

TOP 10 TOPICS

For Directors in 2018



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Top 10 Topics for Directors in 2018

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TOP 10 TOPICS FOR DIRECTORS IN 2018

EXECUTIVE SUMMARY

- 1. Cybersecurity threats.** Cybersecurity preparedness is essential in 2018 as the risk of, and associated adverse impact of, breaches continue to rise. The past year redefined the upward bounds of the megabreach, including the Yahoo!, Equifax and Uber hacks, and the SEC cyber-attack. As Securities and Exchange Commission (SEC) Co-Directors of Enforcement Stephanie Avakian and Steven Peikin warned, “The greatest threat to our markets right now is the cyber threat.” No crisis should go to waste. Boards should learn from others’ misfortunes and focus on governance, crisis management and recommended best practices relating to cyber issues.
- 2. Corporate social responsibility.** By embracing corporate social responsibility (CSR) initiatives, boards are able to proactively identify and address legal, financial, operational and reputational risks in a way that can increase the company value to all stakeholders-investors, shareholders, employees and consumers. Boards should invest in CSR programming as an integral element of company risk assessment and compliance programs, and should advocate public reporting of CSR initiatives. Such initiatives can serve as both differentiating and value-enhancing factors. According to recent studies, companies with strong CSR practices are less likely to suffer large price declines, and they tend to have better three- to five-year returns on equity, as well as a greater chance of long-term success.
- 3. Managing five generations of employees.** In the coming years, employers will face the unprecedented challenge of having five generations of employees in the workplace. Companies and their boards can help address these tensions by better understanding employee expectations, encouraging cross-generation mentorship, and setting an example of generational diversity with respect to company leadership and members of the board. If managed correctly, boards and companies alike can benefit from the wisdom, collaboration and innovation that comes with generational diversity.
- 4. Corporate strategy.** Strategic planning with a particular focus on potential acquisitions should continue to be a high priority for boards in 2018. Boards should expect to face conflicting pressures, since shareholders will expect companies to invest in both long-term growth opportunities and short-term stock enhancement measures, including the deployment of excess cash for stock buybacks. Cross-border transactions will likely continue to be attractive options, subject to increased regulatory scrutiny in certain industries and of certain buyers.
- 5. Board composition.** Board diversity is being actively considered and encouraged by regulators, corporate governance groups and investors, both in the United States and internationally, and the current focus on board diversity is likely to continue. Companies should review the applicable diversity-related obligations in their jurisdictions and assess their current board composition, director search and nomination process, board refreshment practices and diversity policies.
- 6. Shareholder activism.** Shareholder activism has entrenched itself in the modern climate of corporate governance. In particular, shareholder activists have entered industries that, until recently, have generally steered clear of such investors, including the energy sector. There is an increased emphasis by prominent investors on challenging transactions, corporate strategy and traditional corporate governance concerns, such as board composition and staggered boards.
- 7. Internal investigations.** Boards are increasingly confronted with the possibility of wrongdoing implicating the company or its employees. The decision whether or not to undertake an independent internal investigation, and how, requires careful consideration and consultation with counsel, since the response of the board will have important implications for the ultimate effects on the company.

8. **SEC regulatory relief.** We expect that the Trump administration and the Republican-led U.S. Congress will advance reforms in 2018 designed to encourage companies toward public ownership and to facilitate capital formation in both public and private markets. Although smaller companies will likely be the greatest beneficiaries of the proposals currently being considered, many proposals are expected to also benefit large public companies-by eliminating certain duplicative and nonmaterial disclosure requirements and by addressing concerns regarding shareholder proposals.
9. **SEC enforcement.** In addition to new leadership at the SEC, ambitious legislative proposals in Congress and further developments in insider trading law have the potential to impact SEC enforcement, although certain enforcement streams, such as accounting and other disclosure-related investigations, are likely to remain largely unchanged. The SEC’s own cyber breach has brought renewed focus at the agency on information security and the integrity of trading systems. Efforts to repeal Dodd-Frank have also advanced through both chambers of Congress.
10. **Trade and sanctions.** During the first year of the Trump administration, U.S. sanctions were expanded significantly to include complex new restrictions that target transactions with Iran, Russia, North Korea and Venezuela, among others. Additionally, there has been an uptick in sanctions enforcement actions, including a continued focus by U.S. enforcement agencies on officers and directors that approve, or engage in, proscribed activities. Accordingly, in an effort to avoid running afoul of U.S. sanctions, boards should be vigilant in understanding how these evolving rules apply to the business activities of their companies and management teams.

Special Bonus: Tax reform. Tax reform has been a top priority for the Trump Administration and Republicans in Congress. After a slow start to 2017 in terms of legislative wins, the House and Senate are poised to send the first comprehensive tax reform bill to the President’s desk in more than thirty years. While the differences between the House and Senate bills still need to be resolved, the new Tax Cuts and Jobs Act is expected to pass by the end of the year and will present both benefits and challenges for companies in implementation and adaptation as unintended consequences are inevitably uncovered in the months and years to come.



FULL REPORT

1. Cybersecurity threats

The stakes will continue to rise for boards in connection with cybersecurity in 2018. The past year has redefined the upward bounds of the megabreach. The Yahoo! hack (three billion accounts) forced Yahoo! to accept a \$350 million decrease in purchase price from Verizon. The Equifax hack, affecting 143+ million individuals, and exposing the social security numbers of nearly half of the adult U.S. population, resulted in the ouster of the CEO and a shakeup of the board. Additionally, the fallout from the Uber breach, affecting 57 million riders and drivers, is ongoing.

Ransomware threats shut down major multinational companies for days and have [increased fourfold](#) in the past year. SEC itself fell prey to a [cyberattack](#), with the breach undisclosed for nearly a year. As a result, the next year will likely bring increased state and federal regulation of cybersecurity. As [SEC Co-Directors of Enforcement Stephanie Avakian and Steven Peikin](#) warned, “The greatest threat to our markets right now is the cyber threat.” Boards should continue to focus on governance, crisis management and recommended best practices going forward.

