainties threatening many of the world's markets, it is no surprise that the U.S. continued to attract foreign investment in 2016. Inbound deal volume surpassed \$500 billion, with significant transactional activity coming from Canada, China and the United Kingdom. Notably, Chinese outbound activity was at record levels — \$221 billion, according to Thomson Reuters. While robust asset prices, a strong dollar, the potential impact of changes in Chinese policies affecting outbound transactions from China and concerns regarding the potential for growing economic nationalism may act as headwinds tempering this trend, significant cross-border deal flows into the U.S. appear likely to continue. (See "[Regional Focus: Asia](#).”)

## Unsolicited Activity

Hostile and unsolicited mergers and acquisitions continued to play a small but important role in the M&A market. In 2016, unsolicited transactions accounted for nearly \$400 billion in global deal value.

The varied fates of unsolicited proposals in 2016 again demonstrated the uncertainty of outcomes in hostile activity. As in prior years, while hostile offerors in some situations successfully consummated transactions, success was by no means universal. In other cases, targets of unsolicited proposals ultimately were sold, but to a party other than the original offeror. As in 2015, there also were several examples of target companies successfully defending against unsolicited proposals without an alternative transaction.

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One notable example was the withdrawal by Canadian Pacific Railway of its unsolicited offer for Norfolk Southern Corp. after Norfolk Southern determined that the value generated under its own strategic plan was superior to that in Canadian Pacific's offer and that the proposed transaction was highly unlikely to receive regulatory approval.

For a corporation driven by the fundamental imperatives discussed above, a hostile offer is sometimes the only path to pursue a strategically critical transaction. While commencing a hostile public offer is generally not a would-be acquirer's preference given the cost and uncertainty of the outcome, the elimination of most target takeover defenses as a result of ongoing campaigns to implement governance "best practices" and the evolution of many companies' shareholder bases make unsolicited activity an alternative in appropriate situations.

### **Abandoned Transactions**

A number of large proposed transactions were withdrawn in 2016 after announcement, with estimates indicating that these abandoned deals represented over \$800 billion globally, almost one-fifth the dollar value of transactions announced during that period of time. This statistic reflects transactions abandoned for a number of reasons, and at various stages, such as announced unsolicited offers that never progressed and deals that were signed but ultimately terminated as a result of shareholder dissatisfaction, emergence of a topping bid or regulatory issues.

Several large pharmaceuticals transactions were terminated following administration changes to tax regulations to halt so-called "inversion" transactions in which a U.S. company would be acquired by a smaller foreign company, effectively moving the home tax jurisdiction of the publicly traded parent outside the United States. A continuation of the trend of aggressive antitrust enforcement at the Department of Justice and the Federal Trade Commission — reflecting increased willingness on the part of the government to litigate rather than accept proposed settlements in transactions that raise substantive antitrust issues — led to several large transactions being abandoned. It is unclear how regulatory policy may change under a new administration in the U.S. and how that will impact deals this year. (See "[Antitrust Enforcement in the Trump Administration](#).")

### **Impact of Activism on M&A Activity**

Despite some signs that hedge fund activism may have hit its high-water mark, including commentary from passive investors

and other long-term institutional holders seeking to encourage long-term decision-making by corporate management, shareholder activists have continued to have a meaningful impact in the M&A market. (See "[Directors Must Navigate Challenges of Shareholder-Centric Paradigm](#).")

In an environment supportive of mergers and acquisitions activity, and with both strategic and private equity buyers seeking targets, "sell the company" or "sell a business" platforms can be attractive to activist investors and other active managers looking for short-term returns. Activist campaigns have preceded sales at a number of companies this year. In other cases, activists have sought to block or renegotiate transactions. Appraisal litigation is another area where hedge funds have sought to use M&A transactions to harvest additional returns. (See "[Key Developments in Delaware Corporation Law in 2016](#).")

Activism is not going away, and market participants accordingly need to continue to factor in the potential for activist intervention and how best to respond.

### **Potential Impact of Administration Change on US M&A Activity**

Equity markets to date have reacted favorably to the outcome of the presidential election and the resultant prospect of changes to fiscal and regulatory policies. The makeup of the Trump administration continues to take shape, and perspectives on likely administration policies continue to develop, making speculation regarding the new administration's impact on M&A activity just that — speculation. In the shorter term, uncertainty as to policy could impact the pace of deal activity. However, signals as to potential policy direction indicate areas of likely change that could result in meaningful, and generally favorable, impact on the M&A environment, such as adoption of a more business-friendly approach to regulation, increased competitiveness of the [U.S. corporate tax regime](#) and adoption of incentives to repatriate corporate cash held offshore. The impact of possible changes to fiscal policy, [trade policy](#) and [national security review](#) are more difficult to predict and could lead to positive or negative effects on the deal environment.

Given the significance of some potential changes and the active dialogue of the administration with the corporate community, boards and executives considering extraordinary transactions should carefully consider the possible impact of administration policy.

# Regional Focus: Europe

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## UNITED KINGDOM

### M&A Update

M&A activity in the U.K. was, under the circumstances, relatively robust in 2016, albeit not as strong as in 2015. Deal volume was down, in large part due to political uncertainty surrounding the June 2016 Brexit vote and the November U.S. election. Although this uncertainty was partially offset by the devaluation of the pound following the Brexit referendum, which made U.K. assets relatively cheaper, and while strong inbound interest from both the U.S. and Asia remains, the overall value of U.K. M&A activity relied on a smaller number of relatively high-value deals, such as the London Stock Exchange Group/Deutsche Börse merger and SoftBank's acquisition of ARM Holdings.

For 2017, insofar as domestic activity is concerned, uncertainty as to the structure and timetable for Brexit is expected to exert downward pressure, although the continued availability of debt and (if the markets stay strong) equity financing should offset that to some extent.

From a cross-border perspective, the corrections in the values of the pound and, to a lesser extent, the euro have reduced the apparent cost of European assets for non-European acquirers. This should result in a continued increase in inbound interest, though that interest has not yet translated into significant deal volumes in the U.K. This may in part be because, although in the short term the reduction in value of the pound has lowered the cost of investment in the U.K. for international acquirers and increased the value of exports, the macroeconomic consequences may be unclear for a while. Markets have responded to the decline in the pound with a material rise in market capitalization of U.K.-listed companies that have international exposure. Additionally, imports are commensurately more expensive, and the future levels of tariffs are unknown. Finally, uncertainty surrounding the U.K.'s ability to strike favorable trade deals with other non-EU countries remains.

Other macro factors will likely have a greater specific impact on individual industries. For example, regulatory and financial pressures on the financial services sector, in particular on mixed financial businesses, are likely to lead to pressure for disaggregation, while the settlement of long-running disputes may make some assets more sellable. In the insurance industry, specifically, market fundamentals that have underpinned activity in the sector remain in place. Meanwhile, Solvency II, which regulators intended to reduce regulatory risk by harmonizing capital requirements, has been in place for more than a year, and the impact of the changes to regulatory requirements on potential targets is becoming clearer, as most insurers have reported information showing the effect on their capital positions. Thus, there is greater clarity for companies in buying mode and diversified groups in determining where their capital can be most effectively deployed. This is likely to lead to realignment and consequential transactional activity on both the buy and sell sides this year. Many who have carried out significant analysis and planning in connection with potential deals now appear to be moving toward a position where they consider the consequences of Brexit manageable.

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The broad shape of Brexit is starting to become clearer. Prime Minister Theresa May provided clarity as to the U.K. government's intentions in a speech on January 17, 2017. (See our January 20, 2017, client alert "[UK Prime Minister Outlines Objectives for Exiting the EU](#).") We now know the U.K. government will have to leave the single European market. Additionally, in order to negotiate its own trade deals, the U.K. also will have to leave, either wholly or substantially, the customs union. The U.K. government intends to negotiate a trade deal with the EU and incorporate arrangements beneficial to specific sectors, such as retaining some version of existing "passporting" rights for financial services institutions, with automotive manufacturing also likely to be a hot topic. While the U.K.'s starting point is coming into focus, however, there is little concrete information on what to expect at a granular level and what both the U.K. and the EU would consider acceptable. Companies across sectors should expect continuing uncertainty while the overall position becomes clearer.

President Donald Trump said the U.S. would work to complete a new trade deal with the U.K. quickly once he assumed office, a suggestion that is being cautiously welcomed — provided the outcome isn't shaped by the more aggressively protectionist positioning that President Trump has at times adopted. The evolution of this and other trade deals and what, precisely, Prime Minister May's vision of a "global Britain" means will likely be dominant factors this year.

### **Cooperation With Other Nations, Use of DPAs May Drive Investigation Increase**

When the U.K.'s Bribery Act came into effect in July 2011, many expected U.S.-style Foreign Corrupt Practices Act enforcement to become more prevalent in Britain. And while the Serious Fraud Office (SFO) has brought only four actions against corporations since the Bribery Act's enactment, there are indications that investigations are on the rise. One reason for the low number of investigations so far is that the Bribery Act does not apply to conduct before July 2011. From detection through investigation to enforcement, bribery proceedings can take several years, making it likely that we will see a significant number of cases in the future.

A higher volume of whistleblower activity due to such developments as enhanced whistleblower protections, an increased awareness and acceptance of "speaking up," and significant journalistic coverage of high-profile investigations like the Panama Papers also could drive an increase in enforcement activity. Additionally, increased cooperation with other national regulators, both formal and informal, has improved the speed and

effectiveness with which prosecutors are able to obtain evidence of corporate misconduct from abroad, including through coordinated searches in multiple jurisdictions.

While the SFO has long worked closely with the U.S. Department of Justice, it now also collaborates with a growing number of other regulators in cross-border investigations. For example, the Alstom case involved cooperation between prosecutors in the U.K., Switzerland and Hungary. In September 2014, the SFO brought corruption and conspiracy charges against Alstom Network UK Ltd relating to transport projects in India, Poland and Tunisia. Two company executives also were charged with the same offenses. In December 2014, the SFO brought further charges — under the Prevention of Corruption Act 1906 and the Criminal Law Act 1977 — against Alstom Power Ltd and two executives for offenses committed between 2002 and 2010 related to the refurbishment of the Lithuanian Power Plant.

The U.K. also has made significant changes to its criminal justice system to try to increase its prosecutions of corporations for serious crimes. These changes include clarifying sentencing guidelines for corporate corruption and introducing deferred prosecution agreements (DPAs). DPAs, which are common in the U.S., encourage companies to cooperate with the government in cases involving economic and financial offenses. If a company's conduct meets defined criteria and it agrees to certain conditions, including the payment of financial penalties, a company may elect to use a DPA to avoid prosecution. In contrast to the U.S., the entire DPA process is subject to judicial oversight and approval, which provides greater insight into the decision-making of the judges and the prosecution, as well as a transparency around the factors that will be taken into account. In the Rolls Royce DPA announced in mid-January 2017, the judge went to great lengths to explain the company's "extraordinary cooperation," even though other aggravating features of its conduct tended to support a prosecution.

## **FRANCE**

### **M&A: Domestic Activity Up, Cross-Border Down in 2016**

The French M&A market experienced an 8.1 percent increase in deal value in 2016 (compared to 2015), reaching €76.2 billion on 869 deals, 75 more than 2015, according to Mergermarket. The most active sectors in 2016 were financial services; pharmaceutical, medical and biotechnology; energy, mining and utilities; industrial and chemicals; and real estate. However, such statistics are impacted by the €18.5 billion Crédit Agricole/Sacam transaction (a transfer of a minority interest in the regional banks to Crédit Agricole's parent company) — without it, deal value decreased by 18 percent compared to the previous year.

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Domestic M&A accounted for the highest deal volume (€41.9 billion, up 102.1 percent), while inbound M&A experienced a 31 percent decrease at €34.3 billion, a third of which was the €11.4 billion exchange of assets between France-based Sanofi and Boehringer Ingelheim of Germany. Chinese buyers continue to show interest in inbound M&A, especially in the hospitality business, with deals such as Jin Jiang's acquisition of the Louvre Hotels Group and of a significant interest in hotel group Accor.

Outbound M&A by French companies reached €43.7 billion in 2016, a 1.2 percent decrease compared to 2015. Transactions included the acquisition of U.S.-based WhiteWave by Danone (€11.3 billion), the merger between Technip and U.S.-based FMC Technologies (€4 billion), the acquisition by Accor of Canada-based Fairmont Raffles Hotels International (\$2.7 billion) and the recently announced acquisition by car equipment manufacturer Valeo of the Japanese company Ichikoh. Low interest rates and easy access to funding could spur French companies in search of growth to pursue outbound opportunities in 2017, especially in the telecommunications, media and technology sectors.

Private equity continues to represent a significant portion of the market, with private equity buyout and exit transactions involving French companies totaling €25.2 billion. In some instances, private equity and private equity-led companies have competed head to head with corporates for significant businesses, as in aircraft engineering company Safran's auction of Morpho, a biometric identification business. Advent International-sponsored Oberthur eventually won the auction over Gemalto; both are digital security companies.

### **Implications of French Elections in 2017**

Historically, election years have not been good for M&A in France, which will hold presidential elections in May and parliamentary elections in June, as people tend to wait for the policies of the new administration to become clear before making business decisions. Transactions involving companies where the French state has a significant interest are likely to be the most affected. Material transactions in strategic sectors, for example those in which the foreign investment control regime applies, may be perceived as more difficult.

Several presidential candidates, such as conservative and pro-business François Fillon (the right-wing candidate) or social-liberal Emmanuel Macron (the center candidate), propose to liberalize the French labor market as well as reduce taxation on companies and individuals. Fillon has indicated that he would promote France's disposal of government-owned equity interests that are perceived as nonstrategic. This may prompt companies in which such interests are held to pursue strategic partnerships as a way to secure a stable shareholder base, thus spurring M&A activity.

With the parliamentary elections, it is possible that the new legislature could simplify the M&A process in France, which remains unnecessarily burdensome in certain aspects. For example, cross-border deals involving a French company require a time-consuming tax-ruling process, the legality of which is currently being challenged under European Union law.

### **France Looks to Attract Business After Brexit**

Brexit has had minimal impact on French transactions, including those with a U.K. component. For example, the Technip/FMC Technologies merger, which was announced prior to the Brexit vote, was completed on January 16, 2017. It combined the French- and U.S.-based companies into a new U.K. entity, with completion pursuant to the original structure unaffected by the Brexit vote. Likewise, Nissan, which has a strategic alliance and shares its CEO with French company Renault, has confirmed its plan to manufacture its successful Qashqai SUV in the U.K. as long as the U.K. government gives certain assurances. In the financial sector, French banks have confirmed they have no plans to materially reduce their presence in the U.K.

On the other hand, France is keen on attracting businesses currently located in the U.K., as well as foreign investors already in the U.K. or considering investments there. The current French government has plans to reduce its corporate tax rate progressively to 28 percent and to extend the tax favorable "impatriation" regime, which provides benefits to non-French employees relocated in the country, from five to eight years. France also has favorable tax breaks for research and development ("crédit d'impôt recherche"), which it is trying to promote to attract research programs.

Additionally, France hopes to attract more business from financial institutions that do business across Europe from London and it is advocating in the EU for the relocation of the euro-settlement of transactions in the eurozone.

### **Enforcement and Regulatory Developments**

France has adopted a new anti-corruption law, "Sapin II," which was inspired by the U.S. Foreign Corrupt Practices Act and the U.K. Bribery Act, and which has extraterritorial implications. It requires that large French companies, including their foreign subsidiaries, implement a compliance program; and it allows for the prosecution of acts of corruption committed abroad by French nationals or by persons who ordinarily reside in France or carry out all or part of their economic activity in France. In addition, Sapin II has created a new French anti-corruption authority ("Agence française anti-corruption") that is responsible for monitoring compliance programs and ensuring that French companies subject to foreign investigations comply with the

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French blocking statute (“loi de blocage”), which may block discovery requests from foreign authorities. With regard to sanctions for acts of corruption, the law has created a settlement agreement procedure (“convention judiciaire d’intérêt public”) similar to the deferred prosecution agreement used in the U.S.

French authorities responsible for controlling direct foreign investments in France are focusing increasingly on economic and technological security issues: preservation of essential infrastructure and sensitive technologies, access to vital resources, energy independence, protection of strategic sectors and cybersecurity.

French-listed corporations and their executive officers will continue to face stricter governance requirements and best practices. The corporate governance code for listed corporations (“code de gouvernement d’entreprise des sociétés cotées AFEP-MEDEF”) was amended in fall 2016. The strategic role of the board of directors has been heightened, the criteria used to assess directors’ independence have been specified and the rules governing executive compensation have been strengthened. Meanwhile, under Sapin II, the compensation of executive officers of French-listed companies is now subject to prior authorization by the shareholders, and subsequent shareholder approval of the compensation effectively paid is now compulsory. Furthermore, financial disclosure requirements also have been strengthened, in accordance with the Market Abuse Regulation and as a result of the stricter position taken by the French financial markets authority (“Autorité des marchés financiers”) with regard to issuers’ permanent disclosure obligations. These changes have occurred in a context characterized by the development of shareholder activism in France — though not at the levels found in the U.S. and the U.K. — and by increasing shareholder engagement.

## GERMANY

### M&A: Political Influences, Governance Requirements, Activism and China

German M&A activity in 2016 was broadly in line with prior years, except for a degree of softening in the third quarter of the year due to general uncertainty regarding economic prospects in Europe and Asia as well as political factors such as Brexit, the U.S. election and the constitutional referendum in Italy. Despite unexpected results in all but the Italian referendum, and recognizing that the outcomes in the U.K. and the U.S. are expected to result in changes of policy in those countries, the fact that these votes have passed lifted some of the reservations concerning M&A activity in the fourth quarter. The upcoming elections in France, the Netherlands and Germany are not expected to significantly affect German transaction activity.

In the past year, sellers often were industrial companies divesting individual divisions and private equity sponsors taking advantage of high prices. Distressed and forced sales continued to be rare. Strategic buyers leveraged the availability of cash and cheap financing to achieve growth through acquisitions, winning auctions for a number of high-profile transactions, such as the acquisition of the coffee machine and cookware producer WMF by French Groupe SEB for close to €1.6 billion. Higher valuations made it more difficult for private equity sponsors to achieve the yields they require, resulting in fewer buyouts and smaller deals overall with private equity sponsors as buyers. Apart from a few exceptions, individual domestic M&A transactions were generally valued below €1 billion in 2016. Outbound transactions included a number of significant deals by German corporates in the United States, such as the acquisition by Bayer AG of Monsanto Co. for approximately \$66 billion and the acquisition by Lanxess AG of Chemtura Corp. for approximately \$2.7 billion. Another significant cross-border deal was the December 2016 announcement that U.S.-based Praxair would purchase Germany’s Linde for \$35 billion.

The number of public transactions in Germany was relatively flat compared to prior years and did not reflect the rise in stock prices and economic growth. In our view, this is at least in part a function of German corporate governance requirements and of the need to address complex rules applicable to public companies or to corporations in general. German public companies increasingly find themselves in situations in which they must defend against shareholder activism, including funds acquiring positions in the company and organized opposition from existing shareholders, or address unsolicited or competing bids. While such activity has been (and is likely to continue to be) less aggressive in Germany than in the U.S., investors are taking an increasingly active role, asserting pressure on previously entrenched management and supervisory boards by demanding transactions, reorganizations or other actions to unlock value for shareholders.

A number of other factors are influencing the M&A environment in Germany. Merger control issues are on the rise as a result of an increase in strategic M&A, leading to more frequent dispositions of assets. As a consequence, “hell or high water” provisions and reverse-termination fees have become more important. Additionally, Chinese investors, which account for a higher level of activity than previously, now tend to focus on high-profile and technology-leading companies and are prepared (and able) to pay high prices for these businesses — often justified by the expectation that a German target will be able to successfully access the Chinese market. The level of investments by Chinese buyers in the year ahead will depend on the economy and regulatory changes in China itself (see “[Regional Focus: Asia](#)”), as well as currency stability,

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the recognition of China as a market economy under the World Trade Organization, and the general political climate between China and the United States. Regardless, the success of Chinese buyers thus far has prompted political concerns and initiatives to tighten foreign investment controls on a European level. Reviews under the applicable German foreign investment control regimes have already intensified, making the identity of buyers and the presentation of their background increasingly relevant in bid evaluations.

Looking ahead, we expect corporations to increase the number and overall scope of acquisitions. Share buybacks and extraordinary dividends are often no longer regarded as desirable instruments, and corporates feel pressure to expand their businesses. Transformational M&A will play an important role. In addition, distressed M&A should rise as lenders are less likely, for regulatory and other reasons, to retain outstanding defaulted loans or other indebtedness with limited likelihood of repayment.

### **Brexit: German Perspective**

The impact of Brexit on the German business climate has generally been rather limited. Parties (both German and international) considering investments in Germany do not appear to have placed critical weight on the U.K.'s exit from the European Union. However, investments by German corporates in the U.K. have been affected by the prospect of Brexit as German corporates have postponed a number of transactions there until more clarity on the terms of Brexit becomes available. Companies should take advantage of the common market rules before Brexit becomes effective, including by amending supply channels in order to avoid possible tariffs, making use of the free movement of labor and capital within the EU, and obtaining, where necessary, additional licenses to secure the continuation of operations, among other issues.

While some commentators posit that Frankfurt may benefit over time as a financial center in continental Europe, it is too early to tell whether that will be the case. Ultimately, if Brexit results in an increase of strategic investments in the EU (especially from non-EU buyers), Germany's share of activity may increase over time because of its actual or perceived relative economic and political stability when compared to other EU member states. The real risk of Brexit in the longer term is the general political impact it may have on the fabric of the EU as a whole. As the ongoing refugee and financial crises in certain countries continue to depress pro-EU sentiments, the underlying question is whether the populist movements across Europe will continue to see voter support and whether initiatives in other countries (*e.g.*, Austria, France, Italy, Netherlands) to leave the eurozone or the EU will gain momentum.

## **EUROPEAN CAPITAL MARKETS**

Capital markets in Europe were mixed in 2016. The year saw a healthy volume of high-yield issuances in Europe after a very quiet start of the year. In the U.K., the Brexit vote impacted high-yield issuances somewhat, but such issuances continue. Initial public offering (IPO) volumes were down compared to previous years, but the IPO market this year should be open for strong candidates. Political developments (the Brexit vote, the Italian referendum rejecting reform proposals and the U.S. election) created periods when the capital markets were not generally available for new issuances. However, these "closed periods" were relatively short, and it is unclear how much these developments affected capital market activity overall. European capital markets have dealt with political volatility — notably the Greek debt crisis — for years, and investors seem to have become accustomed to such challenges.

The first part of the year has seen strong volumes of high-yield issuances in Europe. Looking ahead, if attractive interest rates on loans continue to be available, some existing high-yield issuers may look to refinance bonds with lower-cost loans, which would limit the number of "debut" high-yield issuers. The outlook for the IPO market remains uncertain, but the recent increases in key U.S. stock market indices give reasons for optimism. Rising interest rates in the U.S. may prompt U.S. issuers to seek euro-denominated debt if such rates are lower in Europe. In addition, any changes to the sanctions currently in place with respect to Russia could increase capital market activity coming from that region.

### **DACH: Volatility and HETA Restructuring**

The capital markets in the DACH region (Germany, Austria and Switzerland) continue to be characterized by market volatility, mainly because of the European refugee crisis and the continuing financial crisis in countries such as Greece and Italy, as well as Brexit and its implications.

Most equity transactions in Germany last year (in terms of volume) originated from corporate realignment activity and a few large spin-offs, in part because of increasing pressure on German corporate boards to create shareholder value and deliver returns to shareholders.

In an environment where investors are risk-averse and seek to preserve exit options, the current stock markets favor larger, more liquid stocks. The climate for IPO candidates whose valuation was below €1 billion was difficult in 2016, a trend likely to continue in 2017. This was particularly true for companies in

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the technology, biotechnology or other growth sectors because of their risk profile, lack of liquidity and (related) valuation discounts. Most IPOs/private equity exits were structured as dual-track processes, and in light of the difficulties for smaller IPO candidates, most ended up as a trade sale or were abandoned.

In light of the ongoing market volatility, companies that intend to go public or raise capital on the equity markets increasingly are seeking to reduce their time to market by substantially completing due diligence and documentation processes in advance through “in the drawer” prospectus documents. As a result, thorough and well-crafted information for future investors is available early in the process, facilitating investor education, premarketing efforts and possible preplacements, which have lowered risk for equity transactions in the region.

In the DACH debt markets, the €11 billion tender and exchange offer of existing debt instruments of Austrian bank HETA by the province of Carinthia (represented by Skadden) was a landmark transaction likely to redefine the handling of future distressed

debt restructurings of subsovereign obligations in Europe. The transaction involved a number of firsts in Europe, including the first successful distressed debt offer and restructuring under the EU Bank Recovery and Resolution Directive (BRRD), and constitutes an important precedent in Europe with regard to new ground rules on subsovereign distressed debt negotiations imposed by European member states as a result of the implementation of the BRRD.

The German debt markets were characterized by a high volume and significant number of corporate (investment grade) debt issuances in 2016. We expect this method of raising significant liquidity to continue this year, as the European Central Bank announced it would keep interest rates at historically low levels in the EU region. On the other hand, we saw fewer high-yield debt issuances in 2016 than in previous years due to the access by noninvestment-grade issuers to less expensive bank financings (increasingly with local financial institutions more intimately familiar with an issuer’s business model, financial situation and prospects).

# Regional Focus: Asia

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A number of economic and political factors, both domestic and international, influenced M&A and capital markets activity worldwide in 2016. Skadden attorneys Christopher W. Betts, Will H. Cai, Z. Julie Gao, Bradley A. Klein, Steve Kwok and Haiping Li in Hong Kong; Nobuhisa Ishizuka and Kenji Taneda in Tokyo; and Jonathan B. Stone in Hong Kong and Rajeev P. Duggal and Parveet Singh Gandoak in Singapore provide insights on the developments impacting activity in China, Japan and India, respectively.

## CHINA

### Strong Momentum in Outbound M&A Activity

China's outbound M&A activity continued its strong showing in 2016, reaching approximately US\$247.5 billion and surpassing the record set in 2015. Underlying the trend are a number of factors, including a desire to expand into new territories following domestic consolidations in a broad range of industries and to acquire strategic technologies amid the slowdown in China's domestic economic growth. Turbulence in the Chinese stock markets, coupled with the market expectation of renminbi (RMB) depreciation, have driven Chinese enterprises to accelerate their investments abroad in order to diversify risks and hedge against devaluation of domestic assets. The favorable financing environment for acquisitions in the U.S. and European markets has aided this overseas drive. Also, private equity firms were an important player in activity in 2016.

Chinese government policies also assume a key role in M&A activity. On the one hand, policymakers in China are encouraging Chinese enterprises to be more prominent on the world stage; to do so, companies need to look globally for quality investment opportunities to better position themselves for international and domestic competition and achieve long-term growth. On the other hand, in an attempt to curb capital outflows that are putting downward pressure on the RMB and draining foreign exchange reserves, China also imposed various new restrictions on outbound foreign investments in late 2016. This effort resulted in a cap on RMB-denominated loans issued outside China and a requirement that the loans be registered in China. In November 2016, China also imposed new limits on the amount of yuan that Chinese companies can remit overseas.

As the depreciation of the RMB accelerated in the last few months of 2016, Chinese foreign exchange regulators began vetting transfers abroad worth US\$5 million or more to curb capital outflows. Additionally, regulators have privately proposed certain rules that directly restrict outbound M&A transactions valued over US\$10 billion (or over US\$1 billion if without strategic purposes or unrelated to acquirers' core businesses). Lastly, as debts continue to soar, the government is reining in shadow-banking loans and debt-fueled financial investments, raising the cost of borrowing. These regulatory changes have already created difficulties for certain deals; if they are fully implemented, the effects will ripple through the entire region.

### Challenges in Deal Execution and Negotiation

Chinese buyers are still in the process of establishing a track record for executing large M&A transactions overseas. Thus, management teams of Western targets often have concerns regarding financing uncertainties. Some Chinese buyers have opaque corporate and ownership structures, which can raise doubts about the source of funds and present difficulties in securing regulatory approvals, particularly from the Committee

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on Foreign Investment in the United States (CFIUS). Chinese buyer consortiums often consist of a wide array of parties, such as government-backed investment vehicles, trusts, offshore holding companies or newly formed funds for the sole purpose of carrying out the transaction. Therefore, it is often impossible for a vendor or target to properly assess the consortium's creditworthiness.

In addition, Chinese buyers increasingly are using leveraged financing structures for acquisitions. When a Chinese bank funds a transaction with leveraged loans, Chinese buyers often present debt commitment letters that are intended to offer a degree of funding certainty comparable to that provided by their Western counterparts. However, these letters are typically in a short-form format without the customary terms used in the U.S. or Europe. As such, the enforceability of these letters has been a cause for concern.

In the past, Chinese buyers addressed a vendor's or target's worries about funding by offering a significantly higher valuation, thereby outbidding competitors. In more recent transactions, Chinese buyers have been more willing to cater to sellers' requirements and address their concerns over risks of regulatory approvals by depositing reverse-termination fees in an escrow account or by securing such fees with a letter of credit. As a result, reverse-termination fees are heavily negotiated and are often higher than those for U.S. domestic transactions. It remains to be seen whether such an approach is sustainable.

### **China Further Opens Access to Capital Markets, Increases Enforcement**

The most recent development in the Chinese capital markets is the launch of the new Shenzhen-Hong Kong Stock Connect (SZ-HK Connect) on December 5, 2016, which follows the November 2014 launch of the Shanghai-Hong Kong Stock Connect (SH-HK Connect) (see *2015 Insights* article "[Shanghai-HK Connect Opens Possibilities for Companies Looking to Tap Chinese Investor Demand](#)"). These schemes allow investors located in Shanghai and Shenzhen to trade in Hong Kong-listed securities and Hong Kong investors to trade in Shanghai- and Shenzhen-listed securities, in each case through their own brokers and in their own currency.

