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CORPORATE GOVERNANCE AND SECURITIES LAW UPDATE

Below is a summary of the main developments in Asia, US and EU corporate governance and securities law and certain financial markets regulation developments since our last update of October 2018.

Financial regulatory developments are available here.

IN THIS ISSUE

HONG KONG DEVELOPMENTS

SFC Sets Out New Regulatory Approach for Virtual Assets

On 1 November, 2018, the Securities and Futures Commission of Hong Kong (**SFC**) issued a statement (the "**Statement**"), which sets out a new approach aiming to regulate virtual asset portfolio managers and distributors of virtual asset funds and a conceptual framework for the potential regulation of virtual asset trading platforms. In an accompanying circular (the "**Circular**"), the SFC provided detailed guidance and reminded firms that distribute funds investing in virtual assets of the registration and regulatory requirements.

The Statement

The SFC warns investors of the significant risks of virtual assets, some of which are inherent in the nature and characteristics of virtual assets while others arise from the operations of platforms or portfolio managers. In particular, the SFC focuses the regulatory attention on the following risks: (i) valuation, volatility and liquidity; (ii) accounting and auditing; (iii) cybersecurity and safe custody of assets; (iv) market integrity; (v) risk of money laundering and terrorist financing; (vi) conflicts of interest; and (vii) fraud.

Under the existing regulatory regime, virtual assets that fall into the definition of "securities" or "futures contracts" under the Securities and Futures Ordinance and activities related to such virtual assets are subject to regulation by the SFC. Firms must also comply with certain notification requirements if they intend to provide trading and asset management services involving crypto-assets. In addition, firms engaging in the distribution of funds that invest in virtual assets, regardless of whether such assets amount to "securities" or "futures contracts," need to be licensed by or registered with the SFC. However, since some virtual assets may not constitute "securities" or "futures contract," many investors are still left unprotected if they trade in virtual assets through unregulated trading platforms or invest in virtual asset portfolios that are managed by unregulated portfolio managers.

To address such regulatory concerns, the SFC plans to bring a significant portion of virtual asset portfolio management activities into its regulatory net through the following means.

- Scope of Supervision. The expanded scope of supervision of the SFC catches (i) persons managing funds which solely invest in virtual assets that do not constitute "securities" or "futures contracts" and distribute the same in Hong Kong; (ii) persons that are licensed or are to be licensed for Type 9 regulated activity (asset management) for managing portfolios in "securities," "futures contracts" or both; and (iii) persons distributing funds that invest (solely or partially) in virtual assets in Hong Kong.
- Regulatory Standards. With respect to virtual asset portfolio managers under (i) and (ii) above, a set of standard terms and conditions which reflect the essence of the existing regulatory requirements under the SFC will be imposed on them as licensing conditions with certain variations to better address the risks associated with virtual assets.

  Some of the key terms and conditions are available here.

  Virtual asset fund distributors under (iii) above will be subject to further guidance on the expected standards and practices as provided in the Circular.
- Licensing process. License applicants and licensed corporations are required to inform the SFC if they are managing or planning to manage portfolios that invest in virtual assets so that the SFC can assess their business activities and decide the next steps, including imposing the abovementioned standard terms and conditions, rejecting licensing applications and unwinding existing virtual assets portfolios.

In addition to regulating virtual asset fund managers and distributors, the SFC also sets out a conceptual framework for the potential regulation of virtual asset trading platforms. At the current stage, the SFC proposes to work with interested platform operators by placing them in a regulatory sandbox to explore whether such platforms are suitable for regulation. Factors to be considered include the adequacy and effectiveness of the proposed conceptual framework, ability to comply with the terms and conditions and investors' interests, as well as local market and international regulatory developments.

Details of the conceptual framework are available here.

The Statement is available here.

The Circular

The SFC reminds persons licensed or registered for Type 1 regulated activity (dealing in securities) or Type 9 regulated activity (asset management) that are engaged in distributing virtual asset funds under their management about the existing regulatory requirements and provides guidance on the expected standards and practices in relation to the such distribution.

Distributions of virtual asset funds, regardless of whether they are authorized by the SFC, are subject to the regulation of the SFC. However, the Circular further sets out the following additional requirements for firms which distribute non-SFC authorized funds that have a stated investment objective to invest in virtual assets or intend to invest or have invested more than 10% of their gross asset value in virtual assets directly or indirectly: (i) selling restrictions and concentration assessments; (ii) due diligence on virtual asset funds not authorised by the SFC; and (iii) information for clients.

The Circular is available here.

US DEVELOPMENTS

SEC and NYSE/Nasdaq Developments

SEC Report Urges Public Companies to Consider Cyber Threats in Internal Accounting Controls

On 16 October 2018, the U.S. Securities and Exchange Commission (**SEC**) issued a report on an investigation conducted by the SEC's Division of Enforcement related to the internal accounting controls at nine public companies that were the victims of cyber fraud. The report draws attention to the growing issue of cyber fraud, highlights what it believes are necessary and best practices in this area and, importantly, cautions all public companies that failure to strengthen internal controls in the face of the growing risk of cyber fraud could result in an enforcement action in the future.

The SEC considered whether the nine companies that were victims of cyber-related frauds violated federal securities laws by failing to have sufficient internal accounting controls as required under the U.S. Securities Exchange Act, which requires companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are executed with, or that access to company assets is permitted only with, management's general or specific authorization.

The SEC advises that public companies subject to the internal accounting controls requirements of the U.S. Securities Exchange Act "must calibrate their internal accounting controls to the current risk environment and assess and adjust policies and procedures accordingly." It also directly indicated its position that cybersecurity falls squarely within the internal control framework, stating "our report emphasizes that all public companies have obligations to maintain sufficient internal accounting controls and should consider cyber threats when fulfilling those obligations."

The report expressly includes the objective of making "issuers and other market participants aware that these cyber-related threats of spoofed or manipulated electronic communications exist and should be considered when devising and maintaining a system of internal accounting controls as required by the federal securities laws." Moreover, the report concludes that the SEC "is not suggesting that every issuer that is the victim of a cyber-related scam is, by extension, in violation of the internal accounting controls requirements of the federal securities laws. What is clear, however, is that internal accounting controls may need to be reassessed in light of emerging risks, including risks arising from cyber-related frauds."

Companies may wish to consider the following:

- *Cybersecurity Considerations are a Fundamental Part of Internal Controls*. The report is a reminder to all companies of the necessity of considering cybersecurity risks when establishing internal control processes and procedures.
- *One Size Does Not Fit All*. The cybersecurity measures that companies implement as part of their internal control framework should be tailored to the unique nature of cybersecurity risks as compared to other control risks, and such measures should be appropriate to their type of business and the type of cybersecurity risk to which they are vulnerable.
- *Train, Test and Train Again*. As described in the report, even the most robust internal control processes cannot be effective if those required to follow them do not understand them or ignore them. On an ongoing basis, education, training and testing of the relevant personnel on internal control procedures is critical.
- *Keep Track of What Happens*. Companies should document the types of cybersecurity schemes for which they become subject and how the existing internal control processes worked in the face of these schemes. This information should be regularly reported to management and used as part of each internal control review.
- *Do Not Set It and Forget It*. Just as the type and sophistication of cybersecurity schemes expand, companies should assess and reassess the adequacy of internal control procedures as they learn about new threats and vulnerabilities.

Our related client publication is available here

The SEC's report is available here.