Governance. Strength of governance in the risk area of cybersecurity will be a key focus in 2018. [The SEC has recommended](#) that companies designate a committee responsible for overseeing cybersecurity risk, and it has further advised that boards should have at least one cybersecurity expert or consultant. The Equifax data breach serves as a post breach governance case study. The fallout from one of the largest data breaches continues, but, so far, it has resulted in the ouster of the CEO, CIO and CISO; establishment of a special litigation committee; initiation of countless regulatory investigations, including 30+ state enforcement inquiries; investigations by the DOJ, SEC, FTC, UK Financial Conduct Authority and others; and 70+ lawsuits, including consumer class actions and securities class actions. The Equifax board has since appointed a cybersecurity expert to its board and technology committee. Ensuring that directors have properly established governance surrounding cybersecurity will be critical going forward in what is fast becoming a “bet-your-job” and “bet-the-company” risk.

Crisis management. A well-coordinated response to a cybersecurity crisis can mean the difference between being perceived as the victim of hackers or the negligent corporate wrongdoer. Although most breach notification deadlines were, at the earliest, 45 days from discovery of the breach, companies must move much more quickly in notifying consumers and government agencies to maintain credibility. The [New York Department of Financial Services](#) (NYDFS) Cybersecurity Regulation requires notification within 72 hours for covered entities, and the [National Association of Insurance Commissioners](#) (NAIC) just passed a model law that follows suit. The NYDFS, NAIC and countless other regulations require companies to have firmly established and tailored incident response plans and to conduct tabletop scenarios to test them.

Cybersecurity and data protection abroad. The [European Union’s General Data Protection Regulation \(GDPR\)](#) goes into force on May 25, 2018, and has significant implications for companies both in the U.S. and abroad. GDPR expands its territorial reach by applying to any company that offers goods or services or monitors the behavior of EU data subjects. It implements requirements such as requiring Data Protection Officers for certain companies; requiring Privacy by Design; imposing documentation and data



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The greatest threat to our markets right now is the cyber threat.

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-SEC co-directors,
Steven Peikin and Stephanie Avakian



minimization requirements; requiring improved consent procedures; requiring quick data breach notification; and imposing obligations on data processors, not just data controllers. Penalties for noncompliance are steep—with fines of the greater of 4% of worldwide annual revenue or EUR\$20 million. The United Kingdom intends to implement a similar regulation to GDPR following its exit from the EU.

Best practices going forward [Announcing the results of the OCIE's recent exams of registered investment advisors and funds](#), the SEC identified consistent deficiencies by various regulated entities:

- failure to reasonably tailor policies and procedures
- failure to adhere to or enforce policies and procedures
- failure to adequately conduct system maintenance, resulting in Regulation S-P issues
- failure to remediate high-risk observations discovered through penetration tests and vulnerability scans.

The [SEC recommended](#) the following best practices, which also serve as best practices for any public company:

- maintenance of an inventory of data, information and vendors; and classification of risks, vulnerabilities, data, business consequences, and information regarding each service provider and vendor
- detailed cybersecurity-related instructions for issues such as penetration tests, security monitoring/auditing, access rights and reporting guidelines for lost, stolen or unintentionally disclosed sensitive information
- maintenance of prescriptive schedules and processes for testing data integrity and vulnerabilities, including patch management policies
- established and enforced controls for access to data and systems
- mandatory employee training at onboarding and periodically thereafter
- engaged senior management.

Calls for cybersecurity regulation following the Equifax breach have increased substantially. As the scale and scope of breaches continue to broaden, regulations will likely follow. At least [42 states have introduced more than 240 bills or resolutions related to cybersecurity in 2017](#), and some state regulations, such as the Illinois Biometric Information Privacy Act (which has resulted in 35 class action lawsuits in the past year alone), promise to bring increased enforcement. Improved governance and crisis management planning will make directors best prepared to respond to cybersecurity threats.

2. Corporate social responsibility

Boards of directors should leverage CSR initiatives to mitigate legal, reputational, operational and financial risks, and improve their bottom line. While some may perceive CSR efforts primarily as public relations efforts, community engagement or corporate philanthropy, more and more companies have developed systemic and effective programs to successfully meet key environmental, social and governance (ESG) standards as an integral part of their comprehensive risk assessment and mitigation programs. In fact, Boston Consulting Group analyzed some of the world's largest consumer goods, biopharmaceuticals, oil and gas, retail and business banking, and technology companies, and [concluded](#) that those with better ESG standards were more profitable and traded at a higher value than their competitors. According to a 2017 [study](#) by Bank of America Merrill Lynch, companies with strong CSR practices are less likely to suffer large price declines, and they tend to have better three- to five-year returns on equity, as well as a greater chance of long-term success. These trends have not gone unnoticed. Investors are increasingly interested in the CSR performance of target firms as a way to identify economic performance potential and flag potential risks. As such, directors should now consider CSR performance critical to the bottom line.

From a risk assessment and mitigation standpoint, comprehensive CSR programs can help companies identify problems early and respond effectively. Whether the potential liability is legal (e.g., forced labor legislation or environmental regulations), financial, operational or reputational, firms that are not adequately prepared to recognize and resolve issues see their bottom line affected. A comprehensive CSR program can include risk assessments through internal investigations and audits, stakeholder engagement to identify issues and generate potential resolutions, and clear policies to resolve and address ESG risks in the future.

Private equity firms now often consider ESG risks in the due diligence of potential investments and are increasingly imposing ESG reporting requirements on portfolio companies. When companies lack a cohesive and proactive CSR program, ESG-related diligence can reveal unmitigated risks that may affect the value of the entity. In the absence of a comprehensive CSR program, reporting on ESG risks can be burdensome and may inadvertently divert resources from other key initiatives. For companies with developed CSR programs that involve voluntary reporting, however, portfolio companies may be able to satisfy reporting requirements by simply referencing their existing CSR reports.