SZ-HK Connect further increases Hong Kong's appeal as a listing venue for companies seeking to tap Chinese investors and as a base for foreign investment into China. In particular, by virtue of SZ-HK Connect, mainland Chinese investors will now be able to trade in stocks on the Hang Seng SmallCap Index, which offers about 180 shares more than the SH-HK Connect. The Shenzhen Stock Exchange allows foreign investors to buy into the growth stories of the technology, media and health care companies that are primarily listed on the Shenzhen Stock

Exchange instead of in Shanghai. The Stock Connect schemes allow mainland Chinese capital to be invested in Hong Kong-listed entities without drawing the ire of capital control hawks in China, because proceeds from sales are returned to the owners in RMB and do not become part of the foreign currency market.

In addition, there have been increasing regulatory enforcement and disciplinary actions by Hong Kong securities regulators. In May 2016, the Securities and Futures Appeals Tribunal affirmed the Securities and Futures Commission's (SFC) decision to reprimand and fine Moody's Investors Service Hong Kong Limited HK\$11 million (US\$1.4 million) for various failures relating to its preparation and publication of a special comment report. Similarly, in August 2016, the Market Misconduct Tribunal (MMT) found that Andrew Left of Citron Research disclosed false or misleading information in a report he published and ultimately banned him from trading securities in Hong Kong for up to five years, disgorged him of profits worth HK\$1.6 million, and ordered him to pay investigation and legal costs of HK\$4 million.

Both rulings were firsts for Hong Kong. Moody's fine was the first disciplinary action of its kind the SFC has taken against a credit rating firm since it started regulating rating activities more than five years ago. Similarly, the MMT's finding against Left was the first time it had found a short seller guilty of market misconduct arising from the publication of otherwise unregulated market commentary.

### **FCPA Scrutiny of Chinese Companies and Executives**

The Foreign Corrupt Practices Act (FCPA) enables U.S. authorities to assert "territorial jurisdiction" over foreign entities and nationals. Under this theory, as the FCPA Resource Guide warns, "a foreign national who attends a meeting in the United States that furthers a foreign bribery scheme may be subject to prosecution, as may any co-conspirators, even if they did not themselves attend the meeting."

In the past, FCPA enforcement actions against foreign entities and nationals were relatively rare because of the difficulty for U.S. prosecutors and regulators in identifying a U.S. nexus from the alleged corrupt payments to foreign officials. The enforcement challenge was heightened by the need to gather evidence abroad. With increasing numbers of Chinese companies and employees entering the U.S. to do business, however, many of these evidentiary obstacles no longer stand in the way.

There is already some indication that prosecutors have been paying closer attention to the territorial theory of jurisdiction. In the February 2016 enforcement action against Massachusetts software company PTC, Inc., the U.S. Department of Justice (DOJ) named not only PTC but also PTC's China entities as defendants.

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To do so, prosecutors alleged that the jurisdiction requirement was satisfied because PTC China employees accompanied Chinese “foreign officials” on their travels to tourist destinations in the U.S. such as New York, Las Vegas and Honolulu.

In the debate over what the FCPA enforcement landscape will look like under President Donald Trump, comparatively little attention has been paid to FCPA risks that foreign companies and executives doing business in the U.S. face. Some expect the next attorney general will issue new guidance requiring prosecutors to consider the impact on American business competitiveness in FCPA cases; however, enforcement actions against foreign entities level the playing field by forcing all companies subject to the FCPA’s jurisdiction, foreign and domestic, to play by the same rules.

### **China’s Anti-Corruption Campaign Continues**

These U.S. trends may be of particular relevance to Chinese companies, as China’s anti-corruption campaign, now in its fifth year, continues in full force. Faced with rising public anger about mounting social problems amid a slowing economy, Chinese authorities are expected to continue their scrutiny of industries that have a direct bearing on the quality of life of Chinese citizens in the forms of, for example, drug prices, food safety, environmental quality and building hazards.

Moreover, unlike investigations of corrupt party or government officials that are almost invariably conducted out of public view in their initial stages, investigations of these industries are, with increasing frequency, preceded by highly public exposés that identify the accused and showcase the Chinese government’s ability to bring them to heel.

Once the information is in the public domain, it is readily accessible to regulators in other jurisdictions, including the U.S. This has significant implications for companies operating in China that also are subject to the FCPA. In responding to Chinese government inquiries, companies should take into account the very real possibility that the alleged conduct also may pique the interests of American prosecutors and regulators. As a result, an array of U.S. law issues must be considered at the outset of a Chinese government inquiry. Such issues include safeguarding the attorney-client privilege to enable privilege arguments to be asserted later in a U.S. court if necessary, and conducting an internal review in a manner that will pass the scrutiny of U.S. regulators.

### **External Political Factors and Predictions for M&A Activity in 2017**

Brexit and the U.S. presidential election did not have an immediate impact on China-originated deals. However, as the change in U.S. administration unfolds, we anticipate major shifts on a vari-

ety of policy fronts. It is widely perceived that Chinese buyers will have more difficulties obtaining CFIUS approvals under the Trump administration, especially given that technology and intellectual property assets are prized targets for many outbound transactions. (See “[CFIUS and Foreign Investment Reviews in 2017 and Beyond](#).”) This trend would follow an already challenging CFIUS environment for Chinese investors. In 2016, for example, CFIUS blocked Fujian Grand Chip Investment Fund’s purchase of German semiconductor maker Axitrom and prompted the Blackstone Group to withdraw the sale of Hotel del Coronado to Anbang Insurance Group.

More importantly, in a country where government policies heavily influence private dealmaking, the general political and economic tensions between the U.S. and China may impact cross-border M&A activity. International trade, cybersecurity and currency manipulation were all prominent issues during the U.S. election cycle. More recently, there is renewed concern that Taiwan may again become a critical feature of U.S.-China relations. These all increase the unpredictability of future policy directives and contribute to the volatility of the M&A market.

That said, the strongest headwind to outbound Chinese M&A is China’s move to combat capital flight. If these temporary control measures are lifted, and absent any major changes in the regulatory environment, we expect to see continued momentum in Chinese outbound M&A dealmaking.

## **JAPAN**

### **Cross-Border Activity Slows Amid Rising Domestic Consolidations**

Cross-border Japanese M&A activity significantly decreased in 2016 compared to 2015. This can be attributed in part to a pause in activity stemming from a number of companies continuing to integrate large acquisitions from prior years; increasing competition for attractive assets, particularly from Chinese acquirers; a lack of larger targets at appealing valuations; and a significant increase in domestic consolidations that likely diverted attention from outbound activity in some sectors.

In addition, uncertainties created by Brexit, the U.S. election and financial market volatility at the beginning of the year made Japanese buyers more cautious when considering foreign acquisitions. Notably, only two transactions accounted for over 50 percent of Japanese outbound deal volume during the first three quarters of 2016 — Softbank/ARM and Sompo Japan/Endurance Specialty Holdings — underscoring the relative lack of activity.

By contrast, domestic Japanese M&A activity in 2016 increased significantly over the prior year, due to consolidation transactions. The continuing global slowdown in the industrials and

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chemicals sectors, persistent low oil prices in the energy, mining and utilities sector, and conglomerate reorganizations drove companies in these sectors to seek greater competitive advantages through combinations with industry peers.

### **Decrease in Capital Markets Activity**

There also was a general decrease in capital markets activity by Japanese issuers in 2016, due to factors such as volatile markets and a negative interest rate environment. In terms of equity capital markets, the number of initial public offerings (IPOs) in 2016 fell to a seven-year low, and despite the successful listings of some prominent companies such as LINE Corporation and JR Kyushu, there were fewer large-scale IPOs than in previous years. In addition, the number of follow-on public capital raises by listed companies fell by more than 50 percent as compared to 2015. This decrease is attributable in part to sluggish share prices that persisted prior to the U.S. presidential election and were due to factors such as a stronger yen and Brexit. However, the decrease in equity offerings also was the result of an enhanced focus that many Japanese corporations have placed on the efficient use of capital, as well as the availability of favorable bank financing caused by negative interest rates.

Activity was somewhat stronger in the debt capital markets, reflecting the availability of low interest rates for domestic bonds. In terms of cross-border activity, overseas issuances were again dominated by Japanese financial institutions, such as banks and insurance companies, offering hybrid and other subordinated debt products to overseas investors to raise regulatory capital.

### **Impact of External Political Factors**

The implementation by the Bank of Japan of its negative interest rate policy in January 2016 and the resulting tightening of credit spreads put pressure on banks to seek more diversified sources of revenue. At the same time, the policy has provided an incentive for Japanese corporate borrowers, which tend to save cash rather than spend capital, to deploy excess savings. Further supplementing this trend is a continued focus on new corporate governance reforms, in their second year of implementation, which impose increased accountability on Japanese companies to productively use their surplus cash with a particular focus on shareholder returns. As a result, while corporate boards are taking a more holistic view of their balance sheets and are increasingly considering M&A transactions in the larger context of overall financial performance, we expect these incentives to productively deploy cash will continue.

For Japanese companies — members of an export-driven economy — currency fluctuation is a double-edged sword that can create uncertainties impacting Japanese outbound M&A

transactions. A weaker yen such as that triggered by the recent U.S. election (as a result of strong dollar-buying) boosts corporate earnings but makes foreign acquisitions more expensive. Conversely, a stronger yen such as that resulting from the Brexit vote (as a result of strong safe haven purchases of the yen) makes such acquisitions cheaper but hurts corporate earnings. On balance, and as Japanese companies have shown in recent years, cross-border M&A activity generally should be immune to both environments because the sustained need to address stagnant growth in the domestic market will continue to drive outbound M&A activity. However, volatility in the strength of the yen complicates valuation and adds to the uncertainties for such transactions. It is too early to tell whether Japanese companies should anticipate continued volatility as the new U.S. administration transitions to governance and implementation of policy and as the U.K.'s exit from the European Union unfolds.

### **Outlook for 2017**

Notwithstanding these potential headwinds, we expect that strategic considerations around the use of large cash reserves and slow domestic growth driven by an aging population and deflation will continue to drive Japanese outbound acquisition activity in 2017.

A heavily import-dependent country for natural resources, Japan is particularly vulnerable to fluctuations in oil prices. As crude oil prices have stabilized and strengthened as a result of the recent Organization of the Petroleum Exporting Countries (OPEC) agreement and ongoing ancillary negotiations to limit production among non-OPEC countries, it remains to be seen what the potential impact will be on Japanese M&A activity in the energy, oil and gas, and industrial and chemicals industries.

The ongoing impact of the Bank of Japan's negative interest rate policy will continue to generate margin pressure on Japanese lenders, which will drive the larger banks to seek more diversified sources of revenue, including potentially through acquisitions, and will increase pressure on smaller regional banks to consolidate.

As the Japanese venture capital market continues to grow after a long, slow development period, smaller independent companies in the technology sector, such as developers of software applications and social media, are becoming increasingly attractive targets for foreign acquirers. While overall inbound acquisition activity has been low relative to outbound activity for a number of years, a majority of the inbound deals in 2016 by value were in this sector, a trend we expect will continue.

In addition, there may be an increase in activity in the equity capital markets due to the recent recovery in share prices that has continued in the aftermath of the U.S. presidential election. In

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particular, higher share prices may attract more exit transactions by major shareholders, including not only private equity funds but Japanese corporates seeking to unwind cross-shareholdings by selling large blocks in the capital markets. In addition, there may be an increase in issuances of debt or equity securities by Japanese companies seeking to finance both domestic and cross-border acquisitions.

## INDIA

### Positive Conditions in Market and Government Spur M&A

India's strong M&A environment in 2016 was driven by favorable economic conditions and an encouraging regulatory regime. Its economy overtook China as the fastest-growing major economy, with a growth rate of almost 7.6 percent last year. The U.S., U.K. and Japan continue to lead in inbound investments, with China's interest in India expected to grow in 2017. Meanwhile, political stability, including one party having an absolute majority, has helped India initiate economic reforms that have had a positive impact on activity.

Technology, media, telecommunications, financial institutions and pharmaceutical companies remain key targets for foreign buyers and private equity investors. Private equity funds, after waiting many years for a capital markets recovery, are finally achieving public market exits for their investments and raising new funds. We expect a lot more private equity deal activity in the coming year, as India-focused funds are sitting on close to \$7 billion ready to be invested. However, valuations and control deals still seem to be a challenge, as Indian promoters (as company founders are known) typically demand comparable market valuations and are reluctant to cede control.

### Active Capital Markets Should Continue

The Indian equity markets were very active in 2016, with more than 25 companies raising almost \$3.6 billion in aggregate through November 30, 2016, and several companies lined up to go public in the coming months. Some very large IPOs are in the pipeline, such as Vodafone, and 2016 was the best year for capital markets fundraising in India in the last five years. We expect this trend to continue in 2017 on the back of stable foreign direct investment inflows. The industrial and financial services sectors have been the busiest in terms of both value and volume.

Domestic dual listings on the Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) continue to dominate India's IPO scene, and very few Indian companies have listed internationally. That said, improved business confidence should drive more companies to pursue fundraising opportunities abroad. We expect some technology companies to explore

international listings in the coming years to target sophisticated global technology investors, offer more attractive valuations and provide a means to access capital not available in India.

### Currency Demonetization Should Positively Influence M&A, Debt Markets

Another factor impacting the deal landscape is India's decision to demonetize its 500 and 1,000 rupee notes (approximately US\$7.50 and US\$15, respectively) in an effort to fight tax evasion and corruption. The notes account for over 85 percent of currency that was in circulation and had to be exchanged with banks for new legal tender prior to December 30, 2016. Because the economy relies predominantly on cash, this change may negatively impact economic activity in the near term. In January 2017, for example, the International Monetary Fund cut India's projected growth rate for the current fiscal year to 6.6 percent. However, in the long run the move could boost government revenue by increasing tax compliance and improving the overall business environment.

One immediate impact of the currency demonetization has been a drop in bond yields, as banks have parked most of the canceled currency into debt securities. This drop should help companies refinance debt and fund capital expenditures, as well as make acquisitions less expensive.

With less developed local debt capital markets, Indian companies have historically borrowed at high interest rates and relied on bank loans to raise funds. The regulators recently eased the rules with respect to the issuance of rupee-denominated bonds to foreign portfolio investors (FPIs), known as "masala bonds." FPIs also have been allowed to invest in unlisted nonconvertible debentures and other debt securities. These developments should have a positive impact on the development of debt capital markets.

### Indian Companies Eye Brexit Cautiously

Many Indian conglomerates and information technology (IT) companies have large U.K. operations that are a gateway to Europe. Brexit threatens the U.K.'s position as a major investment hub for Indian companies, which worry that they could be subject to higher tariffs for exports as well as unfriendly regulatory and immigration policies. British Prime Minister Theresa May's recent visit to India was disappointing to many in the business community given the U.K. government's refusal to ease visa restrictions for business travel. At the same time, the decline in the pound has been a cause for concern, and many companies are cautiously reviewing their operations in the U.K.

On a positive note, Brexit will likely compel Britain to seek a more robust trade relationship with India. The two countries have

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been unable to reach a free trade agreement so far, with negotiations becoming mired in the politics of the European Union bloc; however, with Britain's commitment to attract new investment from further afield, this could change. A lot will depend on the shape and timing of the U.K.'s actual exit from the EU. If the process is drawn out, Germany and France may be able to nullify the U.K.'s diplomatic first-mover advantage and reach an EU-India free trade agreement first.

### **IT and Pharma Sectors See Downside to Potential Trump Policies**

In general, the U.S.-India relationship is expected to continue on a positive trajectory under President Donald Trump. India is seen as a strategic and economic partner and thus has strong bipartisan support in the U.S. The two countries work together on a range of issues, from defense and security to space, health care, energy, technology and climate change. The U.S. is also India's largest trade partner.

However, some of President Trump's protectionist policies could adversely affect Indian industry and bilateral trade. For example, India's IT industry earns 60 percent of its \$100 billion revenue from the U.S., much of which is attributable to outsourced U.S. jobs. If the Trump administration works to bring back these jobs, Indian IT companies could suffer. In addition, the possibility of extra duties being levied on imports could impact Indian exports to the U.S. and adversely affect the Indian pharmaceutical industry in particular, which accounts for about 40 percent of all generic medicines supplied to the U.S.

President Trump is likely to pressure India for more market access, especially as it relates to defense. We expect to see some major investments and joint ventures between Indian and American companies in this sector.

### **Impact of Regulatory Developments in 2017**

India has seen quite a few developments on the tax front that could significantly impact companies in the year ahead. The general anti-avoidance rules (GAAR) will be applicable starting April 1, 2017, and provide sweeping powers to Indian tax authorities to declare any arrangement an "impermissible avoidance arrangement" if it has been entered into with the principal purpose of obtaining a tax benefit. Because the taxpayer has the

burden to demonstrate that this is not the case, the tax authorities could question any transaction that results in tax savings. The rules also could deny tax treaty benefits to many investors who are unable to show "commercial substance" in the country through which they invest. Investments made before April 2017 will be grandfathered in, but GAAR will apply to arrangements where an entity continues to claim tax benefits on an ongoing basis.

In 2016, India and Mauritius announced an amendment to their tax treaty, as a result of which Mauritius tax residents will no longer be exempt from Indian capital gains tax on sales of shares of Indian companies that are acquired on or after April 1, 2017. Investments from April 1, 2017, that are sold prior to April 1, 2019, will be taxed at 50 percent of the prevailing rate, subject to satisfying certain requirements, including a minimum spend in Mauritius and that the Mauritius resident not be a shell or conduit company. Similar changes were made to the India-Singapore tax treaty on December 30, 2016. Thus, we expect that investors will have to think about alternative investment structures into India.

The recently passed Goods and Services Tax Bill, which takes effect on April 1, 2017, will completely overhaul India's current indirect tax system and unite it as a common tax market for the first time. Currently, goods are taxed multiple times at different rates and at different stages by the federal and state governments, which makes it challenging and costly to do business across state borders.

Additionally, the passing of the Insolvency and Bankruptcy Code 2016 and the Reserve Bank of India's initiative to require banks to clean up their books should make the next few years ripe for stressed-asset investors. However, the speed with which the attendant regulations and infrastructure will be rolled out remains unclear.

Coupled with these regulatory changes, the government's push to encourage investments through policies such as Make in India and Start-Up India and to improve the overall ease of doing business is expected to start showing results in 2017.

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Skadden is not admitted to practice law in India. This article is for general informational purposes only, and Skadden would work with Indian counsel on specific transactions.

# Directors Must Navigate Challenges of Shareholder-Centric Paradigm

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The corporate governance landscape has become more complicated, making it more difficult for directors to manage the often inconsistent demands of multiple constituencies while pursuing the fundamental fiduciary obligation to act in the best interests of the corporation and its stockholders. Evolution in the prevailing corporate governance model to a more shareholder-centric paradigm, widening fault lines between the perspectives of different types of shareholders, and the expanding reach of governmental regulation and enforcement efforts, among other forces, have contributed to the issues contemporary boards face. Directors' ability to assess these factors and successfully navigate these challenges will be critical in the year ahead.

## Shareholder Activism and Engagement

Activist agitation, proxy contests and precatory proposals were all evident last year, including at large-cap issuers, with activists continuing to see significant success. While name-brand activists continued to obtain board seats through settlements without pursuing proxy contests, newer entrants into the asset class pursued aggressive campaigns. Activist success is due to a number of factors, including the growth of assets under management (AUM) by investors pursuing activist strategies, increased sophistication in dealing with both companies and other investors, and leveraging media focus. The most important factor, however, has been the support of activist campaigns by traditional long equity investors. While activists funds are estimated to have over \$150 billion in AUM, this figure is minimal compared to the trillions of dollars under management by pension funds, mutual funds and other traditional investment intermediaries. Activists rely on these institutions for support.

There are signs, however, that the tide of hedge fund activism may have reached its high-water mark and that influential market participants believe elements of activism have gone too far. Discussion of activism has been increasingly enveloped in a broader debate over corporate "short-termism" and its effects on the companies, the economy and society. Passive investment managers such as index funds represent an increasingly significant portion of holdings at many companies (estimated at 30 percent of Standard & Poor's 500 index companies) and together with other traditional institutional investors have become more vocal in articulating a preference for corporate strategies supporting long-term value creation. In the last couple of years, the CEOs of BlackRock and Vanguard wrote open letters cautioning against pursuit of short-term agendas that negatively impact long-term growth. In October 2016, State Street Global Advisors published a statement voicing concerns over companies' quick settlements with activists without receiving input from long-term shareholders, and suggesting that settlements with activists contain terms that align with the interests of long-term shareholders. These institutions do not propose to return to a more board-centric governance paradigm or to provide greater board insulation from shareholder sentiment — their published governance policies promote shareholder power and corporate responsiveness — but greater investor support for well-functioning boards pursuing long-term strategies would be a welcome development. Unfortunately, many investors continue to judge corporate performance on the basis of quarters, not years.

Companies must continue to embrace meaningful engagement with shareholders, with directors overseeing — and at times directly participating in — that engagement. This provides an opportunity to communicate corporate vision and strategy as well as an opportunity to hear shareholder views and concerns outside the context of an activism campaign. In the specific context of such a campaign, the nature and degree of engage-

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ment with institutional shareholders on the activist requests will vary based on multiple factors, including the nature of the request or proposal, prior engagement, the state of public disclosure and the company's proposed response.

### Corporate Governance

The multidecade campaign by shareholder advocates and proxy advisers for implementation of a fairly standard set of corporate governance "best practices" at U.S. public companies fundamentally shifted the role and relative influence of shareholders in corporate governance. Much of this agenda, such as annual director elections by majority vote and implementation of shareholder ability to call meetings or act by written consent, has been implemented at larger public companies. However, additional items continue to be added to the list of best practices. In considering these items, boards must continue to balance the policy preferences articulated by many of their largest shareholders with directors' views on appropriate governance based on individual company circumstances. (See "[US Corporate Governance: Will Private Ordering Trump Political Change?](#)")

**Proxy Access.** Shareholder proponents continue their focus on proxy access, having submitted over 200 proxy access proposals for 2016 annual meetings. A market standard has developed based on 3 percent ownership for a three-year period. In the 2016 season, a majority of companies receiving a proxy access shareholder proposal adopted a 3 percent proxy access bylaw or announced an intention to do so, resulting in a majority of the 2016 shareholder proposals being withdrawn by the proponents or excluded pursuant to the Securities and Exchange Commission no-action process on the basis of substantial implementation. In votes where companies had not adopted or proposed a 3 percent proxy access bylaw, more than 75 percent of the shareholder proposals received the support of a majority of votes cast. Almost 350 public companies — including approximately half of S&P 500 companies — now have a proxy access bylaw, up from approximately a dozen companies at the end of 2014. Companies that have not yet adopted proxy access are increasingly likely to come under pressure to do so.

**Board Composition and Director Tenure.** Investors, academics and others continue to scrutinize board composition, including director skill sets, diversity and tenure. An increasing number of institutions have been adopting tenure policies that can differ in important ways — for instance, noting that long board tenure is not necessarily an impediment to director independence and that a variety of tenures in the boardroom can be beneficial (BlackRock); voting against nominating committee chairs if average board tenure is 15 years or longer or if there has not been a new board appointment for five or more years; and voting against

the lead independent director and any member of a key board committee when the person's tenure is 15 years or longer (Legal & General Investment Management). Investor focus on board composition and tenure will be ongoing, and boards should continue to pursue board refreshment.

**Board Leadership.** Separation of the roles of CEO and board chair continues to engender discussion and a significant number of shareholder proposals. However, most institutional investors are satisfied with a board leadership structure pairing a robust lead independent director with a combined chair/CEO, and shareholder support for proposals to require an independent board chair continues to fall below 30 percent of votes cast in favor (no proposals received majority support in 2016). Still, boards should continue to periodically consider the leadership structure that best suits the company and its particular circumstances.

**Compensation Design and Clawbacks.** Based on concerns that some management compensation structures have incentivized excessive risk-taking, and consistent with re-emerging investor focus on long-term value creation, boards are re-evaluating compensation programs to ensure management's financial incentives are aligned with long-term strategy. Trends include reassessing the balance of base and incentive compensation, implementing holding periods for equity awards and adopting incentive compensation clawback policies. Compensation committees and boards likely will continue to spend significant time reviewing and adjusting management compensation programs to ensure that they support corporate strategy, are appropriately tied to both annual and long-term performance goals and are sufficiently competitive to retain employees.

**Mergers and Acquisitions.** While M&A opportunities generally are identified by management, oversight of material transactions is a core board function. In the context of the sale of a company, this means active director decision-making as to whether and how to pursue a sale, consideration of implications of political and regulatory environments relevant to a proposed transaction, and active oversight of executives during any sale process. In the case of significant acquisitions, the nature and amount of board focus and attention on any particular transaction will vary based on factors related to significance.

### Risk Oversight

Shareholders, government enforcement agencies and courts have continued to scrutinize the performance of boards of directors in overseeing compliance and management of enterprise risk. While many directors are frustrated with the amount of time they must spend on regulatory and financial compliance matters, this need is not likely to abate. Dramatic shifts in the political,

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economic and regulatory environments are occurring, changing the business environment and regulatory framework within which many companies operate.

The obligation to appropriately oversee risk is an element of directors' overarching duties of care and loyalty. Directors must pay sufficient attention to business risks in order to be able to act on them in an informed manner. Overall, case law reflects that it is difficult to show a breach of fiduciary duty for failure to exercise oversight, provided a monitoring system is in place. In *Reiter v. Fairbank*, the Delaware Court of Chancery recently provided an explanation of Delaware law on the standard for imposing oversight liability, noting that there must be evidence of directors' bad faith — that “the directors knew that they were not discharging their fiduciary obligations.”

Cyber risks also were on public display in 2016, including data breaches at consumer-facing companies, email hacking of corporations and political parties, and unauthorized transfers from financial institutions. (See “[Despite Aversion to Regulation, Trump May Expand Cybersecurity Efforts.](#)”) Cybersecurity has become one of the most significant enterprise risk issues that companies encounter, and the importance of board attention to this issue has become clear. Board engagement on cyber risk can help set an agenda benefiting the company and reduce the risk certain types of post-breach investigations and litigation pose.

# US Corporate Governance: Will Private Ordering Trump Political Change?

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In the weeks following the U.S. presidential election, companies and investors enjoyed a stock market rally fueled by expectations concerning tax cuts, increased government spending and significant deregulation. While the legal and regulatory changes envisioned under a new presidential administration may present real and substantial opportunities for companies, those changes may have little if any impact when it comes to corporate governance. The forces driving shareholder activism, governance activism, scrutiny of board composition, concerns regarding board oversight of risk management and director-shareholder engagement remain present and may gain strength in a period of deregulation. Investors, having successfully employed “private ordering” in recent years to achieve corporate governance changes, may find that private ordering will be able to trump the impact of political change.

**Private Ordering and Proxy Access.** Private ordering is not a new concept, nor is it limited to corporate governance. It is the notion that private parties are best positioned to order their affairs rather than relying on government regulation to do so. In the corporate governance context, many in the business community championed private ordering when criticizing the Securities and Exchange Commission’s (SEC) 2010 adoption of a proxy access rule that would apply to all public companies. Under that SEC rule, vacated in litigation due to procedural flaws, holders or groups of holders of at least 3 percent of a company’s shares for at least three years would have the ability to nominate candidates for 25 percent of the board seats and have those candidates appear in the company proxy statement alongside the board’s nominees. Rather than an SEC-mandated one-size-fits-all proxy access rule, the rallying cry was that individual companies — management, the board of directors and shareholders — should be left to decide for themselves what form of proxy access, if any, was appropriate for them.

As a result of private ordering, the number of companies that provide shareholders with a proxy access right has increased from a handful at the end of 2014, to 125 at the end of 2015, to approximately 350 in early 2017. This number includes more than half of the companies in the Standard & Poor’s 500 index. The rapid rate of adoption is likely to continue unabated through 2017 and for the foreseeable future. Although there is some company variation in the proxy access details, private ordering has coalesced around a 3-3-20-20 proxy access right: Holders of 3 percent of a company’s shares for three years may nominate and include in the company’s proxy materials candidates for up to 20 percent of the board (often permitting a minimum of two nominees) and form a group of up to 20 shareholders to meet the 3 percent ownership requirement.

Of course, the ultimate impact of proxy access on board composition and behavior remains to be determined. In November 2016, GAMCO and Gabelli Funds became the first shareholders to use proxy access, nominating one person for inclusion in the proxy materials of National Fuel Gas Company pursuant to the company’s proxy access bylaw. Prior to submitting the nomination, Gabelli-affiliated funds had been advocating for change at National Fuel Gas for some time, including by submitting a 2015 shareholder proposal requesting that the company hire an investment bank to explore a spin-off of the company’s utility business. Referencing those prior actions, National Fuel Gas determined that GAMCO and Gabelli Funds were not eligible to use proxy access, as they could not accurately represent that they lacked the intent to “change or influence control” of the company, as required by the company’s proxy access bylaw (and virtually all other proxy access bylaws adopted to date). The proxy access nomination was subsequently withdrawn. Presumably, however, it is just a matter of time until investors submit a nomination that is compliant with a company’s proxy access bylaw and a proxy contest ensues.

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The reluctant acceptance of proxy access by corporations is in large part the result of an alignment of views across a wide swath of investors. The campaign for proxy access was largely spearheaded by the New York City comptroller's "Boardroom Accountability Project," which in late 2014 submitted 75 proxy access shareholder proposals to companies with perceived issues relating to executive compensation, board diversity or climate change. Other institutional investors joined the campaign, submitting shareholder proposals to additional companies. The voting results in favor of those shareholder proposals could not have been achieved without the support of some of the largest mutual funds and asset managers, such as BlackRock, State Street, T. Rowe Price and Vanguard. Finally, individual investors and corporate gadflies aligned around the proxy access parameters preferred by larger investors and have been submitting a significant number of proxy access shareholder proposals. These investors now have a well-developed playbook for employing the power of private ordering to create corporate governance change. The question is what the next issue will be that can achieve a similar alignment of investor views.