SEC Overhauls Disclosure Requirements for Mining Companies

In October 2018, the SEC adopted new disclosure rules for companies with material mining operations, which will replace the existing Industry Guide 7. The new rules are intended to bring the SEC's mining disclosure requirements closer in line with international standards, in particular the Committee for Mineral Reserves International Reporting Standards (CRIRSCO). SEC-registered mining companies (other than Canadian companies using Form 40-F) that have mining operations (including royalty companies) that are material to the company's business or financial condition will be subject to the new rules, which will take effect beginning with a company's first fiscal year beginning on or after 1 January 2021. Key changes from the SEC's existing rules for mining companies include:

- requiring that every disclosure of mineral resources, mineral reserves and material exploration results reported in a company's registration statements and periodic reports be based on, and accurately reflect, information and supporting documentation prepared by a "qualified person;" and

- requiring the disclosure of mineral resources (currently prohibited under SEC rules except in limited circumstances) in addition to mineral reserves.

Our related client publication is available here.

The SEC's final rule is available here.

Amendments to Nasdaq Shareholder Approval Rule for Private Placements

On 26 September 2018, the SEC approved amendments to Nasdaq Rule 5635(d), also known as the "20% Rule," which required shareholder approval prior to the issuance in a private placement of 20% or more of a company's common stock or 20% or more of its voting power outstanding before the issuance, if the issuance was at a price less than either market value or book value.

The amended rule creates a new defined term for "20% Issuance," which is defined as a transaction, other than a public offering, involving the sale, issuance or potential issuance by the company of common stock (or securities convertible into or exercisable for common stock), which alone or together with sales by officers, directors or substantial shareholders of the company, equals 20% or more of the common stock or 20% or more of the voting power outstanding before the issuance.

Under the modified rule, shareholder approval is only required prior to a 20% Issuance at a price that is less than the "minimum price," instead of the market value or book value. "Minimum price" is defined as "the lower of (i) the closing price (as reflected on nasdaq.com) immediately preceding the signing of the binding agreement; or (ii) the average closing price of the common stock (as reflected on nasdaq.com) for the five trading days immediately preceding the signing of the binding agreement."

Nasdaq considered that the term "book value" may not be an appropriate measure for requiring shareholder approval. The amended rule no longer requires the use of book value as an accounting measure to determine whether shareholder approval is required for a 20% Issuance.

These amendments, which only apply to companies listed on the Nasdaq, aim to provide companies with additional flexibility in structuring private placement transactions and maintain dilution protection for shareholders.

As with most of the Nasdaq corporate governance standards, foreign private issuers may opt to follow their home country practice in lieu of the Nasdaq rules. However, such companies must disclose non-compliance in their annual report on Form 20-F and are required to submit to Nasdaq a statement from legal counsel certifying that the practice is not prohibited under the home country's laws.

The amended rule is available here.

Risk Disclosure—SEC Areas of Focus in 2019

In a recent speech, SEC Chairman Jay Clayton emphasized three areas of risk disclosure that the SEC will monitor in the upcoming filing season: (1) Brexit, (2) the transition away from LIBOR in financial contracts and (3) cybersecurity. The following points from this speech provide insight into what the SEC staff may be looking for in reviewing companies' public disclosures, in particular in the "Risk Factors" and "Operating and Financial Review and Prospects" sections of Form 20-F and other company reports.

Brexit

Chairman Clayton stated he believed that the potential impact of Brexit has been understated, and indicated that the SEC will focus on disclosure regarding risks and uncertainties faced by SEC reporting companies in connection with the United Kingdom's exit from the European Union.

Chairman Clayton noted that:

- he has directed the SEC staff to focus on disclosures companies make about Brexit; and
- in contrast to some existing disclosures that simply state that Brexit presents a risk, he would like to see more robust disclosure regarding management's consideration of Brexit and its potential impact on companies and their operations.

Transition away from LIBOR

With LIBOR set to be phased out by 2021, the SEC will be looking to ensure that companies have planned and are acting accordingly.

Specifically, disclosures should address the following:

- For companies with floating rate obligations tied to LIBOR, does the documentation provide fallback language?
- If so, will it work in such a situation?
- Will consents be needed to amend the documentation, and have market participants considered the difficulty and costs associated with obtaining such consents?

Cybersecurity risk

From a disclosure perspective, key takeaways include:

- The importance of sufficiently informing investors of cybersecurity risk.
- Ensuring that disclosure controls and procedures are in place for the disclosure of material cybersecurity events, as well as policies that protect against corporate insiders trading in advance of company disclosures of material cyber incidents.

For further guidance, the SEC has issued interpretive guidance to assist public companies in preparing their disclosures on cybersecurity risks, which is accessible here.

Chairman Jay Clayton's speech is available here.

SEC Goes After Company for Presenting Non-GAAP Financial Measures without Giving Equal Prominence to GAAP Measures

On 26 December 2018, the SEC issued a cease and desist order and imposed a $100,000 civil penalty on a company for including financial measures that do not conform to U.S. GAAP (referred to as "**non-GAAP measures**") in earnings releases without giving equal or greater prominence to the most directly comparable GAAP financial measures. Under Item 10(e)(1)(i)(A) of Regulation S-K and other SEC rules and guidance, the presentation of any non-GAAP financial measure in an SEC filing (including, for foreign issuers, non-IFRS financial measures) must be accompanied, with equal or greater prominence, by the most directly comparable U.S. GAAP (or IFRS, as applicable) financial measure.

In this case, the SEC found that the company included non-GAAP measures in the headlines and in bullet points in the "highlights" section on the first page of its earnings releases without giving equal or greater prominence to the comparable U.S. GAAP financial measures, which were disclosed later in the body of the earnings release. This practice violated Section 13(a) of the U.S. Securities Exchange Act of 1934 and SEC rules regarding disclosure of non-GAAP measures.

As a reminder, the staff of the SEC's Division of Corporation Finance ("**Staff**") has provided guidance on the use of non-GAAP measures in its Compliance and Disclosure Interpretations (**C&DIs**). The C&DIs provide the following examples where the Staff would consider the disclosure of a non-GAAP measure to be more prominent (and therefore in violation of the rule):

- Presenting a full income statement of non-GAAP measures or a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures.
- Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures.
- Presenting a non-GAAP measure using a style that emphasizes the non-GAAP measure over the GAAP measure (bold text or a larger font).
- A non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline).

The SEC's enforcement action is available here.

Reduced SEC Operations during Federal Government Shutdown

On 27 December 2018, the SEC began reduced operations as a result of the federal government shutdown.

The SEC is operating with a very limited number of staff members and has stated that it will continue the operation of certain systems, including EDGAR, and will be able to "respond to emergency situations involving market integrity and investor protection."

The SEC has announced that it will not consider requests for acceleration of registration statements until further notice. This should not affect companies that are either "well-known seasoned issuers" (WKSIs) or companies that have an effective shelf registration statement on file with the SEC. Other companies planning to make registered offerings should consult with their U.S. legal counsel.

Any updates to the SEC's operational status will be posted on www.sec.gov.

The SEC Division of Corporation Finance's announcement regarding operations during the government shutdown and related Q&As is available here.

Shearman Publishes Recent Trends and Patterns in the Enforcement of the FCPA

On 2 January 2019, Shearman & Sterling published its biannual *FCPA Digest: Recent Trends and Patterns in the Enforcement of the Foreign Corrupt Practices Act*, which provides insightful analysis of recent enforcement trends and patterns in the United States, the U.K. and elsewhere, as well as helpful guidance on emerging best practices in Foreign Corrupt Practices Act (**FCPA**) and global anti-corruption compliance programs.

This publication is an invaluable compendium of all FCPA-related developments in 2018, including U.S. foreign bribery proceedings and criminal prosecutions, U.S. Department of Justice (**DOJ**) foreign bribery civil actions, SEC actions, DOJ policy, ongoing FCPA investigations, pre-FCPA prosecutions and parallel litigation related to the FCPA.