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Such voluntary reporting is a prominent way in which companies communicate their CSR commitments to a variety of stakeholders. These reports, which can range from one-page mission statements to flashy, interactive webpages, serve many purposes. In addition to satisfying investor requirements, increasingly, shareholders have demanded the inclusion of ESG factors in a company's reporting, which reflects a growing consensus that CSR factors are material in a corporation's health and potential growth. Additionally, through CSR reporting, a company can communicate with its consumers and other key stakeholders about the steps it is undertaking to increase awareness about ESG initiatives and compliance throughout its operations.

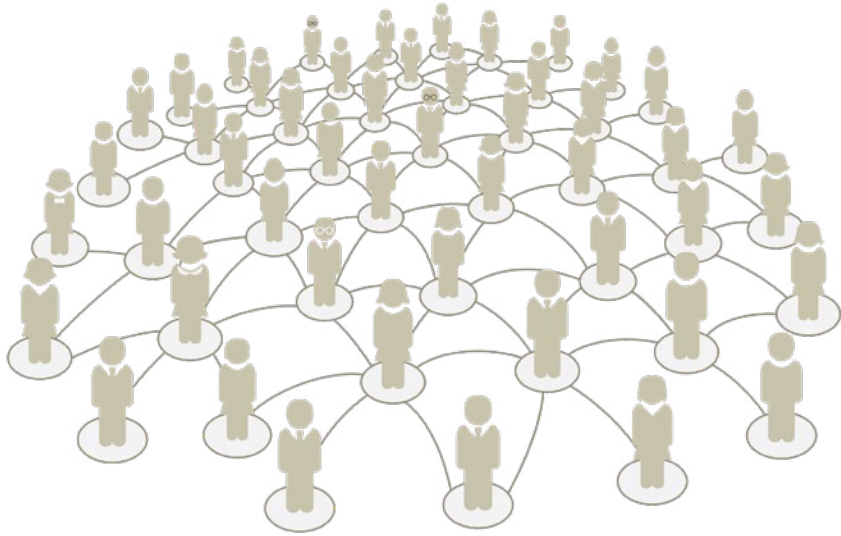
Embedding CSR considerations into day-to-day operational decisions has resulted in cost reductions for a number of leading corporations. While it is difficult to quantify savings based on risks that are mitigated through the implementation of social and governance standards, evaluating the impact of more stringent environmental standards has now become more common. For instance, by the end of 2013, [GE had reduced greenhouse gas emissions](#) by 32 percent compared to its 2004 baseline, and water use by 45 percent compared to its 2006 baseline, resulting in \$300 million in savings. Similarly, in 2011, [Dow Chemical reported](#) that, by investing less than \$2 billion dollars since 1994 to improve resource efficiency, the company saved more than \$9.8 billion from reduced energy consumption and water waste.

ESG risks, including those that may not produce legal liability, are of growing importance to [investors](#), shareholders and consumers. How an entity identifies and mitigates these risks, whether through proactive CSR initiatives or reactive ad hoc responses to specific incidents, can have an impact on its bottom line. Boards should therefore consider investing in CSR initiatives that proactively address these risks, treating these initiatives as an integral part of the entity's compliance program and leveraging voluntary reporting frameworks to ensure that these initiatives are more visible to stakeholders.

3. Managing five generations of employees

In the coming years, employers will face the unprecedented challenge of having five generations of employees in the workplace. This encompasses those from the Silent Generation, born before 1945, through Generation Z, those born after 2000 and about to enter the workforce, and the Baby Boomers, Generation X-ers and oft-maligned Millennials in between. Having multiple generations in the workplace can result in tensions based on different priorities, workplace expectations and communication styles. Companies and their boards can help address these tensions by better understanding employee expectations, encouraging cross-generation mentorship, and setting an example of generational diversity with respect to company leadership and members of the board.

People from different generations often have [different priorities](#). For instance, Millennials commonly prioritize a work-life balance in a way Baby Boomers do not. Because of this, younger employees may seek a casual work environment, flexible schedules and the ability to work from home. For older employees, however, a formal physical presence in the office can be paramount, and a basis on which performance is evaluated. Employees from different generations may also have differing views relating to compensation. Older generations tend to be comfortable with traditional compensation structures and look for higher base salaries and more comprehensive benefit plans. However, these forms of compensation do not always appeal to younger generations in the same way. Many members of the younger generation look beyond a paycheck and respond better to “soft perks,” such as sabbaticals, office amenities and even branded gear. We find that younger employees often respond best to work cultures that emphasize entrepreneurship and individuality. They appreciate companies that encourage side projects and allow exploration of individual interests.



Employees from different generations can also have [different expectations](#) regarding the type of work they will perform and the leadership style they will encounter. Younger employees tend to expect to be involved in meaningful work quickly. They resist doing more administratively focused work or duties considered to be “grunt work.” Older employees, however, can expect younger employees to “pay their dues.” Millennials are also often quick to put forward their own ideas and opinions, since they commonly experienced that type of open learning environment in school; but those from older generations may view this forwardness as disrespectful. Younger generations that grew up with regular feedback in school and through social media tend to expect superiors to provide real-time and frequent, although not formal, evaluations. The opposite, annual formal feedback with little in between, is more commonly the expectation of older generations.

Finally, employees across generations can [struggle to communicate with one another effectively](#). Older generations may prefer in-person interaction or phone conversations, whereas Millennials, who grew up with technology, often prefer communicating through text-based platforms, such as email. Even in emails, different generations may have varying expectations about what language and tone is appropriate. Abbreviations, the use of capitalization and red exclamation marks mean different things to different people.

Many options are available for addressing the issues facing a multigenerational workforce. Companies and their boards should examine what motivates their specific employees. Because every workforce varies, it can be helpful to conduct surveys or hold informal focus groups to find out what employees respond best to with respect to compensation, schedules, even dress codes. Being open to a broader array of options on something like compensation, rather than a one-size-fits-all-approach, can result in greater employee satisfaction and performance. To help employees work together effectively, employers can encourage cross-generational mentorship programs. Team-building exercises, social excursions and even just making sure that breakout groups in training or projects include employees from different generations are all successful strategies.