**Potential Dodd-Frank Repeal.** The Dodd-Frank Act encompassed a wide-ranging set of banking and financial sector reforms enacted in response to the 2007-08 financial crisis. The statute also contained a number of securities law and corporate governance provisions applicable to all or most U.S. public companies — for example, establishing the requirement that public companies provide shareholders with an advisory vote on executive compensation (commonly referred to as "say-on-pay"). Expected efforts by the new presidential administration to repeal or replace the Dodd-Frank Act primarily will relate to banking and financial sector regulation but likely will also address these securities law and corporate governance provisions of wider applicability. (See "[The Trump Impact: Key Issues in Financial Services Reform for 2017](#).") Although the ultimate form of any new law remains to be seen, the "Financial CHOICE Act of 2016" — approved on a party-line vote by the House Financial Services Committee in the fall of 2016 — represents the most advanced effort thus far. One section in the Financial CHOICE Act would repeal the Dodd-Frank provision authorizing the SEC to adopt proxy access rules. As a result of private ordering, this repeal would be somewhat irrelevant.

Another provision in the Financial CHOICE Act would amend the requirement to have a say-on-pay vote. Rather than the current requirement that companies hold a say-on-pay vote at least once every three years, companies would be required to hold such a vote only when there has been a material change to the compensation of executives from the previous year. In 2011, when most large companies last solicited shareholder feedback on the desired frequency of say-on-pay votes, more than 90

percent of S&P 500 companies adopted annual say-on-pay votes. Many companies will hold their next say-on-frequency vote in 2017 and the expectation is that investors will again express a preference for annual say-on-pay votes. It would appear that even if the law was amended to require say-on-pay votes only upon material changes to executive compensation, private ordering likely would result in maintaining the status quo of annual votes at most companies.

**Board Composition.** Investors continue to scrutinize director skill sets, diversity and tenure as well as company disclosure regarding how boards consider these issues. Although there have been calls by some investors or investor groups to expand SEC disclosure rules concerning director diversity, most of the change to date in this area has been the result of private ordering. Prompted by investor calls for better disclosure, the appearance of board skills matrices in company proxy statements continues to expand. While progress may be viewed as slow by some, boards are steadily increasing their gender diversity. On the issue of director tenure, investors continue to raise concerns where average tenure is lengthy, where a high percentage of directors are considered long-tenured or where no new director has been added for some length of time. In any event, private ordering is likely to continue to spur boards to consider these issues, take responsive action and improve disclosures to reflect their understanding and consideration of these matters.

**Environmental and Social Issues.** The level of assets managed using ESG — environmental, social and governance — factors continues to grow, as does the number of mainstream investors that consider ESG to some degree in their portfolio decision-making. Much like corporate governance, some investors view environmental and social issues as additional lenses through which to analyze risk in their portfolio companies. It is worth recalling the role that environmental and social concerns played in selecting the companies initially targeted by investors for proxy access shareholder proposals. In 2016, a record nine shareholder proposals on environmental and social issues received majority support, including proposals on board diversity, gender pay equity, political contributions disclosure and sustainability reporting. Also in 2016, a record 91 climate change shareholder proposals were submitted, driven in part by the climate change agreement reached in Paris in December 2015. Although specific proposals vary, a new proposal seeking an assessment of the impact of climate change policies aimed at reaching the 2-degree Celsius target adopted by the Paris climate accord received significant shareholder support, ranging from 38 percent to 49 percent of votes cast at a number of major energy companies.

Under a presidential administration skeptical about climate change and likely to revisit many of the Obama administra-

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tion's environmental initiatives, environmental and climate change matters may be the next private ordering battlefield. It is estimated that more than 200 environmental and climate change shareholder proposals will be submitted for the 2017 proxy season. In addition, mutual fund companies and asset managers are facing shareholder proposals relating to incongruities between their voting records on these types of proposals and their stated positions on climate change. These and other pressures could result in increasing levels of voting support for climate change proposals and impact companies' willingness to negotiate for the withdrawal of some proposals.

Private ordering also may impact climate-related corporate disclosures. In December 2016, the Task Force on Climate-related Financial Disclosures (TCFD), established by the Financial Stability Board (an international body that monitors and develops policies concerning the global financial system), published for public comment recommendations for voluntary climate change-related disclosures as part of company financial disclosures. The TCFD members include banks, insurance companies, asset managers, pension funds, large nonfinancial companies, accounting firms and credit rating agencies. The stated expectation is that large asset owners and asset managers will influence the companies in which they invest. The focus of the TCFD recommendations is disclosure related to the financial impact of climate change on a company, rather than a company's

impact on climate change. If a broad coalition of investors emerges in support of enhanced disclosures on climate change, private ordering may again prevail over deregulation efforts stemming from political change.

**Shareholder Engagement.** Companies are likely to continue along the current path on which shareholder engagement and enhanced disclosure are driven by the demands of investors rather than in response to regulatory requirements. Company proxy statements continue to evolve, not just in terms of the use of color and graphics, but in addressing topics such as shareholder engagement and other items of interest to investors. Shareholder-director engagement continues to increase, and companies that have a policy prohibiting shareholder-director engagement may find shareholders voting against key directors.

Regardless of the regulatory climate, companies and their directors are well-served by being able to articulate a long-term business strategy that considers the risks faced by the company and how the board oversees those risk areas, including cybersecurity and climate change risks. They also should be able to explain to investors how the company's executive compensation fits with the business strategy and risks, and how the board's composition and refreshment plans tie back to the strategy and risks. Private ordering is calling on companies and boards to do these things and to do them well.

# Trump's Proposed Changes to Tax, Dodd-Frank, DOL Could Impact Executive Compensation

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President Donald Trump's campaign proposals included changes to tax rates and a promise to repeal the Dodd-Frank Act. If enacted, these proposals could have a significant impact on the way businesses handle executive compensation, permitting companies greater flexibility in structuring compensation arrangements. His staff also hinted at a reversal of Department of Labor (DOL) conflict of interest regulations. However, even if these proposals are enacted, some aspects of compensation programs that companies implemented to comply with current or, in the case of the DOL rules, anticipated requirements are likely here to stay given their popularity with institutional shareholders or due to the significant business restructuring already undertaken.

## Tax Reform

President Trump's campaign proposals included a reduction of the maximum corporate tax rate to 15 percent (from 35 percent) and the elimination of the alternative minimum tax. If either President Trump's plan or a similar proposal from House Republicans moves forward (see "[Business Tax Reform All but Certain in US, Europe](#)"), companies may be less concerned by the \$1 million limit on deductions of executive compensation under Section 162(m) of the Internal Revenue Code because the lower overall tax rate would reduce the value of the tax deduction. Nevertheless, performance-based compensation programs, which are not subject to the deduction limit, would likely remain the norm, driven by the expectations of institutional shareholders.

President Trump also proposed lowering individual tax rates, which likely would discourage the use of deferred compensation. Individuals would have less incentive to defer taxes with lower income tax rates in effect. In addition, individuals may choose to accelerate payment of previously deferred amounts, although any such acceleration could be subject to significant restrictions under applicable tax rules, including Section 409A of the Internal Revenue Code.

In recent years, there have been various proposals — including one by President Trump — to eliminate what has been described by many politicians as the carried interest tax “loophole.” Carried interest, or profits interest, is an interest in a partnership that gives the holder the right to receive a portion of future profits from the partnership. Under current law, a profits interest holder is taxed annually on his or her allocable share of partnership income, if any, and the tax treatment of that income is the same for the holder as it is for the partnership. Therefore, to the extent the partnership's profits constitute long-term capital gains, an individual holder is taxed at the capital gains rate of 20 percent (rather than the 39.6 percent maximum ordinary income tax rate). If carried interest becomes subject to ordinary income tax rates, companies likely would seek alternative methods of structuring incentive compensation, unless tax rates on ordinary income are also dramatically reduced.

## Repealing or Replacing Dodd-Frank

President Trump said he would eliminate or “change greatly” the Dodd-Frank Act. If this were to occur, the executive compensation-related rules in the act could be repealed, including the say-on-pay, say-on-frequency and say-on-golden-parachute rules currently in effect. The rules requiring disclosure of the pay ratio of the CEO's compensation to that of a company's “median” employee, scheduled to take effect in 2018, have been particularly controversial, and the progress of any repeal efforts may provide insight into how President Trump reconciles his pro-business and populist instincts. In addition, the proposed multiagency rules imposing significant new requirements on incentive

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compensation arrangements of covered financial institutions also may be targeted for revision or repeal. Because they have yet to be finalized, the proposed rules regarding disclosure of pay for performance may be the rules most likely to be repealed. Even if the act is repealed or significantly modified, the “real world” impact on company practices relating to say-on-pay and claw-backs of incentive compensation may ultimately be minimal. These measures are supported by institutional shareholders, and companies may continue to follow them to maintain positive relationships with them. (See [“US Corporate Governance: Will Private Ordering Trump Political Change?”](#))

### **DOL Fiduciary Rule**

It is not yet clear whether or how the new administration might seek to block, delay or revise the DOL’s conflict of interest regulations (the so-called DOL fiduciary rule), which were issued in April 2016 with compliance to begin in April 2017. Generally, the rule expands the types of communications with retirement plans and individual retirement accounts that could be construed as investment advice or a recommendation. Under the Employee Retirement Income Security Act, the person providing such advice or recommendation would be considered a fiduciary with respect to the retirement plan investor. While the president has not directly addressed the rule, a Trump adviser has indicated that the administration may initiate efforts to reverse or modify it. Some members of Congress also have indicated a desire to reverse the regulations and previously took legislative action, which President Barack Obama vetoed, to do so. The House Republicans’ financial reform bill, the Financial CHOICE Act, proposes repealing the fiduciary rule, and

Republicans in Congress are considering other ways to delay the effectiveness of the rule. President Trump also has generally indicated an intention to review and suspend current regulatory activity, which could implicate the rule. On January 20, 2017, the president’s chief of staff sent the heads of executive departments and agencies a memorandum asking that the effective date of already published regulations that have not yet taken effect be postponed for review, for at least 60 days from the date of the memorandum. The memorandum did not specifically address any particular regulation, and because the DOL fiduciary rule is already “effective” with an “applicable date” of April 10, 2017, it is not clear whether the memorandum applies to it. However, there is some expectation among practitioners in the industry that the administration may soon take action to specifically postpone the DOL fiduciary rule. Even if the rule is delayed and perhaps eventually repealed or significantly amended, it appears likely that many of the practices already implemented by market participants in response to the DOL fiduciary rule will remain in place. On the whole, market participants appear to be continuing to analyze and work toward compliance with the rule while keeping an eye on political developments. (See [“Change in Administration Presents Opportunity to Revisit DOL Fiduciary Rule.”](#))

### **Conclusion**

Depending on the magnitude of changes to the rules impacting executive compensation, companies will need to reconsider the design of their compensation programs and related disclosure. Companies should be driven by their established, guiding compensatory principles rather than by reactionary policy, while continuing to stay apprised of impending legal changes.

# Navigating the Challenges of Chinese Acquisitions of US Insurers

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Chinese investment in the U.S. insurance industry continued steadily in 2016, notwithstanding efforts by the Chinese government to impose new restrictions on outbound M&A. (See “[Regional Focus: Asia.](#)”) Examples of such investments included China Minsheng Investment Corp.’s purchase of specialty insurer Sirius International Insurance Group from White Mountains Insurance Group and China Oceanwide Holdings Group’s acquisition of life and health insurer Genworth Financial. Meanwhile, the outcome of Anbang Insurance Group’s proposed \$1.6 billion acquisition of Fidelity & Guaranty Life, announced in November 2015, is pending, with U.S. insurance regulatory approvals still to be obtained. As a result, parties to similar transactions should continue to pay attention to the issues that both private and state-owned Chinese buyers encounter when investing in U.S. insurance companies.

## Regulatory Considerations for Chinese Insurance Investors

### US State Insurance Approvals

The continued delay of the Fidelity & Guaranty Life transaction underscores a primary concern for sellers and acquirers alike: the ability of Chinese acquirers to obtain timely U.S. regulatory approvals, most notably U.S. state-based “Form A” change-of-control approvals. To obtain consent of any change in control, the acquirer typically must file an application with the U.S. state insurance regulators in the states of domicile of each target insurance company, disclosing, among other information, its background (and that of its executive officers and directors), its financial condition and that of its affiliates, the source and amount of funds it will use for the acquisition, and any plans to change the management and operations of the target insurers. In addition to this information, regulators also will consider potential anti-competitive results of the transaction.

Potential concerns regarding plans to change business operations or management and the acquirer’s transparency in connection with its control persons and sources of funding are not unique impositions on Chinese (or other foreign) buyers of U.S. insurance companies. The U.S. private equity industry has encountered similar scrutiny for many years, and various approaches exist to address these concerns, including the use of blocker vehicles to simplify and clarify the ultimate regulatory control structure. In Delaware Life Holdings’ purchase of the U.S. annuity business of Sun Life Financial and Athene Holding’s acquisition of Aviva USA Corp., the New York State Department of Financial Services imposed a number of conditions on its approvals, including heightened risk-based capital levels, backstop trust accounts and the requirement for prior written approval of material changes to each target insurer’s plan of operations.

### Restrictions on Chinese Governmental Ownership or Control of Insurers

Nearly 30 U.S. states have decades-old statutes that generally prevent foreign government-owned, operated or controlled insurance companies from being licensed to transact insurance in those states. Many of these statutes were adopted in the mid-1950s due to concerns regarding global socialism and unfair competition. Transactions involving companies in those states should be structured in a way to separate the foreign government from any “control” over the U.S. insurer in order to obtain the necessary approvals. Because a perception (perhaps unjustified) remains that all Chinese investors have some level of governmental ownership, they should be prepared to prove the lack of such ownership or wall off control from such unknown owners and take additional steps beyond Form A approval to comply with U.S. state laws and regulations.

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## **Committee of Foreign Investment in the United States (CFIUS) Review**

Chinese acquirers should be prepared to seek CFIUS approval of acquisitions of insurance companies that are based in, or sell into, the U.S., particularly if the target does business involving the U.S. federal government or its employees. (See [“CFIUS and Foreign Investment Reviews in 2017 and Beyond.”](#)) In September 2016, following its acquisition by Fosun Group, Ironshore divested its subsidiary Wright USA, which held federal agency employee data, leading many to speculate that CFIUS review prompted the divestiture.

## **Identifying and Allocating US Regulatory Risk**

### **Conducting Sell-Side Due Diligence of Potential Control Persons**

The importance of a potential Chinese acquirer’s increased vigilance in sell-side due diligence regarding regulatory preparedness cannot be overstated. U.S. state insurance regulators have not taken an arbitrary approach to reviewing Form A applications from Chinese acquirers; the applications they have approved contain sound business plans and transparent disclosure regarding the acquirer’s ownership structure. Sellers should ensure Chinese acquirers are able to complete Form A filings satisfactorily, including by disclosing their “top level” ownership and control, as well as the source of funds for the acquisition. Sellers also need to determine whether any of their businesses could be viewed as implicating national security issues that attract the attention of CFIUS.

Likewise, Chinese investors should understand the scope of expected disclosures and ultimately be prepared to share significant information regarding the composition of their investor base or risk being penalized during a sale process for being perceived as less likely to obtain insurance regulatory approval.

### **Reviewing Form A Applications, Obtaining Representations or Covenants Regarding Control Structure**

Sellers should review completed Form A applications, and the definitive purchase agreement should require the prompt filing of the reviewed applications. Given the due diligence requirements on the acquirer, the preparation of Form A applications should not significantly lengthen the presigning timeline. Moreover, sellers need to consider requiring a Chinese acquirer to represent and warrant both as to the accuracy and completeness of the relevant draft applications and to disclose a list of all potential controlling persons, as was provided by China Minsheng and

China Oceanwide. These representations, if negotiated correctly, can be significant tools to bridge perceived acquirer transparency risk in connection with insurance regulatory approvals.

### **Incorporating Real Remedies in Transaction Agreements**

Reverse-termination fees tied to U.S. insurance regulatory approvals are rare, and there are few, if any, examples of such fees in insurance M&A practice. Therefore, it may not be practical or reasonable for a U.S. seller to expect a Chinese buyer to agree to pay a reverse-termination fee if U.S. insurance regulatory approvals are not obtained for any reason.

However, the China Minsheng and China Oceanwide transactions provide two recent examples of transactions where Chinese counterparties have been willing to secure their potential obligations for contractual breach. China Minsheng delivered a \$200 million standby letter of credit issued by the Hong Kong branch of a Chinese bank as security for its obligations under its purchase agreement for Sirius. China Oceanwide deposited \$210 million into escrow and agreed to pay a \$210 million reverse-termination fee to Genworth (approximately 8 percent of the announced transaction value) if the transaction was terminated as a result of failure to obtain PRC, Hong Kong, Macau or Taiwan regulatory approvals or because of material breach of the merger agreement by China Oceanwide.

From a seller’s perspective, the willingness of an acquirer to stand behind these representations and to backstop potential breach claims with secured funds should provide a measure of additional confidence that U.S. state regulators’ informational requirements will be satisfied. From the acquirer’s perspective, complete and correct underlying representations may well limit the risk of not obtaining regulatory approvals.

### **Divestiture Covenants**

Practitioners typically have viewed divestiture covenants as less practical in insurance M&A transactions given the low likelihood (at least outside of the health insurance industry) that a deal will raise competition concerns. However, divestiture and “hold separate” covenants in transactions where the target has insurance (or other) businesses with direct links to the U.S. government or government employees may be beneficial given the likelihood of CFIUS review, particularly with regard to businesses that are less material to the target company.

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Because Chinese counterparties may provide an available source of increased shareholder value, sellers of U.S. insurance companies should continue to view transactions with Chinese investors as viable and potentially attractive, despite the potential for increased execution risk. Well-counseled Chinese investors can be successful acquirers in the U.S. market with the right preparation and understanding of the expectations of state insurance regulators, as well as willingness to share some aspects of regulatory risk with sellers. Despite uncertainty, we expect to continue to see Chinese companies play a meaningful role in U.S. insurance M&A in 2017, and all parties involved should be prepared to implement structures necessary to facilitate successful transactions.





# Litigation

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# 2016-17 Supreme Court Update

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In a season of political surprises, the eight-member U.S. Supreme Court has stirred no controversy with its decisions so far this term. The handful of opinions the Court released in the fall were unanimous and, for the most part, favorable to the federal government. But potentially significant decisions remain on the docket, possibly awaiting the addition of the ninth justice.

**Insider Trading.** In *Salman v. United States*, a unanimous Supreme Court affirmed the U.S. Court of Appeals for the Ninth Circuit's broad interpretation of insider trading liability, abrogating (at least in part) a contrary, high-profile decision by the U.S. Court of Appeals for the Second Circuit. At issue in *Salman* was whether an insider "tipper" breaches a fiduciary duty — by disclosing confidential corporate information for personal benefit — when the disclosure is a gift to a trading relative or friend. In a significant setback for the government in 2014, the Second Circuit in *United States v. Newman* narrowed the circumstances when such a personal benefit can be inferred: It required "proof of a meaningfully close personal relationship" between tipper and tippee "that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." But in *Salman*, the Ninth Circuit disagreed with the Second Circuit and did not require similar proof of potential gain. Instead, it relied on the Supreme Court's 1983 decision in *Dirks v. SEC*, which stated, without qualification, that the tipper receives a sufficient personal benefit by making "a gift of confidential information to a trading relative or friend." In an opinion by Justice Samuel A. Alito Jr., the Supreme Court agreed with the Ninth Circuit that *Dirks* "easily resolves" the issue: "In such situations, the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds" to the relative or friend.

**Sealing False Claims Act Complaints.** In *State Farm Fire and Casualty Co. v. United States ex rel. Rigsby*, the Court addressed the proper remedy for violations of a statutory requirement that certain complaints under the False Claims Act be sealed. When a private party known as a "relator" brings a False Claims Act complaint, the pleading must "be filed in camera, shall remain under seal for at least 60 days, and shall not be served on the defendant until the court so orders." This sealing requirement was breached in *State Farm* through disclosures to media outlets and legislators. But does the violation necessarily require the complaint to be dismissed? In a unanimous opinion by Justice Anthony M. Kennedy, the Court ruled that it does not. Applying standard statutory interpretation tools, the Court held that Congress did not intend dismissal to be the sole remedy. Legislative history also indicated that the sealing requirement "was meant to allay the Government's concern that" the complaint "would alert defendants to a pending federal criminal investigation." Accordingly, the Court reasoned, "it would make little sense to adopt a rigid interpretation" that, through automatic dismissal, "prejudices the Government by depriving it of needed assistance from private parties."

**Fraud on Financial Institutions.** In *Shaw v. United States*, a unanimous Supreme Court had no trouble concluding that an individual who steals from a bank account can be convicted of defrauding the bank. Federal law makes it a crime to "knowingly execut[e] a scheme ... to defraud a financial institution." The defendant, who diverted funds from a bank customer's account, argued that he did not thereby defraud the bank itself, which suffered no pecuniary loss. In an opinion by Justice Stephen G. Breyer, the Court disagreed. It reasoned that the bank had a cognizable property interest in its customer's account and that conviction does not require proof that the bank suffered financial loss.

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**Design Patents.** Writing another chapter in the litigation between two mobile phone giants, the Supreme Court concluded in *Samsung Electronics Co. v. Apple Inc.* that, when it comes to infringements on design patents, damages may be computed from profits on a component of a consumer product rather than the whole product. The Patent Act provides that a person who manufactures or sells “any article of manufacture to which [a patented] design or colorable imitation has been applied shall be liable to the owner to the extent of his total profit.” After a jury found that Samsung’s smartphones violated Apple’s design patents related to the device’s face or screen, Apple was awarded as damages the entire profit Samsung made from the sales of infringing smartphones. The U.S. Court of Appeals for the Federal Circuit affirmed this aspect of the damages award, reasoning that the entire device sold to consumers — not its component, such as the screen or face — must be an “article of manufacture” under the statute. In a unanimous opinion by Justice Sonia Sotomayor, the Supreme Court reversed, holding that “the term ‘article of manufacture’ is broad enough to encompass both a product sold to a consumer as well as a component of that product.” But the Court did not fully resolve the dispute, sending the case back to the Federal Circuit for a determination whether, in the context of the Apple-Samsung dispute, the relevant “article of manufacture” was the smartphone itself or a particular smartphone component.

**Controversies on the Horizon.** Still undecided are a number of more controversial cases, including about whether a city has standing to bring claims under the Fair Housing Act (*Bank of America Corp. v. City of Miami*); whether a state law banning surcharges for the use of a credit card unconstitutionally restricts speech (*Expressions Hair Design v. Schneiderman*); whether agreements to resolve employer-employee disputes through individual arbitration, rather than collective or class proceedings, are enforceable (*Epic Systems v. Lewis*); and whether excluding churches from a state aid program for nonprofits violates the Free Exercise and Equal Protection clauses (*Trinity Lutheran Church of Columbia, Inc. v. Pauley*). In addition, in a case arising from disputes over the use of school bathrooms by transgender students, the Court may revisit foundational administrative law doctrines on deference accorded to federal agencies’ conclusions (*Gloucester County School Board v. G.G.*). Whether that case will be heard at all may depend on positions yet to be taken by the Trump administration, whose actions — most importantly, the nomination to fill the vacancy left by Justice Antonin Scalia’s death last year — may be the most significant developments of the Supreme Court’s term.

# Near-Record Securities Litigation Filings Show No Signs of Slowing

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Plaintiffs filed 300 securities class actions in 2016 — a mark much higher than the annual average of 221 from 2011 to 2015 (as reported by NERA Economic Consulting). Indeed, the number of filings in 2016 was the second-highest filing total in 15 years. The earlier high mark, set in 2001, reflected a series of cases brought in connection with the allocation of shares in high-tech initial public offerings (IPOs). The uptick in filings this year ought to be viewed against the backdrop of an overall decline in the number of public companies compared with 2001. According to a [recent \*Wall Street Journal\* article](#), the number of U.S.-listed companies has declined by more than 3,000 since peaking at over 9,000 in 1997. Since public companies are often the targets of securities lawsuits, the meteoric rise of filings in 2016 is even more remarkable. On average, and taking into account the decline in the sheer number of public issuers, public companies are today more susceptible to being the target of a securities fraud claim than at any other time.

## Rise in Securities Class Actions

Various factors likely account for the increased number of filings. The decline in financial crisis cases, which dominated the landscape since 2008, has freed the resources of the plaintiffs' bar to focus on nonfinancial institutions and to target more traditional corporate stock-drop cases. It appears that the antique model of asserting a securities action virtually every time a stock declines in price (a tactic reminiscent of those employed prior to the enactment of the Private Securities Litigation Reform Act, which heightened the pleading standards required to bring such cases) is back in vogue. The reversion may be financially motivated, as the crowded field of the plaintiffs' bar looks to file more cases, hoping to hit benchmarks. It also is common for securities fraud suits to follow the disclosure of any corporate crisis, including environmental, antitrust, Foreign Corrupt Practices Act (FCPA) or other regulatory issues. The rise in post-crisis disclosure lawsuits (particularly those that follow FCPA investigations) is evident in the increased number of suits brought against foreign issuers, including from Brazil and Asia.

We also have witnessed a rise in accounting and restatement allegations, including actions brought against foreign issuers. And as stock markets (and companies' market capitalizations) have risen, smaller percentage price declines have resulted in larger absolute exposure and thus attracted greater scrutiny from the plaintiffs' bar. The rise in securities cases brought in federal court also may be linked to the reluctance of courts in Delaware to sanction merger settlements following the Delaware Court of Chancery's January 2016 decision in *In re Trulia, Inc. Stockholder Litigation*. (See "[Key Developments in Delaware Corporation Law in 2016](#).") Plaintiffs' counsel appear to be filing disclosure claims under the securities laws in federal court, perhaps as a way of avoiding the traditional path that originally led those litigants to Delaware. Finally, life sciences, technology and other companies that may have highly volatile results depending on the success of certain products remain particularly susceptible to securities actions and were frequently targeted in 2016. These trends, and a continued high number of securities class actions filings, are all expected to persist in 2017.

## Significant Decisions

A number of significant decisions in securities litigation are expected in 2017, especially in the area of class certification. In the era of globally offered securities, the U.S. Court of Appeals for the Second Circuit is poised to issue a ruling in the *Petrobras* case on the impact of the extraterritorial application of the securities laws on the ability to certify a class of globally offered, nonexchange-traded notes. (Petrobras issued globally offered securities that were traded throughout the world and were registered in the United States

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but not exchange-traded.) The court will determine, among other factors, whether the individualized need to determine if a transaction was “domestic” renders the class unascertainable and not appropriate for class certification. Given the reality of globally connected financial systems, the extraterritorial application of U.S. federal securities laws to nonexchange-traded securities will be a closely watched development.

The Second Circuit also is expected to issue three decisions relating to the determination of market efficiency at the class certification stage. These decisions will touch upon who bears the burden of proof and what level of evidentiary support is necessary at the class certification stage to trigger the rebuttable presumption of reliance based on the fraud-on-the-market theory. This theory is necessary for plaintiffs to achieve class certification to avoid the inherent individual inquiries that arise from allegations of direct reliance.

Other areas and issues that we expect to percolate through the courts in 2017 include further clarification of Item 303 trend disclosure (*i.e.*, known trends and uncertainties that will have a material impact) as the basis for a securities class action, loss

causation and the price maintenance theory, and the delineation of statutes of repose and tolling. For example, the U.S. Supreme Court will decide in *CalPERS v. ANZ* whether, pursuant to the *American Pipe* tolling rule, the filing of a putative class action satisfies the three-year time limitation in Section 13 of the Securities Act with respect to the claims of unnamed class members. The outcomes of these cases will impact the arguments defense lawyers can make on motions to dismiss and beyond, as well as on the exposure to such cases. While we anticipate a number of decisions that will benefit public corporations, it is important to analyze each case based on its own allegations, facts and nuances.

The upcoming year is not expected to offer defendants in securities cases a break. While the change in administration is unlikely to have an immediate effect on private securities class actions, if President Donald Trump’s policy proposals result in an increase in the number of IPOs, plaintiffs may have the opportunity to bring more actions under the Securities Act of 1933. (See [“Volatility and Uncertainty Continues in the US Capital Markets.”](#)) In addition, if market volatility increases, securities filings are likely to go up, as plaintiffs will focus their attention on the more significant price declines following disclosure of negative news.

# A Trump-Appointed AG May Not Translate to Less Aggressive Enforcement

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Forecasting the enforcement priorities of the Department of Justice (DOJ) under the Trump administration is difficult at best. Previous statements from both President Donald Trump and his nominee for attorney general, U.S. Sen. Jeff Sessions, R-Ala., shed some light as to their views. While some priorities, such as emphasizing individual culpability, seem likely to continue unchanged, economic realities, changing global dynamics and the promise of deregulation could all impact key areas of enforcement, such as Foreign Corrupt Practices Act (FCPA) prosecutions and criminal and civil cases against financial institutions.

## Individual Culpability

The prosecution of corporate officers and employees involved in misconduct — a key DOJ priority under former Attorney General Loretta Lynch — is unlikely to change with the new administration. The DOJ's focus on individual accountability was formally emphasized in then-Deputy Attorney General Sally Yates' September 2015 memorandum outlining a series of department steps to ensure that corporate officers and employees engaged in wrongdoing, and not just corporate entities, are held accountable. In a late November 2016 speech, Yates indicated that the DOJ viewed these efforts as successful to date. She suggested that corporations have made efforts to provide the DOJ with information on individual wrongdoers and that prosecutors have focused on individuals at earlier stages of investigations since the publication of the Yates memorandum.