As is further detailed in the FCPA Enforcement Report, among the highlights from 2018 were:

- Seventeen corporate enforcement actions, with total sanctions of approximately $2.9 billion, make 2018 a fairly typical year in terms of level of FCPA enforcement activity. Although only four more enforcement actions were brought in 2018 than in 2017, the total assessed sanctions were nearly $900 million higher than in 2017, making the penalties assessed in 2018 the second-highest of any year.
- As in recent years, three outlier enforcement actions (Petrobras, Société Générale and PAC) greatly distort the picture, raising the average corporate sanction for 2018 to $171.1 million, whereas the average with outliers excluded is significantly less than this figure ($18.3 million). This type of difference between the true average and average excluding outliers is typical: in 2017 the true average was $151.2 million while the average excluding outliers was $83.3 million, and in 2016 the true average was $223.4 million while the average excluding outliers was $13.2 million.
- The median sanction of $9.2 million is down from recent years ($29.2 million in 2017, $14.4 million in 2016 and $13.4 million in 2015).
- The Second Circuit's decision in *Hoskins* has the potential to alter the scope of FCPA prosecutions and alter the investigation process by limiting the number of defendants that are within the jurisdictional grasp of the enforcement authorities.
- The DOJ entered into its first coordinated resolution with French authorities in a foreign bribery case, possibly heralding the emergence of France as an important global anti-corruption authority.
- The DOJ continued its recent trend of updating various enforcement policies, announcing: (i) a new policy addressing situations where enforcement actions involve "piling on" of fines and penalties in matters involving multiple enforcement authorities; (ii) an updated policy on corporate monitors; and (iii) updates to the policy on cooperation credit originally set forth in the Yates Memo (see below "*Noteworthy U.S. Securities Litigation and Enforcement—U.S. Department of Justice Changes Policy on Corporate Cooperation*"). In addition, the effect of the FCPA Corporate Prosecution Policy, announced late in the previous year, was also apparent in 2018's DOJ matters.

The FCPA Digest: Recent Trends and Patterns in the Enforcement of the Foreign Corrupt Practices Act is available here.

Shearman Publishes Recent Developments and Trends for the Preparation of Form 20-F

On 11 January 2019, Shearman & Sterling published its annual *Recent Developments And Trends For The Preparation Of Form 20-F*, which provides helpful information for foreign private issuers in the preparation of their annual reports on Form 20-F.

The publication discusses recent developments and trends, as well as topics that may be areas of focus of the SEC Staff in reviewing Form 20-Fs and other disclosures.

Our publication is available here.

Noteworthy US Securities Litigation and Enforcement

US Department of Justice Changes Policy on Corporate Cooperation

The DOJ recently made a significant change to its policy regarding corporate cooperation. Since 2015, that policy has been governed by a memo titled "Individual Accountability for Corporate Wrongdoing" — popularly known as the "Yates Memo" — which stated that "[t]o be eligible for any cooperation credit, corporations must provide to the Department all relevant facts about the individuals involved in corporate misconduct." This policy was incorporated into the United States Attorney's Manual, which guides DOJ investigations.

On 29 November 2018, Deputy Attorney General Rod Rosenstein announced revisions to the Yates Memo policy. Under the revised policy, companies are only required to identify all individuals who were *substantially* involved in a potential crime in order to receive cooperation credit in criminal investigations. This is a significant change to the Yates Memo policy, which required companies to provide information on *all* individuals who were involved in potential misconduct, no matter how insubstantial their role.

In explaining the DOJ's policy shift, Mr. Rosenstein indicated a desire to focus on individuals who play "significant roles in setting a company on a course of criminal conduct" and that the DOJ wants to "know who authorized the misconduct, and what they knew about it." Mr. Rosenstein acknowledged that it is not practical to require a company to identify every employee who played any role in alleged illegal schemes that encompass otherwise routine activities of numerous employees, particularly when the government and company want to resolve the matter, but disagree over the scope of misconduct.

Under the revised Yates Memo policy, companies can now determine which individuals were substantially involved in wrongdoing, rather than providing the DOJ with information on every individual involved, no matter the level of involvement (although, of course, the government will have to agree with where the company draws the line on which employees were "substantially" involved). That being said, the policy shift may not impact the scope of internal investigations conducted by companies in response to government investigations, as there are still ample incentives for the company to understand the full breadth and scope of alleged misconduct. Indeed, a full understanding of the scope and facts underpinning potential misconduct will likely be necessary to effectively determine which individuals were "substantially" involved and which individuals were not. Furthermore, the revised Yates Memo policy conflicts with the FCPA Corporate Enforcement Policy, which still requires the disclosure of "all relevant facts about all individuals involved." As FCPA investigations are often among the most sprawling and expensive of white collar investigations, this conflict will likely be a discussion point between the defense bar and the DOJ in the context of ongoing FCPA investigations.

US Supreme Court Considers Relationship Between Scheme Liability and False Statement Liability Under Federal Securities Laws

On 3 December 2018, the U.S. Supreme Court heard argument in *Lorenzo v. SEC*. The case is an appeal of the D.C. Circuit's ruling that a person who does not make the alleged false statement can still be primarily liable for securities fraud.

Lorenzo, the petitioner, sent an email to investors containing misrepresentations about key features of a securities offering. There is no dispute that the emails contained false or misleading statements, and that Lorenzo possessed the requisite intent. The relevant portions of the email, however, were drafted by Lorenzo's boss. Lorenzo merely passed along his boss' statements at his direction. That said, Lorenzo also compiled the email, sent it out on behalf of the investment banking division (of which he was the head), and personally offered to answer any follow-up questions about it.

In his brief before the Court, Lorenzo proposes that the federal securities laws prohibit two distinct categories of fraudulent conduct. First, SEC Rule 10b-5(b), as well as Section 17(a)(2) of the Securities Act prohibit the making of a false statement. Second, SEC Rules 10b-5(a) and (c) and Section 17(a)(1) and (3) of the Securities Act proscribe operating a "device, scheme" or "course of business that would operate as a fraud." The parties agree that Lorenzo cannot be liable under Rule 10b-5(b) and Section 17(a)(2) because he did not "make" the false statement as that term has been defined by the Court in an earlier decision (*Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011)). At issue is whether Lorenzo nonetheless can be found liable for having engaged in fraudulent misconduct.

In the *Lorenzo* decision below, the D.C. Circuit affirmed a finding of liability with respect to Rule 10b-5(a) and (c). The D.C. Circuit agreed with the decision below that Lorenzo's "active role in producing and sending the emails" constituted being "engaged in a fraudulent act [or] employ[ing] a fraudulent device" for purposes of liability" under Rules 10b-5(a) and (c) and Section 17(a)(1). Further, the D.C. Circuit found that the three components of Rule 10b-5 are not mutually exclusive. Instead, they "may overlap in certain respects." For this reason the D.C. Circuit concluded that there is nothing incongruous in finding that Lorenzo did not "make" any false statements under Rule 10b-5(b), but nonetheless engaged in the fraudulent act of preparing and disseminating statements under Rules 10b-5(a) and (c).

Lorenzo's brief before the Court argues that finding Lorenzo liable for the ministerial conduct of facilitating the preparation of others' statements would undo the Court's *Janus* decision and swallow the bright-line test between primary and secondary liability. The government responds that Lorenzo is impermissibly seeking to re-litigate the facts of the case, and that *Janus* never suggests that fraudulent conduct could not involve misstatements even in the absence of liability for making those misstatements. As to primary and secondary liability, the government argues that Lorenzo's conduct is a primary violation, so that distinction is not implicated here.

At oral argument before the Court, the Justices focused heavily on the extent of Lorenzo's conduct as distinguished from the mechanical making of the statements. Lorenzo's counsel highlighted his position that "sending the email does not rise to the level of using or employing a fraudulent device." Justice Alito, as well as the four dissenting justices in *Janus*, expressed doubt as to this view — Justice Alito went so far as to state that Lorenzo "did the act that is described in [Rule 10(b)-5(c)]." Similarly, Justice Kagan suggested that Section 10(b) is a "belt-and-suspenders statute" where there is clear overlap between one section and the other, implying that scheme liability could be found. Justice Gorsuch articulated an opposite view, noting that if "the only false act, the only *actus reus*, was a statement, and he didn't make it, then what?" A decision is expected in the Spring 2019 term.