Employees from all generations can benefit from these arrangements, and they help to dispel stereotypes. Companies can also enact firmwide policies regarding dress, office presence, and email etiquette to clarify expectations and present a cohesive appearance to clients. One place to consider embracing generational diversity is the composition of company managers and the board itself. The addition of younger members in lead positions at various levels and as board members not only can make transitions easier, but younger generations can make meaningful contributions and offer insights about their own communities. If managed correctly, boards and companies alike can benefit from the wisdom, collaboration and innovation that comes with generational diversity.

4. Corporate strategy

Strategic planning should continue to be a high priority for directors in 2018. In an increasingly competitive and evolving marketplace, coupled with a [domestic economy growing at a low single-digit rate](#), stagnation is tantamount to failure, and singular reliance on organic growth is effectively a bet on poaching market share from rivals. In almost all industries, a company’s chances for success, survival and growth are dependent on accretive acquisitions. This is especially true in certain sectors, including [health care](#) and [technology](#), as rapid consolidation and vertical integration in these industries continues. Boards will continue to struggle with the balance between achieving short-term results and/or otherwise using cash resources to satisfy calls by investors with an appetite for immediate gratification versus deploying capital to invest in longer-term growth opportunities that involve additional risk. Board discussions and decisions about capital deployment, risk tolerance and strategic plans are, and for the foreseeable future will continue to be, complicated by the [unexpected continued low-interest-rate environment](#), which has enabled companies’ access to debt at historically low rates. Boards should expect to face mounting pressure to take advantage of the low-rate debt to finance share repurchases at the same time they consider potential acquisitions that could be financed with cheap debt.

Cross-border acquisition opportunities will be tempting to many companies, either as buyers or sellers. However, challenges will remain, since certain potential buyers, particularly Chinese entities, will likely continue to face [enhanced regulatory and congressional scrutiny in the U.S.](#) Enhanced scrutiny relating to political pressures can affect a buyer’s ability to execute a transaction and therefore adversely impact deal certainty, which is a critical factor for a board’s assessment of the sale of a company or its assets. Further, certain industries, including technology, must cope with different regulatory structures from jurisdiction to jurisdiction, and companies with strong intellectual property assets will need to continue to be mindful of, and responsive to, various countries’ less-than-rigorous intellectual property protections.

Perhaps as a result of unquantifiable risks relating to cross-border opportunities, we expect that 2018 will provide a continuum of strong M&A activity throughout certain domestic sectors of the U.S. economy, including infrastructure and construction. Of course, it remains to be seen whether “Buy American” will be mainly a slogan or an actual trend for boards and companies in the effort to achieve long-term and sustainable growth.



5. Board composition

One of the primary functions of a board of directors is to enhance shareholder value. Advocates argue and studies show that companies with greater board diversity outperform those companies with less diversity. This is one of the reasons that board composition (and, in particular, gender, race and ethnic diversity) is a topic of increasing focus among corporate governance groups, investors, and regulators in both the U.S. and Europe.

In 2016, Mary Jo White, then-Chair of the SEC, in her [keynote address](#) to an international corporate governance conference, cited [research](#) showing that “boards with diverse members function better and are correlated with better company performance” and stated that “major efforts are underway in the United States and elsewhere to improve board diversity.”

Also in 2016, Business Roundtable, an association of chief executive officers of leading U.S. companies, published [Principles of Corporate Governance](#), which included that diverse corporate boards “strengthen board performance and promote the creation of long-term shareholder value” and that board composition “should reflect a diversity of thought, backgrounds, skills, experiences and expertise and a range of tenures.”

In early 2017, State Street Global Advisors, one of the world’s largest asset managers, published [guidance on enhancing gender diversity](#) on corporate boards. The guidance referred to gender diversity as “one of many ways a board can introduce a varied set of skills and expertise among its directors to help improve financial performance” and expressed a belief that “boards should have at least some independent female directors.”

And in late 2017, Institutional Shareholder Services ISS released the results of its [2017-2018 Global Policy Survey](#), in which more than two-thirds of the investor respondents indicated that a public company board without any female directors would be considered problematic.

Regulatory frameworks Two of the main approaches taken by governments to promoting board diversity are (1) quotas and (2) disclosure. A number of countries in continental Europe follow the first approach with legislated board quotas. For example, France, Spain, Norway and Iceland generally require public companies to have at least 40 percent female board representation. Similar quotas exist in Italy (one-third), [Germany](#) (30 percent), the



Netherlands (30 percent, nonbinding) and other countries. The [specific requirements](#) vary by country and, in some cases, also apply to private companies, state-owned enterprises and/or large companies only.

By comparison, the United Kingdom and the United States follow the second approach, requiring companies to disclose certain information and allowing investors to evaluate the disclosure and underlying policies. In the U.K., the [Corporate Governance Code](#) (the “Code”) calls for all companies with a Premium Listing of equity shares on the London Stock Exchange’s Main Market to consider diversity (including gender) in the board appointment process and to describe in their annual reports the board’s policy on diversity, any measurable objectives set for implementing the policy and progress on achieving the objectives. Noting that good governance may be achieved by other means as determined by the board, the Code allows companies to comply with the Code provisions or to explain specific noncompliance to shareholders (i.e., “comply or explain”).

In the U.S., SEC rules (specifically, [Item 407\(c\)\(2\)\(vi\) of Regulation S-K](#)) require public companies to describe the nominating committee’s process for identifying and evaluating director nominees (including whether and how diversity is considered) and whether the company has a diversity policy for identifying nominees (including how the policy is implemented and how the effectiveness of the policy is assessed). In early 2017, the SEC’s Advisory Committee on Small and Emerging Companies [concluded](#) that the SEC’s existing rule “failed to generate information useful to stockholders, employees and customers in assessing board diversity” and recommended an amendment that would require companies to describe, in addition to their diversity policies (if any), the extent to which their boards are diverse, including with respect to race, gender and ethnicity of the nominees.