As Yates noted in that speech, whether the DOJ will continue the policies outlined in her memorandum remains to be seen. But the focus on individual accountability in criminal cases is long-standing, particularly because corporate liability always has been predicated on violations of law by individual corporate actors. And as Yates pointed out, the emphasis on individual accountability is not ideological, and other key DOJ policies — such as the factors considered in evaluating whether a corporation should be criminally charged — have endured despite changes in administrations. Sen. Sessions' prior statements may foreshadow his current views on the issue. At a 2002 Senate Judiciary Committee hearing, he spoke favorably about the deterrent value of incarceration in bank fraud prosecutions he supervised as U.S. Attorney for the Southern District of Alabama during the savings and loan crisis of the 1980s. In the same hearing, Sen. Sessions also opposed sentencing leniency for white collar offenses, equating sentences for such crimes with those for bank robbery. Given his comments, it would seem that Sen. Sessions agrees that holding individuals accountable for white collar crime has law enforcement value. In the absence of a compelling reason to reverse these policies, the department is expected to stay the course.

## FCPA Prosecutions

Whether the DOJ will continue its focus on new FCPA prosecutions is less certain. The statute was a department priority in the George W. Bush administration, and the Obama administration pursued FCPA prosecutions aggressively thereafter. President Trump's 2012 comments strongly criticizing the statute have been widely reported: At the time, he contended that official corruption should be prosecuted by the authorities in the country in which it occurred, and he asserted that the statute disadvantaged U.S. companies — presumably by prosecuting them for conduct that non-U.S. companies routinely engaged in as a cost of doing business.

While such statements could suggest that the DOJ may de-emphasize FCPA prosecutions in the new administration, it is unclear whether President Trump still holds these views five years later, particularly in light of the changing landscape. Since 2012, some

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countries, including China, Brazil and the U.K., have strengthened their anti-corruption laws and more aggressively prosecuted companies for corruption offenses. Non-U.S. authorities also increasingly initiate and lead such prosecutions against both U.S. and non-U.S. entities, arguably leveling the playing field. Furthermore, a number of the DOJ's recent prosecutions have targeted non-U.S. companies as well as U.S. companies, for conduct that primarily occurs overseas.

The DOJ has invested significantly in the FCPA Unit, where it has a group of dedicated prosecutors and law enforcement agents. The department requires U.S. Attorneys' offices handling FCPA cases to coordinate with the Criminal Division of the DOJ in Washington, D.C.; such coordination is not required in the majority of other types of cases. The increase in prosecution resources to date seems commensurate with the hefty criminal fines imposed in FCPA cases. In 2016, FCPA prosecutions generated a total of \$2.48 billion in monetary resolutions obtained by the DOJ and the Securities and Exchange Commission. For example, it obtained a \$230 million penalty in February 2016 from Amsterdam-based VimpelCom and its subsidiary Unitel for conspiracy to bribe government officials in Uzbekistan and continued, through the end of the year, to resolve a number of foreign bribery investigations with substantial criminal fines and penalties.

The DOJ also has explored policies to encourage corporate voluntary disclosures and resolve its FCPA prosecutions more quickly and efficiently, including a one-year pilot program announced in April 2016 that seeks to quantify benefits from voluntary self-disclosure of corruption-related conduct, full cooperation with the DOJ and remediation. If the program continues to generate voluntary disclosures and cooperation, the DOJ largely could rely on companies' own investigations while conserving its own resources and still collect significant penalties. (The program will be evaluated in April 2017.) Given this combination of factors, it is entirely plausible that the department will not shift its priorities away from FCPA enforcement in the new administration.

## Prosecution of Financial Institutions

Another key question concerning the DOJ's approach to white collar criminal enforcement is whether the DOJ will continue its aggressive approach to prosecutions of financial institutions. Over the last several years, it has investigated multiple global financial institutions and resolved these cases in an increasingly harsh manner, with escalating fines. For example, the DOJ resolved many of its investigations of Libor manipulation with nonprosecution and deferred-prosecution agreements or by the guilty plea of a global financial institution's foreign subsidiary, with fine amounts ranging from approximately \$50 million to approximately \$625 million between October 2013 and March 2015. The department resolved subsequent investigations of manipulation of foreign exchange rates with greater demands: guilty pleas at the parent level of five global financial institutions and criminal fines ranging from \$203 million to \$925 million. More recently, the DOJ imposed even higher penalties — in the billions — on a number of major financial institutions involved in the sale of residential mortgage-backed securities, collecting or reaching agreements to collect over \$18 billion in civil penalties and consumer relief payments in such cases in 2016, with civil penalties ranging from \$2.48 billion to \$3.1 billion and consumer relief payments ranging from \$2.8 billion to \$4.1 billion.

Whether the DOJ continues to pursue financial institutions involved in misconduct under the new administration as aggressively as it has in the recent past remains to be seen. President Trump has stated that U.S. businesses, including financial institutions, are overregulated. He has expressed his intent to repeal all or some of the Dodd-Frank Act (see "[The Trump Impact: Key Issues in Financial Services Reform for 2017](#)") and adopt a general deregulatory policy agenda. However, these efforts may not affect the DOJ's pursuit of substantial civil and criminal penalties against financial institutions. The authorities the DOJ has employed in the majority of its financial institution prosecutions to date — including mail and wire fraud statutes; the Financial Institutions Reform, Recovery and Enforcement Act of 1989; and securities and antitrust laws — will surely remain viable, notwithstanding any regulatory overhaul.

Accordingly, it would be prudent for businesses and their officers to prepare for more of the same aggressive enforcement from the DOJ under the Trump administration.

# Key Developments in Delaware Corporation Law in 2016

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Significant changes in Delaware merger litigation and settlement practice in 2016, as well as noteworthy case law developments and trends, will continue to affect merger parties and litigants in 2017 and beyond.

### **Trulia and Corwin Shake Up Deal Litigation in Delaware and Across US**

One of the biggest developments in Delaware corporation law in 2016 was the Delaware Court of Chancery's decision to upend its long-standing practice of approving disclosure-based deal litigation settlements. In *In re Trulia, Inc. Stockholder Litigation*, issued in January 2016, Chancellor Andre G. Bouchard fashioned a new standard for evaluating disclosure settlements — the “plainly material” standard — and expressed the Delaware courts' preference that disclosure claims be either litigated to a preliminary hearing or made moot by supplemental disclosures.

The decision sparked three observable trends in 2016: lower rates of deal litigation generally, a declining share of such litigation in the Delaware Court of Chancery relative to other states and courts, and decreased fee opportunities for plaintiffs' lawyers. Although the long-term implications are not yet fully clear, we anticipate that these trends will continue in 2017.

According to a [report](#) published in August 2016 by Cornerstone Research, an economic and financial consulting firm, stockholder plaintiffs filed lawsuits challenging 84 percent of M&A deals valued over \$100 million in 2015, which dropped to 64 percent of such deals in the first half of 2016 after the *Trulia* decision was issued. Further, among deals that were litigated, plaintiffs sued in Delaware in 61 percent of cases during the first three quarters of 2015 but only in 26 percent of cases in the fourth quarter of 2015 and first half of 2016. The timing and magnitude of this shift strongly suggests that the plaintiffs' bar is responding to *Trulia* by filing fewer claims overall and avoiding the Delaware Court of Chancery much more often than previously (in some instances, in violation of a company's forum selection charter or bylaw provision). While some states have continued to approve disclosure-based settlements as in the past, other states have adopted Delaware's new, more stringent standards. Most notably, the U.S. Court of Appeals for the Seventh Circuit in *In re Walgreen Co. Stockholder Litig.* recently adopted the *Trulia* standard as well. It remains to be seen whether courts will continue to change their approach in these cases based on *Trulia*.

Disclosure-based settlements also have significantly declined post-*Trulia*, becoming virtually nonexistent in the Delaware courts. Instead, plaintiffs have seemed more inclined to challenge proposed transactions solely on disclosure grounds rather than bring broad claims for breach of fiduciary duty based on the merger price and process, in the hopes of a “mootness”-based resolution through supplemental disclosures. Plaintiffs' lawyers who have sought mootness fees have faced mixed but mostly negative results. For example, in 2016, the Court of Chancery decided several contested mootness fee applications in cases where the defendants issued supplemental disclosures designed to moot the disclosure claims. In each of those cases, the plaintiffs sought fee awards in the \$275,000 to \$350,000 range, but the court only granted amounts of \$50,000 and \$100,000, if any at all.

Meanwhile, as stockholder plaintiffs shift tactics in response to *Trulia's* disfavor of disclosure-based settlements, the importance of disclosures as a matter of substantive corporation law has increased significantly following the Delaware Supreme Court's late-2015 decision in *Corwin v. KKR Financial Holdings LLC*. In its May 2016 opinion

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in *Singh v. Attenborough*, the Delaware Supreme Court reaffirmed the defendant-friendly *Corwin* rule, explaining that “[w]hen the business judgment rule standard of review is invoked because of a vote, dismissal is typically the result.” The court clarified that when a fully informed stockholder vote makes *Corwin* applicable, the only remaining claim a plaintiff stockholder might have is under the “vestigial waste exception,” which has “long had little real-world relevance.” In the aftermath of *Corwin* and *Singh*, the Court of Chancery also issued a string of important rulings in challenges to already-closed mergers that had obtained majority approval from the target company’s stockholders. In each of the *Volcano Corporation*, *Comstock*, *Larkin*, *OM Group, Inc.* and *Solera* cases, the Court of Chancery dismissed stockholders’ claims for breach of fiduciary duty where the plaintiffs failed to state viable disclosure claims to undermine the effect of a disinterested stockholder vote or tender, and failed to allege that the transaction amounted to waste or was tainted by a conflicted controlling stockholder.

Another important trend in 2017 may be the interplay between *Trulia* and *Corwin*, which, in combination, could provide businesses relief from the previous status quo in which nearly every M&A transaction — even those with well-run processes and premium prices — attracted stockholder lawsuits. Overall, *Trulia* has led to a decrease in both deal litigation generally and injunction requests based on disclosure claims specifically. At the same time, the only path for plaintiffs to avoid a post-closing pleadings-stage dismissal under *Corwin* might be to cast doubt on the stockholders’ “fully-informed” approval of the merger — by challenging the disclosures. This has proven difficult given that in most instances, without an injunction-based or settlement-based discovery record from which to draw, plaintiffs’ claims are considered conclusory and fail to gain traction. It remains to be seen whether stockholder plaintiffs will experiment with new strategies and recalibrate, or if the trends of 2016 will lead to permanent changes in deal litigation practice. Additionally, several of the Court of Chancery’s rulings applying *Corwin* have been appealed to the Delaware Supreme Court, and those cases may result in key opinions in 2017, along with new applications of the *Corwin* progeny in the Court of Chancery.

### Several 2016 Appraisal Decisions Depart From Previous ‘Merger Price’ Trend

In 2015, the Delaware Court of Chancery issued several important rulings in the appraisal context. In each of those cases, the court found that the fair value of the dissenting stockholders’ shares was best determined by the per-share merger price (less any merger-related synergies). Several notable opinions in 2016 departed from this trend, finding that, in some cases, the fair value for appraisal was significantly above the price the acquirer paid in the transaction.

Most notably, in *In re Appraisal of Dell Inc.*, the Court of Chancery determined that the fair value of the company was roughly 28 percent above the merger price that Michael Dell and Silver Lake paid to take the company private in 2013. Vice Chancellor J. Travis Laster ultimately gave the merger price no weight in its fair value determination, instead relying entirely on a discounted cash flow valuation. This was especially notable because the court’s assessment of the sale process, led by the special committee of Dell’s independent board of directors, was positive.

Two appraisal cases following Dell also rejected the merger price as evidence of fair value. In the *ISN Software Corporation* case, the court used a discounted cash flow analysis to conclude that the company’s fair value was roughly 158 percent greater than the merger consideration. The court relied exclusively on the discounted cash flows because the method used by the controller to determine value was “unreliable,” and neither historical sales of stock nor analyses of comparable companies and transactions provided reliable indicators of fair value. In the *DFC Global Corporation* case, the court similarly declined to rely on the merger price because the merger “was negotiated and consummated during a period of significant company turmoil and regulatory uncertainty, calling into question the reliability of the transaction price as well as management’s financial projections.” The court weighed a discounted cash flow model, a comparable company analysis and the merger price, and concluded that the fair value of the company was 7.47 percent greater than the merger price.

How the Delaware courts continue to resolve these appraisal issues — most notably, the question of whether “merger price” is the best evidence of fair value — is a ripe area for further development in the coming year. In particular, the respondent companies in the *Dell Inc.* and *DFC Global Corporation* cases have taken appeals to the Delaware Supreme Court. Those cases could bring significant developments to the increasingly important area of appraisal litigation.

### Zynga Adds to Case Law on Director Independence

The Delaware Supreme Court recently issued an important decision on the subject of director independence. In *Sandys v. Pincus*, a rare split decision reversing the Court of Chancery on a fundamental issue of corporation law, the Delaware Supreme Court held that certain directors of Zynga, Inc. were not independent because of personal and professional connections to Mark J. Pincus, the company’s founder and controlling stockholder, and Reid Hoffman, an outside director. Specifically, the majority found that one of the three directors in question — Ellen Siminoff, an outside director — was not independent for purposes of considering the demand because she and her husband co-owned a private airplane with Pincus. The majority also found that

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directors William Gordon and John Doerr were not independent under Delaware law because their venture capital firm owned 9.2 percent of Zynga's equity and was invested in One Kings Lane (a company co-founded by Pincus' wife) and Shopkick, Inc. (another company where Hoffman is a director). The majority opinion determined that this "mutually beneficial ongoing business relationship ... might have a material effect on the parties' ability to act adversely toward each other."

One area to monitor is how the Court of Chancery responds to the *Sandys* opinion, and whether plaintiffs use the opinion as the basis for increased challenges to director independence, especially in companies with controlling stockholders.

# In Chinese Investment Treaties, Questions Arise on Who Qualifies for Protection

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Despite recent criticism from some quarters concerning the use of investment treaties and free trade agreements, the Chinese investment treaty system remains firmly in place. Since 1982, the People's Republic of China (PRC) has concluded over 100 investment treaties with a variety of countries, including numerous African, Latin American and Southeast Asian states. This reflects not only a “capital exporting” trend toward foreign investment by PRC enterprises, but also the PRC government's long-standing policy of fostering protection of those investments.

The terms of Chinese bilateral investment treaties (BITs) vary according to the year they were made and the counterparty state involved. They often provide protection against expropriation of investments along with investor-state arbitration of disputes before tribunals constituted by the International Centre for Settlement of Investment Disputes (ICSID) or established under the arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL), or ad hoc tribunals to determine the extent of compensation due in cases of expropriation. The precise scope of disputes that can be arbitrated (including whether such disputes can involve nonexpropriation claims) has occasionally stirred controversy, and investors must always consult the precise terms of the treaty in question.

One hot-button issue is the question of who qualifies for protection as a “Chinese” investor. The wording of PRC investment treaties typically protects PRC nationals or companies, without elaborating on the criteria for establishing such nationality. The question is whether individuals or companies from “special administrative regions” of China, Hong Kong and Macau may be included in this definition.

Two arbitral tribunals have answered this in the affirmative. In *Tza Yap Shum v. Peru*, an ICSID tribunal held that a Chinese citizen from Hong Kong was entitled to claim damages under the China-Peru BIT. The 2009 case later resulted in an award of damages to the investor as compensation for state interference with a factory he owned in Peru.

More recently, in the case of *Sanum v. Lao Republic*, an UNCITRAL tribunal held in 2013 that a Macau corporation could take advantage of the China-Laos BIT. *Sanum* was the subject of a spirited challenge by the Laos government in the courts of Singapore, where the arbitration was based. In 2015, a single judge of the Singapore High Court annulled the jurisdictional ruling, holding that Macau investors could not avail themselves of the treaty because “the PRC-Laos BIT does not apply to Macau.” But in September 2016, the Singapore Court of Appeal (the nation's highest court) restored the award, holding, on its own independent review of the China-Laos BIT, that its terms embraced Macau investors. The Singapore appeal court's ruling has not quelled controversy over this issue. In October 2016, the PRC's Ministry of Foreign Affairs reacted by stating that it disagreed with the decision, that only mainland Chinese investors are entitled to treaty protection, and that Hong Kong and Macau investors should not be allowed to take advantage of Chinese nationality for such purposes. The issue is complicated by the fact that Macau and Hong Kong still have their own independent investment treaties with some countries — as highlighted recently by *Philip Morris v. Australia*, in which the claimant attempted to use the Hong Kong-Australia BIT (and its UNCITRAL arbitration clause) as a basis for challenging “plain packaging” legislation. (The case was dismissed on jurisdictional grounds, without any discussion of the status of Hong Kong or the substantive merits of the tobacco legislation in question.)

Assuming future arbitral tribunals follow these rulings (and the PRC government does not terminate or otherwise curtail the scope of treaty coverage), investors incorporated

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or based in the two special administrative regions (Hong Kong and Macau) — potentially including corporations that are owned by non-Chinese investors — could utilize PRC investment treaties as a means of protecting their investments and seeking damages for expropriation.

The continuing debate over whether Chinese investment treaties cover only mainland investors or extend to Hong Kong and Macau serves to underscore a broader point — that the PRC government has its own trade, development and investment promotion agenda, and that Chinese trade and investment treaties may well play a significant (if not heightened) role in the decade ahead, in line with the greater overseas deployment of Chinese capital.

# PEMEX and US Enforcement of Foreign Arbitration Awards Nullified in Their 'Home' Courts

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One of the benefits of using arbitration to resolve international disputes is the availability of worldwide mechanisms to enforce an arbitral award. For example, the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention) and the 1975 Inter-American Convention on International Commercial Arbitration (Panama Convention) state that a “winning” party may take an award rendered in a signatory country and enforce it in the courts of any other signatory country where the losing party’s assets are located. Moreover, these treaties provide only very narrow grounds upon which a court may refuse enforcement of a foreign award. Such grounds include violation of fundamental due process, the absence of an arbitration agreement or a breach of international public policy.

The New York Convention also empowers a court to decline enforcement of an award that had been “set aside ... by a competent authority of the country in which, or under the law of which, that award was made.” The Panama Convention has a similar provision. A “set aside” sometimes occurs where the “losing” party resided in the country where the award was made and/or was affiliated with that country’s government and persuaded its own local courts to annul the award, leading to claims that it used its “home court advantage.”

Historically, the attitude of U.S. courts toward foreign set-aside decisions has varied. Several courts have taken the view that, where an award was annulled in the place where arbitration occurred, the award can no longer be enforced in the United States. A few U.S. decisions have taken a different view. In 2016, in *COMMISA v. PEMEX*, the U.S. Court of Appeals for the Second Circuit held that, under the right circumstances, U.S. courts may enforce international arbitration awards even when foreign jurisdictions annul them.

## Enforcement in US Courts

*PEMEX* arose from a dispute between private enterprise *COMMISA*, a Mexican subsidiary of the Texas-based corporation *KBR Inc.*, and state-owned Mexican petroleum company *PEMEX* concerning two contracts to build oil platforms in the Gulf of Mexico. Those contracts provided for arbitration of disputes in Mexico. In 2009, an arbitral tribunal awarded *COMMISA* over \$350 million in damages for breach of the construction contracts. In 2011, however, a Mexican court set aside the award, on the grounds that Mexican administrative law did not permit arbitration of claims against a state instrumentality.

Undeterred, *COMMISA* sought enforcement of the award in U.S. courts. In 2013, a New York federal judge held that the award should be enforced because the Mexican court judgment had offended “basic notions of justice” by retroactively applying administrative laws in such a manner that rendered the case nonarbitrable. The Second Circuit affirmed the lower court’s decision on August 2, 2016.

The Second Circuit’s ruling is in sharp contrast with previous rulings on the issue, including in *TermoRio S.A. E.S.P. v. Electranta S.P.* (D.C. Cir. 2007), in which the U.S. Court of Appeals for the District of Columbia Circuit held that, absent “extraordinary circumstances,” awards that were set aside by the courts of the country in which they were made should not be enforced in the United States. That case involved annulment by the Colombian courts of an international arbitration award rendered in that country.

Several recent U.S. decisions have followed the *TermoRio* approach. In *Thai-Lao Lignite (Thailand) Co. v. Gov’t of Lao People’s Democratic Rep.* (S.D.N.Y. 2014), a New York

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federal court denied enforcement of an arbitration award rendered in Kuala Lumpur that was subsequently set aside by Malaysian courts. And in *Getma Int'l v. Rep. of Guinea* (June 9, 2016), the U.S. District Court for the District of Columbia denied enforcement of an award rendered by a regional West African arbitral tribunal that had been set aside by Ivory Coast courts on the grounds that the arbitrators allegedly were paid above ordinary scale.

In *PEMEX*, the Second Circuit held that under the Panama Convention's enforcement framework, a U.S. court “*must* enforce an arbitral award rendered abroad unless a litigant satisfies one of the seven enumerated defenses [in Article V of the Convention]; if one of the defenses is established, the district court *may* choose to refuse recognition of the award” (emphasis in original). Here, one of those defenses was established, *prima facie*, because the award had been set aside in the courts of the place in which it was made.

Although the Panama Convention provided “discretion” as to whether to give effect to the Mexican court’s ruling, the Second Circuit held that this discretion “is constrained by the prudential concern of international comity,” which treats the judgment of a foreign court as conclusive “*unless ... the enforcement of the foreign judgment would offend the public policy of the state in which enforcement is sought — which requires the US court to analyze whether the foreign set-aside decision violated fundamental notions of what is decent and what is just*” (citation and internal quotations omitted; emphasis in original).

The Second Circuit held that the Mexican court’s decision in setting aside the award violated these principles. In particular, it found that: (1) the Mexican court had allowed an “eleventh hour” sovereign immunity defense to succeed, even though PEMEX had not timely raised this defense during the arbitration; this “shattered” COMMISA’s “investment-backed expectation in contracting” and “impair[ed]” a “core” precept of contract law; (2) the Mexican court’s decision allowed Mexico’s statutes to

be enforced on a “retroactive” basis so as to shield PEMEX from arbitration; (3) the set-aside decision deprived COMMISA of any effective forum for seeking relief; and (4) the net effect of the decision was to expropriate assets, without compensation. Thus, the lower court’s decision affirming the award, and entering judgment against PEMEX, was affirmed.

In reaching its conclusion, the Second Circuit panel wrote that a court should “act with trepidation and reluctance in enforcing an award that has been declared a nullity by the courts having jurisdiction over the forum in which the award was rendered.” However, it concluded that the *PEMEX* case was not one of the U.S. courts “second-guess[ing]” a foreign judicial decision. Rather, in this “rare” case, enforcement of the foreign award was necessary to uphold “public confidence in laws” and to prevent the diminishment of “personal rights and liberty.”

PEMEX, having failed to obtain *en banc* review of the Second Circuit’s decision, will likely seek to appeal the matter to the U.S. Supreme Court. Regardless of whether the Court weighs in on the issue, *PEMEX* is not likely to be the last case to deal with awards that are vacated in the losing party’s “home” court — and the U.S. courts are not the only courts to have addressed this issue. For example, in 2016, the French courts held that a large arbitration award against Russia (brought by the former shareholders of Yukos) may be enforced, even though it was annulled by a first-instance judge in the Netherlands, where the arbitration occurred.

These cases thus serve as a timely reminder not only of the importance of choosing an appropriate arbitration seat but also of the complex enforcement issues that may arise once an award is rendered. They also show that, although the U.S. courts generally will respect the decisions of foreign courts (such as those in Mexico), that deference is far from absolute, and foreign judicial decisions will not be enforced where they violate basic U.S. conceptions of fairness and due process.

# Business and Human Rights Movement Spurs Development of Remedial Options

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In the emerging area of business and human rights, the endorsement of the United Nations Guiding Principles on Business and Human Rights (UNGPs) by the U.N. Human Rights Council five years ago marked a watershed event. The UNGPs consist of three pillars, summarized as Protect, Respect and Remedy. Specifically, they recognize: (1) the state's obligation to protect against human rights abuse, (2) the responsibility of business enterprises to respect human rights, and (3) the need for access to effective remedies for human rights abuses.

As noted in the recently published IBA Practical Guide on Business and Human Rights for Business Lawyers, while the UNGPs do not have the force of law and are nonbinding, they “are increasingly reflected in public policy, in law and regulation, in commercial agreement, in international standards that influence business behavior, in the advocacy of civil society organisations, and in the policies and processes of companies worldwide.”

With respect to the call for effective remedies, divergent proposals have been advanced, largely independent of one another, and corporate actors and their lawyers should be aware of key developments in this area.

## Judicial Remedies

In many instances, national courts have restricted claims by citizens (or groups of citizens) concerning personal injuries and/or violations of basic human rights. As we have noted in previous articles (available [here](#) and [here](#)), the trend in the United States has been to limit the ability of parties to invoke the protections of U.S. courts in lawsuits arising out of alleged tortious activity occurring in another country. In particular, in *Kiobel v. Royal Dutch Petroleum Co.*, the U.S. Supreme Court held that the Alien Tort Claims Act did not have extraterritorial application, and it upheld the dismissal of claims alleging that certain corporations aided and abetted an African government's human rights violations. This trend has led to increased consideration of alternative nonjudicial remedies.

## Private Arbitration

One nonjudicial proposal calls for the creation of a private international arbitration system to address disputes relating to alleged business-related human rights abuses.

This system, which would be similar to the one currently used for international commercial business disputes, would include an International Arbitration Tribunal on Business and Human Rights created by the Permanent Court of Arbitration, which is headquartered in the Hague. The tribunal would, among other things, adjudicate claims brought against multinational business enterprises by human rights nongovernmental organizations (NGOs) on behalf of victims.

The proponents of such a Tribunal cite as advantages that (1) proceedings, mutually agreed upon by the parties, could be held throughout the world in a neutral location, before a neutral tribunal with expertise in business and human rights issues; (2) disputes would be resolved in a shorter time frame than available through many national court proceedings and would result in arbitration awards widely enforceable throughout the world; and (3) the parties would have the ability to craft procedures tailored to the needs of the dispute. Submission of a human rights dispute to the Tribunal would, however, require consent of both the business enterprise and the NGO, and proponents recognize that it may take time for both sides to accept such a forum.

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### **Other Nonjudicial Options**

Other nonjudicial mechanisms for addressing business and human rights issues, both state-based and private, are also being explored. The private mechanisms include operational-level grievance procedures allowing affected parties to engage with representatives of the business enterprise. Some companies have also sponsored remediation plans, but such programs have been criticized as not being fully independent or not fully addressing the grievances of local communities.

State-based nonjudicial grievance mechanisms include the National Contact Points (NCP) system, which has been heralded as a “global forum for remedy for corporate human rights abuses” in a June/July 2016 *IBA Global Insights* article. Under this system, in place in more than 40 nations, the NCP for a particular country may accept complaints, provide an opportunity for parties to undergo a mediation process, investigate the

allegations and issue final statements at the end of the process. However, a lack of consistency across the NCP system has been reported resulting in varying degrees of success.

### **Human Rights Treaty**

In July 2014, the U.N. Human Rights Council established an intergovernmental working group to develop a binding treaty to address corporate responsibility for human rights abuses. This effort has generated much controversy and debate, and its future remains uncertain.

In the meantime, as private and corporate actors continue to adopt initiatives to promote compliance with human rights in the countries in which they operate, divergent proposals for a mechanism to remedy alleged violations of those rights will continue to be put forth.





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# Financial Regulation

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# The Trump Impact: Key Issues in Financial Services Reform for 2017

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The Trump administration has provided few specifics regarding its plans for financial regulatory reform. But Republican control of the executive and legislative branches of the federal government should create a favorable environment for financial services deregulation. We expect that regulatory relief will be most advantageous for community and regional banks and will spur, over time, accelerating consolidation among those banks.

### Reforming Dodd-Frank: The View From the White House

During the campaign, candidate Trump promised to eliminate or “change greatly” the Dodd-Frank Act. Rather than offer specifics, President Trump and his team have provided insights into the key goals they hope to achieve in financial reform.

President Trump, along with his nominee for secretary of the Treasury, Steven Mnuchin, expressed concern that Dodd-Frank disproportionately harms community financial institutions relative to large banks. Accordingly, we expect financial reform to focus on benefiting small and medium-sized banks. This approach also would allow President Trump to project a populist approach to financial regulation — maintaining a hard stance toward the country’s largest banks while responding to constituents by easing regulation of their community and regional depositories. Mnuchin’s recent testimony to the Senate Finance Committee provides further support that the administration will adopt this regulatory philosophy: Mnuchin committed to reducing regulation for local and regional banks, stated that he supports the Volcker Rule (but expressed concern about the rule’s definition, including its impact on market liquidity) and noted that he and the president had discussed implementing a 21st-century version of the 1933 Glass-Steagall Act.

Perhaps the biggest question for financial regulatory reform is the degree to which the White House will prioritize it in relation to its other initiatives. Few commentators believe President Trump or Mnuchin is a financial reform ideologue. Instead, most expect that the administration will focus on health care, tax reform and infrastructure spending before addressing wholesale financial reform.

### Reforming Dodd-Frank: The View From the Hill

By contrast, the House of Representatives is prepared to move forward with a comprehensive plan for financial reform. Rep. Jeb Hensarling, R-Texas, chairman of the House Committee on Financial Services, has said that his financial reform bill, the Financial CHOICE Act, will be his top legislative priority.

The Financial CHOICE Act is a comprehensive Republican-proposed financial reform bill, and Rep. Hensarling has considerable influence over financial reform legislation. The House will likely approve legislation reported by the Financial Services Committee. Therefore, we believe some version of the Financial CHOICE Act will be the framework congressional Republicans use to initiate financial reform.