The US Supreme Court Will Analyse Mental State Standard for Claims Alleging Misstatements in Connection with Tender Offers

On 4 January 2019, the U.S. Supreme Court agreed to consider whether negligence or scienter is the appropriate mental state standard for misstatements or omissions made in connection with a tender offer. The case is *Emulex Corp. v. Varjabedian*. The decision from the Ninth Circuit below held, in express conflict with five other circuit court decisions, that mere negligence suffices to support a private right of action arising under Section 14(e) of the Exchange Act. The Second, Third, Fifth, Sixth and Eleventh Circuits have held that 14(e) claims require a higher showing of scienter, or intent to defraud.

The Ninth Circuit's decision stems from the 2015 acquisition of Emulex by Avago Technologies Wireless Manufacturing pursuant to an all-cash tender offer. After the closing, investors filed a class action alleging that Emulex had failed to disclose in its recommendation statement on Schedule 14D-9 one of six financial analyses performed by Emulex's financial advisor in delivering its fairness opinion to the Emulex board. The omitted analysis found that the merger premium was fair and within the normal range, but fell below the average for comparable transactions in the industry. After private plaintiffs brought putative class action claims arising under Section 14(e), the district court dismissed the complaint for failure to adequately plead a strong inference of scienter.

On appeal, a Ninth Circuit panel reversed the dismissal and remanded for reconsideration under a negligence standard. The Ninth Circuit noted that Section 14(e) prohibits (1) making untrue statements or omissions of material fact, or (2) engaging in fraudulent or deceptive acts. By focusing on the use of the word "or," the court found that the two components of Section 14(e) created two different offenses. Because the former does not contain the words "fraudulent," "deceptive," or "manipulative," which have been held to support a scienter standard, the Ninth Circuit concluded that misstatement liability could be proven based upon a showing of mere negligence.

The five other circuits that have considered this issue have held that claims under Section 14(e) require a finding of scienter because of its "shared text" with SEC Rule 10b-5 (the primary basis for federal securities fraud liability, which has a well-established scienter requirement. As the petition notes, because words are known by the company they keep (*Yates v. U.S.*, 135 S. Ct. 1074, 1085 (2015)), it makes sense to read meaning into words like "deceptive" and "manipulative" by applying them to the entire statute, not reading them out because of the word "or." The Ninth Circuit rejected this rationale and found that standards of Rule 10b-5 do not apply to Section 14(e) because one is an SEC rule, and the other is a statute.

The Ninth Circuit's decision is an outlier and, if left undisturbed, would make Ninth Circuit lower courts a magnet for this type of litigation. While the Court could limit its decision to the narrow issue of scienter versus negligence for 14(e) claims, it also could use *Emulex* as a vehicle to opine on the standards for Section 14 claims as a whole (which also include claims based on false statements in proxy solicitations). Indeed, an amicus brief filed in support of the petitioner by the U.S. Chamber of Commerce argues that the Court should address the threshold issue of whether a private right of action exists under Section 14 at all (despite the fact that many lower courts have found that it does). Briefs will be filed in *Emulex* in the coming months, and oral argument likely will be held in Spring 2019.

SEC Enforcement Releases Its Annual Report

On 2 November 2018, the Division of Enforcement of the SEC released its annual report setting forth enforcement-related statistics and its key initiatives. The report covers the fiscal year ended 30 September 2018.

Notably, on the statistics side, the annual number of SEC enforcement actions increased by approximately 9 percent (from 754 actions in FY 2017 to 821 actions in FY 2018). Of those actions, 490 were "stand alone" actions brought in federal court or as administrative proceedings, 210 were follow-on proceedings seeking bars and suspensions based on the outcome of other actions and 121 were proceedings to deregister public companies — typically microcap issuers — that were delinquent in their regulatory filings. The penalties imposed by the SEC increased by approximately 73 percent (from $832 million in FY 2017 to $1.439 billion in FY 2018), but the disgorgement of profits declined by approximately 15 percent (from $2.957 billion in FY 2017 to $2.506 billion in FY 2018). The Report notes that a decision by the U.S. Supreme Court in 2017 holding that SEC claims for disgorgement are subject to a five-year statute of limitations "continues to have a significant effect on the Commission's efforts to obtain disgorgement."

As to the 490 "stand alone" actions brought by the SEC in FY 2018, it has increased the number of actions related to securities offerings (25%), investment advisor issues (22%), broker-dealer misconduct (13%) and insider trading (10%). While the number of actions related to issuer reporting (16%) and market manipulation (7%) remain significant, their numbers decreased from FY 2017. A large majority of the 490 "stand alone" actions (72%) involved charges against one or more individuals. The report points out that these individuals "include senior officers at prominent issuers and other public figures, including the CEOs of Tesla Inc. and

Theranos Inc., the former CEO of Seaworld Entertainment Inc., a U.S. Congressman, the former CEOs and CFOs of Walgreens Boots Alliance Inc. and Rio Tinto p.l.c., and a professional football player."

In terms of the key enforcement initiatives, the report describes three areas: protecting retail investors, combating cyber threats and misconduct between investment professionals and clients. During FY 2018, the SEC formed a Retail Strategy Task Force that uses data analytics to generate leads for enforcement actions. The report states that this lead generation is focused on disclosures concerning fees and expenses and conflicts of interest for managed accounts, market manipulations, fraud involving unregistered offerings and trading suspensions related to companies that purport to be in the cryptocurrency and distributed ledger technology space. The report also details increased activity by the Cyber Unit. In FY 2018, the SEC brought 20 stand-alone cases involving cyber-related misconduct (including initial coin offerings, digital assets and the disclosure of cyber-related risks and incidents) and by the end of the year had more than 225 ongoing cyber-related investigations. Finally, the SEC has formed a Share Class Selection Disclosure Initiative to address disclosure failures relating to marketing and distribution fees paid by investment advisory clients. The Initiative is a voluntary program for investment advisers to self-report to the SEC their failures to disclose their financial conflicts of interest relating to compensation they received via fees.

Snap Securities Class Action Leads to Government Subpoenas

While an investigation by the SEC or the DOJ often can lead to private securities litigation, sometimes it happens the other way around. In May 2017, Snap, Inc. (the social media company that runs Snapchat), was sued by its investors in a securities class action alleging that its pre-IPO disclosures failed to accurately disclose its reported user growth, including the competitive impact of Instagram. In June 2018, the court denied the motion to dismiss and the case is in discovery.

In November 2018, the U.S. government made a sealed filing in the securities class action. In response to press inquiries about the filing, Snap revealed that it has received subpoenas from the SEC and DOJ (along with other information requests) that related to the same subject matter as the litigation. Snap also stated that it has responded to these subpoenas and intends to continue cooperating with the government. The private plaintiffs will be pleased to have this potential affirmation of their theory of securities law violations.

Aveo CFO Found Liable for Securities Fraud for Failing to Tell Investors about Regulatory Developments

In a closely-watched trial, the former CFO of Aveo Pharmaceuticals has been found liable for federal securities fraud. On 20 November 2018, a jury in the U.S. District Court for Massachusetts found that David Johnston failed to adequately disclose the company's interactions with the Food and Drug Administration (**FDA**) over a kidney-cancer drug, called tivozanib. Aveo began clinical trials of tivozanib in 2010 and met with the FDA in May 2012 to discuss those trial results ahead of seeking FDA approval of the drug. In those meetings, the FDA expressed concerns about survival rates of patients on tivozanib and recommended that Aveo undertake a second clinical trial of the drug, but in subsequent public disclosures the company did not disclose that another trial could be necessary.

