SHEARMAN & STERLING

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CORPORATE GOVERNANCE AND SECURITIES LAW UPDATE

Below is a summary of the main developments in US and EU corporate governance and securities law and certain financial markets regulation developments since our last update in January 2019.

Financial regulatory developments are available here.

IN THIS ISSUE

EU DEVELOPMENTS

Narrative Reporting: European Commission Publishes Technical Expert Group on Sustainable Finance Report on Climate-Related Disclosures

On 10 January 2019, the Technical Expert Group (**TEG**) set up by the European Commission ("**Commission**") to assist in four key areas of the Action Plan on Financing Sustainable Growth published its report on climate-related disclosures.

The report follows on from the European Commission's Action Plan, which committed to revising the non-binding guidelines of the Non-Financial Reporting Directive (2014/95/EU) regarding disclosure of environmental, social and governance-related information. In drafting the report on climate-related disclosures, the Technical Expert Group sought views of stakeholders through a number of outreach activities, including an open stakeholder meeting and meetings with banks and listed companies. The report proposes climate-related disclosures to assist the Commission in revising the non-binding guidelines. See also the Commission consultation on this revision, discussed below.

The guidance proposed by the TEG assists companies in developing climate-related disclosures that comply with the non-binding guidelines. For example:

- There is a high expectation that companies should disclose their governance process addressing climate-related risk and opportunities, how climate change is incorporated into their strategy and risk management processes, and their Scope 1 and Scope 2 GHG emissions.
- Companies should consider disclosing business segments' financially-material exposure to climate-related risks, the impact of the company's activity on climate change and potential mitigation or adaptation strategies, and key performance indicators such as GHG emissions breakdowns.

Comments on the report were due by 1 February 2019. The Group will then report to the Commission on the responses, and the Commission will then update the guidelines, taking into account the comments from the Group. The updated guidelines are expected to be adopted in June 2019.

The full report can be found here.

The press release can be found here.

ESMA Publishes Annual Report on AMPs in Accordance with MAR

On 16 January 2019, he European Securities and Markets Authority (**ESMA**) published its annual report to the European Commission on the application of accepted market practices in accordance with the EU Market Abuse Regulation.

The Market Abuse Regulation provides certain prohibitions against market manipulation. Accepted market practices (**AMPs**), which are established by competent national authorities and notified to ESMA, provide a defence against any allegations of market manipulation. In particular, a dealing on a financial market which was carried out for legitimate reasons and in line with an established AMP, will not be found to constitute market manipulation.

In the report, ESMA identifies AMPs which were established before the Market Abuse Regulation came into force, or which became effective after that date.

The full report can be found here.

Transparency Directive and Prospectus Directive: Updated ESMA Questions and Answers

ESMA published an updated version of its Questions and Answers (**Q&As**) on the Transparency Directive and its separate Q&As on the Prospectus Directive on 31 January 2019.

The Transparency Directive aims to ensure transparency of information for investors through regular disclosure of regulated information, and dissemination of information to the public. The Prospectus Directive provides for a single regime throughout the EU that governs the content, format, approval and publication of a prospectus for a securities offering.

The updated Q&As clarify the application of the Prospectus and Transparency Directives if the UK leaves the European Union in 2019 with no withdrawal agreement in place, i.e., a "no-deal Brexit."

The Q&As provide the following clarifications:

- When issuers of equity securities and non-equity securities with a nominal value of below €1,000 who currently have the UK designated as their home Member State for purposes of the Prospectus Directive, choose a new home Member State, they should choose between the EU27 Member States / European Economic Area (**EEA**) States in which they have activities after the date of exit.
- Issuers admitted to trading on a regulated market within EU27 / EEA EFTA, who currently have the UK as their home Member State for purposes of the Transparency Directive, should choose and disclose their new home Member State without delay following the date of exit.
- As the UK will be a third country, prospectuses and supplements approved by the Financial Conduct Authority (**FCA**) before the date of exit cannot be used in the EU27 / EEA after a no-deal Brexit.

The press release can be found here.

The full Q&As regarding the Transparency Directive can be found here.

The full Q&As regarding the Prospectus Directive can be found here.

EU Provisionally Agrees Draft Directive on Digitalisation of Company Law Rules

On 4 February 2019, the EU Member States and European Parliament reached a provisional agreement on a draft directive regarding the digitalisation of company law rules. The directive will aim to revise and facilitate the rules in governing the use of digital and online communication with public authority contacts.

Consistent with the EU's broader objectives of transparency, efficiency and legal certainty in the digital era, the directive would provide:

- permission for companies to register, set up new branches or file documents to the business register online;
- harmonisation of the relevant fee requirements;
- coherent procedural requirements in relation to online registration of companies; and
- precautions against online misuse of information (e.g., identity fraud).

The directive must now be formally adopted by the Council of the EU and the European Parliament.

The press release can be found here.

The joint statement by the First Vice-President and Commissioner can be found here.

New Prospectus Regulation: ESMA List of Thresholds Below Which Prospectus Not Required

On 8 February 2019, ESMA published a revised list of thresholds, below which an offer of securities to the public will not need a prospectus in EU member states.

The Prospectus Regulation has introduced a new threshold of €1 million, below which an offer does not require a prospectus. A Member State may decide to raise the threshold to a maximum of €8 million, provided that the offer cannot be passported to another Member State. ESMA has drawn up this list to create transparency across the various regimes adopted in the EU.

The list, which contains information provided by national competent authorities (**NCAs**), sets out for each EU member state:

- a short description of the national thresholds below which no prospectus is required;
- a summary of any national rules which apply to offers below that threshold; and
- hyperlinks to relevant national legislation and rules.

When any of the member states or NCAs change their information, ESMA plans to update and republish the document upon notification.

A link to the list of thresholds can be found here.

Narrative Reporting: Commission Consultation on Update of Guidelines on Non-Financial Reporting

The Commission launched a consultation, lasting from 20 February 2019 until 20 March 2019, on its proposed revisions to the non-binding guidelines on non-financial reporting.

The Non-Financial Reporting Directive requires large public interest entities to make climate-related disclosures. The guidelines help companies disclose the information in a more consistent and comparable manner.

The motivation behind revising the guidelines follows on from the 2015 Paris Agreement, the United Nations' Sustainable Development Goals and the Special Report of the Intergovernmental Panel on Climate Change in October 2018, which all urged and accelerated decisive climate action to reduce greenhouse gas emissions, and to create a low-carbon and climate-resilient economy. The new guidelines propose climate-related disclosures for each of the five reporting areas (business model; policies and due diligence; outcomes of policies; risks and risk management; and key performance indicators) and are divided into two types: disclosures that a company should consider if climate-related information is necessary for an understanding of its development, performance, position and impact of its activities, and additional disclosures that companies may consider to provide enhanced information.

The guidelines are intended for use by companies for which climate is a material issue; e.g., if climate-related information is necessary for an understanding of the development, performance and position of the company, or for an understanding of the external impact of the company.

The guidelines expect that most companies under the scope of the directive are likely to deem climate a material issue. Entities that conclude that climate is not a material issue are advised by the guidelines to consider making a statement with an explanation as to why.

The consultation homepage can be found here.

The full consultation document can be found here.

Shareholder Rights Directive: Commission Consultation on Guidelines for Standardised Presentation of Remuneration Report

Between 1 and 21 March 2019, the European Commission consulted on proposed new non-binding guidelines regarding the standardised presentation of a directors' remuneration report. The guidelines aim to address uneven levels of transparency regarding executive pay in different Member States. The guidelines in particular aim to address this discrepancy in cross-border investments. The consultation seeks specific input from Member States and stakeholders on the draft guidelines.

The proposed new guidelines include:

- A recommendation that the content of the report should be "clear, concise, meaningful and understandable."
- A specific structure and order of presentation, including:
    - the total remuneration for directors;
    - share-based remuneration for directors;
    - how the remuneration complies with the remuneration policy, including performance criteria;
    - any deviation from the remuneration policy;
    - information on change of remuneration and company performance; and
    - information regarding shareholder votes.
- A recommendation that reports should be produced annually.

The consultation closed on 21 March 2019.

The consultation webpage can be found here.

The proposed guidelines can be found here.

Report of the Technical Expert Group Subgroup of the European Commission on Green Bond Standard: Proposal for an EU Green Bond Standard

In an Interim Report on green bonds published on 6 March 2019, the Technical Expert Group (**TEG**) produced a proposal for an EU Green Bond Standard..

Green bonds are bonds specifically earmarked to be used for climate and environmental projects. The aim of the consultation was, in light of the European Commission's Action Plan on Financing Sustainable Growth published in March 2018, in which, the newly created TEG were tasked with creating a standard that would further improve the credibility of green bonds and help the EU market mature.

The preliminary recommendations for the creation of a Green Bond Standard include:

- creating a voluntary EU Green Bond Standard;
- monitoring the impact of the use of a new voluntary standard;
- considering further action including possible legislation after an estimated period of three years;
- developing a legislative proposal for a centralised accreditation regime, potentially operated by ESMA, for external green bond verifiers; and
- setting up a market-based voluntary Accreditation Committee for external verifiers of green bonds during any transition period.

The preliminary recommendations to support the adoption of the EU GBS include:

- investors, in particular, institutional investors, to adopt the requirements of the EU GBS when designing their green fixed-income investment strategies and to communicate their commitment and their expectations actively to green bond issuers as well as to underwriters;
- adopt an ambitious disclosure regime for institutional investors;
- consider promoting the "greening" of the financial system by expressing and implementing a preference for EU Green Bonds;
- develop credit enhancement guarantees for sub-investment grade green bonds;
- all types of bond issuers to issue their future green bonds in compliance with the requirements of the EU GBS;
- the European Commission to consider setting up a grant scheme to offset the additional cost of external verification for issuers; and
- promote adoption of the EU Green Bond Standard through the EU eco-label for financial products.

The full proposal can be found here.

Commission Publishes Two New Delegated Regulations; One on the Format, Content, Scrutiny and Approval of Prospectuses, the Other on Regulatory Technical Standards

On 14 March 2019, the Commission published two draft texts of delegated regulations concerning prospectuses.

The first delegated regulation concerns the format, content, scrutiny and approval of prospectuses. This is intended to be the final draft of the new regulation and is subject to European Parliament and Council approval.

Broadly, the content of the draft regulation is the same as that published by the Commission in November 2018. The regulation proposed new requirements for the content and format of prospectuses, the EU growth prospectus, the scrutiny and approval of prospectuses and review of universal registration documents.

The second regulation relates to regulatory technical standards. The specific standards relate to:

- key financial information in the summary of a prospectus;
- the publication of a prospectus;
- the classification of prospectuses and practical arrangements to ensure machine readability of the classifications;
- advertisements and their dissemination;
- situations where the publication of a supplement to the prospectus is required; and
- technical arrangements necessary for the functioning of the notification portal.

The regulation on the format, content, scrutiny and approval of prospectuses can be found here, and a link to the annexes can be found here.

The regulation on regulatory technical standards can be found here, and a link to the annexes can be found here.

Commission Communication on Progress on Building the Capital Markets Union

On 15 March 2019, the European Commission published its latest progress report on its project of building the Capital Markets Union (**CMU**).

The Commission has been working on building the Capital Markets Union since September 2015. The Capital Markets Union is an EU initiative which aims to deepen and further integrate the capital markets of the Member States by safeguarding financial stability, strengthening the international role of the euro and diversifying sources of finances for small and medium entreprises (**SMEs**) in particular. The CMU aims to allow consumers to buy cheaper and better investment products, and enable financial services providers to scale up by offering services in other Member States.