Important elements of the Financial CHOICE Act include:

- allowing banks to forgo many Dodd-Frank rules by adhering to a heightened leverage ratio, including:
  - eliminating various concentration limits related to M&A activity and
  - eliminating the requirements that bank holding companies with \$50 billion or more in assets notify the Federal Reserve Board of any acquisition of a company engaged in financial activities with \$10 billion or more in assets;

- eliminating the Federal Deposit Insurance Corporation's (FDIC) orderly liquidation authority and replacing it with a new chapter in the Bankruptcy Code;
- downgrading the Financial Stability Oversight Council and removing its nonbank systemically important financial institution (SIFI) designation authority; and
- repealing the Volcker Rule.

Whether through the Financial CHOICE Act or other legislation, we expect the Trump administration and a Republican Congress to increase the current \$50 billion automatic SIFI-designation threshold, which has been a meaningful deterrent for bank M&A activity at the regional and community bank level.

In the Senate, the path to reform is less clear. Sen. Mike Crapo, R-Idaho, the new chairman of the Banking, Housing and Urban Affairs Committee, has not yet identified his legislative priorities beyond regulatory relief for small banks and housing finance reform. Additionally, Republicans are eight votes short of the 60 votes they need to end a filibuster. So any financial services bill approved by the Republican-controlled House likely will be subject to negotiation with Senate Democrats. The degree of ultimate financial reform is not certain, and major elements of Dodd-Frank may remain.

### Changing of the Guard at Federal Banking Agencies

Regulatory reform legislation is subject to obtaining the votes of Democratic senators. But regulatory appointments are not. Needing only a simple majority of senators to confirm his appointments, President Trump will have the opportunity to significantly affect the policy direction of the three major federal bank regulators through his appointment power within his first two years in office:

- In March 2017, President Trump will be able to appoint a new comptroller of the currency, who also will serve as a member of the FDIC board;
- In November 2017, President Trump will have the chance to appoint a new chairman of the FDIC, where one seat is already vacant; and
- In February 2018, Federal Reserve Chair Janet L. Yellen's term as chair expires. In June 2018, Vice Chairman Stanley Fischer's term as vice chairman expires. Two Federal Reserve Board seats are currently vacant, and the post of vice chairman for supervision, created by the Dodd-Frank Act, has never been designated. In total, President Trump will have the opportunity to appoint at least four of the seven members of the Federal Reserve Board within two years of taking office.

The Trump administration is focused on filling the role of the Federal Reserve vice chairman for supervision. This appointee will have a significant impact on the direction of financial regulatory policy in many important areas, including bank M&A and stress testing/Comprehensive Capital Analysis and Review (CCAR) policies.

### Implications for Fintech

The implications of deregulatory changes on the financial technology sector remain unclear. On the one hand, deregulation should help fintech companies navigate the increasingly complicated regulatory regimes to which they are often subject (*e.g.*, Consumer Financial Protection Bureau regulation and enforcement). But on the other hand, it could be a catalyst for regulated players like banks to get back into areas they previously shunned due to the regulatory burden (*e.g.*, certain types of consumer lending).

Regulatory support for fintech firms may come from Congress. Rep. Patrick McHenry, R-N.C., vice chairman of the House Financial Services Committee, introduced the Financial Services Innovation Act of 2016 in September. The proposed bill would create a Financial Services Innovation Office in certain government agencies that would be committed to fintech. The bill also would establish a framework that would provide regulatory protection to fintech companies' new products. We expect Rep. McHenry will continue to pursue a version of the bill in the 115th Congress.

### Implications for Bank M&A

Reduced regulation of banks is likely to open new opportunities for depository institutions to grow organically and by merger. Raising the SIFI designation threshold would encourage dealmaking among regional and community banks, which could be further assisted by new regulatory policy directions from federal banking agencies. Although legislation reforming the Dodd-Frank Act may take time and should not be expected earlier than mid-year, we expect the regulatory environment to become more favorable to dealmaking in 2017 and beyond.

# Future of Sanctions on Iran, Russia and Cuba Uncertain Under Trump

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Throughout the eight years of the Obama administration, the development and implementation of economic sanctions was a key element of U.S. foreign and national security policy. This strategy continued into the post-election lame-duck period, with new sanctions against Russia, further changes to the Iran sanctions, the easing of sanctions on Sudan and the continued targeting of North Korea, terrorist networks and transnational criminal organizations.

President Donald Trump has been critical — during the campaign and since his election victory — of the Obama administration’s approach to Iran, Russia and Cuba, raising the prospect of sanctions-related policy changes in his administration. Regardless of how the Trump administration deploys sanctions as a tool of U.S. foreign policy, we expect continued vigorous enforcement of sanctions violations by federal and state regulators.

## Iran

During the campaign, President Trump threatened to dismantle and renegotiate the Joint Comprehensive Plan of Action (JCPOA) negotiated by China, France, Germany, Russia, the United Kingdom and the United States (the P5+1) with Iran. In exchange for steps taken by Iran with respect to its nuclear program, the U.S. suspended certain sanctions on Iran, with a principal focus on lifting so-called secondary sanctions that targeted non-U.S. financial institutions and other non-U.S. companies doing business with Iran. (See our January 28, 2016, client alert [“Implementation Day’: Key Aspects of US and EU Implementation of Iran Sanctions Relief”](#) and our July 23, 2015, client alert [“Sanctions Relief Under the P5+1 Agreement With Iran: Implications for US, EU and International Business.”](#)) The United Nations and European Union simultaneously lifted many of their respective sanctions on Iran.

We see four broad sanctions scenarios available to the Trump administration with respect to Iran.

- 1. Maintenance of Status Quo.** Although unlikely in view of the statements made to date, it is conceivable that the Trump administration could generally continue the path the Obama administration took if there is a determination that core U.S. objectives are being achieved under the deal. The Obama approach to Iran sanctions post-JCPOA principally involved the implementation of the JCPOA sanctions relief and a limited number of “maintenance” actions sanctioning individuals and entities for non-nuclear Iranian conduct that falls outside the scope of the negotiated relief.
- 2. Withdrawal From the JCPOA.** The JCPOA is not a treaty, but rather an executive agreement with voluntary undertakings by the parties. The Trump administration could unilaterally withdraw the United States from the JCPOA. Alternatively, the administration could reimpose some or all sanctions for which relief was provided under the deal — with or without a violation by Iran. Iran would likely respond to a reimposition of suspended sanctions, regardless of the motivation for such a step, by asserting a U.S. breach and taking counteractions of its own. In all likelihood, even if the JCPOA dispute resolution mechanism is employed, a material breach by either party would result in the deal’s demise.

The U.S. would be expected to follow a collapse of the deal with a robust sanctions campaign. However, if the United States was blamed for the deal’s failure, it could create diplomatic challenges for the U.S. with key allies, including European partners that were essential to sanctions efforts before the JCPOA and would be important to any renewed sanctions intended as leverage to achieve new deal terms.

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**3. Preservation of JCPOA Sanctions Relief While Increasing Non-Nuclear Sanctions.** In light of the challenges associated with withdrawal from the JCPOA, President Trump could continue implementation of the negotiated nuclear-related sanctions relief but increase non-nuclear sanctions on Iran (e.g., sanctions related to support for terrorism, human rights abuses, activities in Syria). Such measures could include the designation of additional actors under existing authorities and the imposition of new categories of sanctions by executive order. Alternatively, the administration could let Congress take the lead on new measures and then implement the statutory sanctions.

It is likely that such an approach would be met by Iranian accusations of a breach of the spirit, if not the letter, of the agreement. Whether or not this approach could trigger the end of the JCPOA will likely depend on the nature of any new sanctions, the extent of their economic impact and whether the new measures would replicate relieved sanctions in practice if not in name. Also in question is how they might play out domestically in Iran in the context of its presidential election in May 2017 and how election politics could drive the Iranian response.

**4. Return to the Negotiating Table?** If President Trump pushes for renegotiation of the JCPOA, the willingness of Iran and the other members of the P5+1 to participate will be essential. That said, it is unclear what new terms may be sought from Iran with respect to its nuclear program, or whether the negotiations could potentially expand in scope to include other areas of concern for the U.S. government, such as Iran's support for terrorist groups and its activities in Syria. Similarly, it is far from clear what the U.S. might offer with respect to sanctions relief in the context of any renewed negotiations.

At this early stage of the Trump presidency, it appears most likely that the administration will continue to provide the technical nuclear-related U.S. sanctions relief under the JCPOA but — either on its own or through Congress — increase non-nuclear sanctions on Iran.

## Russia

U.S. sanctions against Russia have received significant attention in recent weeks and months, including as a result of new U.S. sanctions targeting Russia's principal intelligence services, the FSB and the GRU. On January 11, 2017, President Trump's nominee for secretary of state, Rex Tillerson, asserted in his Senate confirmation hearing that Russia "poses a danger" to the United States. He also appeared to signal simultaneously no immediate change on policy with regard to sanctions against

Russia and a willingness to review the current approach, stating it is "important that we keep the status quo until we are able to develop what our approach is going to be." Later that same week, then-President-elect Trump stated in an [interview](#) with *The Wall Street Journal* that he would keep certain sanctions on Russia "at least for a period of time" but signaled that he would consider relieving them if Russia proved helpful on other U.S. policy objectives, such as counterterrorism.

While Congress passed two pieces of sanctions legislation in 2014 with respect to the situation in Ukraine, most U.S. sanctions on Russia have been imposed via executive order. Consequently, if the Trump administration were to adopt a shift in U.S. policy toward Russia, nearly all current U.S. sanctions on Russia could be modified or removed by executive action.

A radical shift in U.S. sanctions on Russia without a corresponding change in Russia's activities involving at least Ukraine and Syria would likely encounter significant objections, and a legislative response, by many in Congress. On January 10, 2017, five Democratic and five Republican senators announced a new Russia sanctions bill, the Countering Russian Hostilities Act of 2017, which seeks to limit the flexibility of the president and includes new measures that, if enacted, would be among the most powerful sanctions imposed on Russia since the first round of Ukraine-related sanctions were issued in March 2014. The timing of the introduction of the bill — the day before the Tillerson confirmation hearing — appeared intended to send a message that Congress plans to be an active participant in setting Russia policy.

Sanctions on Russia in response to the situation in eastern Ukraine have been a trans-Atlantic effort, with closely coordinated measures by the U.S. and the European Union. A change in U.S. policy toward Russia — or even a less resolute status quo — would likely have ramifications for EU sanctions as well, where the retention of sanctions measures requires unanimity among the 28 member states. In that regard, there are three important tests for the EU in the next six months, when the EU financial sanctions against targeted individuals and entities (March 2017), the EU restrictive measures against Crimea and Sevastopol (June 2017), and the EU sectoral sanctions on Russia (July 2017) all come up for renewal.

## Cuba

Sanctions involving Cuba received less attention than those on Iran and Russia during the U.S. presidential campaign. President Trump has criticized the Obama administration's shift in the decades-long U.S. policy toward Cuba and several rounds of sanctions easing, tweeting that "if Cuba is unwilling to make

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a better deal for the Cuban people ... I will terminate [the] deal.” During his confirmation hearing, Tillerson indicated that a review of Cuba policy would be undertaken, including “the change in the status of travel to Cuba as well as business activities in Cuba” and the appropriateness of Cuba’s 2015 delisting as a state sponsor of terrorism.

Although the Obama administration’s changes have allowed for increased travel from the United States to Cuba and more commercial activity between the two countries, most elements of the U.S. embargo remain in place. If President Trump were to reverse the easing of sanctions, he could do so easily and quickly, as the steps President Obama took were all done by executive action and could be undone in the same fashion.

Although the longer-term approach to Cuba is unclear, it appears likely in the near term that the Trump administration will hit the pause button on Cuba while it conducts the policy review Tillerson referenced. During this period, we do not expect a reversal of the Obama administration’s changes; however, further rounds of easing are unlikely.

# Blockchains Offer Revolutionary Potential in Fintech and Beyond

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Blockchain, the distributed ledger technology that underlies bitcoin transactions, has been heralded as a transformative technology that is as significant as the development of the internet. The enthusiasm for blockchain technology over the last two years has little to do with bitcoin itself. Rather, the distributed ledger technology the blockchain utilizes has myriad potential powerful applications that could fundamentally change the financial services industry as well as any industry relying on the use and sharing of data.

According to an August 2016 study by the World Economic Forum, over \$1.3 billion was invested in blockchain technology over the past three years, with more than 90 companies joining blockchain consortia seeking to develop useful applications. In late September 2016, congressional representatives unveiled the bipartisan Congressional Blockchain Caucus to “educate, engage, and provide research to help policymakers implement smart regulatory approaches to the issues raised by blockchain-based technologies and networks.” Rep. Mick Mulvaney, R-S.C., who helped launch the caucus, has been selected by President Donald Trump to serve as the director of the Office of Management and Budget. We expect 2017 to be a watershed year in terms of both blockchain development and how regulators address this technology.

## Distributed Ledgers: The Basic Concept Behind Blockchains

The key to blockchain technology is the concept of distributed ledgers. In traditional centralized ledger systems, a single trusted party controls the master database that records all processed transactions. These hubs also serve as a trusted third party through which two unrelated parties can safely exchange items of value. While centralized systems provide key benefits, they lack transparency, add an additional layer of transaction costs and are only as safe as the security of that central database.

With blockchains, distributed ledgers provide the same benefits as a trusted third party, but in a far more efficient and secure manner. In a blockchain, every network user has its own verified copy of the ledger. Through cryptography, distributed consensus networks and other algorithms, each new transaction is verified across the network and then added to the block. Each ledger is updated simultaneously, creating an immutable record. The security of these systems is virtually guaranteed by the fact that a hacker would have to infiltrate more than half the nodes on the network — a virtually impossible task and, in any event, likely cost-prohibitive. Since each transaction is verified by the network, blockchain users can transact directly with each other, eliminating the transaction costs of a central hub. To date, blockchains are divided between those that are “private” or “permissioned” and those that are “public.” In a private blockchain, participation is controlled (*e.g.*, a group of banks that agree to use a blockchain for interbank transactions), while a public blockchain has no limitations on participation.

Blockchain technology could be applied to any system that has historically relied on a central trusted authority for functions such as payment transfers, clearing and settlement. Indeed, blockchains could fundamentally reshape the entire architecture of the financial system. Moreover, since the essence of blockchain technology is to allow for quicker, more efficient and more reliable data exchanges, the blockchain could revolutionize any industry that relies on data. Common examples are the recording and management of chain of title or equity ownership, or the protection and dissemination of personal information. Since any asset can be represented by data, blockchain proponents see new paradigms for the licensing and distribution of intellectual property content, supply chain management and the recording of corporate shares. For example, through its Blockchain Initiative, the state of Delaware is promoting blockchain-based corpo-

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rate shares. While the state government has acknowledged that multiple regulators would have to join that effort, the state's goal is to clear the legal path to make the initiative viable.

### **The Regulatory Environment**

Since blockchain technology is still evolving in the financial services sector, no meaningful regulation has yet been issued. Nonetheless, regulators are watching this space closely, hoping to avoid a situation in which they are reactive to technology that has already been implemented. In 2016, the U.S. Federal Reserve, the People's Bank of China, the Bank of England and the Central Bank of Russia all issued pronouncements about the importance of this technology and its potential impact. For example, Federal Reserve Chair Janet Yellen, testifying at a congressional hearing in September 2016, stated that "[blockchains] could have very significant implications for the payments system and the conduct of business," and that "innovation using these technologies could be extremely helpful and bring benefits to society." The U.K.'s Financial Control Authority "regulatory sandbox," which was established in 2014 to create a "safe space" in which businesses could test innovative technology products and services in a live environment while ensuring that consumers are appropriately protected, has placed great emphasis on blockchain solutions.

Regulators also must evolve with the introduction of this new technology. The Securities and Exchange Commission (SEC) has established a blockchain working group that is considering, in part, the need for the commission to have stronger technology expertise to address issues as they arise. More generally, the SEC has focused on gathering information about blockchain technology and how it could impact transfer agents, for example. In 2017, the SEC likely will make more definitive pronouncements on blockchain adoption.

The concept of blockchain regulation is anathema to many proponents of the technology who believe its transparency and decentralization eliminate the need for regulation. Blockchain systems ultimately may lower compliance costs by allowing regulators to take advantage of the transparency of the system and access data directly, but regulators likely will not allow time- and battle-tested systems such as payments, clearing and settlement to be replaced wholesale without some degree of regulatory oversight. Notwithstanding the strong focus on blockchains

within the financial services sector, the looming possibility of regulation may result in blockchain systems being implemented in nonregulated contexts first, such as in a supply chain system.

### **Smart Contracts**

Blockchains are rarely discussed without mention of "smart contracts." The concept behind smart contracts is that machine code would replace or, more likely, supplement legal contracts so the terms of a contract would be executed automatically. For example, the system would be able to verify that a party satisfied its performance obligations and then transfer the applicable consideration from the counterparty. Of course, the numerous subtleties of complex commercial agreements do not lend themselves to being expressed in objective computer code. Nonetheless, many standardized agreements, especially those that are entered into repeatedly within an industry, might be amenable to legally binding code-based solutions. For example, a smart contract in the mortgage context might track and automatically release a lien when a mortgage is fully paid. The concept of smart contracts should advance significantly in the coming year, with regulators — particularly in the financial services space — paying particular attention to the intersection of smart contracts and blockchains and whether they might permit users to circumvent long-established regulatory requirements.

### **The Road Ahead**

While blockchain technology is in its nascent stage, technologists expect it will evolve and be adopted at a much faster rate than other information technologies. Their optimism is based on the fact that distributed, interconnected computers — which are the essence of blockchain technology — are already well accepted and understood, and almost every potential user already has multiple devices connected to the network.

That said, a number of hurdles remain before blockchain technology can be widely adopted. Some have expressed concern that the technology has become fragmented without a coherent direction, which creates confusion in the marketplace and could slow adoption. Others question whether blockchains can efficiently handle large transaction volumes. Companies should closely monitor developments and consider how they might benefit from use of the technology.

# The Uncertain Future of the Consumer Financial Protection Bureau

## Contributing Partners

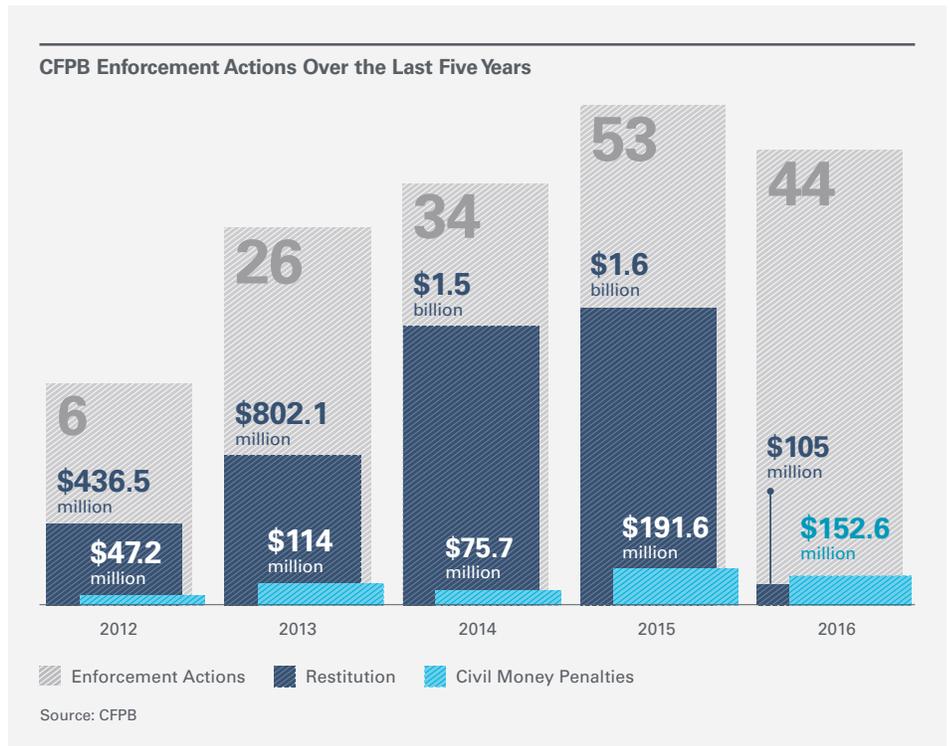
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Since its inception in July 2011, the Consumer Financial Protection Bureau (CFPB) has sought to prove itself as a powerful regulator through significant enforcement actions and settlements. In 2016, the CFPB continued to aggressively enforce federal consumer protection laws, including imposing its largest civil penalty to date — \$100 million — in a settlement announced in September. But two developments in 2016 threaten to disrupt the CFPB's operations: the U.S. Court of Appeals for the District of Columbia Circuit's *PHH* decision and the election of Donald Trump.

## Enforcement Actions Trending Downward

The CFPB has filed more than 160 enforcement matters to date, including more than 40 in 2016 alone. These actions have resulted in restitution to consumers totaling more than \$4.4 billion and civil money penalties (CMPs) of more than \$580.9 million. The following chart summarizes CFPB enforcement actions over the last five years:



As the chart shows, after a very active 2015, the CFPB's restitution and civil penalties from enforcement actions decreased in 2016. Moreover, the majority of the total penalties assessed in 2016 related to one case — the CFPB's September 8, 2016, settlement with Wells Fargo regarding sales practices.

## Recent Court Decisions Limit CFPB Power

Two court decisions in 2016 have placed significant constraints on CFPB authority. In *CFPB v. Accrediting Council for Independent Colleges and Schools*, the U.S. District Court for the District of Columbia held that the CFPB did not have the authority to issue a civil investigative demand (CID), a type of administrative subpoena, to an accreditor of for-profit colleges. This case, decided on April 21, 2016, represents the first time that

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a federal court has quashed a CFPB CID. In doing so, the court noted that the CFPB's investigative authority is limited to inquiries regarding potential violations of consumer financial laws, and that there is no "clear nexus" between these laws and the for-profit college accreditation process. The court also warned, "Although it is understandable that new agencies like the CFPB will struggle to establish the exact parameters of their authority, they must be especially prudent before choosing to plow head long into fields not clearly ceded to them by Congress." The CFPB has appealed this decision to the D.C. Circuit, with a ruling expected in 2017.

A second decision poses an even greater threat to the authority of the CFPB's director. In October 2016, in *PHH Corp. v. CFPB*, two of three judges on the D.C. Circuit held that the single-director structure of the CFPB was unconstitutional and a departure from the setup of other independent agencies, which are overseen by multimember commissions. The court stressed that placing so much power in the hands of a single director was particularly concerning because, given the broad scope of the CFPB's authority and jurisdiction, the agency exercises "massive power." The court concluded that the provision governing removal of the CFPB director — which authorizes removal by the U.S. president only for cause — violates constitutional separation-of-powers principles. However, rather than shut down the agency, the court severed the removal provision from the rest of the statute, a narrow remedy that would allow the CFPB to continue to operate and give the president the authority to remove the director at will.

The *PHH* case has a complicated history. In 2014, the CFPB filed an administrative action against PHH alleging that the company's captive reinsurance agreements violated the anti-kickback provisions of the Real Estate Settlement Procedures Act. After a trial, an administrative law judge ruled against PHH but assessed damages at \$6.9 million. Both PHH and the CFPB sought CFPB Director Richard Cordray's review of that decision. On review, Director Cordray broadened the relief significantly and ordered PHH to pay \$109 million in disgorgement. PHH appealed to the D.C. Circuit, arguing in part that the structure of the CFPB was unconstitutional.

The CFPB has since filed a petition for rehearing *en banc* by the D.C. Circuit, asserting that this "may be the most important separation-of-powers case in a generation." In the interim, the court has stayed its issuance of a mandate, so the ruling has no immediate legal effect.

### **Election Brings More Uncertainty to the CFPB's Future**

At the political level, President Trump's victory and continued Republican majorities in the House and Senate introduce significant uncertainty with respect to the CFPB's future in three primary ways:

- **Removal of the Director.** Now that he has taken office, President Trump may take action to remove Director Cordray even before a final ruling in the PHH case. The president could seek to fire Director Cordray for cause — that is, for "inefficiency, neglect of duty, or malfeasance in office" — citing actions Director Cordray has taken during his term that CFPB critics claim exceeded his authority. Alternatively, President Trump may conclude that he has the independent authority to decide whether the CFPB's structure is constitutional and remove Director Cordray without cause. Either action would be controversial and could lead Director Cordray to sue President Trump to get his job back.
- **Legislative Action.** On the campaign trail, President Trump promised to "dismantle" the Dodd-Frank Act, which created the CFPB. Although it is unlikely that the law would be repealed in full and the CFPB shut down, the Trump administration and the Republican Congress are expected to support sweeping changes to the statute and the CFPB's structure and authority. Indeed, in late 2016, House Financial Services Chairman Jeb Hensarling, R-Texas, introduced the Financial CHOICE Act, a bill that would require substantial changes to the Dodd-Frank Act and to the CFPB's structure and funding, including replacing the CFPB director with a multimember commission and subjecting the agency to the congressional appropriations process.
- **U.S. Supreme Court.** President Trump will seek to fill the vacancy on the Supreme Court left by Justice Antonin Scalia's death in early 2016. It is unlikely that any new Supreme Court justice would be particularly sympathetic to the CFPB, and, in any event, such appointment increases the chances that, should the Court review the *PHH* decision, it would (1) decide that the CFPB's structure is unconstitutional and (2) possibly reach a broader view of the appropriate remedy, such as invalidating all of Title X of the Dodd-Frank Act, which created the CFPB and introduced the prohibition of unfair, deceptive, or abusive acts or practices.

### **Looking Ahead**

Two CFPB rules have generated significant controversy since they were proposed in 2016 and are likely to be at risk under the new administration and Republican Congress: one that would prohibit certain mandatory arbitration clauses in consumer financial contracts and another that would restrict certain payday, auto title and high-cost installment loans. Despite the challenging political landscape for the CFPB, it has recently indicated that priorities for the new year will include continued focus on redlining, as well as emerging fair lending focus on mortgage and student loan default servicing and small business lending. Undoubtedly, the wide range of the CFPB's authority, and its exercise of that power, will be scrutinized carefully in 2017 and beyond.

# Reform, Not Repeal, Likely for US Swaps Regulations

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Swaps transactions, virtually unregulated before the 2008 financial crisis, are regulated in the U.S. under Title VII of the Dodd-Frank Act. Title VII empowers the Commodity Futures Trading Commission (CFTC), for most swaps, and the Securities and Exchange Commission, for the balance of swaps (securities-based swaps), to adopt a comprehensive regulatory framework. Many other G-20 countries have added similar responsibilities for financial regulators given the role swaps played in the financial crisis.

The CFTC now is being run by Acting Chairman J. Christopher Giancarlo. He is the lone Republican CFTC commissioner and recently criticized many, but not all, of the Dodd-Frank swap regulations adopted in recent years. As a result, rules governing CFTC swaps — both those that have been adopted and those still pending — are expected to get something of a fresh look. Renewed scrutiny, however, is expected to lead to perfecting reforms rather than wholesale repeal in many areas, including the four core elements of the Dodd-Frank-authorized swaps regulatory framework: reporting, trading, clearing and cross-border.

## Reporting

Dodd-Frank requires all swaps to be reported to entities called swap data repositories (SDRs). Two types of reports are called for: real-time reports and regulatory reports. Real-time reports are filed with the SDRs after execution of the transactions, as soon as technologically practicable and without disclosing the parties to the trade. These reports are designed to be public, providing important market and pricing information to market participants. Their goal is to enhance price transparency for a market that would otherwise be largely opaque. In contrast, regulatory reports are filed with SDRs on a private, confidential basis and are designed to provide granular detail about swaps transactions and the parties to those swaps. Regulatory reports are a monitoring device that allows regulators to become familiar with every swaps market participant's risk exposures in order to assess whether a party presents credit or systemic risk that requires regulatory attention.

Despite best intentions by regulators and market participants, the success of the standardized reporting regime has been uneven — not surprising, given the nonstandardized, tailored nature of swaps. While price transparency has improved and regulators have much more information available to them on the risk exposures of swaps market participants, compliance with reporting regimes has been challenging. The CFTC staff itself has put out hundreds of pages of guidance with seemingly constant, iterative updates advising on its compliance expectations. Perfecting the reporting data set has been a priority for the CFTC, and even its Enforcement Division has been enlisted in recent years to bring enforcement actions for reporting violations to ensure that banks, which have the bulk of the reporting duties under the CFTC's rules, have been diligent in their implementation efforts.

Despite these measures, Acting Chairman Giancarlo, who is a leading candidate for permanent chair, said in a December 9, 2016, speech: “[E]ight years after the financial crisis the SDRs still cannot provide regulators with a full and accurate picture of bank counterparty risk in global markets.” Acting Chairman Giancarlo recommends enhanced international regulatory cooperation while harnessing emerging digital technologies and network sciences to improve systems. These steps will be important, but figuring out what data are essential and how best to work with the private sector to get the data to the SDRs will be vital, too. Regulators will need to make sure that banks are not required to report details or transactional quirks just for the sake of reporting.

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## Clearing

Dodd-Frank generally calls for most standardized swaps to be cleared by a derivatives clearing organization (DCO). Like regulatory reporting, the purpose of the clearing mandate is to reduce counterparty credit risk in the swaps markets and systemic risk in the U.S. economy. Statutory exemptions are available for commercial end users who use swaps for hedging purposes.

In Dodd-Frank, Congress prescribed a specific process for the CFTC to determine which swaps should be subject to the clearing mandate. By applying that process, the CFTC implemented the clearing mandate for many standardized swaps, namely credit default swaps with a broad-based group of securities and a variety of interest rate swaps. Acting Chairman Giancarlo has observed that the ability of the CFTC to make new clearing mandate determinations has been complicated by issues related to its trade execution rules that apply to swaps subject to the clearing mandate. Once these issues are resolved, some new liquid, standardized swaps may become subject to the clearing mandate.