In 2016, the SEC brought a civil action against Aveo and certain of its executives. Aveo and the other executives settled the matter, leaving Johnston as the only defendant to go to trial. At his trial, Johnston argued that as the CFO, he relied upon the company's internal processes and advisors in deciding what to disclose about the FDA interactions. The advisors included in-house and external lawyers who allegedly approved the omission of the FDA's recommendation for a second trial. These communications with the company's attorneys were privileged, however, and the privilege was held by the company. As a result, the jury did not hear any testimony concerning the advice the attorneys provided, and the SEC questioned whether Johnston had provided the attorneys with sufficient information about the FDA interactions. In the end, Johnston was found liable after only four hours of jury deliberation.

The Aveo/Johnston case illustrates (a) the aggressiveness of the SEC in bringing disclosure actions, including against corporate executives who do not have any particular expertise in the subject matter being disclosed, and (b) the importance of well-documented corporate disclosure procedures.

EU DEVELOPMENTS

European Commission Work Programme 2019: Corporate Aspects

On 24 October 2018, the European Commission published its 2019 Work Programme.

The programme covers the repeal of the remaining provisions of the Consolidated Admissions and Reporting Directive, along with further details of the Commission's intention to carry out checks of corporate reporting and evaluate corporate reporting requirements. The programme also includes information about the Commission's position on pending proposals.

The European Commission Work Programme can be accessed here.

MAR: ESMA Updated Q&A (October and November 2018)

October

On 1 October 2018, the European Securities and Markets Authority (**ESMA**) published its twelfth edition of its EU Market Abuse Regulation (**MAR**) Q&A. This edition featured the addition of three new questions and the responses (5.3, 5.4, and 5.5) clarifying the position of an issuer who is either a credit or financial institution and is considering delaying the disclosure of inside information to preserve financial stability as permitted under Article 17(5) MAR.

The new questions and responses are:

- Question 5.3, which clarifies the factors the issuer should consider when evaluating whether the conditions listed in Article 17(5) apply and therefore enable the issuer to delay disclosure.
- Question 5.4, which confirms that the issuer must notify the NCA of the expected duration of the delay under Article 17(5). The issuer must inform the NCA if it becomes aware of an event or issue which may affect the duration of the delay.
- Question 5.5, which confirms that an issuer will not be able to rely on Article 17(4) to delay disclosure where the NCA does not provide its consent under Article 17(5) to delay disclosure of inside information.

November

On 12 November 2018, ESMA published the thirteenth edition of its MAR Q&A.

The main highlight was the introduction of question 7.10, which discusses whether the restriction in Article 19(11) MAR, preventing PDMRs from trading in a closed period, applies to transactions of the issuer relating to its own financial instruments where it is the PDMR who makes the decision or implements a previous decision with respect to the issuer's "own dealing."

In its answer, ESMA explains that the restriction in Article 19(11) MAR does not prohibit the above issuer transactions as the PDMRs are implementing the transaction in their capacity as directors or employees for the issuer. The transactions are not for the benefit of a third party as Article 19(11) specifies but technically actions of the issuer itself. Article 19(11) MAR does not prohibit the issuer itself from conducting these transactions but the PDMRs within the issuer.

It should be noted that the PDMR implementing a decision on behalf of the issuer remains subject to the restrictions of insider dealing and must therefore proceed with caution.

The MAR Q&As can be accessed here.

ESMA's First Annual Report on Administrative and Criminal Sanctions and Other Administrative Measures under MAR

On 15 November 2018, ESMA published its first annual report on administrative and criminal sanctions imposed by member state authorities under MAR. The report details the number of criminal or administrative sanctions imposed from 3 July 2016 to 31 December 2017 and can be accessed here.

European Company and Securities Law: Commission Communication on the Single Market (Corporate Aspects)

On 22 November 2018, the European Commission published a communication on the Single Market calling on the Council of the European Union to adopt certain legislative proposals (including relating to the Prospectus Regulation (EU) 2017/1129 ("**Prospectus Regulation**") and promotion of SME growth markets). The European Commission also directed member states to vigilantly implement and enforce EU rules in order to maintain and maximise the economic benefits of the Single Market (which it estimates to amount to about 8.5% of the EU's gross domestic product).

The European Commission communication can be accessed here.

European Commission Publishes Communication on Capital Markets Union

On 28 November 2018, the European Commission published a communication on the Capital Markets Union marking the achievements of the Union thus far and listing unimplemented legislative proposals. These include proposals relating to promoting SME growth markets, cross-border distribution of collective investment funds and sustainable finance.

The European Commission called on the European Parliament and the Council to adopt the pending proposals before the European Parliament elections in May 2019.

The European Commission communication can be accessed here.

European Commission Publishes Final Draft Commission Delegated Regulation on the Specification of a Single Electronic Reporting Format

On 17 December 2018, the European Commission published a final draft text of its delegated regulation with regard to regulatory technical standards on the specification of a single reporting format. From 1 January 2020, the Transparency Directive requires all annual financial reports to be prepared in the eXtensible HyperText Markup Language, or XHTML, format (for the human-readable representation of financial reports) and eXtensible Business Reporting Language, or XBRL, format for machine-readable reports.

The regulation will enter into force on the twentieth day of its publication in the Official Journal and can be accessed here.

UK DEVELOPMENTS

Brexit Legislation

As the U.K. prepares to leave the EU — with or without a "deal" — at 11 pm on 29 March 2019, the U.K. Government has published a whole raft of draft secondary legislation to onshore EU legislation. The draft U.K. legislation is designed largely to ensure that, as required by the U.K.'s European Union (Withdrawal) Act 2018, there will be no deficiencies or problems with respect to the effective "onshoring" of existing EU law into U.K. domestic law with effect from 29 March 2019 (if there is a "no deal Brexit") or the end of any "transition period" that is agreed in the withdrawal agreement as part of a Brexit deal. The draft legislation corrects a limited range of deficiencies in directly applicable EU Regulations that will be retained on exit and in the existing U.K. law that implements the requirements of EU Directives.

Of particular interest to the readership of this newsletter will be the draft legislation published in the area of securities and financial services regulation. This draft legislation includes, for example, legislation addressing deficiencies in the way in which the provisions of the Prospectus Directive, Transparency Directive, Market Abuse Regulation, public takeover regulation under the U.K. Takeover Code, Accounts Directive, European Company Statute, AIFM Directive, MiFID II, EMIR, Benchmarks Regulation and Securitisation Regulation, etc., would apply in U.K. domestic law after Brexit.

In most, if not all cases, the draft legislation is not intended to introduce into any policy changes, other than to reflect the U.K.'s new position outside the EU and to help smooth the U.K.'s transition to fully leaving the EU. However, necessarily, there are various decision points that U.K. legislators have needed to take in relation to territorial scope and third-country issues as well as future relationships.

Once there is greater clarity and certainty about the exact timing and legal basis of Brexit, we may, as appropriate, issue an update and further summary of key aspects of certain of this Brexit legislation.

CMA Launches Market Study into Statutory Audit Market

On 9 October 2018, the Competition and Markets Authority (**CMA**) launched a market study into the statutory audit market.

The study will explore the following main themes:

- Choice and switching — despite changes introduced by the Competition Commission to strengthen the competition between the Big Four, the largest U.K. companies still turn almost exclusively to one of them when making their choice of auditor.
- Resilience — commentators have raised concerns around whether each of the Big Four is 'too big to fail,' potentially threatening long-term competition if any of the Big Four were to exit the audit market.
- Incentives — as companies choose their own auditors, the market study will explore what incentive issues are raised. In particular, it will consider the range of incentives for all stakeholders in the market, and how this affects competition.

The CMA notes that these themes are essential in achieving its overall objective of ensuring delivery of high-quality audits, at competitive prices.

The CMA press release can be accessed here.

The market study notice can be accessed here.

The invitation to comment can be accessed here.

BEIS Committee Launches Inquiry on the Future Of Audit

On 12 November 2018, the Department for Business, Energy and Industrial Strategy Committee (the "**BEIS Committee**") launched an inquiry into the future of audit, focusing on the likely impacts of the market study launched by the CMA (see above) and the Kingman review (further details of which are addressed below).