The progress report notes that the CMU is an important Single Market project that will give increased access to capital to both companies and citizens, especially in smaller countries. A well-developed CMU increases the EU's attractiveness to foreign investment and complements the EU's agenda of free and fair trade. Broadly, the Commission has delivered measures it committed to at the beginning of the mandate and put in place the "building blocks" of the CMU. However, the report notes that it may take time for the impact of the Commission's actions to be felt "on the ground."

The Commission has proposed six legislative measures introducing new EU-wide rules for products, labels and passports, five of which have been adopted or a political agreement has been reached, but urgent progress is required on the last:

- regulations on European venture capital and social entrepreneurship funds, making it easier for investors to invest in innovative SMEs by opening up regulation to fund managers of all sizes and expanding the available range of companies;
- regulations harmonising the securitization legal framework and creating "Simple, Transparent and Standardised" securitisations to help build confidence in the securitisation market, prevent mistakes from the past reoccurring and free up the balance sheet of banks;
- regulations on a Pan-European Pension Product, introducing an EU-wide voluntary pension product;
- a political agreement on common rules on covered bonds, which are based on high national standards and best practice to develop covered bonds as a stable and cost-effective source of funding;
- a package of rules on facilitating cross-border distribution of collective investment funds, improving the transparency of national requirements and cutting red tape to make the distribution of funds quicker and easier; and
- proposals for a regulation on crowdfunding, which is still being negotiated but would allow platforms to apply for an EU license under a single set of rules.

The Commission has proposed five legislative measures providing more simple, clear and proportionate rules for entrepreneurs, businesses and financial institutions:

- the Prospectus Regulation, adopted in June 2017, which cuts red tape by making a prospectus simpler to produce and clearer to understand;
- more proportionate and risk-sensitive rules for investment firms were agreed upon in February 2019, which introduce simpler and less burdensome prudential rules for non-systemic investment firms;

- a political agreement on the Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures was reached in December 2018;
- new rules that will facilitate financing through capital markets for small businesses were agreed by co-legislators in March 2019 by cutting red tape for small and medium-sized companies trying to access SME Growth markets, a new category of trading venue dedicated to small issuers; and
- a proposed regulation on the law applicable to the third-party effects of assignments of claims, which will significantly increase legal certainty and facilitate cross-border investment by determining which national law applies to the effects on third parties where a claim is assigned cross-border. More work is required to reach an agreement on what the form of this regulation will be.

The Commission has proposed two legislative measures to ensure a more integrated and efficient supervision of capital markets, of which one has been politically agreed upon:

- revamped rules for more robust supervision of central counterparties, agreed upon in March 2019, to ensure that the EU supervisory framework is sufficiently robust to anticipate and mitigate risk from EU central counterparties and from systemic non-EU central counterparties that provide services to EU clients; and
- reform of the European supervisory authorities to make European financial supervision stronger and more integrated, and a proposal to strengthen the supervisory framework for anti-money laundering and terrorist financing. Good progress has been made in negotiations, but the Commission calls on the European Parliament and the Member States to reach a political agreement with urgency.

The Commission is also aiming to develop local capital markets, which primarily benefit medium-sized companies that are not large enough to tap capital markets across borders. The report notes that this requires significant action at the level of Member States, as well as cross-border and regional initiatives.

The communication can be found here.

Screening of Foreign Direct Investment: Council Adoption of Proposed Regulation

On 5 March 2019, the European Council adopted a proposed regulation to establish a framework for screening foreign direct investments (**FDI**) into the EU.

The adoption of the framework shows a marked change in attitude on behalf of the EU, which has previously opposed moves aimed at introducing EU-wide FDI screening mechanisms.

The new regulation introduces an EU-wide FDI screening framework, but it differs significantly from the current EU merger control regime. The EU mechanism for FDI screening will not be an overarching regulator, and will neither hold supranational jurisdiction nor issue binding decisions. It will also, unlike the EU merger control regime, not require Member States to harmonise existing national regimes beyond minimal procedural requirements.

Instead, the regulation will:

- create a cooperation mechanism between the Commission and Member States. This will facilitate coordination of screening decisions and throw light on specific investments for review;
- impose transparency and information requirements; and
- confirm Member States' right to maintain, amend or adopt their own national FDI screening mechanisms, but imposes a number of basic requirements for such a mechanism, including transparency and lack of

discrimination between third-party countries, established time frames, protection of confidential information and the possibility of judicial redress.

The new framework may have a significant impact on intra-EU transactions. In particular, the regulation will lead to a dual-track system for merger control and FDI reviews and may lead to closer scrutiny of certain transactions which would not otherwise raise concerns in the merger control system.

The adopted text can be found here.

New Prospectus Regulation: ESMA Questions and Answers

On 27 March 2019, ESMA published its first set of Questions and Answers ("**Prospectus Q&As**") for the new Prospectus Regulation.

The new Prospectus Regulation came into force in July 2017 and the majority of the new rules will apply from July 2019. The Prospectus Q&As provide useful clarifications on the application of the new rules.

The new Prospectus Q&As cover:

- The scope of the grandfathering of prospectuses that are approved under the national laws of Member States implementing the Prospectus Directive. "Grandfathering" refers to a prospectus that was approved under an existing regime, as implemented in the relevant Member State, before the date of application of the new Prospectus Regulation. For example, an advertisement will not fall within the grandfathering provisions.
- Where a Member State that has implemented the Prospectus Directive has approved a prospectus under their national laws, that prospectus may be notified to a competent authority in a host Member State for the purposes of passporting. However, this notification should take place after the effective date of the Prospectus Regulation and should be made in accordance with national laws that implement the Prospectus Directive in the Member State of the competent authority that approved the prospectus.
- The applicability of level 3 guidance (i.e., Prospectus Q&As relating to prospectuses and the ESMA update of the CESR recommendations) on the Prospectus Directive after entry into application of the new Prospectus Regulation. Specifically, these will now only apply to the extent they are compatible with the new Prospectus Regulation.
- The process of updating the information included in registration documents and universal registration documents; e.g., the information in a registration document needs to be updated via a supplement if it is not a constituent part of a prospectus and must be submitted to the competent authority for approval.

ESMA notes that the information relating to grandfathering and the applicability of level 3 guidance is particularly important and will help parties manage the transition by:

- determining the effect of the new Prospectus Regulation on their current prospectuses and related issuance programmes; and
- helping market parties to draw up prospectuses for approval under the Prospectus Regulation.

The full questions and answers can be found here.

The press release can be found here.

ESMA: Final Guidelines on Disclosure of Risk Factors in Prospectuses

On 29 March 2019, ESMA published final guidelines on how NCAs should review risk factors as required by the new Prospectus Regulation.

The guidelines aim to encourage more appropriate, focused and streamlined risk factor disclosures for securities.

The purpose of including risk factors in a prospectus is to ensure that investors can assess the risks related to their investment, therefore allowing them to make informed investment decisions. Risk factors generally include information concerning:

- the issuer's financial situation;
- the nature of the security;
- the issuer's business activities and industry;
- legal and regulatory risk;
- internal control risk; and
- environmental, social and governance risks.

Amendments to the guidelines in the draft include:

- clarification with regards to an NCA's role, which includes ensuring that the specificity of any risk factor is clear from the particular disclosure, and clarifying what is expected when issuers operate in the same industry and seem to be exposed to the same risks;
- guideline 3 on materiality, clarifying that an NCA must ensure that the materiality of the risk factor is clear from the disclosure, and clarifying the steps they should take where materiality is not evident;
- guideline 4 on quantitative information. The new guideline provides that, where the information has already been published, it should be included, if appropriate, to illustrate the potential negative impact. The new guidelines also acknowledge that it is not always appropriate to include quantitative information. If qualitative information is included, NCAs should ensure the materiality of the risk factor is evident from its disclosure; and
- guideline 6 to clarify that NCAs need to ensure that the materiality and specificity of the risk factor is corroborated by the overall picture presented by the prospectus.

More generic amendments have been made to the way guidelines are presented, including the movement of examples to an appendix, the removal of references to non-approval of prospectuses where the materiality or specificity of a risk factor is unclear, and the insertion of explanatory text in the background section about how the process of approving the prospectuses should be conducted.

The full guidelines can be found here.

The press release can be found here.

UK DEVELOPMENTS

House of Commons Library Publishes Briefing Paper on Corporate Governance Reform

The House of Commons Library, an independent research and information unit that provides impartial information for MPs and their staff, has published a brief paper on corporate governance reform on 4 January 2019. The brief paper reviews the UK's corporate governance framework, in particular the revised UK Corporate Governance Code published last July.

The key highlights of the report include:

- a review of the response published by the government in response to its consultation on corporate governance that lasted from November 2016 until August 2017. The response proposed eight reforms, including reforms in the areas of pay, employee and stakeholder voice, and the governance of large private companies. All changes have been implemented;
- a review of the independent review of the Financial Reporting Council (**FRC**) led by Sir John Kingman ("**Kingman Review**", to which the government has now responded, see "*Government Confirms New Regulator to Replace FRC on Recommendations of Independent Review Led by Sir John Kingman, and BEIS Launches Initial Consultation on the Recommendations*" below); and
- a review of research commissioned in January 2018 on the buyback of shares by companies, as part of the government's corporate governance reforms and industrial strategy. The research aimed to address recent concerns that share buybacks could be used to inflate executive pay.

The full briefing paper can be found here, and a link to the webpage can be found here.

BEIS Committee Questions Sir John Kingman Following Recent Review of the FRC

On 23 January 2019, the BEIS Committee questioned Sir John Kingman following the review of the FRC that took place in 2018. For more detail about the review, see page 6 of our previous Governance & Securities Law Focus Europe Newsletter, published in January 2019.

During the interview, Sir John:

- said that the most important recommendation from the report was the need to move away from self-regulation by audit firms;
- recognised that some recommendations – for example, putting the new regulator replacing the FRC on a statutory footing – would require primary legislation, which could take time;
- acknowledged that, given Brexit, it was not possible to say if primary legislation could be brought in;
- acknowledged that some recommendations required further consultation and analysis before proceeding; and
- hoped that the government and the FRC would move ahead quickly with the interim steps set out in the report that would not require primary legislation, particularly in light of encouraging conversations that he had with the Secretary of State.

A full recording can be found at here.

Government Confirms New Regulator to Replace FRC on Recommendations of Independent Review Led by Sir John Kingman, and BEIS Launches Initial Consultation on the Recommendations

On 11 March 2019, BEIS published its initial consultation paper seeking views on the recommendations of the Independent Review of the FRC.

The FRC regulates auditors, accountants and actuaries and sets the UK's Corporate Governance and Stewardship Codes. The Kingman Review recommended, among other things, that:

- the FRC be replaced by a new independent regulator;
- the new regulator be given a range of new extensive powers;
- the new regulator promote brevity and comprehensibility in accounts and annual reports, and increase the number and impact of corporate reporting reviews; and

- corporate governance staples such as the viability statement and UK Stewardship Code should be fundamentally reformed.

The government has confirmed that they will take forward these recommendations, including the replacement of the FRC by a new regulator called the Audit, Reporting and Governance Authority. The new authority will regulate the biggest audit firms directly and have extensive new powers, including the ability to impose greater sanctions.

In this latest consultation, the BEIS is seeking views on specific questions, such as whether there are specific considerations in taking forward the recommendations and if there are any other key ideas which should be implemented alongside the recommendations. Responses are due by 11 June 2019.