Recommendations The current focus on board diversity is likely to continue. It is clear that board diversity is being actively considered and encouraged by regulators, corporate governance groups and investors. As a starting point, companies should review the applicable diversity-related obligations in their jurisdictions. Additionally, companies should assess their current board composition, director search and nomination process, board refreshment practices and diversity policies. [Business Roundtable](#) specifically recommends that “boards of directors should develop a framework for identifying appropriately diverse candidates, which asks the nominating or governance committee to consider women and/or minority candidates for each open board seat.” Finally, with board diversity, as with other matters, companies should prioritize good disclosure and transparency with investors.

6. Shareholder activism

After an uptick in activist campaigns in the last couple of years, followed by a recent minor plateauing, shareholder activism has entrenched itself in the modern climate of corporate governance. In particular, shareholder activists have entered industries that, until recently, have generally steered clear of such investors. One such industry is the energy sector, which has, until very recent times, often avoided prominent campaigns as a result of commodity price volatility.

With the recent “relative” stabilization of the price of oil has come an increased emphasis by prominent investors on different themes from challenging transactions (see EQT Corporation’s acquisition of Rice Energy, Inc.) and corporate strategy to traditional corporate governance concerns. One of the most ubiquitous of these concerns is board composition; shareholder activists are even more insistent on independence and director turnover than they have



been in past years. As a result, companies in the energy sector should consider these points themselves before an investor raises them in order to avoid campaigns.

In particular, the days of staggered boards seem to be numbered. According to the *2017 Board Practices Study* published by [Institutional Shareholder Services](#), approximately 65 percent of S&P 1500 companies and 90 percent of S&P 500 companies now hold annual elections for all directors. Statistics such as these make energy companies with staggered boards an attractive governance target for shareholder activists. Additionally, energy companies with long-term directors and relatively little director turnover can indicate entrenchment to an increasingly sensitive institutional investor base.

Other corporate governance themes of activists include composition of management; related-party transactions; compensation; and, as previously discussed, CSR, which can include addressing the horizontal drilling and hydraulic fracturing concerns of environmentalists. As we noted in [last year's Top 10 alert](#), a board needs to be prepared to understand, communicate and respond to shareholder activist concerns. Shareholder rights plans and takeover defenses, including staggered boards, can give the board thoughtful time to analyze and respond to a hostile approach. In the energy industry, shareholder rights plans have been implemented to potentially preserve a company's usable tax net operating loss carryforwards by deterring an ownership change under the Internal Revenue Code.

Energy companies can avoid costly campaigns and increased investor scrutiny by becoming governance leaders and taking such factors into advisement. The board's fiduciary duty run to all stockholders not just proposals by activists. While un-staggering a board or changing bylaws may not always be prudent, allowing some new blood in the boardroom can satisfy an investor base and provide new perspectives and opportunities for the company. The board, however must be mindful of its duties of care and loyalty with a careful deliberation in reaching its decision.

7. Internal investigations

Boards are increasingly confronted with the possibility of wrongdoing implicating the company or its employees. These situations can come to the attention of the board in a number of ways, including from private-party lawsuits, internal audits, whistle-blower tips and governmental inquiries.

How the board or appropriate board committee responds to a particular situation will have important implications for the ultimate effects on the company. The requirements and atmosphere created by laws such as Sarbanes-Oxley and Dodd Frank have heightened the scrutiny of the actions (and the inactions) of boards, including individual directors, in the context of allegations of violations brought to their attention. The board will be called upon to determine what type of review of the allegations should be undertaken, including whether an internal investigation conducted under the auspices of a committee of independent directors (such as the audit committee or a special committee established solely for this purpose) is warranted.

The decision whether or not to undertake an independent internal investigation requires careful consideration. In certain situations, the decision to conduct such an investigation is clear because of the credibility of the initial evidence and/or the nature of the allegation (e.g., if true, it would have a material impact on the legal position or the operations of the company). Due to these factors and other considerations, including good corporate governance, the board could very well find that the most prudent and responsible course is to conduct such an investigation. Additionally, it has become ever more common for the company's independent auditors to expect



that the company will conduct such an investigation in many situations, especially where the allegations could implicate financial matters or involve possible fraud.

Once it is determined that an internal investigation is warranted, the board, in close consultation with counsel, should decide (a) who should oversee the investigation, including whether a committee of independent directors, such as the audit committee or a special committee, should be used to foster both the reality and perception of independence; (b) the scope of the investigation, taking into account the imperative of learning all the relevant facts in an efficient and cost-effective manner; and (c) which professionals should conduct the investigation (i.e., should the investigation be conducted by inside or outside counsel). In these situations, it is always important to take appropriate steps to preserve attorney-client privilege and confidentiality.

Quite often, it is determined that experienced outside counsel will be retained because of the nature of the allegations and to build additional credibility for the independence of the investigation with third parties, such as the independent auditors, and potentially with governmental agencies. Counsel should have experience in dealing with the myriad issues that accompany an investigation, including possessing an extensive knowledge of the relevant law implicated by the allegations; taking the steps necessary to maintain privilege; ensuring the appropriate conduct of interviews, particularly those of current and past employees; retaining and working with other professionals whose expertise will be required, such as forensic accountants; counseling the board on the difficult issue of whether, and when, to self-report to relevant governmental agencies; and recommending remedial measures to deal with any issues that arise out of the investigation.

8. SEC regulatory relief

We expect that the Trump administration and the Republican-led U.S. Congress will advance significant policy shifts and rule changes at the SEC that are designed to encourage companies toward public ownership and to facilitate capital formation in both public and private markets.

Reforms designed to promote public ownership will likely focus on (a) eliminating duplicative requirements (including disclosures already required by generally accepted accounting principles); (b) removing “non-material” disclosure requirements (including conflict materials, mine safety and pay ratio); (c) providing additional scaled disclosure requirements for smaller public companies (extending the definition of “smaller reporting company” and “non-accelerated filer” to cover companies with higher public floats and extending the length of time that a company may be considered an emerging growth company); and (d) addressing concerns regarding shareholder proposals (increasing holding requirements and revising resubmission thresholds) and shareholder advisory firms.