While Dodd-Frank added swaps to the menu of financial products that are cleared, Congress also demanded greater CFTC oversight of DCOs to ensure financial integrity. As recent positive stress test results show, DCOs have enhanced their already strong protections. DCOs and the CFTC are likely to build on these results without additional regulatory mandates.

## Trading

Dodd-Frank requires any swap subject to the clearing mandate to be traded and executed either on a new type of regulated trading platform called a swap execution facility (SEF) or on a regulated trading platform on which futures have traditionally traded (a designated contract market, or DCM). A swap that is not required to be executed on a regulated trading platform could continue to be executed either bilaterally or through voice brokers that are not regulated as SEFs.

The trade execution mandate was designed to promote transparency and market liquidity. In contrast to the clearing mandate — and as Acting Chairman Giancarlo noted in his 2015 white paper on SEF rules — Dodd-Frank contemplates no process for, or even issuance of, a determination of which swaps are “made available to trade” (MAT). Rather, the statute simply provides that a swap that is required to be cleared must be traded and executed on an SEF or DCM unless “no board of trade or swap execution facility makes the swap available to trade.”

In a move many have questioned, the CFTC adopted rules over three years ago setting out a process for determining which swaps are MAT and thus subject to the trade execution mandate.

The CFTC may propose to reform or repeal the MAT process under the new administration and to loosen the reins on how trading and execution of swaps on regulated trading platforms must occur. These changes could enable the CFTC to make new clearing mandate determinations for additional types of standardized swaps. The CFTC also may revisit how its rules might better promote the trading of swaps on SEFs between qualified U.S. and non-U.S. persons.

## Cross-Border

Recognizing the potential for regulatory disconnects in applying swaps regulations globally, Dodd-Frank included a provision that U.S. swaps reforms not apply to activities outside the U.S. unless the activities have “a direct and significant connection with activities in, or effect on, commerce of the [United States].” Consistent with this provision and principles of comity, the CFTC’s stated policy has been that compliance with a foreign jurisdiction’s law and regulations can substitute for compliance with many of the CFTC’s swaps regulations if the CFTC determines that the foreign regime’s requirements are comparable to and as comprehensive as CFTC regulations. Other countries also address cross-border regulatory duplication and coordination. For example, in the European Union, a determination must be made that regulations in a non-EU jurisdiction are equivalent to EU requirements.

The Financial Stability Board’s 11th progress report on implementation of swaps regulatory reforms, published in August 2016, found that “[a]uthorities continue to engage bilaterally and in multilateral fora seeking to resolve cross-border issues.” Indeed, 2016 ended with a flurry of cross-border decisions on clearing relief from the CFTC and third-party central counterparty recognition by the EU and the European Securities and Markets Authority. Likewise, during 2016, the U.S., EU, Canada, Japan and other countries began to implement uncleared margin requirements with coordination on many issues, such as the types of collateral permitted, the daily nature of margin and implementation dates.

Even with this kind of cooperation, global market participants and U.S. regulators alike are becoming increasingly concerned that the cross-border harmonization of regulatory schemes is lagging too far behind the adoption and implementation of derivatives regulations. As more such regulations take effect, Acting Chairman Giancarlo has observed that U.S. market participants are being “shunned” as counterparties by non-U.S. traders because their U.S. person status is a “scarlet letter” that triggers CFTC regulation of the transaction. As a result, swaps markets are being divided into two sets of liquidity pools — one with U.S. persons and one without. In the coming year, the CFTC

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and perhaps even Congress can be expected to re-examine how to ensure that transacting with a U.S. person does not automatically subject the transaction and the parties to CFTC jurisdiction. This reassessment of the U.S. cross-border approach will require consideration from non-U.S. regulators regarding whether and how to pull back their jurisdictional parameters in a manner akin to whatever solution the CFTC and Congress may devise. In other words, global cooperation and mutual regulatory respect will still be needed for the global swaps market. How that can be achieved will be a great challenge for the CFTC and Congress as the new administration begins its work.

# Change in Administration Presents Opportunity to Revisit DOL Fiduciary Rule

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In 2016, regulatory developments introduced fundamental changes in the legal standards that govern the relationship of broker-dealers with their customers. Although the changes are not applicable until April 10, 2017, most in the industry have already been preparing for compliance. The new regulations appear likely to increase costs and risks and could drive a rapid evolution in the brokerage industry, encouraging consolidation of broker-dealer firms and also limiting the range of financial products offered to investors. These unintended consequences, along with promises by members of the new administration and the Republican-controlled Congress of significant deregulation in the financial sector, present the possibility that the new regulations will be reconsidered before they become applicable.

## DOL Fiduciary Rule

In April 2016, the Department of Labor (DOL) issued a final regulation that expanded the scope of who is considered a “fiduciary” of employee benefit plans, individual retirement accounts (IRAs), and other accounts and arrangements subject to the Employee Retirement Income Security Act of 1974 (ERISA) or Section 4975 of the Internal Revenue Code (the Code). Known as the fiduciary rule, it expands the ERISA definition of a fiduciary (one who “renders investment advice for a fee or other compensation, direct or indirect”) to include anyone making a “recommendation” or a “communication ... reasonably viewed as a suggestion” as to certain decisions regarding investments and related strategies and policies. Consequently, any broker-dealer would be a “fiduciary” if it communicates in such a manner with an IRA owner or other retail customer that is a retirement investor within the rule’s scope. (See our November 8, 2016, client alert [“Department of Labor Issues Guidance on Conflicts of Interest Rule”](#) and our April 25, 2016, client alert [“Labor Department Redefines ‘Fiduciary’ for ERISA and Internal Revenue Code Purposes.”](#))

The DOL issued its fiduciary rule before the Securities and Exchange Commission (SEC) had taken any action, as authorized by the Dodd-Frank Act, to assess the effectiveness of the standards of care applicable to broker-dealers and investment advisers and to issue rules that could potentially require broker-dealers to adhere to the same fiduciary standard that applies to investment advisers under the Investment Advisers Act of 1940, as amended. Under current law, any broker-dealer providing investment advice that is solely “incidental” to its broker-dealer business activities and for which it receives no “special compensation” is excluded from regulation under the Advisers Act. Instead, broker-dealers are subject to the suitability standards of the Financial Industry Regulatory Authority (FINRA) pursuant to Rule 2111. Operating under the suitability standard, broker-dealers commonly receive transaction-based compensation (such as brokerage commissions) and 12b-1 fees (mutual fund marketing or distribution fees) and participate in revenue-sharing arrangements with advisers and other providers of services to mutual funds.

A broker-dealer that is a fiduciary to a retirement plan investor under the DOL’s new rule and receives compensation through commissions, 12b-1 fees or revenue sharing would, absent an exemption, be engaging in a nonexempt prohibited transaction under ERISA and Section 4975 of the Code. The “best interest contract exemption” (BICE) would permit a broker-dealer to receive these forms of compensation if it adheres to certain requirements and, with respect to plans not covered by ERISA, enters into a written contract (referred to as a “best interest contract” or BIC) with its customer essentially including such requirements. The BIC must include provisions specifying that the

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broker-dealer is acting as fiduciary under ERISA or the Code with respect to any investment advice provided under the contract and that the broker-dealer will:

- adhere to “impartial conduct standards” by providing advice that is in the investor’s best interests, charging no more than reasonable compensation and refraining from making materially misleading statements;
- implement policies and procedures that specifically identify and document material conflicts of interest and include measures reasonably and prudently designed to prevent such conflicts from causing violations of its impartial conduct standards; and
- not use incentives for investment personnel that are intended or would reasonably be expected to cause its representatives to make recommendations that are not in an investor’s best interests.

The broker-dealer also would be required to provide a set of clear and prominent disclosures regarding various aspects of the relationship, including the standard of care owed to the investor, the compensation to be earned directly from the investor and indirectly through third-party payments, material conflicts of interest, and the investor’s right to obtain a copy of the policies and procedures described above. The BIC cannot contain any exculpatory provision or limitation of liability for breach, nor can it contain any waiver or qualification of a right to bring or participate in a class action or other representative action.

The standards of conduct will apply as of April 10, 2017. However, most of the BICE’s procedural conditions will not apply during an initial transition period that runs until January 1, 2018. During this transition period, no written contract will be required.

As an alternative to BICE, the new DOL regulation provides a more streamlined variant commonly known as “BICE lite.” BICE lite would cover certain investment recommendations, most prominently including rolling assets from a plan into an IRA or switching assets from a commission-based account to a fee-based account. Unlike BICE, BICE lite does not require a broker-dealer to enter into a written contract with each applicable retirement investor and does not prohibit any waiver of a private right of action. However, BICE lite does not allow the commissions and other transaction-based fees permitted under the full BICE.

To operate under BICE lite, a broker-dealer may receive only a “level fee” that is disclosed in advance to the investor. This is a fee or compensation that is fixed at a percentage of the value of the assets under management or set fee that does not differ based on any particular investment recommended. Level fees do

not include commissions or other transaction-based fees and do not include any payments from third parties, such as 12b-1 fees or revenue-sharing payments. Moreover, any recommendations under compensation structures that are limited to proprietary products would not fall under BICE lite. Under BICE lite, a broker-dealer must acknowledge in writing to the retirement investor that it is acting as fiduciary under ERISA or the Code with respect to any investment advice and must adhere to the “impartial conduct standards” described above.

### Prospects for the Rule and Brokerage Industry

Despite uncertainty over how President Donald Trump may attempt to deregulate the sector, many brokerage firms have already begun to restructure their business and operations to meet the BICE or BICE lite standard, or have taken other steps aimed at complying with the new rules. Some brokerage firms have eliminated commissions and third-party payments and moved to a flat fee-based system. Mutual fund sponsors have responded by planning to issue a new “T Share” class that would bear a uniform front-end load and trailing 12b-1 fee. The uniform sales charges, across all fund categories, would represent an attempt to eliminate the conflict of interest and other concerns as to whether compensation is “reasonable” inherent in the current structure where one fund may provide a broker a higher commission than another. On December 15, 2016, the SEC’s Division of Investment Management released guidance that would streamline the manner in which funds could disclose newly established share classes (including the T Share class) and sales load variations that would apply uniformly to investors that purchase shares through a given intermediary.

Members of the new administration (such as Anthony Scaramucci, in his November 1, 2016, op-ed in *The Wall Street Journal*, “Your 401(k) Doesn’t Need a Federal Babysitter”) have suggested that the unintended consequences of the DOL’s fiduciary rule make it counterproductive. In September 2016, House Financial Services Committee Chairman Jeb Hensarling, R-Texas, introduced his financial reform bill, the Financial CHOICE Act, which would repeal the fiduciary rule and prohibit the DOL from passing another such rule until the SEC has promulgated a new rule, as authorized by the Dodd-Frank Act, governing the standard of conduct applicable to broker-dealers. On January 6, 2017, Rep. Joe Wilson, R-S.C., introduced the Protecting American Families’ Retirement Advice Act, which would delay effectiveness of the DOL fiduciary rule for two years, for the stated purpose of “giving Congress and the new administration adequate time to re-evaluate the new regulation.” Republicans in Congress also are considering additional methods to delay the effectiveness of the rule through procedural means, including through the appropriations process. However, even if

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the fiduciary rule were to be delayed or repealed, for better or worse, some of the changes that it catalyzed in the industry may now be irreversible.

Ideally, any reconsideration under the new administration of the rules governing the relationship of broker-dealers with their customers will recognize the value of investor choice, financial product innovation and economic efficiency, and will seek to integrate these objectives with the imperative of investor protection. The new administration may wish to re-examine some of the conclusions that the DOL reached in its cost-benefit analysis. For example, the DOL projects the harm that IRA holders can expect to suffer over the next 20 years due to underperformance as a result of conflicted advice at 50 to 100 basis points per year, but the analysis does not quantify the harm that IRA owners may suffer as a result of the unintended consequences of the fiduciary rule.

The BICE requirements may limit the range of financial products available to retirement investors. The requirement that any compensation be “reasonable” may discourage broker-dealers from offering innovative products that may be appropriate for the IRAs of some investors but can only be provided at higher rates of compensation due to steeper costs and lower volumes associated with those products. A lack of comparable products in the market may put the broker-dealer at risk of being unable to establish that its compensation is reasonable under the applicable standards. Because reliance on the BICE would allow the customer to participate in a class action, if an account underperforms (even as a result of benign causes) and a plaintiff’s attorney were to initiate a class action, this risk would be particularly acute.

The DOL decided that “disclosing conflicts alone would fail to adequately mitigate the conflicts or remedy the harm.” Nevertheless, it may be useful to reconsider whether the objectives of the “reasonable compensation” standard could be accomplished with less risk of unintended consequences through enhanced disclosure of the structure, sources and rates of compensation for the applicable investment.

Institutions subject to the fiduciary rule face substantial costs and disruption to comply with many of its requirements and, in particular, to operate under the BICE. Smaller firms that do not

wish to pursue a level fee model may no longer be viable unless they are absorbed by larger institutions that are able to deploy infrastructure and systems of a scale more likely to meet the procedural and compliance burdens. Consolidation of brokerage firms as a result of these factors (which, as reflected in recent press reports, is already underway) would narrow the range of firms available to investors.

The potential impacts of overlapping regulatory jurisdiction on economic efficiency in the markets for investment products and services also may be an appropriate subject for re-examination. The fiduciary rule encompasses areas that already are covered by the securities regulators, including the SEC and FINRA. Different standards and compliance systems may apply to an IRA and a taxable account held by the same customer with the same broker, even if there is no other reason for the different treatment, and may force investments into a taxable account (or a separate account at a different institution), even if contrary to the customer’s best interests.

The DOL acknowledged that it received commentary to the effect that “subjecting SEC-regulated ... broker-dealers to a special set of ERISA rules for ... IRAs could lead to additional costs and complexities for individuals who may have several different types of accounts at the same financial institution some of which may be subject only to the SEC rules, and others of which may be subject to both SEC rules and new regulatory requirements under ERISA.” However, the DOL observed that ERISA and the Code cover some types of investment advice that are not within the scope of the federal securities laws and that, in issuing the new regulations, it believes that it has taken care to honor the text and purposes of ERISA and the Code, including the “special emphasis on the elimination and mitigation of conflicts of interest.”

This observation by the DOL is consistent with the axiom that regulations must be designed to fulfill the purposes of the governing statutes. But the need for reform — via regulation and perhaps even legislation — presented by the inconsistencies, overlap and potential for unintended results in the existing rules is, arguably, equally important. This new year may be a good time for reform to begin.





# Other Regulatory Developments

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# Antitrust Enforcement in the Trump Administration

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Republican administrations historically have taken a less interventionist approach to antitrust enforcement than their Democratic counterparts, but many of President Donald Trump's policy positions have not tracked traditional Republican paradigms. During his campaign, for example, he vowed to challenge certain high-profile mergers in the telecommunications industry — including the 2011 acquisition of NBC Universal by Comcast, which was already approved by the relevant government authorities — and decried the “antitrust problems” of companies across the technology industry. Both statements raised concern among some Republicans that the Trump administration would press for aggressive investigation of companies perceived to have a dominant position in their respective markets or, at the very least, would be less predictable in antitrust enforcement decisions. Notwithstanding these widely publicized declarations, early indicators — such as the selection of Joshua Wright as head of President Trump's antitrust transition team and assurances by attorney general nominee Jeff Sessions in his confirmation hearing that there will be “no political influence” in enforcement of the antitrust laws — point to a more conservative approach to antitrust policy under President Trump. Indeed, it is fair to expect some tempering of the level of activity that characterized the Obama administration, particularly with respect to merger challenges.

In the coming months, President Trump will make several leadership appointments to the Antitrust Division of the Department of Justice (DOJ) and the Federal Trade Commission (FTC), the two federal agencies that share responsibility for antitrust enforcement. These appointments, for which no candidates have been announced, will be subject to the same Senate confirmation process that is required for Cabinet-level positions. With the nominations yet to come, one cannot predict with any certainty the direction that antitrust enforcement will take under President Trump, but his transition team provided important clues. A former Republican FTC commissioner, Wright developed a reputation as the commission's most conservative voice, staunchly advocating an “evidence-based” approach to antitrust policy and decision-making based on the relevant law and demonstrable economic evidence, which manifests in principled restraint in enforcement actions.

Wright emphasizes three methodological commitments that ought to apply in antitrust enforcement: (1) integrating economic analysis into all stages of enforcement decision-making, (2) drawing on empirical evidence to improve the decision-making process, and (3) minimizing the adverse costs and impacts of speculative enforcement decisions. In merger enforcement specifically, Wright argued that prevailing merger analysis improperly ignores the efficiencies resulting from transactions (including those “outside” the alleged market) and does so asymmetrically, often embracing “probabilistic prediction, estimation, presumption and simulation of anticompetitive effects on the one hand” but requiring “efficiencies to be *proven* on the other.”

Beyond his role in the presidential transition, some have speculated that Wright himself may be a candidate for assistant attorney general, and, if nominated and confirmed, would name key members of the Antitrust Division's senior leadership team. Others have suggested that Wright could reprise his role as FTC commissioner, likely taking on the role of chairman, where he could better influence FTC policy across antitrust, consumer protection and privacy issues. Regardless of whether Wright is appointed to a position in government, his influence over the Trump administration's nomination of senior antitrust officials to the DOJ and FTC is likely to leave its imprint on antitrust policy for the foreseeable future.

In terms of appointments, the changes will be most dramatic at the FTC, where President Trump will nominate at least three, and possibly four, commissioners within his

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first year in office — an unprecedented transformation in such a short period. The FTC is composed of five commissioners, no more than three of whom may be from the same political party. They are nominated by the president and serve seven-year terms. Due to vacancies, there are currently three sitting commissioners — two Democrats and a Republican. The existing chairwoman, Democrat Edith Ramirez, is serving under an expired term and recently announced her resignation effective February 10, 2017. President Trump’s responsibilities will include picking several candidates to bring the commission up to full strength and shifting the chairmanship to a Republican commissioner, either current Republican Commissioner Maureen K. Ohlhausen or a new appointee. The new chair, in turn, will hand-select candidates for key leadership positions, such as director of the Bureau of Competition and general counsel. Moreover, Democratic Commissioner Terrell McSweeney’s term expires on September 25, 2017, meaning the Trump administration will nominate a fourth commissioner during the latter part of 2017 (albeit likely a Democrat). However it unfolds, for the first time in nearly a decade, the commission will be led by a Republican majority and chairperson, increasing the likelihood that the overall antitrust enforcement climate in the U.S. will be less aggressive.

These changes will take time to run their course. The antitrust agencies typically are not the highest priority of a new president’s administration, and in past administrations the president has not completed his antitrust selections until several months into his presidency. Even assuming a smooth nomination process made possible by Republican control of the Senate, it may be several months before the new senior antitrust officials are in

place and executing their decision-making authority within the agencies. One aspect of the process that some have speculated could proceed more quickly would be the appointment of Commissioner Ohlhausen as the FTC’s acting chairwoman. The act of elevating a sitting commissioner to the chairmanship does not require Senate confirmation and could theoretically occur immediately, but whether this will happen ultimately depends on the end game that the new administration has in mind. In particular, if the new administration decides to shift the chair to one of its new nominees, it may defer any action until later or request that Commissioner Ohlhausen serve as chair on an acting basis, in which case she would be unlikely to select new senior enforcers.

Either way, the U.S. antitrust landscape is poised to undergo considerable transition. After a slow start, the Obama administration became very active on a number of fronts, with both the DOJ and FTC making aggressive moves to enforce the antitrust laws, particularly in their scrutiny of mergers. The levels of antitrust enforcement seen at the tail end of the Obama administration were consistent with President Barack Obama’s 2008 campaign promise to “reinvigorate antitrust enforcement, which is how we ensure that capitalism works for consumers.” Over time, we expect the Trump administration’s antitrust outcomes — even if laden with more evidence-based economics — in many respects to resemble those of past Republican administrations, with fewer challenges to merger activity overall, an implicit or express endorsement of “creative destruction” (even when it might lead to dominant market positions), and perhaps greater reliance on economic analysis for changes in policy and to reach enforcement decisions.

# Big Data an Ongoing Concern for EU Competition Law

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The question of how “big data” should be treated in merger control and antitrust enforcement was a key issue for the European Commission and national regulators in European Union member states in 2016, with competition authorities of individual countries and the EU Commission addressing the issue through published reports, investigations and merger decisions. Big data refers to increasingly large data sets that companies collect from activity on the web, including on social networking sites and connected devices. The emergence of big data is the result of the exponential growth in both the availability and automated collection of information, which has prompted the development of complex algorithm-based analytics to spot patterns. Companies collect and analyze this data to improve the quality and scope of their services as well as to offer more targeted advertising services.

One of the key questions is whether, and to what extent, access to and use of big data can be considered to confer market power in relation to a particular goods or services market. Another central issue is whether, and to what extent, concerns around big data should be considered data privacy or data protection issues as opposed to competition law issues. Antitrust authorities in Europe addressed these emerging questions in 2016, but there is no doubt that the responses will be further refined and clarified this year.

## Joint Report on Big Data

In May 2016, the French Competition Authority and German Federal Cartel Office published a joint report on big data, which identified issues that antitrust authorities should consider when assessing the interplay among big data, market power and competition law. The key issues concerned potential data concentration and foreclosure of competitors in related markets (*e.g.*, online advertising) resulting from a transaction, and potential contractual foreclosure or marginalization of competitors active in markets where the data is used. Also in May 2016, the French authority announced a “full-blown sector inquiry into data-related markets and strategies.” The Competition and Markets Authority in the U.K. had analyzed the topic in a June 2015 report on “the commercial use of consumer data.” While also addressing consumer protection laws, the U.K. report outlined potential competition law issues similar to those identified in the German and French authorities’ joint report.

## Merger Control

Competition authorities have raised questions about the concentration of data resulting from a merger of two firms active in the collection and sale of big data. They also have expressed concerns about potential vertical foreclosure effects that may arise when two firms active in vertically or otherwise related activities in the big data value chain (*e.g.*, data collection and online targeted advertising) merge.

The EU Commission already confirmed in its August 2014 Facebook/WhatsApp decision that privacy-related concerns flowing from the increased concentration of data within the control of one company as a result of a transaction would fall within the scope of EU data protection rules, not EU competition law rules. In its Facebook/WhatsApp merger investigation, the EU Commission looked at the potential impact of data concentration on online advertising and concluded that, regardless of whether Facebook would introduce advertising on WhatsApp and/or start collecting WhatsApp user data for advertising purposes, the transaction raised no competition concerns. Besides Facebook, the EU Commission determined, a number of alternative providers would continue to offer targeted advertising after the transaction, and a large amount of internet user data that is valuable for advertising purposes is not within Facebook’s exclusive control. In its

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December 6, 2016, decision on the Microsoft/LinkedIn transaction, the EU Commission confirmed its approach in Facebook/WhatsApp that privacy-related concerns do not generally fall within the scope of EU competition law but clarified that privacy-related concerns can be taken into account in a competition assessment to the extent that consumers see it as a significant factor in the quality of the services offered. The EU Commission concluded that data privacy was an important parameter of competition among professional social networks on the market and could have been negatively affected by the potential data concentration as a result of the merger, but it ultimately cleared the transaction subject to certain conditions.

### **Antitrust Enforcement**

Another area of concern is that big data could result in the foreclosure or marginalization of competitors active in markets where the data is used. Concerns include refusing to provide access to the data, requiring contractual exclusivity provisions, conditioning access to a valuable data set on the use of a company's own data analytics services or using big data as a vehicle for price discrimination against different customer groups. Notably, in March 2016,

the German Federal Cartel Office opened an investigation against Facebook for allegedly violating the country's competition laws (alleged abuse of a dominant position) by infringing German data protection rules. Details of the investigation are not yet publicly available; therefore, it is unclear whether the German authority would consider a violation of data privacy rules also a violation of competition laws, at least under certain circumstances.

### **Conclusion**

The competitive dynamics of transactions and other business relations involving big data are complex, and the technologies and related business models around it are evolving rapidly. Competition agencies around Europe are paying ever-increasing attention to this phenomenon. It is clear that big data is and will continue to be on the agenda of European competition authorities for years to come. That focus on the issue is expected to provide further guidance to companies on the legal implications under EU competition laws of the concentration and use of big data and the delineation between privacy and data protection and competition laws.

# CFIUS and Foreign Investment Reviews in 2017 and Beyond

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President Donald Trump has made foreign trade and foreign competition main areas of focus early in his presidency. The new administration's appointments reinforce expectations of a multipronged approach to foreign investment and specifically to reviews by the Committee on Foreign Investment in the United States (CFIUS). While most foreign acquisitions and investors will continue to be welcomed, those presenting potential national security issues — which the Trump administration may come to view as including risks to American jobs and pre-eminence in certain industrial sectors — can expect more searching CFIUS reviews.

**Trump Administration.** Additional subcabinet appointments to executive positions within key agencies will further clarify the new administration's approach. Early indications suggest it will be open to investments from friendly nations but more skeptical of those from nations it deems to be economic or strategic adversaries or engaging in trade-distorting practices. Notably, the long-standing split within CFIUS between economic and national security agencies may become more stark in the Trump administration. Appointments to the Trump Cabinet in key economic positions, including Treasury, State, Commerce and the National Economic Council, indicate an administration preference for practical dealmaking, given top-level appointees' experiences in the private sector. At the same time, some key economic appointees have indicated that the CFIUS process may not be adequately addressing trade issues, such as reciprocal market access. For example, during confirmation hearings, Commerce secretary nominee Wilbur Ross Jr. was asked about CFIUS reviews of Chinese acquisitions in the entertainment industry. Ross indicated that he was "struck to learn" that the industry is "not very reciprocal [in] that [Chinese investors] want to control entertainment and other media here, and yet are denying our companies anything getting remotely close to that." Moreover, the administration also has signaled through its appointments at Defense and Justice that it may be highly skeptical of investments from geopolitical rivals and can be expected to encourage a more rigorous and thorough review of investments from those nations.

**Job Retention.** Foreign investors can expect all of these agency priorities to yield at times to the unifying principle of President Trump's foreign investment platform: maintaining domestic employment. Treasury secretary nominee Steven Mnuchin nodded to this possibility when referring during his confirmation hearing to a potential committee role in "protecting American workers." In addition, during the transition, the incoming president broadcast his meetings with CEOs and foreign investors, such as Masayoshi Son of Japan, who have committed to expanding employment and keeping facilities and technology in the United States. As shown in those transition discussions and in the recent Carrier and Ford onshoring decisions, investors who commit to maintaining jobs in the United States can expect more favorable treatment in the Trump administration.

**Reciprocal Market Access.** The president's continuing emphasis on reciprocal market access, as shown in senior White House appointments, also demonstrates that countries with strong bilateral trade relationships with the United States should continue to enjoy a more favorable position in transactions before CFIUS. Still, while individual cabinet members have significant control over the strategies of their cabinet departments, senior and mid-level political appointees — who may not be named for several months — will ultimately be responsible for overseeing the day-to-day activities of government officials and making the majority of CFIUS decisions. Close attention should be paid to the backgrounds and views of these appointees, given their prominent roles in managing the CFIUS process.

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**Coordination With NATO Allies.** As it develops its internal approach to CFIUS reviews, the Trump administration may also be the first to need to develop an internationally coordinated approach to national security reviews, as traditional U.S. allies have begun to institute new, more rigorous oversight regimes. In recent years, CFIUS reviews have increasingly involved international cooperation or parallel national security review involving the United States and its NATO allies. Examples include:

- the recent proposed acquisition of Germany's Aixtron SE by Grand Chip Investment GmbH, ultimately owned by investors in the People's Republic of China, which was blocked by both U.S. and German authorities;
- the recent successful acquisition of Alcatel-Lucent by Nokia Corp., which was cleared by the U.S. and French governments; and
- the acquisition of Alcatel-Lucent Enterprise by China Huaxin Post and Telecommunication Economy Development Centre, which was cleared by the U.S. and French governments, as well as by the Chinese government in a simultaneous national security review.

If these multilateral national security reviews become more common, the Trump administration can be expected to face more requests for intelligence sharing and collaboration, and may elect to use those tools to strengthen alliances with close U.S. partners.

**Revising CFIUS Authorities.** The new Congress also may exercise its authority to refocus the U.S. approach to foreign investment. Members of Congress on both sides of the aisle have shown

a renewed interest in reviewing or reforming CFIUS staffing, funding and/or authorities. Topics have included expanding the committee's jurisdiction to review the economic impacts of foreign investment and requiring the committee to take into account the openness of investors' home countries to U.S. investment when reviewing specific transactions. At the request of several members of Congress, mostly Republicans, the Government Accountability Office recently announced that it will review CFIUS statutory and administrative authorities. Moreover, to the extent that reciprocal market access is revisited by either the Trump administration or Congress, they may take heed of the recent trend in European national security reviews to take market access and other economic issues into consideration.

The laws governing CFIUS last underwent a significant overhaul in 2007, and subsequent legislative attempts to expand the mission of CFIUS have been unsuccessful. However, the heightened focus on foreign trade and investment by Congress and the new administration may create a more fertile environment for change.

Parties pursuing cross-border investments will need to engage in careful advance planning, including the assessment of relevant national security risks and the potential need to craft a pre-emptive risk mitigation package. Parties should consider a proactive approach to CFIUS in advance of the formal process.

# Despite Aversion to Regulation, Trump May Expand Cybersecurity Efforts

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President Donald Trump's statements to date on regulation in general and cybersecurity regulation in particular suggest a conflict between his desire to strengthen the country's cybersecurity efforts and his general antipathy toward federal directives. Although President Trump may try to streamline and simplify the regulatory regime corporations face, he is unlikely to try to dramatically weaken U.S. laws in this area.