The government's approach is:

- to proceed as quickly as possible with reform that can be immediately delivered;
- to consult on reforms that can be delivered in advance of legislation but where there are policy choices to be made; and
- to highlight reforms that will require primary legislation and which may require further consultation.

The press release can be found here.

The original Kingman review can be found here.

House of Commons Library Publishes Briefing Paper on Company Audits

On 10 January 2019, the House of Commons published a briefing paper that considered how audit works, the problems facing the audit industry and some proposals for reform.

The paper highlights that the purpose of audit is to provide assurance to shareholders that the financial statements of a company give a true and fair view of the company. Good audit protects not only shareholders, but also employees, pensioners, suppliers, customers and the wider community.

The paper notes that in recent times accounting and audit failures have turned a spotlight on a range of problems in the industry, and particularly in large audit companies. Well-publicised failures include the downfall of Carillion in 2018.

Key themes highlighted by the report include:

- Lack of competition: the "Big Four" accountancy firms dominate the market and are "too few to fail."
- Conflicts of interest: auditors can be caught between the interests of the company's management, their own interest, that of their firm and their duties as auditors.
- Poor quality and inadequate purpose: too many audits are found to be wanting by the regulator, and fail to meet wider expectations.
- Weak regulation and supervision: the regulator lacks resources, power and independence.
- Lack of prudence in the accounts: accounting standards have evolved in a direction that permits or encourages less prudent accounting.

The report discusses the following potential reforms:

- Measures by the Competition and Markets Authority to increase competition and focus competition on quality rather than price.

- The creation of an independent statutory regulator, accountable to Parliament, with a new mandate, new clarity of mission, new leadership and new powers recommended by the Kingman Review. The government has announced it will be implementing this recommendation.
- Strengthening the UK's framework in relation to capital protection and dividend payments (See the research commissioned by the government consultation mentioned in "*House of Commons Library Publishes Briefing Paper on Corporate Governance Reform*" above).
- An independent review of the purpose and future of audit (Brydon Review).

On 18 April 2019, the House of Commons published an updated briefing on company audit. A link to this new report can be found here.

Audit Committees: IOSCO Report on Good Practices in Supporting Audit Quality

On 17 January 2019, he board of the International Organization of Securities Commissions (**IOSCO**) produced a report concerning the role of audit committees of listed companies in supporting and promoting external audit quality.

Broadly, findings by audit regulators indicate a need to improve audit quality and the consistency of audit execution, and that the practices of audit committees within the same jurisdiction, and across jurisdictions, can vary from one listed company to the next, leading to a lack of consistency in the way audit committees carry out their responsibilities.

To remedy this, the report suggests several good practices for audit committees including:

- recommending the appointment of an auditor;
- assessing potential and continuing auditors, considering for example the auditor's knowledge of the listed company´s business and industry;
- considering the extent to which audit fees are consistent with the audit plan and a quality audit;
- facilitating the audit process by seeking explanations and advice on the appropriateness of accounting treatments and estimates, proper books and records, and systems and controls;
- assessing auditor independence by, for example, reviewing and challenging management's accounting treatments and estimates, and not feeling encumbered by management from consulting with, when considered necessary, an external party (for example and as applicable, a regulator); and
- communicating with the auditor about risks, issues and other matters;
- assessing audit quality.

The full report can be found here.

The press release can be found here.

Corporate Governance: Government's Response to BEIS Committee Report on Gender Pay Gap Reporting (Corporate Aspects)

The Business, Energy and Industrial Strategy Select (**BEIS**) Committee published a report in August 2018 on its inquiry into aspects of executive pay and the gender pay gap in the private sector. The Committee confirms it will continue with the second strand of its inquiry, examining progress of reforms relating to executive pay levels and structure, in the autumn of 2019.

The government's response, published on 17 January 2019, addressed certain recommendations by the BEIS Committee:

- The Committee initially recommended that the revised Stewardship Code include reference to ensuring that gender diversity is properly reflected throughout the company. The government has responded that as part of the consultation on a new Stewardship Code, the FRC should consider how it can support and challenge investors to improve diversity and succession planning within UK listed companies.
- The Committee initially commented that the revisions to the UK Corporate Governance Code ("**Governance Code**") and the government's urging of the FRC to monitor the quality of reporting on gender diversity and the pay gap in annual reports were insufficient. The government responded that the FRC has stated that it will increase monitoring of corporate governance statements, which will include diversity and remuneration and reporting practices. It notes that the gender pay gap reporting regulations and the Governance Code apply to different categories of companies. Additionally, the Government Equalities Office or the Equality and Human Rights Commission will determine how and when to monitor progress made in closing the gender pay gap for all companies subject to the regulations and whether further measures are needed.

The government did not address the BEIS Committee's recommendation that company boards introduce key performance indicators for reducing and eliminating pay gaps and that remuneration committees, in reporting on pay policy, should explain how this commitment to reducing the pay gap is being reflected in their decisions.

The full BEIS Committee report can be found here.

The full government's response can be found here.

The press release can be found here.

PLSA Publishes Response to BEIS Consultation on Ethnicity Pay Reporting

On 11 January 2019, the Pensions and Lifetime Savings Association (**PLSA**) published a response to the BEIS consultation on ethnicity pay reporting that concluded in October 2018.

The PLSA is a trade association that represents over 1,300 pension schemes with just over £1 trillion in assets under management and over 400 supporting businesses, including asset managers, investment consultants and other service providers. Its response supports making ethnicity pay reporting mandatory, in particular because research has shown that voluntary schemes have typically resulted in slow take-up.

However, the PLSA voices concerns that a balance must be maintained between the mandatory scheme and ensuring both that any information provided is useful and that the mandatory scheme does not place a disproportionate burden on firms. In particular:

- for disclosures to be useful to investors, they must be consistent and comparable, i.e., standardised as far as possible;
- as with gender pay gap reporting, the largest companies are best equipped to adopt ethnicity pay gap reporting in the near-term;
- there is little value for investors in the publication of single pay gap figure as this would not be sufficiently granular to be meaningful, or allow exploration of the issue with the company; and
- reporting time scales on gender and ethnicity pay gaps should be produced for each firm's financial year, rather than firms being compelled to take snapshots each April.

A full link to the response can be found here.

IOSCO Issues Statement on Disclosure of Environmental, Social and Governance Matters

On 18 January 2019, IOSCO issued a statement on the importance of issuers including environmental, social and governance (**ESG**) matters when disclosing information material to investors' decisions.

Key points from the statement include:

- Issuers' disclosure of ESG information in the market has increased in recent years, either on a voluntary basis or as a result of compulsory requirements at a local level. The information ranges from environmental factors related to sustainability and climate change, social factors including labour practices and diversity, to general governance-related factors that have a material impact on the issuer's business.
- However, IOSCO also observes that disclosure practices remain varied among issuers and between markets in terms of type of information disclosed and quality of information.
- Investors' interest in ESG disclosure has grown, and some investors already significantly value ESG matters in their investment strategy, highlighting its importance in their investment and voting decisions.
- At the same time, some investors have expressed the desire for enhanced reliability and comparability of ESG information and disclosures to facilitate a more accurate assessment of risk and, therefore, more informed investment decisions.
- Various related interest groups and private sector bodies have developed disclosure frameworks that issuers may consider, designed to facilitate and guide issuers and improve comparability of disclosures.

IOSCO continues to monitor developments in this area and the perspectives of different market participants, including investors, issuers and other stakeholders. IOSCO has also established a sustainable finance network of securities regulators to consider sustainability issues.

The full statement can be found here.

Government Publishes Report on Employers' Understanding of the Gender Pay Gap and Actions to Tackle It

The government published a report on 21 January 2019 on the framework of the current understanding of the gender pay gap (**GPG**) and active solutions to tackle it.

Against the background of the recent GPG transparency regulation in force since April 2017, the report details research by the government Equalities Office. April 2018 marked the first deadline for the publishing of employers' GPG data.

The report covers:

- *Employers' understanding of the GPG* – it was reported that knowledge of the GPG has improved significantly since the 2017 baseline survey (from 48% to 82%). There is still concern in relation to the staff and general public understanding of the GPG (especially as opposed to equal pay).
- *The experiences and impact of the 2017 regulation* – for instance, the report records that 97% of surveyed employers published their first year's GPG data, with 96% doing so by the official deadline.
- *Actions being taken to reduce the GPG* – the qualitative interviews undertaken indicate that most employers maintain a passive attitude towards the GPG. The priority allocated to tackling it has not changed significantly. However, a main action being taken is the promotion of flexible working (16% increase since 2017).

- *Prospective GPG measurement and reporting* – the report notes that although the employers attach importance to complying with the regulation, they do not intend to publish their results early (with 61% aiming to publish their data for the next report in the last quarter).

The press release can be found here.

The full report can be found here.

The report follows on from the initial baseline report in 2017, which can be found here.

IA Launches Consultation on Sustainability and Responsible Investment

On 25 January 2019, the Investment Association (**IA**), the trade body that represents asset managers, launched the first industry-wide consultation on sustainability and responsible investment.

The consultation will gather the views of asset managers on key aspects regarding sustainability and responsible investment. The aim is to help savers and investors by improving clarity while granting better access to this growing feature of the investment management industry.

The consultation covers the following key areas:

- Agreed standard definitions: Proposed definitions for the different sustainable investment approaches, including commonly used terms such as: ESG, integration, impact investing and negative screening. The aim is to agree a set of industry-endorsed standard definitions.
- Development of a UK product label: A proposed voluntary UK product label designed to assist retail investors by allowing them to easily identify funds which have adopted a sustainable investment approach. The label would also draw attention to the sustainability and responsible investment expertise within the UK.
- Stock-take of reporting frameworks: A review on reporting frameworks used by asset managers to disclose how they embed ESG considerations into their investment process, and the impact that their investments have had on wider sustainability indicators.

Notably, this is a result of the IA identifying sustainability and responsible investment as a dedicated policy area in its own right back in early 2018. This will encourage firms to consider their wider role on the environment and to promote all forms of responsible investment.

The consultation closed on 1 March 2019.

The full press release can be viewed here.

New Prospectus Regulation: FCA Consultation on Proposed Changes to Handbook

The FCA published for consultation proposed changes to the Handbook on 28 January 2019. The changes are to align the Prospectus Rules sourcebook within the Handbook to ensure it is consistent with the new EU Prospectus Regulation that came into force on 20 July 2017.

The EU Prospectus Regulation sets out information that companies need to disclose to investors and potential investors in a prospectus when raising capital. Even though certain provisions of the EU Prospectus Regulation were anticipated to come into effect after the UK's anticipated exit from the EU on 29 March 2019, the EU Prospectus Regulation will still be applicable during any Brexit transition or implementation period.

The consultation proposes the updating of the FCA's Prospectus Rules sourcebook to ensure it is consistent with the new EU Prospectus Regulation. This mainly involves removing existing rules, which implemented the Prospectus Directive in the UK, as the EU Prospectus Regulation will repeal and replace the Prospectus Directive.

The full consultation paper can be found here.

Corporate Governance: PLSA Corporate Governance Policy and Voting Guidelines 2019

As mentioned above, the PLSA is the main UK body representing the interests of the occupational pensions industry. In representing the interests of its members, the PLSA produces policies and guidelines that reflect current market best practice. These policies and guidelines are updated annually.

On 29 January 2019, PLSA published a revised version of its Corporate Governance Policy and Voting Guidelines. Most of the changes to the 2018 version have been made to the section on UK voting guidelines, which has been revised in order to relate to the 2018 Governance Code. While the content remains substantially the same, some of the existing guidance has been moved to sit under new section headings and the following additional guidance has been added:

Section 1: Board leadership and company purpose. The guidelines note that key changes to the 2018 Governance Code are the explicit clarification surrounding a company's responsibilities to its shareholders and stakeholders, including its workforce, and a greater emphasis on the role of the board in assessing a company's culture and values.