In particular, the BEIS Committee is inviting evidence on the following areas:

- The relationship between competition and quality in the audit market and how reforms in one area should complement the other.
- Whether there is agreement with the CMA and Kingman proposals, whether the remedies proposed by the CMA are likely to increase quality and trust in audits and whether there are any potential unintended consequences.
- The extent to which conflicts of interest undermine trust in audits and how they can be removed or mitigated.
- The importance of the relationship between the auditor and audited company to the quality of audit, how to ensure there is the right level of challenge and the role of shareholders in ensuring high-quality audits.
- Whether there is consistency between the proposed audit reforms and other recent reforms of corporate governance and whether any consequential reforms are required.

The deadline for written submissions is 11 January 2019 and the inquiry announcement can be accessed here.

FRC Publishes Final Report of the Kingman Review (Corporate Aspects)

On 18 December 2018, the Department for Business, Energy and Industrial Strategy ("**BEIS**") published the final report of the Kingman review. The review considers how to strengthen the position and reputation of the Financial Reporting Council (**FRC**) and ensure that its structures, culture and capacity are fit for the future.

The review proposed a number of recommendations, including:

- The swift replacement of the FRC with a new independent regulator, the Audit, Reporting and Governance Authority (**ARGA**), which would be directly accountable to Parliament and whose overarching duty is to 'consumers of financial information,' not producers.
- Developing ARGA's capabilities to enable it to identify and mitigate emerging risks.
- An end to the current self-regulatory model for the largest audit firms.
- A Government review of the U.K.'s definition of a 'public interest entity' (**PIE**), which only covers entities with transferable securities admitted to trading in the European Economic Area (**EEA**). At present, only PIEs are bound by caps on the provision of non-audit work by audit firms.
- ARGA should not be funded on a voluntary basis and BEIS should put in place a statutory levy.
- BEIS should closely monitor the speed and effectiveness of ARGA's performance and ARGA should report annually to Parliament on its enforcement performance.
- In relation to the Stewardship Code, a renewed focus on 'excellence in stewardship' with greater emphasis on outcomes and effectiveness, not policy statements. The review further suggested that serious consideration should be given to abolishing the Stewardship Code if it remains a 'driver of boilerplate reporting.'

The Kingman review can be accessed here.

CMA Publishes Update Paper on Statutory Audit Proposed Reforms to Improve Competition

On 18 December 2018, the CMA published an update paper outlining issues and proposed legislative reforms to stimulate competition and improve audit quality.

The CMA identified a number of issues with the current audit landscape, including:

- Companies choosing auditors with whom they have 'chemistry' rather than those that provide appropriate scrutiny.
- Limited choice, with the Big Four audit firms conducting 97% of the audits of the biggest companies.
- With at least 75% of the revenue of the Big Four coming from non-audit services, auditors' focus appears skewed.

In response to these issues, the CMA proposes to:

- Separate audit from consulting services, either through a structural separation (that is, prohibition of certain firms from providing non-audit services) or an operational split (e.g. the audit business has separate board, chief executive, staff and assets).
- Introduce measures to ensure that audit committees are more accountable and are independent enough to choose the most challenging firms, rather than the cheapest.
- Impose a 'joint audit' regime, which would require two firms (one of which must be a non-Big Four firm) to sign off on the accounts of the audit client.

The CMA invites comments on the update paper by 21 January 2019 and the update paper can be accessed here.

BEIS Announces Independent Review of UK Audit Standards

On 18 December 2018, BEIS announced an independent review into the quality and effectiveness of the U.K. audit market, which will build on the CMA's market study and the findings of the Kingman review.

Although detailed terms of reference and a project plan are expected in 2019, it is anticipated that the review will consider:

- How the current model can be made more efficient, taking into account changing business models and new technology.
- How far audit can and should evolve to meet the needs of investors and other stakeholders.
- How to manage any residual gap between what an audit can and should deliver.
- How auditors verify the efficacy of the information they are signing off.
- Public expectations from audit.

The BEIS announcement can be accessed here.

FCA Publishes Discussion Paper on the Disclosure of Climate Change Risks by Listed Companies

On 15 October 2018, the Financial Conduct Authority (**FCA**) published a discussion paper proposing changes to the disclosure of climate change risks by listed companies. It noted that these changes were likely to become even more significant as the U.K. continues to comply with the Paris Agreement.

The discussion paper sets out:

- How the different impacts of climate change could impact the FCA's long and short-term objectives.
- Some of the opportunities and risks the transition to a low-carbon economy presents in the U.K.'s financial services markets.
- The specific action the FCA will take in the near term to ensure that markets function well and deliver good outcomes for consumers.

The FCA invites comments on the discussion paper by 31 January 2019, and the discussion paper can be accessed here.

FRC Publishes Review of Corporate Governance and Reporting 2017/2018

On 24 October 2018, the FRC published its annual review of corporate governance and reporting.

The review covers, among other things:

- Areas for improvement:
    - Corporate reporting — disclosure of judgments and estimates and alternative performance measures (**APMs**) were the most common areas of concern for the FRC.
    - Financial statements — the reporting of significant judgments and estimates, that companies made in the preparation of their accounts require greater attention. As these disclosures enable investors to evaluate the company's financial position, the FRC was disappointed to observe poor disclosure around the assumptions and the estimates on which assumptions were based. Additionally, the FRC identified basic errors and non-compliance in reporting, which, in its view, could have been averted by implementing appropriate pre-publication review processes.
    - Strategic reports — companies should pay particular attention to ensuring that the strategic report includes a fair, comprehensive and balanced review of the company's business and APMs are clearly presented, reconciled to International Financial Reporting Standard (**IFRS**) numbers and explained as required by the European Securities and Markets Authority's (**ESMA's**) Guidelines on APMs, which, in its view, represent best practice.
- Corporate governance and stewardship:
    - Corporate Governance Code — although high compliance with the U.K. Corporate Governance Code was reported, the FRC warned that this may signal an excessive focus on formulaic compliance. In addition, companies remain reluctant to fully explain non-compliance with the provisions of the Corporate Governance Code.
    - Stewardship Code — the FRC will be consulting on a revised U.K. Stewardship Code, the main objective of which is to raise the quality and quantity of the stewardship activities of investors, and the market expectations of signatories to the Stewardship Code.
- Risk reporting and viability statements — many companies' viability statements are not sufficiently illuminating. It noted, in particular, that although some companies have advanced their disclosure this year, many still did not explain the processes they had undertaken to prepare their statement, including the stress and scenario testing carried out.
- Non-financial reporting — the Government has introduced secondary legislation to require certain companies to make a statement under section 172 of the Companies Act 2006 (duty to promote the success of the company)

describing how the directors have had regard to the matters set out in section 172. This reflects society's growing expectation of greater accountability from company directors, their advisors and regulators. As a result, the FRC updated its Guidance on the Strategic Report (including guidance on the new section 172 statements) and revised the Corporate Governance Code, including a provision that asks boards to describe in the annual report how the matters set out in section 172 have been considered in board discussions and decision making.

- Brexit — companies are encouraged to provide disclosure that distinguishes between the specific and direct challenges to their business model from broader economic uncertainties. Where there are particular threats, these should be clearly identified and management should describe any actions being (or already) taken in mitigation. Adjustments may be made in the balance sheet of the company where necessary. While not all companies will require extensive disclosure, where sensitivity or scenario testing indicates significant issues, relevant information and explanations should be reflected in the appropriate parts of the annual report and accounts.

The FRC corporate governance and reporting review can be accessed here.

FTSE 100 Poll: Stakeholder Engagement Mechanisms and Section 172 Disclosures

On 25 October 2018, Practical Law published the results of a poll of FTSE 100 companies, summarising how the sampled companies proposed to comply with amendments introduced by the U.K. Corporate Governance Code 2018 ("**2018 Code**") and new reporting obligations under the Companies (Miscellaneous Reporting) Regulations 2018.