## A Focus on Cyberdefense

Cybersecurity was a front-page issue throughout the 2016 presidential campaign, from Hillary Clinton's use of a private email server to accusations of hacking by the Russian government to general discussions regarding the country's cyberpreparedness in light of increasing threats from countries like Russia, China and North Korea. Although President Trump has challenged the intelligence community's conclusions as to the source and motive of the cyberattacks against the election process, he stated throughout the campaign that cybersecurity would be a priority for his administration. To that end, President Trump has announced the creation of a Cyber Review Team tasked with evaluating the country's cyberdefense and cyberoffense capabilities and created an elevated position — that of homeland security adviser, roughly on par with the national security adviser — for his top cybersecurity nominee, Thomas Bossert. In addition, Mike Pompeo, President Trump's pick for CIA director, has spoken on the importance of cybersecurity in the intelligence space. In some respects, these moves signal a focus on cybersecurity as a national security issue rather than as a cybercrime or commercial issue, but the president is likely to recognize that the two are inextricably interconnected.

## Existing Trend Toward More Regulation Likely to Continue

More and more United States regulators have taken an active interest in cybersecurity issues, and the regulatory trend has been toward greater detail and specificity with respect to the requirements placed upon regulated entities. Starting in the late 1990s and continuing well into 2016, regulators took a broad, flexible approach to cybersecurity matters. They focused chiefly on self-evaluation and assessment of risk, with regulated entities determining for themselves the appropriate means to address risk. Regulators generally refrained from imposing specific security requirements.

In recent months, however, a number of state and federal regulators have signaled a desire for more specific requirements. In September 2016, the New York State Department of Financial Services (NYDFS) announced a regulation that will take effect in March 2017 and with which companies must comply by September 2017. It will place a number of specific requirements on financial institutions within its jurisdiction, including the use of encryption and multifactor authentication in certain circumstances, as well as specific staffing requirements. Similarly, in October 2016, the Federal Reserve, Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation issued a joint advance notice of proposed rulemaking (ANPR) outlining a sweeping set of cybersecurity requirements for the nation's largest banks. The notice described potential requirements for internal staffing and reporting channels in addition to overall risk management within institutions. The notice period for the ANPR closed on January 17, 2017, and the timing of next steps has not been announced.

The shift toward specificity in cybersecurity regulation appears to be driven by a number of trends, all of which are likely to continue in the near future. First, cybersecurity best practices are taking shape, so regulators have a better understanding of what steps are

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necessary and reasonable to protect against cyberattacks. Second, existing regulation appears to have been inadequate to prevent successful cyberattacks, suggesting that companies need greater incentives to protect their systems. Finally, cybersecurity attacks continue to be front-page news, putting pressure on regulators to take action in their respective jurisdictions. Based on the foregoing, it seems unlikely that President Trump will instruct regulators to pull back on cybersecurity regulation.

In light of his professed aversion to regulation in general, however, President Trump may seek to streamline and harmonize federal regulations, perhaps by designating a single regulator as responsible for creating and enforcing cybersecurity requirements. Many have expressed concerns with the existing, multi-party regulatory regime — particularly the administrative burden of complying with different (even if complementary) technology requirements and the need to report to different regulators with overlapping jurisdiction. A financial institution, for example, might be subject to review by the Federal Trade Commission (FTC), the Securities and Exchange Commission, the OCC and the NYDFS, among others, each of which has issued guidance and/or requirements on cybersecurity matters. Designating a single cybersecurity regulator could alleviate these issues.

### **Possible Changes at the FTC**

One area where President Trump could have a near-term impact on cybersecurity regulation and enforcement is at the FTC. As of his inauguration, two of the five commissioner seats at the FTC were vacant, and a third will become vacant on February 10, 2017, when current Chairwoman Edith Ramirez steps down. The ability to appoint the majority of FTC commissioners — as well as a new chair — provides the president with an opportunity to exert strong influence on the commission. (See [“Antitrust Enforcement in the Trump Administration.”](#)) During the Obama administration, the FTC was the most active U.S. regulator when it came to bringing cybersecurity actions against companies. The FTC sought to penalize companies that did not fulfill their cybersecurity promises to consumers or otherwise provide adequate cybersecurity protection. Many asserted the FTC overstepped its authority in these actions, by adopting an overly broad reading of the “deceptive” and “unfair practices” prongs of Section 5 of the FTC Act.

Although we do not expect President Trump to curtail regulatory efforts to address cybersecurity issues overall, his appointees at the FTC may take a narrower view of the commission’s authority. Under such a scenario, the commission could decide to take action only in the most egregious cases — such as where a company willfully misleads customers with respect to cybersecurity matters — without trying to establish a more general standard of cybersecurity “fairness” under the FTC Act. Such an approach would be consistent with an overall effort to streamline cybersecurity regulations in the United States, if the president decides to pursue such an approach.

# FERC Could See Substantial Changes Under President Trump

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The Federal Energy Regulatory Commission (FERC) is a somewhat obscure and highly technical agency that was not discussed specifically during President Donald Trump's campaign. Its regulatory footprint is, however, substantial: The electric utility and natural gas pipeline industries FERC regulates, taken together, account for about 4 percent of the U.S. gross national product. The actions FERC takes under the Trump administration therefore have the potential to be significant. The agency's direction will have more to do with its new chairman than anything else. Because FERC is an independent agency, policy direction will come mostly through appointments, not the White House. History has shown that, even within the same administration, FERC's policies can shift based on the personal preferences of different chairmen.

As of January 27, 2017, the White House had not yet nominated a new FERC chairman or any additional commissioners. On January 26, 2017, President Trump named Commissioner Cheryl A. LaFleur as acting chairman, displacing Commissioner Norman C. Bay. Several hours later, Commissioner Bay resigned from FERC, effective February 3, 2017. That will leave FERC with only two commissioners, below the three needed to provide a quorum required for certain agency actions under the most commonly held view of the governing legal requirements. While FERC will probably seek to use delegated authority to conduct most of its day-to-day business, more important disputed cases may need to await the addition of at least one more commissioner. That may expedite the nomination and confirmation of one or more individuals to serve on FERC. Commissioner Bay's resignation is unusual; the traditional practice at FERC and other agencies is for an outgoing administration's appointees to remain in place long enough to maintain a quorum until the new administration's nominees can be confirmed by the Senate.

## Governmentwide Changes Affecting FERC

As a candidate, President Trump spoke often about rolling back federal regulation. While FERC probably will look for ways to implement that mandate, it may not have many opportunities to do so. Much of FERC's responsibility involves run-of-the-mill regulation dating back to the 1930s, such as deciding whether electric utilities and natural gas pipelines are charging "just and reasonable" rates — a task that will continue. FERC may start off being less inclined to push the boundaries of its statutory authority. However, under past Republican administrations, FERC has not been shy about exploring these limits — often successfully. It thus remains to be seen whether FERC will become more conservative about exploring new frontiers of authority. At a minimum, however, FERC probably will become more reluctant to impose additional regulatory requirements and probably will look to remove some existing ones, turning a skeptical eye to whether the benefits of regulation are worth the costs.

## Power Markets

During the campaign, President Trump frequently mentioned reviving the coal industry, and his transition team focused on preventing the shutdown of nuclear generation. But FERC has relatively few tools to advance those goals. Many of the struggling coal-fired and nuclear units are under severe economic pressure from fundamental market forces, including cheap shale gas and stagnant demand, along with mandated environmental and other upgrade costs. Even relatively efficient natural gas-fired generating resources are encountering financial difficulties, and FERC has no control over the market fundamentals at play.

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## Organized Markets

As a result, FERC's most important role probably will be changing the rules that govern so-called "organized markets." Those markets run complex auctions for various electrical products in broad swaths of the country, covering about 60 percent of the country's demand for electricity. The rules of those markets thus govern the revenue stream for many of the existing generating units that face difficult economic conditions.

Toward that end, FERC could focus on "price formation" in organized markets — determining whether the auction mechanisms used in those markets are setting prices at efficient levels that reasonably compensate existing generation, and support the construction of new generation, when and where it is needed. While FERC already has been working on price formation issues, it may redouble those efforts under the new administration. For example, FERC may explore market-oriented approaches that place more value on the contributions that traditional generating resources make to reliable power grid operations. FERC already has taken some steps in that direction, but they were highly controversial and have not yet reversed the negative economic tide for a number of existing generators.

One targeted tool the administration might consider using, if it wants to keep a specific generator from retiring, is to have the secretary of Energy issue an "emergency" order under the Federal Power Act. The executive branch has broad, but rarely used, authority to require a generator to continue selling and a grid operator to accept delivery. That would, however, require defining a loss of generation fuel diversity as an emergency, a step that would be controversial and probably litigated. FERC has authority to determine reasonable compensation if the buyer and seller cannot agree, and could — again, with litigation risk — set that compensation at levels sufficient to keep the generating station financially afloat.

## State Subsidies

FERC also may face considerable controversy regarding assertions that resources subsidized by states will artificially suppress organized market price outcomes, harming unsubsidized existing generating resources. At the state level, proponents of such subsidies argue that they counteract wholesale market flaws and also advance a variety of social goals, such as maintaining jobs, benefiting the environment, supporting particular fuel types and maintaining reliability. The Trump transition team stated its aim to avoid subsidizing any particular resource type. It remains to be seen, however, how FERC will respond if opponents of particular state subsidy programs seek to block them at FERC — particularly if the resource type is one the administration wants to survive. Disputes about state subsidies already have landed

in federal court; the U.S. Supreme Court decided one case last term, and another case currently is pending in federal district court. It therefore is possible that FERC will seek to avoid acting and leave the question for the courts to decide.

## Demand Response

Another set of organized market issues FERC may address involves "demand response." Demand response uses pricing incentives to encourage retail consumers to reduce their power consumption, particularly during peak periods. FERC has adopted several rules allowing demand response resources to participate in organized market auctions on terms that critics contend create inefficient subsidies. The Supreme Court affirmed one such rule last term. Nevertheless, FERC may pare back, if not eliminate, those rules, which would create the anomalous situation of an agency rescinding or changing a rule after winning affirmance from the Supreme Court. Because the Court found FERC had authority and discretion to act — not that it was required to act — FERC may, under President Trump, conclude it has the ability to reverse course, in whole or in part.

## Renewable Resources

While FERC has adopted some policies that benefit renewable resources, most government support for renewables comes from other sources. A number of states require utilities to purchase large portions of their power supplies from renewable resources. Such resources also receive federal tax credits, which are beyond FERC's ambit. However, FERC could attempt to roll back subsidies for transmission infrastructure built to allow load centers to access distantly located renewable resources, which would require states that want to buy renewable energy to pay for transmission themselves.

In addition, FERC probably will be asked to address issues surrounding "net metering." Under net metering, state regulators allow the output of smaller-scale solar resources, often on residential rooftops, to be offset against retail power consumption, meaning that those resources effectively are compensated at the level of retail rates. Opponents of net metering argue that FERC should assert jurisdiction and rule that compensation equal to retail rate levels is too high. According to opponents, that compensation level inefficiently subsidizes solar resources, harming both those retail consumers who cannot afford to install them and utility companies that are not fully compensated for standing by to provide retail power when the sun does not shine. Proponents of net metering conversely argue that lowering compensation of small solar resources would fail to recognize the value those resources bring, including to the environment and to the reliability of the power system. Complicating the picture politically, some libertarian and conservative factions support

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net metering, viewing it as a question of individual freedom of choice and self-reliance regarding energy consumption decisions. Those views could collide with some proposals for addressing net metering issues, which arguably call for FERC to extend federal regulation to individual homeowners who install solar facilities — hardly a reduction in federal regulatory reach.

Battles over the issue of net metering and governance have been waged, often bitterly, at the state level. FERC previously ruled that, if states adopted net metering, it had no authority over the level of compensation any generating resource subject to that treatment received. FERC probably will be asked to revisit that question and likely will be hard-pressed to avoid doing so. The resulting controversy could prove to be one of the most interesting cases decided by FERC or any other administrative agency under the new administration, pitting opposition to subsidies against at least some libertarian and conservative views regarding energy consumption decisions.

### **New Infrastructure**

President Trump has spoken repeatedly of accelerating new energy infrastructure. FERC surely seeks to improve its approach to approving natural gas pipelines and liquefied natural gas terminals. Until recently, when the then-chairman of FERC was accused of embargoing approval for three major natural gas pipeline projects, FERC had been viewed as supportive of such projects. Any hang-up of approvals surely will stop. In any event, however, FERC is not the only variable; many federal agencies play roles in the environmental review and siting process. The Trump administration thus may take a page from President George W. Bush's energy policy playbook by reviving the inter-agency White House Task Force on Energy Project Streamlining. That interagency task force approach could allow President Trump to advance the installation of new infrastructure by reducing the environmental review time across multiple federal agencies, including FERC.

### **Enforcement**

Some changes to FERC's enforcement procedures probably would have occurred regardless of which political party controlled the agency. There already has been an increased awareness, both inside and outside FERC, that portions of the agency's enforcement program are unnecessary. There is no good reason to require the subject of an investigation to engage in three rounds of written submissions with the enforcement staff. Nor is there a need for FERC to publicly name subjects of ongoing investigations (by issuing what FERC calls a "Notice of Alleged Violation"). FERC also will likely stop claiming it is exempt from the normal civil litigation process when it files cases seeking to impose civil penalties in federal district court — a view two federal district courts have rejected to date.

On substance, FERC may revise or eliminate its penalty assessment guidelines, which critics claim produce penalties too high to allow reasonable settlement. One individual involved in transition efforts at the Securities and Exchange Commission took the position, when he was a commissioner there, that large penalties on companies are misguided because they punish shareholders. If that view holds sway elsewhere in the federal government, it seems reasonable to expect the same at FERC, which then would focus its enforcement efforts more on compliance where companies are concerned, using civil penalties more frequently against individuals who intentionally violate clear rules known in advance.

In addition, while FERC will continue to aggressively pursue market manipulation cases, it may pare back on its expansive practice of claiming that companies violated the previously unexpressed "spirit" or "intent" of the market rules. Critics contend that sometimes the right approach, when rules have unintended consequences, is to change them and move on. FERC is more likely to take that approach in the future.

# Legislative, Regulatory and Judicial Challenges to the 2015 Ozone National Ambient Air Quality Standards

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President Donald Trump has expressed a strong opposition to many federal environmental regulatory programs and the work of the Environmental Protection Agency (EPA) during Barack Obama's presidency. His nominee for EPA administrator — Oklahoma Attorney General Scott Pruitt, an ardent critic of EPA and one of several state attorneys general who has made a practice of filing lawsuits challenging its regulations — leaves no doubt that there will be an effort under the Trump administration to scale back EPA's approach to environmental regulation.

Similarly, Republican party control of both the Senate and House provides an opportunity to pass legislation limiting the nature and reach of federal environmental law, although the ability to pass such legislation is likely to depend on whether Republican senators are willing to dispense with the filibuster on legislation. So far, a number of senators, including Senate Majority Leader Mitch McConnell, R-Ky., have expressed reservations about taking such a step. If the filibuster survives, it is likely that we will not see substantial amendments to existing federal environmental statutes such as the Clean Air Act. In that scenario, the decade-long battle over environmental regulations, with industry on one side and the environmental community on the other, and with EPA favoring one side or the other depending on which party holds office, will continue to play itself out during the new administration.

One prominent example of an important, hotly contested regulation that is likely to be hashed out by the courts is EPA's 2015 revision of the National Ambient Air Quality Standards (NAAQS) for ozone. There is speculation that the Trump administration may attempt to pull back from the defense of the rule or scale back the standards. Even if EPA decides it no longer wants to defend the standards, it is not clear that such a tactic would be effective because briefing has already been completed and there are other parties in the consolidated litigation besides EPA arguing that the standards should be no less stringent than those set forth by EPA. If the standards are upheld by the courts or if the courts agree with environmental petitioners that the standards should be more stringent, EPA may find it difficult, in the absence of new legislation, to develop a factual record to support less stringent standards.

## Ozone Standards

EPA published its revised NAAQS for ozone on October 26, 2015. The revision lowers both the primary and secondary ozone air quality standards from 75 parts per billion (ppb) to 70 ppb. As invariably happens, the revised standards were challenged, on the one hand, by industry and certain state petitioners arguing that the standards should not have been reduced, and by environmental groups on the other arguing that EPA should have lowered the standards further. A number of states also are participating as *amici curiae* in support of EPA. The challenges were consolidated under *Murray Energy Corp. v. United States Environmental Protection Agency*. Briefing occurred in 2016, and the U.S. Court of Appeals for the District of Columbia Circuit has scheduled oral argument for April 19, 2017.

The establishment of NAAQS and implementation of policies to achieve compliance with such standards is one of the central programs of the federal Clean Air Act. EPA identifies pollutants subject to NAAQS and establishes ambient air quality standards for such pollutants pursuant to Sections 108(a) and 109 of the act. EPA is required to review the standards every five years and revise them if necessary to protect the public health and welfare. States are subsequently required to develop plans to achieve and maintain compliance with the revised standards.

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As EPA lowers the standard for a pollutant such as ozone, more areas will be out of compliance with the standards, prompting more stringent regulation of stationary and mobile sources. More stringent ambient air quality standards impose additional obstacles to the construction of new or modification of existing major emitting sources, in both attainment and nonattainment areas. In attainment areas, new or modified major sources have to demonstrate that the emissions from their projects will not cause or contribute to a violation of the standards. In nonattainment areas, new or modified major sources of oxides of nitrogen or volatile organic compounds (the precursor chemicals to the formation of ozone in the atmosphere) have to offset their emissions at a more than 1:1 ratio, with the ratio increasing the more severe the level of nonattainment.

### Potential Impact of the 2015 Ozone Standards

EPA estimated that based on 2012-14 air quality data, approximately 241 counties in 31 states would be in nonattainment at 70 ppb; areas in the Southwest and the industrial Midwest would be most negatively impacted. Industry petitioners have cited studies arguing that the number of affected counties will be much higher. EPA is expected to issue initial attainment/nonattainment designations under the new standards in 2017.

Similarly, there is a wide discrepancy in the estimated costs of complying with the new standards. EPA estimated that the annual cost to comply with the rule by 2025 (excluding California, which has a longer deadline to come into attainment due to more severe ozone issues) would be \$1.4 billion per year, while the National Association of Manufacturers produced an estimate in 2015, based on the assumption that EPA would revise the NAAQS to 65 ppb, that the cost, “as measured in reduced Gross Domestic Product, would be up to \$140 billion annually from 2017-2040.” Much of this discrepancy is due to the methodologies, assumptions and baselines used by the respective analysts. If the environmental petitioners prevail, EPA has estimated that the annual compliance costs would be 10 times its original estimate if the standard is set at 65 ppb rather than at 70 ppb.

### Potential Implications of the Legal Arguments

The potential implications of the NAAQS litigation are significant, despite the fact that the judgment of the D.C. Circuit is directly applicable only to EPA’s implementation of Section 109 of the Clean Air Act. Arguments being made in this case echo those that have been presented in other recent litigation and, depending on how the courts rule, could shed light on the future direction of EPA’s administration of environmental laws.

### Considering Costs

One argument concerns whether EPA can or is required to consider costs in its rulemaking. In its 2001 decision *Whitman v. American Trucking Associations*, the U.S. Supreme Court held, in connection with a challenge to EPA’s 1997 ozone NAAQS rule, that EPA was not permitted to consider cost in the development of ambient air quality standards. Nonetheless, the industry petitioners, taking their cue from Justice Stephen Breyer’s concurrence in *Whitman*, argued that because Clean Air Act Section 109(d) requires EPA to review and revise the standards “as may be appropriate,” EPA was required to consider the adverse socioeconomic and energy impacts of the standards as part of an assessment of the public’s tolerance for the health risks being addressed by the standards. In support of this argument, the industry petitioners cited the Supreme Court’s 2015 decision in *Michigan v. EPA*. In that case, the Court held that EPA’s requirement to regulate hazardous air pollutants emitted by electric steam-generating units if “appropriate and necessary” meant that EPA had to consider all relevant factors, including the cost of such regulation, before deciding to regulate this particular category of emission sources.

EPA’s response is that consideration of “socioeconomic and energy impacts” is simply “costs” by another name, and *Whitman* precludes it from considering costs when establishing national ambient air quality standards. Given that *Whitman* spoke to this very issue, one would think that EPA would prevail on this point; however, *Whitman* was decided 16 years ago, and it will be interesting to see if federal courts today are more receptive to an argument that EPA must consider regulatory impacts more broadly, as the Supreme Court was in *Michigan* (albeit interpreting a different section of the Clean Air Act). To give another recent example, in October 2016, a federal district court in West Virginia ruled in a different litigation filed by Murray Energy Corp. that EPA has an obligation to evaluate the potential loss of or shift in employment resulting from its administration and enforcement of the Clean Air Act. EPA has filed an appeal of this ruling, although the agency reportedly has not decided whether to pursue the appeal.

### Challenging Scientific Judgments

A second argument concerns EPA’s scientific and technical judgments in establishing the standards at 70 ppb. The industry and state petitioners assert that the evidence does not support a standard as low as 70 ppb and that EPA does not satisfactorily explain why it lowered the standard from 75 ppb to 70 ppb. According to the industry petitioners, the evidence is, for

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practical purposes, no different than it was in 2008. The environmental petitioners, on the other hand, argue that EPA's Clean Air Scientific Advisory Committee provided scientific advice that sensitive populations almost certainly experience adverse health impacts at concentrations below 70 ppb and that EPA's refusal to lower the standards below 70 ppb was not consistent with the statutory "requisite to protect the public health with an adequate margin of safety" standard. When an agency such as EPA interprets scientific evidence within its area of expertise, courts show considerable deference to the agency's judgment. That said, such deference is a presumption, and EPA still must demonstrate that its evaluation of evidence is rational in light of the statutory provisions being implemented. Historically, environmental petitioners have been more successful than industry in challenging EPA regulations on the ground that EPA's rules did not adequately protect health or the environment. This is in large measure because the federal environmental laws were drafted with environmental protection as a paramount objective. Nonetheless, in recent years, industry and states have been more successful in challenging EPA regulations. The litigation challenging the 2015 ozone NAAQS is likely to present another important data point about the level of deference that EPA will get from the courts with respect to scientific issues.

## **Conclusion**

Even if the Trump administration is unable to alter the course of the current litigation over the 2015 ozone NAAQS, the new administration could countermand proposed regulations that have not yet become final and, to the extent that it is able to develop a sufficient factual record, amend existing regulations that it finds objectionable. The administration also has considerable discretion in setting both its regulatory and enforcement priorities. Finally, the judicial appointments of the Trump administration also will have an impact on the interpretation and implementation of U.S. environmental laws and regulations. Nonetheless, much of what will happen with U.S. environmental law in the short and long term depends on what happens in Congress. If the administration and the Republican Congress are unable to amend environmental statutes such as the Clean Air Act or otherwise effect changes in the law that impact the implementation of such statutes, environmental groups and others that are intent on preserving an expansive federal environmental regulatory presence still have tools at their disposal. Such tools include the ability to challenge EPA regulations they believe are not sufficiently protective of the environment or that weaken existing regulations and the ability to challenge the failure of EPA to issue regulations that such groups believe are required by environmental laws.

# Republicans Chart New Course for US Health Care System

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While President Donald Trump made repeal of the Affordable Care Act (ACA) a centerpiece of his 2016 presidential campaign, he offered few details about how he would replace it or address other health care issues. More recently, Trump has vowed to provide “insurance for everybody,” though it is unclear how his approach would achieve this goal, as he has said little beyond that he does not want a single-payer system. Congressional Republicans, particularly in the House of Representatives, have mapped out a series of market-oriented health care reform proposals as part of their Way Forward agenda. These include plans to repeal and replace the ACA, speed drug innovation and enhance competition, and restructure Medicaid. Despite enjoying control of the White House and both chambers of Congress, Republicans are likely to face stiff opposition to their repeal efforts from Democrats and powerful interest groups. Meanwhile, President Trump has taken executive action to try to weaken certain parts of the law, though this will have a far more modest effect than the congressional Republicans’ legislative agenda.

## Repealing and Replacing the ACA

President Trump and the Republican leadership in both the House and Senate have made repealing the ACA a top priority. Many of the provisions of the ACA (those related to spending or tax measures) can be repealed by simple majority votes in the House and Senate under so-called reconciliation procedures. Other provisions, such as the coverage mandates on insurers, will require 60 votes in the Senate.

Congressional Republicans have begun the repeal process with a budget plan that uses reconciliation instructions to allow a simple majority repeal of large portions of the law. Provisions under consideration for repeal include the tax penalties for people who go without insurance and the penalties for larger employers that fail to offer coverage. Republicans may also propose eliminating federal insurance subsidies and halting federal spending for the expansion of Medicaid. Repealing other provisions of the law outside the reconciliation process will be more difficult. The rules governing insurance standards or the ability for dependents up to age 26 to be covered by their parents’ insurance, for example, will require 60 votes in the Senate to be repealed.

Recently, calls have grown to repeal the ACA and replace it with new legislation to occur simultaneously. This may mean that repeal occurs more slowly as the administration and Congress work to develop a replacement plan that includes more business-friendly and market-oriented proposals, such as expanded availability of high-deductible plans, allowing insurance companies to sell policies across state lines and medical malpractice liability reform.

If Congress decides to repeal before having replacement legislation, the strategy poses challenges. Repealing the funding mechanisms while leaving the regulations in place risks a breakdown of the market for individual insurance. Without a penalty to pay, relatively healthy individuals, who subsidize the costs of older and sicker Americans, could exit the insurance pool; and hospitals may be required to treat a greater number of uninsured or underinsured individuals without receiving additional Medicaid funding.

## Drug Pricing and Innovation

While President Trump and congressional Republicans are in sync on repeal of the ACA, Trump’s populism may clash with the pro-business, market-friendly approach of Republican lawmakers on the issue of drug pricing. During the campaign, President

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Trump endorsed giving Medicare the authority to negotiate drug prices and called for allowing the reimportation of lower-cost drugs from foreign countries. After the election, he reiterated his position on Medicare drug price negotiations and called on pharmaceutical companies to manufacture their products in the United States. Medicare negotiation authority and reimportation are anathema to the pharmaceutical and biotechnology industries and are not reflected in any congressional Republican reform package. Instead, Republicans have called for speedier approval of new drugs and other pro-competition measures to lower drug prices without stifling innovation in the life sciences sector. These priorities are reflected in the 21st Century Cures Act, which Congress passed and President Obama signed into law in December 2016. It remains to be seen whether these efforts will be enough to head off more populist measures. A recent bipartisan report by the Senate Special Committee on Aging called attention to rising drug prices for off-patent medicines and proposed a series of reform measures. Democrats are likely to offer amendments on reimportation and Medicare negotiation authority, and it is unclear whether President Trump will support such measures during the legislative process. One thing is certain: Drug pricing and innovation are likely to receive considerable legislative and media attention this year.

### **Medicaid Reform**

Republican lawmakers are likely to make Medicaid reform a top priority, including with proposals to transform the program from an entitlement to a block grant program subject to annual appropriations bills. Although the notion of changing Medicaid to a block grant program has strong support, the devil may be in the details. The 32 states that accepted federal funding to expand Medicaid under the ACA are likely to push for a formula that avoids dropping large numbers of current Medicaid beneficiaries off the rolls, while other states will argue that they should not be forced to accept lower block grant levels as a result of their decision not to receive funding from the ACA. While fights over state-by-state formulas for many federal programs are common, the size of the federal portion of Medicaid (\$315 billion in fiscal 2015) means this fight may be particularly contentious and may slow Medicaid reform legislation. In the meantime, we can expect the Centers for Medicare and Medicaid Services (CMS) under the Trump administration to grant Medicaid waivers liberally to states that want to experiment with new health care delivery and payment systems.

### **Enforcing Federal Health Care Fraud and Abuse Laws**

The election results are unlikely to diminish the current focus on combating health care fraud and abuse, including civil and criminal prosecution of health care companies and their execu-

tives. The nominee for U.S. attorney general, Sen. Jeff Sessions, R-Ala., prosecuted corporations and executives during the savings and loan crisis when he was a U.S. Attorney and has said that the behavior in the banking industry improved as a result of these prosecutions. He also has stated that he believes whistleblowers play an important role in policing fraud in federal programs. Although we cannot be certain of Sen. Sessions' views given his limited record in the Senate on white collar crime issues, we believe he is unlikely to buck long-standing bipartisan support for efforts to combat waste, fraud and abuse in federal health care programs. Moreover, even though turnover at the 93 U.S. Attorneys' offices around the country may slow the pace of some enforcement activity, the majority of civil and criminal enforcement decisions are in the hands of career prosecutors, many of whom have extensive health care fraud experience and are likely to continue their focus on health care cases.

### **Trump's Early Health Care Nominations**

If the old adage is true that personnel is policy, President Trump's early picks for key posts reflect a desire to pursue sweeping changes in the federal government's approach to health care. Rep. Tom Price, R-Ga., Trump's nominee to lead the Department of Health and Human Services, is a conservative lawmaker who has called for replacing the ACA with individual health savings accounts and age-adjusted tax credits for Medicare and Medicaid beneficiaries to purchase private health insurance. A practicing orthopedic surgeon, Rep. Price has brought a physician's perspective to the table and been an outspoken critic of reimbursement models (such as the Medicare Part B demonstration project) that he has said attempt to restrict how physicians care for individual patients. Instead, Rep. Price has proposed to allow physicians to bill beyond Medicare's prescribed reimbursement limits and to curb medical malpractice lawsuits.

For the CMS, Trump has picked Seema Verma, who helped create both the Healthy Indiana Plan (HIP), the nation's first consumer-directed Medicaid program, under former Gov. Mitch Daniels of Indiana, and Vice President Mike Pence's HIP 2.0 waiver proposal. Verma is likely to encourage and approve Medicaid waivers from other states that want to experiment with alternative delivery and payment models.

On the Food and Drug Administration (FDA) front, then-candidate Trump called for the FDA to have a "greater focus on the need of patients for new and innovative medical products." The incoming FDA commissioner, who has yet to be nominated, will have a significant say in what role the agency plays on key issues, including implementation of the changes to the drug- and device-approval process recently enacted as part of the 21st Century Cures Act.