Section 2: Division of Responsibilities. The guidance recommends that:

- A company's chief executive should not become chair of the company except in exceptional circumstances and that there should be significant engagement with shareholders setting out the reasons for doing so.
- Shareholders should seek a clear sense of other demands on directors' time, and of any significant developments which have occurred since a director's appointment that may impact on their ability to commit appropriate time to the company.
- The annual report should set out details of other current appointments, including any changes over the previous year.
- Shareholders should ensure they have a clear understanding of any existing (or pre-existing) relationship between the independent non-executives and the company that could potentially compromise the directors' ability to hold management to account.

Section 3: Succession, composition and evaluation. The guidance now states that while external board effectiveness reviews are to be welcomed; shareholders will expect that the organisation responsible for effecting the evaluation is in a position to take an independent and rigorous approach.

Section 4: Audit, risk and internal control. The guidance recommends that shareholders should pay close attention to the composition, skills and experience of the Audit Committee and that committee members should have recent and relevant financial experience related to audit or investor practitioner expertise. It also recommends that any committee member's connections with the current or potential auditor should be clearly disclosed.

Section 5: Remuneration. Investors should continue to express concerns about recent increases in the fixed pay of senior executives (regarding performance-related pay) and should continue to prompt companies clearly to explain their rationale for such increases.

Moreover, the guidance recommends that remuneration policies should not only be coherent and consistent throughout the organisation, but should be clearly linked to incentivising those behaviours which are consistent with the company's purpose and values.

The full Corporate Governance Policy and voting guidelines can be found here.

Corporate governance: FCA and FRC Discussion Paper on Building a Framework for Effective Stewardship

On 30 January 2019, the FCA and FRC published a discussion paper which calls for input on how best to encourage the capital markets community to engage more actively in stewardship of the assets in which they invest. The aim of the paper is to advance debate about what is meant by effective stewardship, what minimum expectations investors have of the financial services firms which invest on their behalf, and what higher standards the UK should aspire to.

Particular issues highlighted by the discussion paper include:

- questioning what the key attributes of effective stewardship may involve, e.g., understanding clearly the scope, role and purpose of stewardship and robust communication;
- establishing the appropriate institutional, geographical and asset class scope of stewardship;
- whether current and proposed regulation supports the role of stewardship in promoting well-functioning markets;
- any issues with proxy advisers that have not been adequately addressed thus far; and
- whether the FCA should consider amendments to other parts of the regulatory framework – e.g., the Listing Rules, Prospectus Rules, Disclosure Guidance and Transparency Rules – to support effective stewardship.

The discussion paper accompanies two consultation papers published by the FRC and FCA on the same day seeking input, respectively, on the FRC's proposed revisions to the UK Stewardship Code and on the FCA's implementation of the Shareholder Rights Directive II into the UK (see "*Shareholder Rights Directive II and Related Party Transactions: FCA Consultation on Proposed Changes to Handbook*" below).

Input for the joint discussion paper will close on 30 April 2018.

The full paper can be seen here. The discussion webpage can be found here.

Corporate Governance: FRC consultation on proposed revisions to the UK Stewardship Code

The FRC published a consultation for its proposed revisions to the UK Stewardship Code on 30 January 2019.

The FRC aims for the new UK Stewardship Code to set "substantially higher expectations for investor stewardship policy and practice." The new code will focus on how effective stewardship delivers sustainable value for beneficiaries, the economy and society. In preparing for the consultation, the FRC has previously engaged with 170 members of the investment community and companies.

The key changes proposed by the FRC include:

- *Purpose, values and culture.* Investors must report how their purpose, values and culture enable them to meet their obligations to clients and beneficiaries. This aligns the UK Stewardship Code with the Governance Code and encourages embedding behaviour conducive to effective stewardship in the investor community.
- *Recognising the importance of ESG (environmental, social and governance) factors.* Signatories are now expected to take material ESG issues into account when fulfilling their stewardship responsibilities.
- *Stewardship beyond listed equity.* The proposed UK Stewardship code now expects investors to exercise stewardship across a wider range of assets where they have influence and rights, in the UK and globally.

The Stewardship Code will also set out more rigorous requirements regarding reporting, including a new focus on how stewardship delivers outcomes against predetermined objectives. The FRC will have oversight over this reporting.

Comments on the proposed changes to the code were requested by 29 March 2019.

The press release can be found here. The proposed revisions can be seen in full here.

Shareholder Rights Directive II and Related Party Transactions: FCA Consultation on Proposed Changes to Handbook

On 30 January 2019, the FCA launched a consultation on proposed revisions to the Handbook to implement changes made to the EU Revised Shareholder Rights Directive. The Directive aims to promote shareholder engagement, effective stewardship and long-term investment decision-making through enhancing the transparency of engagement policies and investment strategies across the institutional investment community.

The current UK rules for premium-listed companies already set out relevant requirements that are more stringent than those suggested by the Directive. The FCA therefore suggests leaving the premium listing regime intact. Broadly, the FCA has taken an approach which imposes minimum change on issuers and would make any changes for non-premium companies proportionate.

The FCA is proposing to introduce rules that require UK companies with shares admitted on a regulated market to disclose and seek board approval for related party transactions. The proposed materiality threshold is 25% of one of profits, assets, market cap and gross capital, and the definition of related party from the Directive is also wider than the definition in the premium listing regime.

The FCA is also proposing to make changes specific to life insurers and asset managers:

- asset managers and certain life insurers would be required to make disclosures relating to their shareholder engagement policies;
- life insurers would be required to make disclosures about their arrangements with asset managers and publicly disclose how the main elements of their equity investment strategy are consistent with the profile and duration of their long-term liabilities and how these elements of their strategy contribute to the medium to long-term performance of their assets; and
- asset managers would be required to make disclosures relating to their arrangements with asset owners and how their investment strategies are consistent with the medium- and long-term performance of the assets of the asset owner or fund.

The consultation closed on 27 March 2019. The full consultation can be found here.

Government Publishes Guidance on Streamlined Energy and Carbon Reporting for Businesses

The BEIS published updated Environmental Reporting Guidelines, including a chapter of guidance that helps companies and LLPs comply with the streamlined energy and carbon reporting regime (**SECR**). The guidelines came into force on 1 April 2019.

The guidance sets out the key obligations that companies must comply with under the SECR, and includes information on:

- which companies or organisations fall within the scope of the SECR;
- what information these companies or organisations need to disclose annually;
- the SECR requirements that differ for quoted and unquoted organisations;
- the requirements that apply to all organisations within the scope of the SECR; and
- best practice and opportunities to go beyond what is just required by the SECR.

The BEIS generally encourages all other private sector organisations which are not in scope of the SECR to report in a similar format, although this is a voluntary guideline.

The full report can be found here.

BVCA Responds to BEIS Consultation on Draft Guidance for the New Streamlined Energy and Carbon Reporting Regime

On 14 January 2019 the British Private Equity and Venture Capital Association (**BVCA**) published a response raising several concerns about BEIS' draft guidance for the new streamlined and carbon reporting (**SECR**) regime.

The BVCA is the industry body and public policy advocate for the private equity and venture capital industry, and represents the vast majority of UK-based private equity and venture capital firms. The BEIS consultation was on draft guidance that came into force on 1 April 2019; the guidance is intended to reflect new SECR requirements, and includes example reports for use by quoted companies and large unquoted companies.

- The BVCA raises concerns regarding the clarity of the guidelines. In particular, it notes that the complex corporate structures used by private equity mean that any guidance should clarify the approach under the new SECR regime to qualification and grouping; there is currently no clear confirmation in the guidance that only companies and LLPs who are incorporated in the UK will need to participate in the SECR; and there is little clarity as to whether a subsidiary's energy and carbon information should be incorporated into group reporting.

The BVCA has also noted that there is little clarity as to how the new regime will be enforced and monitored. Finally, the BVCA asks for some examples of the applications of new exemptions under the regime.

The full response can be found here.

IA Published New Analysis of Voting Trends during 2018 AGM Season

On 18 February 2019, the IA published a new analysis of voting trends during the 2018 AGM season.

The IA runs a public register ("**Public Register**"), which is an aggregated list of publicly available information regarding meetings of companies in the FTSE All-Share index who have received significant shareholder opposition to proposed resolutions (i.e., over 20% or greater voted against the resolution).

The new analysis noted that shareholder rebellions rose by over a quarter in 2018. In particular:

- 120 companies were included on the Public Register of shareholder votes as a result of shareholder rebellions.
- 237 individual resolutions were added to the Public Register in 2018, an increase in 25% from 2017.
- In 2018, 29 "repeat offenders" appeared on the Public Register for the same resolution as 2017.

The analysis also noted that opposition to individual director re-election was a key theme, with the number of "opposed" resolutions doubling from 2017 to 2018.

Executive pay declined overall as an issue in the FTSE All-Share index; in the FTSE 100 index, however, there was a sharp rise in objections.

The IA press release can be accessed here.

The full Public Register can be accessed here.

International Corporate Governance Network Publishes First Annual Investor Stewardship Survey

The International Corporate Governance Network published its first annual survey on investor stewardship in February 2019. The purpose of the survey was to help members benchmark their stewardship activities against peers globally.

Respondents to the survey represent some £10.7 trillion in assets under management and are based in 12 countries. Highlights include:

- Almost 90% of stewardship functions report to either the CIO or CEO of the investment institution.
- Over 80% have some form of exclusions policy, excluding for example controversial weapons in the majority, and tobacco and thermal coal frequently.
- Most respondents carry out 500 company engagements a year, with some reporting significantly more. Board quality, remuneration and climate change are the most frequently discussed topics in company engagements.
- 49% of respondents engaged "sometimes or often" with stakeholders in a company, while less than 47% rarely or never engaged with stakeholders.

A link to the full survey can be found here.

Irredeemable Preference Shares: IA Guidelines on Redemption or Cancellation

The IA has prepared guidelines on the redemption or cancellation of irredeemable preference shares, which aim to provide useful guidance on shareholder expectations and best practice, and to promote market confidence in the asset class. The guidelines were published on 19 February 2019.

The central principles of the guidelines are:

- issuers must follow a fair process and have regard to the fair market price when looking to redeem or cancel irredeemable preference shares;
- as part of ensuring a fair process, an issuer should consult preference shareholders, allowing sufficient time and information for shareholders to reach a properly informed decision;
- the issuer should use the consultation in its decision as to the fair market price to be offered as compensation for any subsequent redemption or cancellation; and
- the issuer should respect the position of ordinary shareholders and consult them equally with regard to fair process and fair market value to be offered to preference shareholders as compensation for any subsequent redemption or cancellation.

The guidelines are to be read as having general application to listed companies.

A link to the guidelines can be found here.

IA Statement on Gender Diversity and Executive Pensions in 2019 AGM Season

The IA announced on 21 February 2019 that it will "name and shame" companies who are lagging behind on diversity, and who pay pension contributions to executives above the rate given to the majority of the workforce.

In relation to diversity, companies with no women or only one woman on their board will receive a "red-top," and companies where less than 25% of the board are women (i.e., not compliant with the Hampton-Alexander review requirements) will receive an "amber-top." A "red-top" represents the highest level warning issued by the

Institutional Voting Information Service and is reserved for companies where shareholders have the most significant and serious concerns.

In relation to pensions, companies who do not explicitly state in their remuneration policy that any new executive director appointee will have their pension contributions in line with the majority of the work force will receive a "red-top."