Reforms designed to promote access to capital will likely focus on (a) liberalizing pre-initial public offering communication (allowing all issuers to “test the waters”), (b) revising the definition of “accredited investors,” (c) considering ways to facilitate pooled investments in private or less-liquid offerings, and (d) expanding the use of Regulation A+ and crowdfunding.

Although smaller companies will likely be the greatest beneficiaries of the proposals being considered, many proposals will also benefit large public companies by eliminating certain duplicative and non-material disclosure requirements and addressing concerns regarding shareholder proposals.

9. SEC enforcement

New leadership and priorities at the SEC. In May 2017, Jay Clayton, President Trump’s pick for the position of Chairman of the SEC, was sworn into office. Chairman Clayton, a former partner at Sullivan & Cromwell LLP, has said that he will not seek “wholesale changes to the Commission’s fundamental regulatory approach,” though he has outlined a [new set of priorities](#). In particular, he has cited retail investor fraud, investment professional misconduct, insider trading, market manipulation, accounting fraud, and cyber matters as areas on which the Commission should focus in order to best serve “Main Street” investors. Also in May 2017, William Hinman was named the new director of the SEC’s Division of Corporation Finance. Given his experience as a partner in the Silicon Valley office of Simpson Thacher & Bartlett LLP, Mr. Hinman’s selection complements Chairman Clayton’s stated objective of encouraging more companies to join the public market. Annual statistics for SEC enforcement actions during its 2017 fiscal year have yet to be released, but, in August 2017, [The Wall Street Journal published an analysis](#) that showed that financial regulators have imposed far lower penalties in the first six months of Donald Trump’s presidency than they did during the first six months of 2016 (during the Obama administration).

Cybersecurity at the forefront. On September 20, 2017, Chairman Clayton released a [statement on cybersecurity](#), which revealed that, in August 2017, the Chairman had learned that “an incident” of cyber breach in the SEC’s online EDGAR filing system “may have provided the basis for illicit gain through trading.” The hack has brought renewed and vigorous focus from the Commission on issues of cybersecurity. Just five days after announcing the SEC’s hacking, the agency announced a series of [enforcement-related initiatives](#) designed to combat cyber-based threats, including the creation of a dedicated Cyber Unit and a Retail Strategy Task Force.

Continued focus on accounting fraud. Both before and after Chairman Clayton’s confirmation, in 2017, the SEC maintained a focus on rooting out and punishing instances of accounting fraud—a trend that is likely to continue as Chairman Clayton pushes his agenda item of protecting “Main Street” investors.



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...far lower penalties
in the first six
months of Donald
Trump's presidency
than they did during
the first six months
of 2016...

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Impending changes to Dodd-Frank In June 2017, the U.S. House of Representatives passed the [Financial CHOICE Act](#), which would repeal significant portions of Dodd-Frank. As passed by the House, the CHOICE Act would curtail the SEC's ability to seek penalties through administrative proceedings and prevent courts from deferring to the SEC's statutory or regulatory interpretations through so-called "Chevron deference." In November 2017, a bipartisan group of senators published a narrower proposal focused on rolling back banking regulations included in Dodd-Frank. As relevant to the securities laws, the proposal would exempt banks with fewer than \$10 billion in assets from the Volcker Rule's proprietary trading ban. In early December 2017, the Senate Banking Committee approved the proposal (now known as the "Economic Growth, Regulatory Relief and Consumer Protection Act") for consideration by the full Senate. Directors should be aware that at least some change, and potentially drastic change, in the area of securities regulation could arrive in the coming months.

Further developments in insider trading. In August 2017, the 2nd Circuit, in a 2-1 panel opinion, [affirmed a criminal insider trading conviction](#) in *U.S. v. Martoma*, No. 14-3599 (2d Cir. Aug. 23, 2017), which held that the Supreme Court's 2016 decision in *Salman v. United States*, 137 S. Ct. 420 (2016), abrogated the requirement for a "meaningfully close personal relationship" between tipper and tippee previously articulated by the Second Circuit in *United States v. Newman*, 773 F.3d 438 (2014). The opinion did not disturb *Newman's* other key holding—which is consistent with language in the *Salman* opinion—that, at least in a criminal case, the government must prove that the tippee knew that the tipper breached a duty and received a personal benefit in order to be liable for insider trading. From a risk-avoidance perspective, compliance professionals across all sectors should take a conservative view and should counsel against trading in a scenario that involves the possession of material non-public information, at least without extremely careful analysis of questions of duties, motivations and personal benefit.

10. Trade and sanctions

[U.S. sanctions](#) administered by the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) apply to U.S. persons, including companies incorporated in the U.S. and U.S. citizens and permanent residents, and, in certain circumstances, non-U.S. persons. U.S. sanctions fall into three general categories: list-based sanctions, comprehensive country- or region-based sanctions, and sector-based sanctions. List-based sanctions prohibit U.S. persons from engaging in virtually all direct or indirect transactions or dealings with persons designated on [OFAC's list of Specially Designated Nationals and Blocked Persons](#) (SDN List) (or companies owned 50 percent or more by such blocked persons). Comprehensive sanctions broadly prohibit U.S. persons and, in certain instances, non-U.S. persons, from engaging in business activities with specific countries or regions (e.g., Iran, Syria, Cuba, North Korea and the

Crimea region), including importing or exporting, directly or indirectly, goods or services to or from such countries or regions, unless authorized by OFAC. Finally, OFAC administers “[sectoral sanctions](#)” that prohibit U.S. persons from engaging in certain specified transactions with certain entities operating in strategic sectors of the Russian economy.