# Significant Changes Likely for US Trade Policy and Enforcement

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U.S. international trade policy and enforcement were centerpieces of President Donald Trump's campaign and are likely to feature prominently in the new administration's agenda in the months ahead. The Trump administration has promised potentially seismic shifts in U.S. trade policy, with the likelihood of more aggressive enforcement of U.S. trade laws, significant action at the World Trade Organization (WTO), negotiation and renegotiation of important U.S. trade agreements, and measures to address the issue of border tax adjustability.

## Trade Law Enforcement

Vigorous enforcement of U.S. trade laws was a key plank in President Trump's "Seven Point Plan to Rebuild the American Economy by Fighting for Free Trade" announced in June 2016. Since that time, President Trump has clearly expressed his intent to use every tool under U.S. law to address unfair trade practices affecting U.S. companies, workers and national security. Among the existing statutory mechanisms that could be utilized in these efforts are the following:

- **Section 232(b) of the Trade Expansion Act of 1962.** Section 232(b) provides for the imposition of tariffs or quotas on imports that threaten to impair U.S. national security. Investigations may be self-initiated by the Department of Commerce (Commerce). They may also be initiated based on an application from an interested party or at the request of the head of another U.S. government agency. If Commerce finds that imports of a particular product or products threaten to impair U.S. national security, the president decides whether to impose tariffs or quotas on such imports.
- **Section 122 of the Trade Act of 1974.** This statute authorizes the president to impose quotas and tariffs of as much as 15 percent for up to 150 days against one or more countries that have "large and serious" balance-of-payment surpluses with the United States. Imports from countries with significant current account surpluses (such as China) would be possible targets for any such measures.
- **Section 201 of the Trade Act of 1974.** Section 201 permits the president to impose tariffs or quotas on imports of a particular product where there has been a surge of imports of that product. To have tariffs or quotas imposed under Section 201, the import surge must constitute a substantial cause of serious injury to the U.S. industry producing the product in question.
- **Section 301 of the Trade Act of 1974.** Under Section 301, upon a finding that another country has denied the United States its rights under a trade agreement or has engaged in practices that are unjustifiable, unreasonable or discriminatory and burden or restrict U.S. commerce, the United States may impose tariffs and quotas against the foreign country's imports. Section 301 investigations are conducted by the U.S. Trade Representative's Office, which has the authority to impose duties and quotas and to suspend benefits granted to the United States' trading partners under trade agreements.
- **The Trading With the Enemy Act (TWEA) and the International Emergency Economic Powers Act of 1977 (IEEPA).** TWEA and IEEPA authorize the president to regulate all forms of international commerce and freeze assets in time of war (TWEA) or in response to "unusual or extraordinary" international threats to the national security, foreign policy or economy of the United States (IEEPA). Past measures imposed pursuant to these statutes have predominantly taken the form of embargoes, economic sanctions and asset freezes, but precedent exists for the imposition of tariffs under the presidential power to regulate imports.

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- **Anti-Dumping and Countervailing Duty Laws.** Upon a finding that a U.S. industry is being “materially injured” or threatened with material injury by dumped or subsidized imports, the United States can impose anti-dumping (AD) or countervailing (CVD) duties to offset the level of dumping or subsidization that is occurring. Investigations may be initiated in response to a petition from a domestic industry or union, or may be self-initiated by Commerce. A number of industries have successfully brought investigations under these laws in recent years to address injury being caused by unfairly traded imports, and the brisk pace of cases and investigations is expected to continue as numerous industries continue to face overcapacity and other structural issues arising from subsidization and government intervention in markets.
  - **Enforcement of Existing AD/CVD Orders and U.S. Customs Laws.** Companies importing into the United States also should expect increased enforcement of existing AD and CVD orders as well as other requirements of the U.S. customs laws. Among other areas, U.S. Customs and Border Protection can be expected to increase enforcement actions against imports suspected of evading AD and CVD duties under the recently enacted Enforce and Protect Act of 2015 and other grants of enforcement authority.

### Initiatives at the WTO

President Trump’s trade agenda calls for strong action at the WTO. Among other measures, the new administration is expected to increase the number and range of cases challenging the unfair trade practices of other WTO members, especially China.

Trump administration officials also have called for more effective use of U.S. leverage at the WTO to better enforce the terms of existing WTO agreements or potentially renegotiate such terms. This could include a withdrawal of some or all of the U.S. commitments under the WTO agreements if U.S. negotiating objectives are not achieved.

### Renegotiating the North American Free Trade Agreement

President Trump has called the North American Free Trade Agreement (NAFTA) “the worst trade deal ever signed” and stated his administration’s intent to renegotiate and potentially withdraw from the agreement. Priorities in any such renegotiation may include the NAFTA rules defining whether a good “originates” in a NAFTA member country, the rules governing investor-state disputes and appeals of AD and CVD cases, and the provisions on labor and environmental regulation.

Under the terms of Chapter 22 of NAFTA, the U.S. may withdraw from the agreement upon six months’ written notice. If NAFTA is terminated, the U.S. may seek to reinstate the Canada-U.S. Free Trade Agreement or negotiate new trade deals with Canada and Mexico.

### Action on Other Trade Agreements

NAFTA will not be the only trade agreement under reconsideration by the Trump administration. The administration has already taken action to withdraw from the Trans-Pacific Partnership Agreement (TPP). In addition, administration officials have heavily criticized the U.S.-Korea Free Trade Agreement, signaling a possible move to renegotiate or terminate that agreement.

At the same time, however, the new administration’s policies should not be taken to mean the end of new trade initiatives. In place of broad multilateral agreements such as TPP, the Trump administration seems likely to pursue a series of bilateral trade agreements with key trading partners such as the United Kingdom and Japan.

### Border Tax Adjustability

Trump administration officials have identified the value-added tax (VAT) systems of U.S. trading partners such as China, Mexico and the EU as one cause of the U.S. trade deficit and the offshoring of U.S. jobs. (See “[Business Tax Reform All but Certain in US, Europe](#).”) Under most countries’ VAT systems, VAT is charged on imports (such as imports from the United States) but is rebated on exports. Such VAT systems generally are permitted under the WTO agreements (such as the Agreement on Subsidies and Countervailing Measures) but are viewed as creating an export incentive and deterring imports, unfairly prejudicing U.S. companies.

Efforts to address this issue are likely to proceed on multiple fronts and may take various forms. For example, the Trump administration may seek to end preferential treatment of VAT systems under WTO subsidy rules or may address Mexico’s VAT system in the context of a renegotiation of NAFTA. Legislation also has been proposed that would create a border tax adjustment in the United States that would mirror the VAT systems of other countries in many respects. Under a proposal floated by the Republican leadership in the House of Representatives, the United States would implement a destination-based tax system that would eliminate the U.S. corporate tax deduction for the cost of imports and exempt income earned by U.S. companies on export sales. This and other measures are likely to continue to be considered and vigorously debated in the coming months.

### Conclusion

The next few years could be some of the most momentous in the history of U.S. trade policy. Investors, companies engaged in international trade and U.S. companies affected by imports should pay close attention to the potentially dramatic changes on the horizon and be prepared for how they may impact their businesses and investments.

# Trump Expected to Alter Labor Laws, Policies

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While President Donald Trump has not discussed in detail how he plans to address labor and employment issues, he likely will pursue a substantial shift in federal labor and employment laws, regulations and enforcement priorities. Indeed, when President Trump nominated Andrew F. Puzder as secretary of the Department of Labor (DOL), he said that Puzder will “save small businesses from the crushing burdens of unnecessary regulations that are stunting job growth and suppressing wages.”

President Trump may have been referring to new workplace regulations the Obama administration put in place over the last eight years, including increasing minimum wage requirements for federal contractors and mandating that most large businesses file employee compensation reports with the federal government. Because President Barack Obama used executive orders and administrative rules to implement many of his initiatives in a challenging political environment, President Trump and his employment-related appointees will have opportunities to scale back the Obama administration's efforts and reshape the regulatory landscape for employers. Notably, on Trump's first day in office, White House Chief of Staff Reince Priebus issued a memorandum to all executive departments and agencies to freeze unpublished regulations and postpone for 60 days the effective date of published federal regulations that have not yet become effective. The actions the new administration takes could influence state and municipal governments in their regulation of employers, which may ultimately impact business trends.

We anticipate significant changes at the following federal agencies:

- **DOL, Wage and Hour Division:** One of President Obama's major labor-related achievements was the overhaul of overtime pay regulations in a manner that would nearly double the minimum salary level at which an employee can be exempt from overtime pay. However, just before the final rule was to go into effect on December 1, 2016, a federal district court judge suspended the regulation while considering a legal challenge from 21 states and a coalition of business groups. Puzder, whose confirmation hearing has been indefinitely postponed, has been critical of the overtime rule, arguing in a May 2016 op-ed in *Forbes* that it will “simply add to the extensive regulatory maze the Obama Administration has imposed on employers, forcing many to offset increased labor expense by cutting costs elsewhere.” Although the DOL has filed an interlocutory appeal challenging the district court judge's preliminary injunction blocking the DOL's overtime rule, the new Trump DOL could either withdraw the appeal (assuming a third party does not intervene to continue the appeal) or begin the administrative rulemaking process to change the regulation. Alternatively, the new Congress may pass legislation nullifying the regulation.

In addition, during Obama's presidency, the Wage and Hour Division issued administrator interpretations (guidance on how to interpret the laws, which are not legally binding on the courts) that sought to greatly expand when businesses can be held liable as joint employers and to narrow the circumstances in which workers could be treated as independent contractors exempt from federal wage and hour laws. Under President Trump, the Wage and Hour Division could scale back these administrator interpretations to provide more employer-friendly interpretations.

- **DOL, Office of Federal Contract Compliance Programs (OFCCP):** The OFCCP is the agency that ensures that employers doing business with the federal government (federal contractors and subcontractors) comply with laws and regulations requiring nondiscrimination. The Obama administration made numerous changes to affirma-

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tive action requirements via executive orders, bypassing the congressional and administrative rulemaking processes. President Trump has stated his intention to revoke President Obama's executive orders. Among the Obama initiatives that could be repealed under President Trump is the Fair Pay and Safe Workplaces executive order, known by its opponents as the "blacklisting" order. The order requires prospective federal contractors and subcontractors to disclose workplace law violations that occurred during the previous three years and to give wage statements detailing pay and hours to employees and independent contractors; it also prohibits arbitration agreements relating to Title VII of the Civil Rights Act or sexual assault. However, because the Federal Acquisition Regulatory Council issued a final rule implementing this order, it may take additional steps for the rule to be changed. Litigation to enjoin the final rule is pending. In the meantime, on January 30, 2017, Republican lawmakers introduced a joint resolution of disapproval, which would permanently block implementation of the final rule, under the Congressional Review Act. The law allows Congress to repeal new rules on an expedited basis through a resolution of disapproval, as long as the regulations were issued within 60 legislative days of the new Congress. The joint resolution will require only a simple majority of the House and the Senate and President Trump's signature. A number of other executive orders issued by President Obama may be scrutinized, including the executive order that raised the minimum wage contractors pay employees performing work on covered federal contracts (\$10.20 per hour as of January 1, 2017) and the executive order that requires federal contractors to provide paid sick leave to employees working on government contracts. Meanwhile, a White House statement issued on January 31, 2017, stated that President Trump will continue to enforce President Obama's executive order barring discrimination against LGBT people working for federal contractors.

- **DOL, Occupational Safety and Health Administration (OSHA):** As DOL secretary, Puzder could review a number of OSHA standards that were issued over the last eight years. He is likely to curtail OSHA's new record-keeping rule, which requires covered employers to file injury and illness information electronically with the government by July 1, 2017 (and on an annual basis thereafter); the information will then be posted online for the public. Puzder also might focus on the standard by which OSHA enforces the more than 22 whistleblower statutes under the agency's whistleblower protection program. In the last several years, OSHA lowered the employee's burden of proof necessary to prove retaliation.
- **Equal Employment Opportunity Commission (EEOC):** On January 25, 2017, President Trump appointed EEOC Commissioner Victoria A. Lipnic as acting chair to take over the leadership role

from Chair Jenny R. Yang. Lipnic joined the EEOC in 2010, and during her tenure, she was one of two commissioners who voted against the EEOC's July 2015 decision that sexual orientation discrimination is gender discrimination prohibited by Title VII. President Trump also will have the opportunity to nominate the EEOC's new general counsel to replace David Lopez, who left in December 2016. Given the change in leadership, the agency's enforcement priorities and litigation decisions will almost certainly shift. In recent years under Yang, the EEOC has made equal pay a top priority. In furtherance of this commitment, in September 2016, the EEOC announced final changes to the Employer Information Report (EEO-1), which will require employers to annually report aggregate compensation data for all employees by gender, race and ethnicity across pay bands. These changes are set to become effective in March 2018; however, under Lipnic, who had voted against the EEO-1 pay data report proposal, and other Trump appointees, the EEOC could seek to modify these changes before they come into effect.

- **National Labor Relations Board (NLRB):** On January 26, 2017, President Trump appointed Philip A. Miscimarra, the sole Republican member of the NLRB, as acting chairman, taking over from Democrat Mark Gaston Pearce. The NLRB currently has two vacant seats, both of which President Trump is likely to fill with Republican members. Additionally, the term of NLRB General Counsel Richard F. Griffin, Jr. will expire in November 2017. With these new appointments, the NLRB's controversial joint employer standard in *Browning-Ferris Industries of California, Inc.* could be reversed. The 2015 decision in *Browning-Ferris* broadened the joint employer standard to include relationships where the potential joint employer has the ability to control an employee's essential terms and conditions of employment — even if it never actually exercises such control. (See *2016 Insights* article "[A New World for Joint Employers.](#)") In addition, since its 2012 decision in *D.R. Horton, Inc.*, the NLRB has consistently maintained that the National Labor Relations Act prohibits arbitration agreements that require employees to waive the right to pursue labor-related class and collective actions. Recently, the U.S. Supreme Court agreed to hear, on a consolidated basis, three cases relating to the *D.R. Horton* decision and the circuit split that developed thereafter. Among the new president's first orders of business was to nominate conservative U.S. Court of Appeals for the Tenth Circuit Judge Neil Gorsuch as a Supreme Court justice to replace the late Justice Antonin Scalia. Judge Gorsuch, if confirmed, would restore the highest court to a Republican majority, but it is too early to predict whether he would join a majority in rejecting the board's position in *D.R. Horton*.

In response to less workplace regulation from the federal government, a number of states and municipalities are likely to initiate

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more legislative action. The idea that state and local governments can fill gaps in workers' rights left open under federal law is not new. Over the last eight years, numerous states and localities enacted ordinances to raise the minimum wage, guarantee paid sick days, provide paid parental leave and protect LGBT rights in the workplace. For example, while the federal minimum wage (for nongovernment contractors) has remained at \$7.25 per hour since 2009, state and local laws enacted last year are expected to increase the minimum wage to \$15 per hour in California, New York and Washington, D.C. over the course of the next five to six years. Likewise, various agencies charged with enforcing labor laws in states such as California, Illinois, Massachusetts and New York have issued guidance and taken enforcement positions in litigation that make it clear they have a narrow view of the permissible use of independent contractors and exemption from overtime requirements, as well as an expansive view of

joint employer liability. Standing in contrast are some states that have stopped municipalities from instituting certain employment legislation (*e.g.*, statewide bans on paid sick leave in Florida, Michigan and Wisconsin).

If the Trump administration rolls back federal protections, we can expect to see countervailing trends from some state and local governments in the form of new legislation and greater employee protections. However, others may be just as happy not to substitute local rights for federal ones. How this will reverberate in the workforce, including with regard to job growth or decline, remains to be seen. With an improving economy, we anticipate that worker mobility will be on the rise, particularly among college-educated workers, and the degree to which a jurisdiction provides workplace rights and protections may play a role in where workers choose to seek jobs.

# Business Tax Reform All but Certain in US, Europe

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## United States

The prospects for business tax reform in the United States were greatly enhanced by the 2016 election results. Reform under Republicans, who control both the White House and Congress, could dramatically impact the cross-border tax planning of both U.S. and foreign-parented multinational groups, requiring multinationals to rethink all aspects of their corporate structures, including capital and supply-chain structures, and the locations of their earnings and operations. Changes in the taxation of domestic and foreign corporate earnings also could facilitate M&A activity by enhancing U.S. multinationals' access to their foreign cash.

The business tax reform proposals set forth during President Donald Trump's campaign and in the House Republican proposal known as the "Blueprint" differ in certain respects but have common themes. Both proposals feature a significantly reduced corporate tax rate (15 percent under President Trump's proposal, 20 percent under the Blueprint). Moreover, both proposals include the ability to deduct capital expenses (at the price of forgoing interest deductions). Each proposes a one-time transition tax on accumulated foreign earnings — the Blueprint at 8.75 percent on earnings held in cash or equivalents and 3.5 percent on all other earnings, the Trump plan at a 10 percent rate. The Blueprint allows companies to pay the resulting tax liability over an eight-year period.

There also are important differences between the proposals. Most notably, the Blueprint imposes a tax on cash flow (not income) akin to a value-added tax (VAT) but with a deduction for wages. This "destination-based" tax exempts all foreign sales and services revenue from U.S. tax, while such revenue generated in the U.S. is subject to full U.S. tax. To this end, the Blueprint does not provide a deduction for the cost of imported goods or services nor for royalties and other payments to non-U.S. taxpayers. However, all payments to U.S. taxpayers are deductible, even if related to export sales that are exempt. These "border adjustments" would effectively tax imports while exempting exports, thus providing an incentive to locate business activities in the United States.

President Trump's proposal has no such destination-based tax or exemption. In lieu of border adjustments, Trump has proposed a 35 percent tax to be directly imposed on imports by U.S. taxpayers who move their manufacturing operations overseas. While both President Trump and Treasury secretary nominee Steven Mnuchin have indicated that "border adjustments" are too complicated, President Trump has said they remain an option. If border adjustments are not included in the Republican tax reform plan, then other means of paying for an overall reduction of rates will be necessary.

In addition, the Blueprint would introduce a territorial tax system under which 100 percent of dividends paid by foreign subsidiaries to their U.S. parents would be exempt from U.S. federal income tax. President Trump's proposal originally would have imposed an immediate 15 percent tax on all income earned by foreign subsidiaries of U.S. corporations; whether he continues to support immediate taxation is unclear.

The Trump proposal is expected to be scored by the Joint Committee on Taxation to reduce corporate tax revenues substantially on both a near- and long-term basis. The Blueprint is expected to reduce corporate tax revenues over a potentially lengthy transition period. Moreover, the Blueprint represents a fundamental departure from our existing income tax system and could benefit taxpayers in certain industries (for example, exporters of U.S.-manufactured goods) at the expense of others (for example, businesses

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such as retailers that rely heavily on imports). It is uncertain whether Congress would ultimately approve either proposal in its current form.

Kevin Brady, chairman of the House Ways and Means Committee, has said that work is currently in progress on the Blueprint, and a tax reform bill is expected to be introduced early this year. The Trump administration likely will release its own proposals at the time that it releases its fiscal 2018 budget — likely by late February or early March 2017. Assuming alignment between the Trump administration and House Republicans, a House bill would then be considered in committee in the spring or early summer. If passed by the House, it would next be reviewed by the Senate, which has not suggested its own tax reform proposals. The Senate can be expected to suggest substantial changes to anything coming from the House. Assuming the two chambers can come to an agreement in conference, it is possible that a bill could be enacted by the end of the year or early in 2018. If that timetable holds, while most aspects of the reform would likely only apply prospectively, certain provisions — notably the transition tax on foreign earnings — could take into account transactions undertaken as early as January 1, 2017. Other provisions, such as the nondeductibility of interest rate reductions and border adjustability, could be phased in over time.

The prospect for tax reform likely will slow further the pace of so-called “inversion” transactions — cross-border mergers and acquisitions using a foreign-parented structure, although certain transactions with a sufficiently compelling business case may continue to move forward. These transactions already had been impacted by recent regulatory efforts by the Treasury Department and the Internal Revenue Service to reduce or eliminate many of the tax benefits associated with them. Further, Republicans have indicated that tax reform, rather than additional punitive rules, is the best way to stop inversion. For example, Mnuchin has said that lowering rates would have a significant impact on stopping inversions. Accordingly, the fate of guidance in this area — in particular, the recently issued final regulations under Section 385 dealing with intercompany indebtedness — is unclear. (Chairman Brady already has stated that these regulations could be revoked under a Trump administration.) Until the possibility and boundaries of tax reform become more certain, taxpayers must assume these regulations will remain in place while planning for a distinctly different tax future.

## Europe

Europe has started to see significant policy development and statutory implementation at national levels for initiatives aimed at increasing regulatory oversight of cross-border transactions

and pushing for transparency and proposals to combat base erosion and profit shifting (BEPS). These initiatives are in relation to specific action plans created as part of the Organisation for Economic Co-operation and Development’s (OECD) BEPS project and, more generally, by jurisdictions looking to curb perceived abuses in cross-border transactions. (Critics contend that such transactions aim to materially reduce the corporate tax rate.)

Notably, the European Union has gone significantly further than the OECD action plans and is channeling the widespread political interest in curbing corporate abuses to advance its long-held goal of harmonizing corporate tax rules within the EU — this, despite tax not being a designated competency for the EU. The so-called “common corporate tax base” is scheduled to be in force by 2019 and a “consolidated common corporate tax base” (CCCTB) by 2021. Additionally, the EU is aiming for a holistic solution for BEPS issues by taxing multinationals’ profits specifically where value is created — payroll and the customer base.

The CCCTB seeks to remove tax competition within the EU, save for rate arbitrage, and eliminate the tax benefits of corporate entities in jurisdictions where they have no material human presence or customers. The CCCTB was developed in the same year as the EU’s Anti Tax Avoidance Directive (ATAD), which, among other measures, contains significant anti-hybrid mismatch legislation aimed at strengthening tax avoidance rules. Recently proposed amendments would extend the EU anti-hybrids legislation globally, provided at least one party is EU-based. If implemented, these measures will become significant factors in the evaluation of the tax benefits of acquisitions for boards of acquiring companies, including reconsidering the traditional architecture of transactions and integration of cash flows and supply chains through tax-advantaged structures.

Also impacting the tax environment is the EU’s state-aid challenges relating to multinationals’ cross-border tax planning. These are a series of high-profile challenges from the European Commission in which it alleges that unfair competition has developed between businesses due to advantageous tax rulings or regimes across EU jurisdictions. The possibility of such challenges for future cross-border M&A means that companies must now consider whether their tax structuring might infringe on EU competition law. Boards also should re-evaluate their structuring to determine whether prior planning would provoke a negative stakeholder reaction if it were brought to light by a state-aid challenge.

Meanwhile, Brexit’s effect on tax policy, though certain to be material, remains unclear. Much of the change to come will depend on the terms of the U.K.’s negotiations with the EU, but it looks like the government is targeting a very clean break from

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the trading bloc. Areas of impact for multinationals are expected to include VAT (a new U.K. system will have to be introduced) and the taxation of upstreamed dividends and interest from EU subsidiaries to U.K. holding companies. It has been argued that departure from the EU will ease issues such as state aid for preferential tax regimes and applicability of anti-abuse legislation under ATAD, but these may be superficial advantages if the terms of Britain's exit include restrictions, which are not uncommon in trade treaties, on U.K. state aid and continued maintenance of a material corporate tax regime, both of which have already been mentioned by some EU jurisdictions as the conditions of a deal. In any event, the U.K. already has instituted its own version of BEPS-related changes, such as its diverted profits tax, anti-hybrid mismatch rules, country-by-country reporting and proposed limitations on interest deductibility to 30 percent of EBITDA (earnings before interest, tax, depreciation and amortization), and it is hard to see these being quickly changed.

# Income, Wealth Transfer Tax Changes Likely Under New Administration

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Comprehensive federal tax reform likely will be a top priority for the Trump administration and Republicans in Congress in the first half of 2017. Although there are differences between their proposals, President Donald Trump and the House GOP have suggested significant changes to the estate tax as well as to the availability of asset step-up in basis after death and itemized deductions during life. High-net-worth individuals and their estate planners should examine all three issues, in addition to state estate tax consequences, when revising their lifetime and testamentary giving plans in the wake of changes at the federal level.

## Tax Reform Plans

The following table compares President Trump’s statements on tax reform during his campaign with the House Republican proposal, known as the “Blueprint.” (See “[Business Tax Reform All but Certain in US, Europe.](#)”)

Issue	Trump Plan	Blueprint
Estate Tax	Repealed	
Gift Tax	Not mentioned	
Generation-Skipping Transfer Tax	Not mentioned	Repealed
Basis of Assets at Death	<ul style="list-style-type: none"> <li>- Step-up to fair market value at death, only for first \$10 million</li> <li>- Carryover basis or capital gains tax at death for amounts exceeding \$10 million</li> </ul>	No change (full step-up to fair market value at death)
Ordinary Income Rates	Top rate of 33%	
Capital Gains Rates	No change (top rate of 20%)	Top rate of 16.5%
Itemized Deductions	<ul style="list-style-type: none"> <li>- \$200,000 cap (married, filing jointly)</li> <li>- \$100,000 cap (single)</li> </ul>	<ul style="list-style-type: none"> <li>- Home mortgage interest deduction preserved</li> <li>- Charitable deduction preserved</li> <li>- No cap, but no other deductions</li> </ul>
Charitable Contributions	Subject to cap on deductions	No change

President Trump and the Blueprint offer additional proposals, such as closing the carried interest tax “loophole” (President Trump only) and income tax rate decreases for corporations and pass-through business entities (both plans). However, the issues of estate tax repeal, changes to asset basis step-up and limitations on deductions will have the most significant effects on estate planning in terms of both testamentary plans and lifetime giving.

## Estate Tax Repeal

Estate tax repeal has been on the Republican wish list for many years, but previous efforts at permanent repeal failed — even during one period of unified Republican government — because of Democratic political opposition and legislative rules relating to the reconciliation process between House and Senate spending bills. However, political will for estate tax repeal is strong this year, both because it is a stated priority for congressional Republicans and President Trump and because Senate Democrats may cede opposition to estate

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tax repeal as a filibuster bargaining chip in overall tax reform. The generation-skipping transfer tax, which prevents individuals from avoiding the estate tax through transfers to grandchildren and more remote descendants, would become largely irrelevant with no estate tax in place and would likely be part of any estate tax repeal bill.

Although the 40 percent rate for transfers at death totaling over \$5.49 million for an individual and \$10.98 million for a married couple in 2017 appears ripe for the legislative chopping block, less certain is the status of the gift tax. Neither plan mentions this tax, which imposes the same rate on transfers exceeding the same amounts during a donor's lifetime. Although transfer taxes represent only a nominal amount of revenue for the government relative to all tax receipts, the gift tax serves as a backstop to the income tax by preventing high-marginal-rate taxpayers from gifting certain assets to low-marginal-rate taxpayers — often, younger family members — who would sell the assets and gift the proceeds back to the donor. If the gift tax remains in effect, transfer techniques such as grantor-retained annuity trusts would continue to be effective estate planning tools even after a repeal of the estate tax.

### **Asset Basis Step-Up**

A major difference between the two plans is whether assets that appreciate will receive a step-up in basis, or a readjustment in value, at an owner's death. Current law and the House GOP plan provide that all assets owned by a decedent at his or her death receive a step-up in basis to their fair market value at the time of death. Unless an asset appreciates significantly after the decedent's death, its recipient will have limited — if any — taxable gain on a later sale or exchange.

However, President Trump's plan appears to limit the step-up in basis to the first \$10 million of built-in gain in assets owned by a decedent at death. If a decedent owned \$100 million of assets at death with an aggregate basis of \$50 million (in the simplest case, having paid \$50 million for those assets, which then appreciated to \$100 million), the basis of those assets in the hands of the recipient(s) would be limited to \$60 million as opposed to their \$100 million fair market value. It is unclear from President Trump's plan how the \$10 million increase in basis would be allocated among multiple built-in gain assets. It also is unclear whether his plan would deem death a capital gains realization event, such that, in the previous example, the decedent's estate would pay tax (presumably, at capital gains rates) on \$40 million of appreciation, and the recipients would take the decedent's

assets with a \$100 million fair-market-value basis. In any event, the full, tax-free step-up in basis at death that estate planners and clients have enjoyed would no longer be in effect.

### **Limitations on Deductions**

Finally, President Trump's plan changes the availability of itemized deductions for all taxpayers, potentially limiting the income tax efficiency of charitable contributions during life for charitably inclined high-net-worth individuals. Although the House GOP plan eliminates most itemized deductions, such as deductions for medical expenses and for state and local taxes, it retains the current charitable deduction, which is unlimited in terms of dollar value but subject to a percentage limitation based on adjusted gross income.

By contrast, President Trump's plan retains all current itemized deductions but caps them at \$100,000 for a single individual and \$200,000 for a married couple. An individual whose annual home mortgage interest, medical expenses, and state and local taxes exceed \$100,000 would thus receive no additional deduction for amounts contributed to charities, perhaps causing him or her to defer charitable giving to later years or until death.

### **State Estate Taxes**

Even if President Trump and the House GOP implement comprehensive tax reform that eliminates the federal estate tax, state estate taxes would not automatically follow suit. New York, for example, imposes an estate tax with a top rate of 16 percent for transfers at death exceeding \$4.187 million (increasing to \$5.25 million in April 2017). Eighteen other states have state estate taxes, with top rates ranging from 12 percent to 20 percent. New York residents and residents of other states that continue to have separate estate taxes must remember to consider the state tax efficiency of their estate plans, even if state estate tax rates remain lower than the current top federal rate of 40 percent.

### **Looking Ahead**

At first glance, changes to the transfer tax system at the federal level would seem to simplify estate planning for many individuals. However, because of offsetting changes to the federal income tax consequences of gratuitous transfers and unchanged state transfer tax systems, individuals and their estate planners should take a cautious approach when revising estate planning documents in the coming year.