The IA press release can be accessed here.

Prospective Financial Information: ICAEW Consultation on Proposed New Guidelines

On 21 January 2019 the Institute of Chartered Accounts in England and Wales (**ICAEW**) published revised draft principles for prospective financial information, in order to get feedback from the market. The original 2003 principles set out a framework for preparing and publishing prospective financial information in a capital markets context. These principles have been revised in accordance with feedback in response to a consultation in 2017.

The main changes to the 2003 principles include:

- extension of the framework to all prospective financial information, including internal prospective financial information and private fundraisings, although this will be subject to proportionality;
- for assessing the relevance of prospective financial information (the "relevance attribute"), the introduction of a preparation principle; and
- three application notes for preparing prospective financial information in relation to:
    - statements of sufficiency of working capital;
    - profit forecasts; and
    - synergy and stand-alone cost saving statements.

The full consultation report can be found here.

UK Government Publishes 2018 FTSE 350 Cyber Governance Health Check Report

On 1 March 2019, the UK government published its annual Cyber Governance Health Check, which it describes as the "barometer of how corporate Britain is responding to the ongoing challenge of cyber threats." The aim of the Health Check is to assess the extent to which boards and audit committees of FTSE 350 businesses understand and oversee risk management measures that address cyber-security threats to their businesses.

The main issues identified by the health check are:

- Only two-thirds of businesses have a cyber strategy that is aligned with their business objectives, and less than half of businesses have a dedicated budget for it.
- Many businesses may have an incident response plan, but are not testing it on a regular basis. Even fewer have been using external audits to check their plans work when put to test.
- The majority of boards do not understand cyber risks further down the supply chains, leaving these lower levels vulnerable to attack and threatening the integrity of the entire chain.
- Only 12% of the respondents rated the boards' awareness of cyber issues as comprehensive, and only 16% stated that their boards have a comprehensive understanding of all types of cyber threat.

Link to the full report here.

Takeover Code: Code Committee Response Statement on Asset Valuations

The Code Committee has published a response to a consultation it held proposing changes to Rule 29 of the Takeover Code. Rule 29 sets out the way in which the assets of a target should be valued in connection with an offer, including the requirement that an independent valuer's opinion must be provided to support any valuation. The amendments consulted on by the Committee aimed to codify existing practice in terms of asset valuations.

The Committee's response confirms the following changes or clarifications:

- codifying the types of asset to which Rule 29 applies;
- clarifying that Rule 29 applies to a valuation of unquoted investments representing in aggregate 10% of more of the gross asset value of any company;
- clarifying that it is only a valuation of the underlying assets falling within the scope of Rule 29 which must be publicised; and
- clarifying that where an estimate of tax liability cannot be given, the announcement or document must explain why this is so and describe the tax consequences of a sale of the assets.

The amendments to the code took effect on 1 April 2019.

The Code Committee's response can be found here.

Takeover Code: Code Committee Response Statement on Brexit-Related Changes

On 6 March 2019, the Code Committee published a response to its consultation on changes to the Takeover Code resulting from the UK's withdrawal from the EU.

The Takeover Directive, which is largely implemented by the Takeover Code, was required to be implemented into national law by any Member State in 2006. Subject to the terms of any withdrawal agreement between the UK and the EU, the Takeover Directive will not apply in the UK on exit day.

In November 2018, the Code Committee published various amendments relating to changes to the Takeover Code upon exit.

The key amendment which the response statement confirms is the deletion of the "shared jurisdiction" rules. This means that, in determining whether the Takeover Code will apply to an offer for a UK-registered company with securities that are traded on a regulated market in the EEA and not on a UK-regulated market, the "residency test" will be applied; therefore, if the place of central management and control of the company is outside of the UK and of any other British crown dependency (for example, the Channel Islands and Isle of Man), the Takeover Code will not apply to it.

Other amendments include changes to the definitions of "regulated market" and "multilateral trading facility," minor amendments to the rules governing bid documentation in Appendix 6, and other minor amendments such as removing references to the EEA.

A link to the response statement by the Committee can be found here.

LSE Published Proposed Amendments to Primary Markets Rulebooks in Case of No-Deal Brexit

The London Stock Exchange (**LSE**) published on 28 March 2019 proposed changes to the Primary Markets Rulebooks if no transitional period is agreed before the UK's withdrawal from the EU. The majority of the amendments include removal of certain references to EU law and EU entities, to the extent these would no longer be relevant.

Proposed amendments to the Admission and Disclosure Standards include:

- the amendment of various glossary terms to remove or replace references to EU law;
- the insertion of new glossary terms for various terms, including EU regulated market, EU MTF, FCA Handbook, FSMA, Prospectus Rules, UK MAR, UK MTF and UK regulated market;
- replacement of "relevant EEA competent authority" with the FCA as regards further issues;
- removal of references to EU regulated market and EEA state competent authority from sections on Continuing Obligations and High Growth Segment Rulebook; and
- in the section on Admission to Trading Only, specifying that the issuer's securities must not have been and must not be offered to the public within the meaning of the Prospectus Rules, as opposed to the public in the EEA within the meaning of the Prospectus Directive.

The LSE has also proposed minor amendments to the AIM Rules, including the amendment of glossary terms to replace references to EU law with references to retained EU law, and the AIM Rules for Nomads, including amendment of the Relevant Transaction section to include references to UK and UK regulated markets.

The amendments would be effective on the date of any hard Brexit.

The market notice on amendment to the LSE Primary Market Rulebooks can be found here.

The re-drafted AIM Rules for Nominated Advisers can be found here.

No-Deal Brexit Changes to Listing Rules, Disclosure Guidance and Transparency Rules and Prospectus Rules

On 22 March 2019, the FCA published a market bulletin that advises issuers and stakeholders of key changes to the Listing Rules, Disclosure Guidance and Transparency Rules and Prospectus Rules that will apply in the event of a no-deal Brexit.

In the event of a no-deal Brexit, the UK's primary market regime will apply to all issuers that have securities admitted to trading, or have applied for admission to trading, on a UK-regulated market or admitted to listing in the UK, or that are making a public offer in the UK. The rules will apply regardless of the country an issuer is incorporated in.

The key changes to the Disclosure Guidance and Transparency Rules are:

- the removal of the home / host state distinction in sections such as the introduction to the Transparency Rules and the continuing obligations and access to information, meaning that Transparency Rules apply to all issuers with transferable securities admitted to trading on a UK-regulated market irrespective of the place of incorporation;
- issuers preparing consolidated accounts will have to use International Financial Reporting Standards (IFRS) as adopted by the UK (UK-adopted IFRS) for all financial years commencing on or after exit day, instead of IFRS as adopted by the EU. However, the Treasury intends to issue an equivalence decision before exit day which means that non-UK incorporated issuers will be able to prepare their accounts in accordance with the EU-adopted IFRS;

- auditors based in the EEA will become subject to the requirements currently applicable to third-country auditors, including registration with the FRC. However, for financial years beginning before exit day, the current provisions allowing the use of an EEA auditor without registration will remain in force; and
- issuers will only be able to use a 'Primary Information Provider' (an FCA approved entity) to distribute regulated information. Currently, they are also able to use an incoming information society service (an EEA-approved processing and data storing service provider).

The key changes to the Listing Rules are:

- Holders from any jurisdiction will be counted towards the free float, so that the calculation will no longer be limited to EEA holders. The free float requirement currently holds that, when an issuer applies for admission of shares to the Official List, it must generally demonstrate that at least 25% of the securities are distributed to the public in one or more EEA states.

The key changes to the Prospectus Directive are:

- Prospectuses passported into the UK before exit day will remain valid for use in the UK until their validity expires—even where the prospectus expires after exit day. Where a supplement is required for such a prospectus after exit day, the issuer must apply to the FCA for approval of the supplement.
- Certain public body issuers can issue their securities without producing a prospectus under the Financial Services and Markets Act 2000. This will no longer be limited to public international bodies for which at least an EEA state is a member. Instead, any public international body for which at least a state is a member will be able to issue securities without a prospectus.
- Governments or local/regional authorities of any state will be able to issue non-equity securities without needing to produce a prospectus. This will no longer be limited to governments and local/regional authorities of EEA states.

The full FCA consultation paper can be found here.

Executive Remuneration: BEIS Committee Report

On 26 March 2019, the BEIS Committee published a report on executive remuneration. The report is the second part of their inquiry, "Delivering on Fair Pay". The first part of their inquiry resulted in their report on the gender pay gap in 2018. Both reports seek to examine aspects of remuneration in the private sector including:

- considering the implementation of the recommendations on executive pay made in the BEIS Committee's report on Corporate Governance issued in 2016/17;
- reviewing recent developments on executive pay; and
- examining the effectiveness of remuneration committees and institutional investors in combatting excessive executive pay.

The Committee's report gives extensive recommendations, including suggesting that:

- pay ratio reporting requirements be expanded to include all organisations with over 250 employees;
- remuneration committees in companies publish and explain an absolute cap on total remuneration for executives every year;
- companies be required to appoint at least one employee representative to the remuneration committee;

- pay ratio reporting should include a requirement to publish the ratio between CEO and the lowest pay band, as well as the bottom quartile; and
- a statutory requirement is introduced to oblige companies and partnerships to publish pay ratios in 2019 annual reports.

In addition, the Committee notes that they are in full support of the proposal made in the Kingman Review to replace the FRC, which is currently directly responsible for regulating the UK's system of corporate governance, with a new body, the Audit, Reporting and Governance Authority (**ARGA**).

The Committee also made several recommendations in relation to ARGA's proposed responsibilities. For example, they advised that ARGA should:

- challenge any company or firm that has published a pay ratio in its annual report but not adequately explained how they have taken pay ratios into account when determining pay;
- be more prescriptive, interventionist and prepared to publicly call out poor practice as regards the absolute cap;
- seek to ensure that engagement with major investors is properly explained in remuneration reports;
- explore effective sanctions for companies that ignore shareholder concerns on pay;
- provide guidance on executive remuneration with a focus on downward pressure on executive pay;
- monitor how remuneration reports meet the aims of increased transparency and objective alignment; and
- create guidelines ensuring any bonuses reward only exceptional performance.

The full report can be found here.

U.S. DEVELOPMENTS

SEC and NYSE/Nasdaq Developments

SEC Proposes to Expand "Testing the Waters" Exemption to Permit Pre-Offering Communications

On 19 February 2019, the Securities and Exchange Commission (**SEC**) proposed an expansion of the allowance under the 2012 Jumpstart Our Business Startups Act ("**JOBS Act**"), referred to as "testing the waters", which is currently only available to emerging growth companies (**EGCs**). The new Rule 163B under the Securities Act of 1933 ("**Securities Act**") would, if adopted, enable all issuers (and their authorised representatives, including underwriters) to engage in communications with certain categories of large institutional investors prior to or after the filing of a registration statement to assess investor interest in a registered offering. These communications would be exempt from the prohibition imposed by Section 5 of the Securities Act on making any written or oral offers prior to the filing of a registration statement with the SEC.

Generally, companies with annual revenues in excess of US$1 billion do not qualify as EGCs and thus currently are unable to "test the waters" in reliance on this JOBS Act provision. In the SEC press release announcing the proposed rule, SEC Chairman Jay Clayton stated, "Extending the test-the-waters reform to a broader range of issuers is designed to enhance their ability to conduct successful public securities offerings and lower their cost of capital, and ultimately to provide investors with more opportunities to invest in public companies."