U.S. directors should be particularly mindful of new changes to U.S. sanctions and avoid actions that could violate these restrictions. This risk is particularly acute for U.S. persons who serve on the boards of non-U.S. companies. For example, although non-U.S. companies that are not owned or controlled by U.S. companies are not generally subject to U.S. comprehensive sanctions against Iran, U.S. directors at these companies must comply with these restrictions. Accordingly, non-U.S. companies should consider establishing blanket recusal policies that require U.S. directors to exclude themselves from engaging in any activities that might

implicate U.S. sanctions and wall them off from meetings, discussions, decisions or other dealings related to such activities. Moreover, given the current dynamic sanctions environment, directors should take care to understand how changes to U.S. sanctions may present potential risk, taking into account the industry, customers and geographic footprint of their respective companies.



As mentioned above, 2017 ushered in significant changes in the complex U.S. sanctions environment. In particular, the Trump administration has [tightened U.S. sanctions against Cuba](#), including some that were relaxed under the Obama administration; implemented [complex new sanctions](#) that restrict certain debt-, equity- and securities-related transactions involving the government of Venezuela; and established [new sanctions](#) targeting non-U.S. persons that engage in business with North Korea, which was also re-designated a State Sponsor of Terrorism. With respect to Russia, Congress passed legislation codifying earlier Obama-era restrictions and imposing [new sanctions](#) targeting the Russian energy sector; certain entities operating in the defense or intelligence sectors of Russia; privatization of state-owned assets; and other activities. In contrast to these new restrictions, the Trump administration has also [lifted most sanctions against Sudan](#). Finally, while the administration has not rescinded U.S. commitments to the Joint Comprehensive Plan of Action (JCPOA) (i.e., the Iran nuclear agreement), President Trump’s decision to “decertify” Iran’s compliance with the JCPOA injects significant uncertainty regarding whether the United States will reimpose sanctions targeting non-U.S. companies that were lifted under the JCPOA.

Combined with these significant changes, the Trump administration has continued to vigorously enforce U.S. sanctions. In [2017](#), the aggregate value of civil penalties imposed on companies was more than five times the total in [2016](#). While most enforcement actions in 2017 involved Iran-related sanctions, OFAC has pursued cases involving an array of sanctioned countries against companies operating in a variety of industries. The agency also continues to track the actions of high-ranking officials in companies to assess penalties. Specifically, an individual’s knowledge of, or involvement in, a prohibited transaction is a factor that may influence civil penalty amounts, and a finding that an individual acted willfully in violation of sanctions laws could trigger a referral to the DOJ for criminal prosecution.

Special Bonus: Tax reform

When President Trump was inaugurated on January 20, Republicans took full control of Congress and the White House for the first time since 2007. Prior to this, the GOP had unified control of the Legislative and Executive Branches for only six and a half of the past sixty-four years. Republicans immediately set about using this historically rare opportunity to push forward long-held policy goals, including comprehensive tax reform.

With control of Congress and the White House, but a slim majority of 52 in the Senate, Republicans planned to use fast-track procedures available under the budget reconciliation process to advance tax reform legislation. However, efforts to repeal and replace the Affordable Care Act took precedence and delayed the start of tax reform by a number of months, ultimately resulting in a stalemate among Republicans over how to move forward on ACA, which remains unresolved.

Seeing the end of 2017 approaching, Republicans laid out an expedited timeline to quickly move tax reform through the House and Senate. Building on months of behind-the-scenes discussions among the so-called “Big Six” – House Speaker Paul Ryan (R-WI), Senate Majority Leader Mitch McConnell (R-KY), Senate Finance Committee Chairman Orrin Hatch (R-UT), House Ways & Means Committee Chairman Kevin Brady (R-TX), Treasury Secretary Steven Mnuchin, and National Economic Council Director Gary Cohn – and their joint statement in July 2017 identifying common goals, Republican leaders aimed to move tax reform through the tax-writing committees in November and send a bill to the President before Christmas.

To the surprise of many, this timeline has largely been met. The House approved their version of the Tax Cuts and Jobs Act (H.R. 1) on November 16 by a vote of 227-205. The same week, the Senate Finance Committee held a four day markup of their version of tax reform, ultimately sending the bill to the Senate floor under fast-track procedures that led to successful passage of the bill 51-49 during the early hours of Saturday morning, December 2. Despite a number of last minute concerns from Republican senators, retiring Senator Bob Corker (R-TN) was the lone Republican “no” vote. No Democrats voted for either the House or Senate bill. While President Trump made some public and private overtures to Democrats, the gulf between tax priorities for Democrats and Republicans was simply too large to bridge.

With significant areas of difference between the House and Senate bills, members of Congress are in the process of convening a conference committee to resolve these issues with the goal of final passage by December 22. As the conference committee gets underway, Republicans are largely united in their effort to get tax reform done this year, but a number of key differences on business, individual, and international tax reform stand between them and the finish line.

Corporate. The House and Senate approaches on corporate tax reform both highlight one of President Trump’s top priorities: a 20% corporate rate. He originally called for a 15% rate, but agreed to 20% and has recently indicated a willingness to accept a 22% rate if necessary, which makes this slightly higher rate more likely since House and Senate conferees will need extra revenue to get to a final agreement.



During final negotiations on the Senate bill, a provision to repeal the corporate Alternative Minimum Tax (AMT) was removed from the bill, leaving the current 20% AMT rate intact. The House proposal includes full repeal. This will be a major area of discussion in conference given the weakening of business credits like R&D if the AMT rate is set at the same rate as the corporate rate since R&D and many other business credits cannot be taken against AMT.

In the House, the bill includes five years of immediate expensing for qualified property (including used property, newly acquired) placed in service after September 27, 2017, in an aim to provide a jumpstart to investment. The Senate bill originally included a similar provision, but was altered to gradually phase-out the provision after five years at the request of Senator Jeff Flake (R-AZ).

In exchange for a lower corporate rate and enhanced expensing, both bills limit or eliminate a number of business credits and other provisions including the rehabilitation credit for preservation of historic properties, New Markets Tax Credit, Orphan Drug Tax Credit, private activity bonds, and renewable energy tax provisions, although there are notable differences between the approach on each in the House and Senate.