The poll questions related primarily to:

- The proposed requirement for workforce engagement in board discussions and decision-making.
- Engagement mechanisms with U.K. employees and suppliers, customers and other stakeholders.
- How companies will prepare the statements relating to:
  - section 172 of the Companies Act 2006;
  - how the company has engaged with U.K. employees, and how the directors have had regard to their interests; and
  - how directors have had regard to the need to foster the company's business relationships with suppliers, customers and others.

Of the 39 respondent companies, none indicated an intention to appoint a director from the workforce; indeed, 64% had yet to decide on a method of stakeholder engagement necessary to comply with the 2018 Code. Similarly, many companies had failed to indicate how they would prepare the section 172 and other statements. However, most indicated that the directors' consideration of the relevant matters would be documented in board minutes, which, for most of these companies, would mark a shift in their current policy on board minutes.

FRC Launches Project to Reconsider Purposes of Corporate Reporting

On 30 October 2018, the FRC launched a project which will review current financial and non-financial reporting practices, consider what information shareholders and other investors require, the purpose of corporate reporting and the annual report and review the extent to which the annual report serves all stakeholder needs. FRC's review will extend to new technologies by which information may be delivered, and may also have implications for audit and assurance models and performance.

The FRC press release can be accessed here.

FRC Publishes Review of Reporting by Smaller Listed and AIM Companies

On 6 November 2018, the FRC published a report aimed at encouraging better reporting by allowing users to access the quality of management's decisions.

The review covered the following topics:

- Alternative performance measures and strategic reports.
- Pension disclosures.
- Accounting policies, including critical judgments and estimates.
- Cash flow statements.
- Tax disclosures.

The FRC noted improvements across all five topics, with more significant improvements seen in the larger companies sampled. However, it also found that there was scope for further improvements; for instance, many companies still failed to use their strategic reports to provide a sufficiently comprehensive analysis of their accounts.

The FRC report can be accessed here.

UK Government Publishes Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018

On 9 November 2018, the Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018 were published to require additional reporting on emissions, energy consumption and energy efficiency action by quoted companies (that is, companies whose shares have been included in the Official List, or are officially listed in an EEA state, or are admitted to dealing on either the New York Stock Exchange or Nasdaq), large unquoted companies and large LLPs.

As a result, the following additional disclosures will be required in directors' reports:

- Quoted companies will be required to disclose energy use from activities for which the company is responsible and from purchases of electricity, heat, steam or cooling for its own use. They must also describe the principal measures (if any) taken to increase its energy efficiency.
- Large unquoted companies will be required to disclose greenhouse gas emissions (as quoted companies already are), energy use from activities for which the company is responsible and action taken to increase energy efficiency.

Large LLPs will be required to prepare an annual energy and carbon report. If the LLP is a parent LLP and prepares group accounts, the energy and carbon report must be a consolidated (group) report.

There are exemptions from these disclosure requirements if making the statements would be seriously prejudicial to the interests of the company or LLP or if the company or LLP has used a small amount of energy (40,000 kilowatt hours or less) in the relevant financial year.

The regulations will come into force on 1 April 2019 and have effect in respect of financial years beginning on or after 1 April 2019. They can be accessed here.

Hampton-Alexander Publishes Third Annual Report on Improving Gender Balance in FTSE Leadership

On 13 November 2018, Hampton-Alexander published its third annual report on improving gender balance in FTSE leadership, assessing the progress that has been made since its predecessor, the Davies Review, and outlining best practices and current challenges.

The review includes a target of 33% representation of women on FTSE 350 boards and FTSE 350 Executive Committees and their direct reports by the end of 2020. The report concludes that, assuming progress continues at the current rate, the FTSE 100 is 'on track' to achieve the 33% target for women on boards by 2020. However, substantial improvements are still required in other areas of appointments, such as to non-FTSE 100 boards and combined executive committee and direct reports.

The report highlights the following key findings:

- Executive committee and direct reports:
  - FTSE 100 — there was an increase in the number of women on the combined executive committee and direct reports to 27%, up from 25.2% in 2017; however, the appointment rate still remained heavily skewed with around 65% of all newly available roles going to men. In addition, 40 FTSE 100 companies had already met the 33% representation target (or were well on their way to do so by 2020).
  - FTSE 250 — the number of women on the combined executive committee and direct reports increased slightly to 24.9%, up from 24% in 2017. Again, the appointment rate was male-dominated with 78% and 69% of appointments to executive committee and direct reports, respectively, being of men. Around 70 companies (including the 40 FTSE 100 companies mentioned above) had already met the 33% target.
- Women on boards:
  - FTSE 100 — women now make up 30.2% of FTSE 100 board members, up from 22.8% in 2017.
  - FTSE 250 — there has also been an increase of female representation on FTSE 250 boards with women now making up 24.9%, up from 22.8% in 2017.

The report can be accessed here.

Glass Lewis Publishes 2019 UK Proxy Guidelines

On 14 November 2018, Glass Lewis published its 2019 proxy guidelines. Some of the key revisions to its 2018 guidelines are as follows:

- Board skills and diversity — FTSE 100 companies should provide meaningful disclosure in line with developing best practice standards. For instance, in accordance with U.K. best practice, FTSE 350 companies should strive for 33% female board representation by 2020.
- Board and committee responsiveness — where at least 20% of shareholders vote contrary to the board's recommendation, the board should demonstrate some level of responsiveness to address shareholder concerns. Glass Lewis notes that, while the 20% threshold alone will not automatically generate a negative recommendation on a future proposal (e.g. against a director nominee), in certain circumstances, committee chairs and members should be held accountable for a failure to adequately address shareholder dissent via a recommendation against their re-election where the response to shareholder concerns has fallen below a qualitative threshold.
- Environmental and social risk oversight — in instances where it is clear a company has not properly managed or mitigated environmental or social risks to the detriment of shareholder value or when such mismanagement has threatened shareholder value, the guidelines recommend voting against the directors responsible for the oversight of environmental and social risks.

- Executive remuneration: realised pay — Glass Lewis will specifically assess the realised pay received by a company's top executives over at least three years when evaluating the link between pay and company performance.

The guidelines also encourage companies to disclose pay ratios between the CEO and medial or average U.K. employees, accompanied by a description of the methodology of the calculation. Pay ratio reporting obligations came into effect on 1 January 2019, and eligible companies will have to start reporting pay ratios in 2020.

The proxy guidelines can be accessed here.

ISS Publishes 2019 Proxy Voting Guidelines Updates

On 19 November 2018, International Shareholder Services (**ISS**) issued updates to its current U.K. proxy voting guidelines. The revised guidelines introduce changes to, among others:

- Appointment of external auditors — ISS recommends approving external auditors' appointment unless there are serious concerns about the effectiveness of the auditors, or current auditors are being replaced without explanation or the lead audit partner(s) has been linked with a significant auditing controversy.
- Director elections — voting against individual directors for 'egregious actions' related to the director(s)' service on other boards. It also recommends voting against director re-elections where there have been repeated absences (defined as less than 75 percent attendance) at meetings that have not been suitably explained.
- Remuneration policy — target bonuses should typically be no more than 50 percent of the maximum bonus potential, with any payout exceeding this limit to be supported by a robust explanation.
- Remuneration report — where there is a material decline in a company's share price, remuneration committees should consider reducing the size of long-term incentive plans (**LTIP**) awards at the time of grant and fees payable to non-executive directors (**NEDs**) should not be excessive relative to similarly-sized companies in the same sector.
- Approval of a new or amended LTIP — shareholders are advised to pay particular attention to dilution limits and, in particular, should ensure that any such limits are in line with the guidelines established by the Investment Association (**IA**).
- Social and environmental issues — consider whether there are significant controversies, fines, penalties or litigation associated with the company's environmental or social practices.
- Stock (scrip) dividend alternative — ISS recommends voting on a case-by-case basis on stock (scrip) dividend proposals, taking into account whether the proposal allows for a cash option and if the proposal is in line with market standards.