In view of the fact that communications under the proposed rule would be limited to "qualified institutional investors" and institutional "accredited investors," the rule as proposed would not require issuers to file or include specific legends on testing-the-waters communications made under Rule 163B. However, these communications would be subject to review by the SEC to ensure that testing-the-waters communications do not conflict with any material information included in the registration statement, in line with the SEC's current practice. These communications would continue to be considered "offers" under the Securities Act, and would consequently be subject to potential liability under the Securities Act and other federal anti-fraud provisions. Furthermore, companies subject to Regulation FD would need to consider whether testing-the-waters communications would be considered selective disclosure of material non-public information and whether the issuer has an obligation to simultaneously make such information public. Under Regulation FD, if the investors in testing-the-waters meetings enter into confidentiality agreements, the issuer may in certain circumstances conclude that public disclosure is not required at that time.

The new rule is meant to be non-exclusive and a company could rely on other Securities Act communications rules or exemptions when assessing the means and timing of communication with potential investors prior to a contemplated offering.

Comments on the proposal are due by 29 April 2019.

The proposed rule release is available here.

SEC Adopts Rule to Modernize and Simplify Regulation S-K Disclosures

On 20 March 2019, the SEC adopted final rules amending Regulation S-K and certain other rules and forms to modernise and simplify disclosure requirements. The amendments are intended to streamline disclosures made by public companies to make them more effective and reduce compliance costs while continuing to provide material information to investors.

Key changes effected by the final rules include:

- revising the requirements for the "Operating and Financial Review and Prospects" (**OFR**) section of annual reports (Item 5 of Form 20-F) to allow companies to exclude a discussion of the earliest of the three years, provided that a discussion of that year has been included in a prior report;
- clarifying that companies do not necessarily need to present the discussion in the OFR section in the format of a year-over-year comparison, but may use any other format that in their judgment enhances a reader's understanding of changes in its financial condition and results of operations;
- allowing companies to redact confidential information from most exhibits to their filings without submitting a request for confidential treatment, provided that the redacted information is not material and that public disclosure would likely cause competitive harm;
- permitting companies to omit entire schedules and similar attachments to any filed exhibits unless the schedules and attachments contain material information that is not otherwise disclosed in the exhibit itself or in the disclosure document;
- revising rules or forms to update, streamline or otherwise improve the SEC's disclosure framework by eliminating the risk factor examples listed in the disclosure requirement;
- clarifying the description of property requirements to emphasise that those disclosures should only include properties that are material to the company; and
- incorporating technology to improve access to information by requiring data tagging for items on the cover page of certain filings and the use of hyperlinks for information that is incorporated by reference and available on EDGAR.

The amendments will become effective 2 May 2019, except for the amendments concerning the redaction of confidential information in material contracts, which are effective as of 2 April 2019. The provisions requiring XBRL (eXtensible Business Reporting Language) data tagging are subject to a three-year phase-in, depending on the filing status of the company.

On 1 April 2019, the SEC published guidance on complying with the new rules allowing issuers to redact non-material competitively sensitive information from material contracts filed as exhibits to SEC reports. In this guidance, the SEC notes that it intends to review for compliance with the new rules by requesting a paper copy of the unredacted exhibit and may ask companies to further substantiate redaction decisions.

The final rule can be accessed here.

Our related client publication is available here.

SEC Official Provides Guidance on Good Disclosure of Complex, Uncertain and Evolving Risks

On 15 March 2019, at the 18th Annual Institute on Securities Regulation in Europe in London, William Hinman, the Director of the SEC's Division of Corporation Finance, outlined best practices companies should consider when deciding what to disclose about complex and evolving risks, such as Brexit and sustainability.

Mr. Hinman emphasised that the SEC's disclosure rules generally favour a principles-based, rather than prescriptive, approach to topics that are complex, associated with uncertain risks and rapidly evolving. He reiterated that, when drafting risk factor disclosures, companies should focus on the most significant things that make an investment in a company and its securities subject to uncertainties or risk. Concise and focused disclosure explaining how each risk affects the company is most useful for investors. Companies should take care not to bury the reader in generic boilerplate or laundry lists of risks that might apply to any company.

Mr. Hinman provided a framework that may be helpful to companies in making disclosure decisions about Brexit and other complex and uncertain risks:

> *[I]nvestors are better served by understanding the lens through which each company's management looks at its exposure. How does management assess and analyze Brexit-related risks and the potential impacts on the company and its operations? What is management doing to mitigate and manage these risks? What is the nature of the board's role in overseeing the management of these risks? Depending on the facts and circumstances of each company, the answers to these questions should provide material information to investors seeking to understand the risks attendant to Brexit for that company. One analytical tool to evaluate disclosure in this context is to consider how management discusses Brexit-related risks with its board of directors. Obviously not all discussions between management and the board are appropriate for disclosure in public filings, but there should not be material gaps between how the board is briefed and how shareholders are informed. For those of you involved in crafting disclosure documents, you can ask yourself a straightforward question: would these disclosures satisfy the curiosity of a thoughtful, deliberative board member considering the potential impact of Brexit on the company's business, operations and strategic plans?*

Specifically, companies should consider whether Brexit exposes companies to material risks in the following areas:

- regulatory risk;
- supply chain risk;
- loss of customers, decrease in sales or increase in costs, due to tariffs or other factors;
- currency devaluation, foreign currency exchange rate risk or other market risk;
- contractual risk; and

- effect on financial statement recognition, measurement or disclosure items, such as inventory write-downs, long-lived asset impairments, collectability of receivables, assumptions underlying fair value measurements, foreign currency matters, hedge accounting or income taxes.

Director Hinman's full speech is available here.

SEC Recognises TISE as a Designated Offshore Securities Market

On 2 November 2018, the SEC approved Guernsey's The International Stock Exchange (**TISE**) as a "designated offshore securities market," within the meaning of Rule 902(b) of Regulation S under the Securities Act. TISE has become an increasingly popular listing venue for debt securities in particular.

This means that issuers of securities listed on TISE can rely on the provisions of Regulation S to issue securities outside the United States without the need for them to register with the SEC and without the seller having to undertake the onerous diligence to be able to form a reasonable belief that the buyer is outside the United States.

This latest recognition is in addition to the TISE's recognition by the German regulator BaFin, the Australian Stock Exchange (**ASX**) and HMRC in the UK.

U.S. Congress Considers Restricting Rule 10b5-1 Insider Trading Plans

On 28 January 2019, the U.S. House of Representatives passed a bill that, if enacted into law, would direct the SEC to conduct a study of Rule 10b5-1 trading plans and revise Rule 10b5-1 in light of the study's results. In general, Rule 10b5-1 provides a safe harbor against allegations of insider trading by enabling corporate executives to enter into trading contracts, give instructions or adopt plans for the future purchase or sale of their own company's securities at a time when they are not aware of material, non-public information. Concerns over Rule 10b5-1 trading plans have emerged from time to time since its adoption in 2000.

The bill would direct the SEC to conduct a study on whether Rule 10b5-1 should be amended to:

- limit the availability of trading plans to issuer-adopted trading windows;
- limit an insider's ability to adopt multiple 10b5-1 trading plans;
- establish a mandatory delay between trading plan adoption and first trade execution;
- limit the frequency with which plans can be modified or cancelled;
- require SEC filings upon trading plan adoptions, amendments, terminations and transactions; and
- require trading plans adopted by boards of issuers to meet additional requirements.

Considering the prevalence of blackout periods that already restrict the ability of key corporate executives and insiders to execute trades, these potential additional limitations to 10b5-1 plans could be significant. The bill has been received in the Senate and referred to the Committee on Banking, Housing, and Urban Affairs.

The Act may be accessed here.

NYSE Amends Shareholder Approval Requirements for Securities Issuances

On 20 March 2019, the SEC approved amendments to Sections 312.03 and 312.04 of the NYSE's Listed Company Manual, which are the rules setting out when a NYSE-listed company must seek shareholder approval before issuing securities.

Under existing NYSE rules, shareholder approval is required for share issuances to related parties exceeding 1% of outstanding shares (by number or voting power) and otherwise for share issuances exceeding 20% of outstanding shares (by number or voting power). There is an exception to this rule where the issuance relates to a sale of common stock, for cash, at a price at least as great as (i) the market value and (ii) the book value of the common stock of the company. Prior to the rule change, "market value" was defined as the official closing price on the NYSE as reported to the 'Consolidated Tape' immediately preceding the entering into of a binding agreement to issue the securities.

Under the amended rules, the concept of "market value" is replaced with a "minimum price" for purposes of determining whether the exception to the shareholder approval requirement applies. "Minimum price" is defined as the lower of (i) the official closing price on the NYSE as reported immediately preceding the signing of a binding agreement to issue securities, and (ii) the average of the official closing price for the five trading days immediately prior to the signing of a binding agreement to issue securities.

The rule change also eliminates the book value prong of the exception.

The amendments are intended to simplify the shareholder approval requirements and provide NYSE-listed companies with more flexibility to negotiate and price an offering.

As with most of the NYSE corporate governance standards, foreign private issuers may opt to follow their home country practice in lieu of the NYSE rules. However, such companies must disclose non-compliance in their annual report on Form 20-F and in their annual written affirmation to the NYSE.

The amended rule is available here.

Noteworthy US Securities Litigation and Enforcement

Individuals May Be Liable for Securities Fraud for Disseminating False or Misleading Statements, Even If the Statements Were "Made" by Others

On 27 March 2019, the U.S. Supreme Court held, in a 6-2 decision, that an individual who disseminates false or misleading statements to investors (even if the statements were made by someone else) can be primarily liable for securities fraud under Rule 10b-5 under the Securities Exchange Act of 1934 ("**Exchange Act**"), as well as related securities laws.

In *Lorenzo v. SEC*, the Court addressed an action by the SEC against the director of investment banking at a brokerage. Lorenzo sent two e-mails to investors, the contents of which were provided to him by his boss, that he knew falsely touted a potential investment. In an administrative action, the SEC found that Lorenzo had violated Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5.

Lorenzo appealed. The U.S. Court of Appeals for the District of Columbia sustained the administrative ruling. In so doing, it held that Lorenzo could not be liable under subsection (b) of Rule 10b-5, but could be liable under subsections (a) and (c) as well as the related securities laws.

Next, Lorenzo appealed to the U.S. Supreme Court, arguing that his case should be only governed by subsection (b) of Rule 10b-5, which specifically addresses misstatements. The Court—in its 2011 decision in *Janus Capital Group, Inc. vs. First Derivative Traders* (which we have previously covered in this newsletter)—had held that an individual who does not have "ultimate authority" over a misstatement is not its "maker" and cannot be primarily liable under subsection (b). Given that Lorenzo's boss was the maker of the misstatements (which the SEC did not contest), Lorenzo concluded that he should not have faced primary liability for his actions.

Affirming the Court of Appeals' decision, the Supreme Court focused on subsections (a) and (c) of Rule 10b-5. By their plain language, subsections (a) and (c) cover a wide range of potential conduct, including "employing" a "device," "scheme," or "artifice to defraud" and "engaging in any act, practice, or course of business" that "operates . . . as a fraud or deceit." The Court found it "obvious" that "the words in these provisions are, as ordinarily used, sufficiently broad to include within their scope the dissemination of false or misleading information with the intent to defraud." As to whether applying these subsections in a misstatements case would render subsection (b) "superfluous", the Court concluded that the subsections are not mutually exclusive and any other conclusion "would mean those who disseminate false statements with the intent to cheat investors might escape liability under the Rule altogether."