Lastly, the House and Senate proposals both limit the deductibility of net interest expenses to 30% of pretax earnings. In the House, the limitation applies to 30% of earnings before interest, tax, depreciation and amortization (EBITDA). In the Senate, the limitation applies to earnings before interest and tax (EBIT). Both proposals include carve-outs for public utilities and certain real property businesses.

Pass-throughs. Reform for businesses organized as pass-throughs will be a major focus of the conference given the significant differences between the House and Senate approaches to providing relief. The House bill includes a 25% rate for 30% of business income with the remaining 70% treated as wage income at the owner or shareholder's regular individual rate, with a very low 9% rate for the first \$75,000 of business income if earning less than \$150,000. In the Senate, the bill instead provides a 23% deduction for domestic "qualified business income." An additional difference is that the pass-through provisions in the Senate approach are temporary (expire in 2026), while the House proposal is permanent, although many assume that popular tax changes would be extended before their expiration.

Despite beginning in different places, the House and Senate bills both include a three-year holding period for long-term capital gains treatment for carried interest.

International. The House and Senate bills propose fundamental changes to the taxation of businesses with international operations. Beginning in 2018, both bills would exempt from U.S. taxation (with important exceptions, the biggest of which are noted below) 100 percent of the foreign earnings repatriated to certain U.S. corporations. As a means of transitioning to this new "territorial" system of taxation, any U.S. corporation that owns at least 10 percent of a foreign corporation with previously untaxed (in the United States) post-1986 foreign earnings will have to pay a one-time mandatory tax of around 14 percent on its share of the cash portion of such earnings (or around 7 percent on its share of the remaining illiquid earnings), payable over eight years. The so-called "repatriation rates" were originally lower in both the House and Senate, but were raised to account for needed revenue.



Two significant new anti-base erosion measures are proposed as part of the move to territorial. The first is a sort of global minimum tax on foreign-source intangible-like income. While the House and Senate proposals differ in name (the House taxes foreign high returns, while the Senate taxes global intangible low-taxed income), they both tax essentially the same income at the same rate. They levy on certain U.S. corporations (whether they are part of a U.S.-parented multinational or a foreign-parented multinational) an effective 12.5 percent tax on all of the active, otherwise untaxed (in the U.S.) income earned by their foreign subsidiaries minus an amount of income designed to represent the return on tangible investments in the foreign jurisdictions (although



the Senate provides a higher rate of return for this purpose—10 percent as opposed to 8 percent). The primary difference between the two is that the Senate adds a special patent box-like deduction (of 37.5 percent, to effect a rate of 12.5 percent) available to U.S. corporations (including those that are foreign controlled) on certain of their U.S.-source income that is foreign derived (and that would otherwise be taxed at 20 percent, beginning in 2019).

The second new anti-base erosion measure is effectively an import tax. Again, the House and Senate proposals differ in name (the House is described as an excise tax/effectively connected income election while the Senate is called the base erosion and anti-abuse tax or BEAT), but they both involve a tax on deductible payments made by a U.S. corporation (no matter if the parent is U.S. or foreign) to a related foreign corporation. That's where the similarities end. The House's version would impose a 20 percent tax on the payment made by the U.S. corporation (effectively negating the value of the deduction), unless the foreign corporation treats the amount received as effectively connected income, taxed in the United States at 20 percent with deductions allowed for deemed expenses and some foreign tax credits. The Senate's version is an alternative tax regime that applies if the U.S. corporation has made a lot of base eroding payments. If the BEAT applies, it adds back into taxable income the full amount of the payments and taxes the whole amount at 10 percent (as opposed to the corporation's regular tax liability, which taxes at 20 percent a smaller amount of income). While the House's version appears to sweep in payments for cost of goods sold, the Senate's version does not.

Individual. House Republicans stuck to their original goal of simplifying the individual rates by reducing the number of tax brackets and lowering the rates. The House ultimately went with four brackets, including a top bracket of 39.6% on income above \$1 million. Seeing challenges in the House with making the distributional impact work under a smaller number of brackets, the Senate stuck with the current seven brackets, but still lowered the rates and adjusted the bracket breakpoints with the top bracket set at 38.5% on income over \$500,000. Also, the House bill repeals individual AMT, while the Senate maintains it at a slightly higher exemption amount. The House bill would also repeal the estate tax effective in 2024, while the Senate would double the exemption amount from \$5 million to \$10 million.

The deduction for state and local taxes (SALT) was a major sticking point, particularly in the House where the deduction was limited to up to \$10,000 for property taxes only. While not part of the Senate Finance proposal, the final bill included a concession to the House approach thanks to advocacy from Senator Susan Collins (R-ME).

On the mortgage interest deduction, the Senate bill would leave the current deduction of interest on up to \$1 million, the House limited it to \$500,000 and only on a primary residence.

Lastly, the Senate bill repealed the ACA's individual mandate, which requires individuals to purchase or obtain qualified health insurance coverage and certify that to the IRS, or else pay a penalty. This provision is likely to be maintained in the conference committee.

Next steps. Conferees will have a limited window to come to an agreement on a final version of tax reform. In most cases, the Senate version is expected to prevail since it is more challenging to pass a bill in the Senate with a slim majority margin of only two votes. The conference committee will also need to consider any final changes to issues like effective dates, provisions with a phase-in or phase-out, and transition rules. Reconciliation also comes with a complex set of rules and budgetary constraints, and conferees will need to closely examine all final provisions to ensure compliance with those rules. Otherwise, the bill would lose its privileged nature in the Senate, and with it, the ability to pass it with only a simple majority.

2018 and beyond. Even if tax reform makes it to President Trump by year-end, tax policy issues will not take a backseat in 2018. Due to the expedited timeline with limited ability to review the proposed changes in a methodical fashion, technical fixes will no doubt be necessary in 2018. Monitoring the implementation process at Treasury and the IRS will also be top of mind as many of the changes will require new regulations and guidance from the Administration. Lastly, Chairman Brady has indicated an interest in continuing to work on other tax reform issues in the new year, specifically mentioning topics such as the tax treatment of financial products and retirement savings incentives.



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