In a vigorous dissent written by Justice Thomas, two justices argued that the majority decision "eviscerates" the *Janus* distinction between primary and secondary liability. Justice Thomas noted that this will have a wide impact on the enforcement of the securities laws, because "virtually any person who assists with the making of a fraudulent misstatement will be primarily liable and thereby subject not only to SEC enforcement, but private lawsuits." Because investors cannot bring actions for secondary liability in private securities litigation, we expect there to be significant litigation in the lower courts over who is a "disseminator" of statements. Under *Lorenzo*, liability could extend to administrative employees and outside consultants, depending on the exact factual circumstances of the case.

DOJ Revises FCPA Corporate Enforcement Policy

On 8 March 2019, the Department of Justice (**DOJ**) released a revised version of its FCPA Corporate Enforcement Policy ("**Policy**"), which provides enforcement and practice guidance to DOJ prosecutors and was formally incorporated into the U.S. Attorneys' Manual in November 2017. An Assistant Attorney General announced the revisions to the Policy in a speech where he highlighted the DOJ's commitment to transparency and the need to ensure its "ongoing process of refinement and reassessment." Important changes to the Policy include expansion of the Policy in the context of mergers and acquisitions, as well as softening the DOJ's approach to software that does not retain communications.

The FCPA Corporate Enforcement Policy was designed both to aid the DOJ's ability to identify and punish criminal conduct efficiently and to provide "guidance and increased certainty to companies struggling with the question of whether to make voluntary disclosures of wrongdoing." The changes to the Policy announced by the DOJ on 8 March 2019 fall into three categories.

First, the updated Policy now includes specific guidance for companies that discover Foreign Corrupt Practices Act (**FCPA**) violations in the course of due diligence, creating a "presumption of a declination" in cases "where a company undertakes a merger or acquisition, uncovers misconduct through thorough and timely due diligence or, in appropriate instances, through post-acquisition audits or compliance integration efforts, and voluntarily self-discloses the misconduct and otherwise takes action consistent with this Policy." A declination, as defined by the DOJ, "is a case that would have been prosecuted or criminally resolved" except for the company's actions. The issue of successor liability for past FCPA violations committed by a target company presents a significant risk for companies in M&A transactions, particularly given that M&A transactions sometimes involve limited access to a target company's data and records.

Second, the updated Policy explains that while senior management involvement in potential violations is considered an aggravating factor, it will not automatically preclude companies from receiving a declination. In fact, two recently announced DOJ declinations—Cognizant and ICBL—included involvement of high-level management in the alleged wrongdoing. However, because the companies voluntarily self-disclosed (in the case of Cognizant, within two weeks of discovering the misconduct), fully cooperated, and timely remediated (including removing the high-level managers involved), the companies were granted a declination.

Finally, a small change in the wording of the Policy softened the Policy's approach to a company's use of software that does not retain records. On its face, the original Policy appeared to indicate that companies would not be eligible for remediation credit if they did not "prohibit[] employees from using software that generates but does not appropriately retain business records or communications." Many current technologies and applications, especially internal messaging systems used by companies, may not save their content or might otherwise make the information unavailable later. Because of the language of the original Policy, companies had to decide whether to ban these ubiquitous technologies entirely or risk being automatically ineligible for remediation credit. The new language merely states that companies must "implement[] appropriate guidance and controls on the use of personal communications and ephemeral messaging platforms that undermine the company's ability to appropriately retain business records or communications."

All these changes seem designed to further incentivise corporations to voluntarily self-disclose potential misconduct, and to adjust the Corporate Enforcement Policy to address concerns that were likely voiced by practitioners.

Second Circuit Affirms Dismissal of Putative Securities Class Action, Holding That the Occurrence of Regulatory Problems Do Not Render Materially Misleading Generic Positive Statements Regarding a Corporation's Compliance Efforts

On 5 March 2019, the U.S. Court of Appeals for the Second Circuit affirmed the dismissal of a putative securities class action against Cigna and several of its officers. In *Minohor Singh v. Cigna Corporation, et al.*, the plaintiffs had alleged that defendants violated Sections 10(b) and 20(a) of the Exchange Act and Exchange Act Rule 10b-5 by making a series of materially misleading statements concerning Cigna's compliance with regulatory requirements. The defendants filed a motion to dismiss. The lower court granted the motion, holding that the plaintiffs did not adequately allege material misstatements and scienter. On appeal, the Second Circuit affirmed the dismissal of the case, agreeing that the plaintiffs had failed to adequately plead actionable material misrepresentations.

In 2012, Cigna acquired a regional Medicare insurer with the objective of entering the Medicare insurance market. As a result of the acquisition, Cigna was required to comply with various federal regulations governing that market. The plaintiffs alleged that Cigna made misleading statements about its compliance efforts in its SEC filings and in another publication. Specifically, the plaintiffs focused on statements in the company's 2013 Form 10-K that it had policies in place to comply with pertinent Medicare regulations, and Cigna's statement in its 2014 Form 10-K that it would continue to "allocate significant resources" towards compliance. The plaintiffs also alleged there were materially misleading statements in a pamphlet published in December 2014 discussing Cigna's dedication to integrity and regulatory compliance.

The Second Circuit (which covers Connecticut, New York and Vermont) first considered whether the alleged misstatements were material (i.e., whether a reasonable investor would view the allegedly misleading statements as "important" in his or her decision to purchase or sell stock). The court found that: the language in Cigna's Form 10-K filings were generic statements about its compliance efforts; the language in the pamphlet constituted mere puffery regarding Cigna's "reputation, integrity and compliance with ethical norms;" and such statements were too vague with respect to Cigna's compliance with regulatory requirements to create an inference that Cigna was in "satisfactory compliance." The court contrasted the statements at issue with statements in prior cases where the court "found that descriptions of compliance efforts amounted to actionable assurances of actual compliance." The court noted that in those cases "the descriptions of such efforts were far more detailed" and that "[s]uch detailed descriptions stand in sharp contrast to Cigna's simple and generic assertions about having 'policies and procedures' and allocating 'significant resources." The court further noted that the manner in which the allegedly misleading statements were presented—including that they were accompanied by acknowledgements of the complexity and numerosity of applicable regulations—should have indicated to investors that Cigna actually was cautious about the adequacy of its compliance efforts.

Having found that no material misstatements were alleged, the court declined to address the issue of scienter and affirmed the judgment of the lower court. In doing so, the court stated: "This case presents us with a creative attempt to recast corporate mismanagement as securities fraud. The attempt relies on a simple equation: first, point to banal and vague corporate statements affirming the importance of regulatory compliance; next, point to significant regulatory violations; and *voila*, you have alleged a prima facie case of securities fraud! The problem with this equation, however, is that such generic statements do not invite reasonable reliance. They are not, therefore, *materially* misleading, and so cannot form the basis of a fraud case."

This case should be an important precedent for securities litigants. An increasing number of securities class actions in recent years have been geared toward allegations that companies failed to disclose shortcomings in legal and regulatory compliance, many of them falling within the much talked about "event-driven" trend in securities litigation. Against that backdrop, *Cigna* reflects an important reminder to courts that regulatory compliance issues or other events allegedly evidencing failures by a company to manage compliance risks do not necessarily render the company's statements about its compliance efforts materially false or misleading.

Tenth Circuit Holds that Dodd-Frank Act Granted SEC Extraterritorial Authority

On 24 January 2019, the U.S. Court of Appeals for the Tenth Circuit affirmed a decision by the U.S. District Court for the District of Utah that the Dodd-Frank Act of 2010 grants the SEC authority to enforce extraterritorially the antifraud provisions of the Securities Act and the Exchange Act.

Months before the Dodd-Frank Act was passed, the U.S. Supreme Court in *Morrison v. National Australia Bank* held that, given the general presumption against extraterritorial application of U.S. laws and the lack of clear indicia of congressional intent to the contrary, the federal securities laws did not apply extraterritorially. But the Tenth Circuit (which covers Colorado, Kansas, New Mexico, Oklahoma, Utah and Wyoming) in *SEC v. Scoville* concluded that the Dodd-Frank Act "affirmatively and unmistakably" evidenced Congress's intent to allow the SEC to enforce the federal securities laws whenever the "conducts-and-effects" test is met, effectively rendering *Morrison* inapplicable to SEC and other government enforcement actions (while not disturbing its impact on private securities actions).

By way of background, *Scoville* originated from a July 2016 enforcement action against an internet traffic exchange company and its founder, in which the SEC alleged that the company was running an unlawful Ponzi scheme. The company sold buyers "clicks" for their websites to boost their position in search engine results. Allegedly, the company misled customers in a number of ways, including by promising them a share of the company's revenue if they purchased an "Adpack" and clicked on a certain number of ads for the websites of the company's other customers. Approximately ninety percent of Adpack purchasers were located outside the United States.

The SEC's enforcement action alleged that the Adpacks constituted securities, and that their sale violated Sections 17(a)(1) and (a)(3) of the Securities Act and Section 10(b) of the Exchange Act, as amended by the Dodd-Frank Act. The district court ruled in favor of the SEC and granted a preliminary injunction against the defendants. The company and its founder filed an interlocutory appeal, arguing that the federal securities laws could not apply to sales abroad, given the Supreme Court's holding in *Morrison*.

In *Morrison* (which we have covered previously in this newsletter), the Supreme Court applied the general presumption against extraterritoriality, which requires courts to assume a statute only applies to domestic conduct unless there is a "clear indication" of extraterritorial application, to its interpretation of Section 10(b) of the Exchange Act. Concluding a "clear indication" of congressional intent for extraterritoriality was lacking, it rejected decades of circuit court precedent and held that Section 10(b) did not apply to activity outside the United States.

The Dodd-Frank Act, however, was passed only months after *Morrison* was decided. The Act amended the securities laws interpreted in *Morrison* by adding a key provision—Section 929P(b). This section expanded the scope of both the Securities Act and the Exchange Act to cover SEC enforcement actions against "conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors" and "conduct occurring outside the United States that has a foreseeable substantial effect within the United States." The Tenth Circuit agreed with the lower court that this timing and language indicated an "affirmative[] and unmistakab[le]" rebuttal to the presumption against extraterritoriality for SEC actions.

In further support of its conclusion, the Tenth Circuit found that a separate provision of the Dodd-Frank Act—Section 929Y—which directed the SEC to receive public comment and conduct a study on whether private actions brought under the antifraud provisions should be extended extraterritorially, showed that Congress thought it was passing a statute granting the SEC extraterritorial enforcement authority. And the court found the title of Section 929P(b), "Strengthening Enforcement by the Commission," to be further evidence that Congress intended to make explicitly clear that Dodd-Frank's antifraud provisions applied extraterritorially.

Applying this conclusion to the facts of the case, the Tenth Circuit held that because the company was conceived of, created and promoted by its founder while he was living in Utah, and used servers in the United States to conduct its business, there were sufficient U.S.-based conduct and effects to support the enforcement action. The Tenth Circuit rejected the defendants' additional arguments that the company's products did not qualify as securities subject to Dodd-Frank, and its contention that the SEC failed to show a likelihood of success in proving all necessary elements of the antifraud claims.

U.S. Supreme Court Seeks Solicitor General's Input on Whether to Hear Case Raising the Question of Whether a Non-U.S. Corporate Issuer with No Involvement in Establishing or Selling ADRs Can Be Subject to a Section 10(b) Claim So Long as Plaintiff's Alleged Securities Transaction Was "Domestic"

On 14 January 2019, the U.S. Supreme Court invited the Solicitor General to file a brief expressing the views of the government in connection with a pending petition for writ of certiorari regarding whether Section 10(b) of the Exchange Act applies to all domestic securities transactions, even if the claims are predominantly foreign.

Under the Ninth Circuit's decision in *Toshiba Corp. v. Auto. Indus. Pension Trust Fund, et al*., for which review is being sought, a foreign issuer that has no involvement in establishing or selling American Depositary Receipts (**ADRs**) for its securities can be subject to a Section 10(b) claim so long as the plaintiff purchased or sold the ADRs in a U.S.-based transaction. As noted by the defendant and various amici in support of the petition for certiorari, the Ninth Circuit's holding significantly extends the extraterritorial application of Section 10(b) to non-U.S. companies that have not availed themselves of the U.S. capital markets.

The approach of the Ninth Circuit (which covers Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon and Washington) appears to be in tension with the concerns expressed by the Supreme Court in *Morrison*. In *Morrison*, the Court emphasised the importance of the presumption against extraterritoriality of U.S. statutes and held that Section 10(b) and Exchange Act Rule 10b-5 only apply to (i) the purchase or sale of a security listed on a U.S. securities exchange, or (ii) the purchase or sale of any other security in the United States.

Since *Morrison*, lower courts have addressed its rule that Section 10(b) only applies to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities" (id. at 267) in various contexts. The transnational nature of transactions involving ADRs, in particular, has given rise to a number of decisions concerning the applicability of Section 10(b). ADRs are negotiable certificates issued by a U.S. depositary institution, typically banks, which represent a beneficial interest in a specified number of shares of a non-U.S.

company. They allow investors in the U.S. to invest in foreign companies and facilitate access to the U.S. capital markets. ADRs can be traded on U.S. exchanges, such as the New York Stock Exchange, or on over-the-counter markets, such as the Over-the-Counter Bulletin Board. Unsponsored ADRs are registered by depositary institutions with the SEC without the foreign company's participation, whereas sponsored ADRs are jointly registered by the depositary institution and the foreign company.

Courts have repeatedly held that Section 10(b) claims based on ADRs listed on a domestic exchange are permitted under *Morrison*. The law is more unsettled concerning whether Section 10(b) claims can be brought on the basis of transactions related to ADRs or other instruments that are not listed on a U.S. exchange. The *Morrison* court did not define the scope of "domestic" transactions. In two significant cases, the Second Circuit has (i) held that a transaction is domestic "if irrevocable liability is incurred or title passes within the United States" (*Absolute Activist*), and (ii) held that, in any event, finding that a transaction is domestic is not sufficient to conclude that Section 10(b) applies to the transaction, if the claims are "so predominantly foreign as to be impermissibly extraterritorial" (*Parkcentral*). Numerous courts, including the Third Circuit (which covers Delaware, New Jersey, Pennsylvania and the US Virgin Islands), have adopted the "irrevocable liability" test.

In *Toshiba*, however, the Ninth Circuit held that the purchase and sale of unsponsored ADRs traded on an over-the-counter market could qualify as domestic transactions under *Morrison* and subject the foreign issuer (to whose securities the ADRs refer) to a Section 10(b) claim. The named plaintiffs, U.S.-based funds, had made over-the-counter purchases of unsponsored ADRs of Toshiba, a Japanese company whose shares trade on the Tokyo Stock Exchange. The district court dismissed the case with prejudice, finding that Section 10(b) did not apply under *Morrison* because the over-the-counter market was not a "stock exchange" under the Exchange Act, and plaintiffs had failed to allege Toshiba's involvement in the ADRs at issue. On appeal, the Ninth Circuit agreed that the over-the-counter market was not a "domestic exchange" for purposes of a Section 10(b) claim. Then, adopting the Second Circuit's "irrevocable liability" test, the court concluded that the complaint did not include sufficient factual allegations to determine where the parties incurred irrevocable liability, but suggested that "an amended complaint could almost certainly allege sufficient facts to establish that [plaintiff] purchased its Toshiba ADRs in a domestic transaction," noting that the plaintiffs, the over-the-counter market, and the depositary banks were all based in the United States.

The court rejected the defendant's argument, based on the Second Circuit's *Parkcentral* decision, that a domestic transaction is not sufficient to subject a non-U.S. issuer to a Section 10(b) claim where the plaintiffs did not allege any connection between Toshiba and the ADRs. The Ninth Circuit stated that the *Parkcentral* decision was "contrary to Section 10(b) and *Morrison* itself" because, according to the Ninth Circuit, "[i]t carves out 'predominantly foreign' securities fraud claims from Section 10(b)'s ambit, disregarding Section 10(b)'s text." The court reversed and remanded the case to allow the plaintiffs to file an amended complaint.

The defendant submitted a petition for writ of certiorari to the U.S. Supreme Court asking the Court to decide whether a domestic securities transaction is or is not sufficient by itself to subject a defendant to a Section 10(b) claim. The defendant argued that by holding that the Exchange Act always applies if the claim involves a domestic securities transaction—even when it involves foreign conduct, has an effect on foreign securities exchanges and interferes with foreign securities laws—the Ninth Circuit created a circuit split with the Second Circuit over how to apply *Morrison's* limitation on the extraterritorial reach of Section 10(b). The defendant further contended that the issue is of significant and immediate importance because the Ninth Circuit's rule (i) interferes with foreign securities regulation and (ii) may lead foreign issuers to attempt to prevent trading in unsponsored ADRs referencing their stock.

Numerous amici filed briefs in support of the petition—including by the Securities Industry and Financial Markets Association, the U.S. Chamber of Commerce, and the Institute of International Bankers—and similarly argued that the Ninth Circuit's decision impermissibly extends the reach of Section 10(b) extraterritorially, in contravention of *Morrison*, and could have detrimental effects on non-U.S. companies, the U.S. regulatory system and the global securities market.

The Court's invitation for a brief from the Solicitor General suggests that the Court may possibly be leaning toward granting the petition. We will continue to closely follow this case.

ITALIAN DEVELOPMENTS

Italian Government Approves Measures for Regulated Firms in Case of a No-Deal Brexit Scenario

On 25 March 2019, the Italian government issued Law Decree No. 22/2019 ("**Brexit Decree**") setting forth a number of measures aimed at, among other things, protecting financial stability and market integrity, as well as ensuring an orderly termination of existing contractual relationships, in the event of a no-deal Brexit.

Notably, the Brexit Decree introduced a transitional regime applicable to certain UK-based regulated entities operating in Italy, including UK banks, investment firms, insurance companies and other financial services companies. The provisions are differentiated according to the type of intermediary involved and type of clients. In general, the transitional period ranges between six and 18 months. In certain cases, a prior notification to the competent Italian authority is required. The Italian Companies and Exchange Commission (**CONSOB**) and the Bank of Italy issued implementing guidelines and regulatory instructions.

The Brexit Decree contains a number of additional measures, including provisions applicable to Italian regulated entities operating in the UK and provisions aimed at protecting depositors and investors.

Under Italian law, a law decree is adopted by the Italian government and has the force of law. However, it lapses unless it is ratified by the Italian Parliament within 60 days. The Parliament may also introduce amendments in the process of conversion of the law decree into law.

Amendments to the Italian Securities Act Relating to Competent Authorities and Sanctions Pursuant to the Benchmark Regulation and the SFT Regulation

By means of Legislative Decree No. 19 of February 13, 2019, Legislative Decree No. 58/1998 (Italian Securities Act) was amended, in order to implement provisions of EU Regulations (i) 2016/1011, relating to indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds ("**Benchmark Regulation**") and (ii) 2015/2365, relating to transparency of securities financing transactions ("**SFT Regulation**"). The aim of the Benchmark Regulation is to ensure the proper functioning of the markets, as well as a high level of consumer and investor protection, determining a common regulatory framework in relation to benchmarks. The Benchmark Regulation is intended to address the fact that the pricing of many financial instruments and financial agreements depends on the accuracy and integrity of benchmarks and that serious cases of manipulation of interest rate benchmarks such as LIBOR and EURIBOR, as well as allegations that energy, oil and foreign exchange benchmarks have been manipulated, have proven that benchmarks' determination process can be subject to conflicts of interest.

The aim of both the Benchmark Regulation and the SFT Regulation is to create a common regulatory framework in relation to critical matters such as the process for determining benchmarks and securities financing transactions (**SFTs**). The SFT Regulation is intended to address shadow banking activities, which are carried out as bank-like credit intermediation activities. Several supervision bodies (the Financial Stability Board and the European Systemic Risk Board) have identified the risks of securities financing transactions (SFTs). SFTs allow the build-up of leverage, pro-cyclicality and interconnectedness in the financial markets. In particular, a lack of transparency in the use of SFTs has prevented regulators and supervisors, as well as investors, from correctly assessing and monitoring the respective bank-like risks and level of interconnectedness in the financial system in the period preceding and during the financial crisis.

CONSOB and the Bank of Italy have been identified as the main competent authorities for the different tasks to be carried out pursuant to the Benchmark Regulation and the SFT Regulation.

In particular, for the Benchmark Regulation, CONSOB will be the competent authority with respect to, among other things, the supervision of administrators (i.e., a natural or legal person that has control over of the process relating to the provision of a benchmark) and supervised contributors (i.e., a supervised entity that contributes input data to an administrator located in the EU), while the Bank of Italy shall be responsible for, among other things, contributors under its supervision. Also IVASS and COVIP have been recognised as competent authorities for their scope of action (supervision on insurance companies and pension funds).

As for the SFT Regulation, CONSOB has expressly been identified as the competent authority for the supervision of the disclosure obligation, also relating to the reuse of financial instruments received as guarantee for obligations, with respect to non-financial counterparts (i.e., entities that differ from those already supervised by authorities such as investment firms, credit institutions, insurance or reinsurance companies, UCITs and the relevant management companies, central counterparties or central securities depositories).

In order to grant the effectiveness of the authorities' supervision, the Italian Securities Act has been amended also to include sanctions relating to the violation of the obligations arising from the Benchmark Regulation and from the SFT Regulation, to be directly applied by CONSOB, Bank of Italy, IVASS and COVIP.

Borsa Italiana Approves Amendments to Market Rules and Related Instructions Relating to the Criteria for the Determination of Free Float for the Admission to Trading and/or Admission to Trading on the STAR Segment

Borsa Italiana S.p.A., the managing company of the Italian Stock Exchange ("**Borsa Italiana**"), amended its market rules and the related instructions (new version entered in force on 4 March 2019). The most significant amendments were those relating to the criteria for determining free float.

In particular, as for the admission to trading and/or the admission to trading on the *Segmento Titoli ad Alta Regolamentazione* (**STAR**) segment or maintenance of such status: (i) only shareholdings equal to or higher than 5% will not be taken into account for the determination of the free float, thus eliminating the other relevant threshold (3%); (ii) calculations will be carried out having regard to the number of shares as opposed to the number of votes; (iii) for STAR segment, the calculation critieria for the determination of the capitalisation is set forth; and (iv) the provisions relating to the derogations to the free float requirements have been simplified, always in the perspective of granting an efficient secondary market for the shares admitted to trading.

Corporate Governance Committee

Following the approval by the Italian Corporate Governance Committee of certain amendments to the Corporate Governance Code for listed companies ("**Self-Regulation Code**"), relating to gender diversity in the composition of corporate bodies, and in the general context of a similar reviewing process started by the FRC in the UK with respect to the Code of Conduct, the Corporate Governance Committee decided to proceed with a general review process of the Self-Regulation Code, to be completed in 2019, in order to rationalise the structure and strengthen and enhance the role of corporate governance.

The most significant amendments are aimed at facilitating access to the markets and inducing listed companies to adopt long-term, sustainable growth strategies and solutions.

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