The proxy voting guidelines can be accessed here.

Investment Association Publishes Principles of Remuneration for 2019

On 22 November 2018, the IA published its principles of remuneration for 2019 against the backdrop of the 2018 Code. The IA noted that its members were frustrated that some companies were not responding to their shareholders' views in relation to their remuneration policies.

In response, the IA issued revised principles of remuneration, including in respect of:

- Performance adjustments and clawbacks — remuneration structures should include specified circumstances in which the company is allowed to make performance adjustments (i.e. the company forfeits all or part of an incentive award before it has been vested and paid) and/or initiate clawbacks before awards are made. The new principles require remuneration committees to consider the most appropriate trigger events on a case-by-case basis.

- Shareholding requirements and post-employment holding periods — the principles have been updated to outline which shares can count towards the shareholding guidelines and the expectation of investors on post-employment holding periods.
- Pensions — the 2018 Code states that only basic salary should be pensionable and pension contribution rates for executive directors, or payments in lieu, should be aligned with those available to the workforce. Investors expect new executive directors and directors changing roles to be appointed on this pension contribution level. The pension contributions for current executive directors should be reduced over time to equal the rate received by the majority of the workforce.
- Restricted shares — the principles provide an update on investor expectations for those companies seeking to introduce a restricted share scheme. A majority of members are willing to consider the introduction of restricted shares. In considering whether to support the introduction of a restricted share scheme, investors will compare the previous pay-out levels to historic company performance and reflect on the level of trust they have with the remuneration committee when assessing any proposals.
- Leaver provisions — the principles have been updated to reflect member expectations and current best practice, for instance, where individuals opt to terminate their employment or they are considered a "bad leaver", any unvested options or conditional share-based award should normally lapse.

The principles of remuneration can be accessed here.

LSE Issues Public Censure and Fine for Breaches of AIM Rules 11 and 31

On 7 December 2018, the London Stock Exchange (**LSE**) publicly censured and fined Bushveld Minerals Limited ("**Bushveld**") £700,000. The fine was subsequently discounted to £490,000 for early settlement. Bushveld, a mineral development company, was considering a reverse takeover pursuant to AIM Rule 14 and had agreed to pay an exclusivity fee (subject to a solicitor's undertaking) that, in the context of its financial position, constituted a material sum.

The LSE found that the Bushveld had breached the AIM Rules, in particular:

- AIM Rule 11, by failing to comply with its disclosure obligations to notify information without delay when the undertaking was given. The giving of the undertaking created binding obligations in respect of the exclusivity fee, which was a new development requiring disclosure without delay; and
- AIM Rule 31, by failing to provide its nominated adviser with information in relation to the undertaking, in circumstances where Bushveld knew or ought to have known that this was information that the nominated adviser had reasonably requested and required in order to fulfil its obligations to the LSE.

The LSE statement can be accessed here.

GC100 and Investor Group Publish Updated Directors' Remuneration Reporting Guidance

On 10 December 2018, updated Directors' Remuneration Reporting Guidance was published by the GC100 and Investor Group.

The main updates, which largely reflected the additional requirements introduced by the Companies (Miscellaneous Reporting) Requirements 2018, include:

- The requirement for companies to provide a summary of any discretion exercised in the award of directors' remuneration within the committee chair's annual statement.
- Guidance on the new requirement for companies to disclose the proportion of the remuneration that has been apportioned to share price appreciation and whether discretion has been exercised as a result of fluctuations in the share price value.
- Guidance for companies that are required to disclose pay ratio tables on how to prepare consistent reports, structure information and how to calculate required statistics.
- Guidance on the requirement for companies to disclose, in their remuneration policies, an estimation of maximum director remuneration with share price appreciation at 50% in one financial year.

The GC100 and Investor Group's Directors' Remuneration Reporting Guidance 2018 can be found here.

FRC Publishes Final Wales Corporate Governance Principles for Large Private Companies

On 10 December 2018, the FRC published the final Wates Corporate Governance Principles for Large Private Companies. In publishing the six principles, the FRC is aiming to assist companies in complying with the Companies (Miscellaneous Reporting) Regulations 2018.

The six principles covered in the guidance report are:

- Principle one — Purpose and leadership: this principle aims to encourage companies to have a well-defined purpose, which should be promoted by the board and support the company's long-term success. A company's purpose should reflect the values of a company and establish expected behaviours and practices which should help create an effective culture within the workplace.
- Principle two — Board composition: this principle aims to ensure companies have a diversified board composition, led by an effective chair that facilitates meaningful discussion. The size of the board should reflect the size and nature of the company comparatively.
- Principle three — Director responsibilities: this principle aims to encourage companies to create and sustain a strong sense of director accountability to help nurture an effective culture of stewardship and leadership within an organisation. Maintaining strong corporate governance practices and transparent polices will help solidify the relationship between the company's directors and owners.
- Principle four — Opportunity and risk: this principle aims to encourage companies to plan for long-term growth by finding the equilibrium between preserving company value and taking educated risks where opportunities arise in the marketplace.
- Principle five — Remuneration: this principle aims to encourage companies to align executive remuneration with performance and overall achievement of the company, as well as reflecting remuneration levels across the whole of the organisation to ensure a shared sense of purpose and achievement is reflected by the remuneration award.
- Principle six — Stakeholder relationships and engagement: this principle aims to encourage companies' boards to focus on engagement with the wider community and the external impact its businesses. Increasing external engagement should be considered in view of developing effective relationships with key stakeholders, such as the workforce, customers and suppliers as well as specific industries or sectors the company operates in.

The Wates Corporate Governance Principles for Large Private Companies can be found here.

PERG Publishes Report on Conformity with Walker Guidelines and Updated Good Practice Reporting by Portfolio Companies

On 14 December 2018, the Private Equity Reporting Group (**PERG**) issued a report assessing the private equity sector's conformity with the Walker Guidelines (PERG's 11th Report) and providing recommendations to the British Private Equity and Venture Capital Association ("**BVCA**").

The report found, among other things, that:

- All portfolio companies sampled complied with the disclosure requirements in their annual report compared to 79% in the 2017 PERG Report.
- Of the companies reviewed, 81% and 74% published their annual reports and mid-year updates, respectively, on their websites in a timely manner (compared to 78% and 72% in 2017).
- There was a drop in non-compliance within the sample as 7% of portfolio companies (all of which were backed by non-BVCA members) had not complied with any of the components of the Walker Guidelines that applied to them compared with 12% in 2017.

The PERG report can be accessed here.

FCA Publishes Latest Review on MAR Implementation

On 17 December 2018, the FCA published issue 58 of its Market Watch newsletter. This edition focused on the industry-wide review of the implementation of the Market Abuse Regulation (EU) No 596/2014 (**MAR**) and covered the following topics:

- Compliance with MAR
  - The FCA noted that the most effective risk-assessments were arrangements and polices that had been modeled on the particular market or specific asset class relating to the company's business. The monitoring of suspicious transactions was seen as requiring further improvement by the industry in general in order to be fully compliant with MAR.
- Market soundings
  - The FCA confirmed that it had not detected any impact on the ability of an issuer to raise finance as a consequence of the market sounding regime implemented by MAR. The FCA highlighted that there remained a strong market appetite for using such protections offered by the sounding regime.
  - Where companies were implementing market sounding arrangements in the workplace, the FCA noted the benefits of appointing specific teams to decide whether a wall-crossing invitation should be accepted or not.
  - The FCA reiterated the importance of recording communications regarding market soundings, as well as encouraging companies to document their reasons for the response (such as accepting or declining a wall-crossing). Where a sounding has been declined, the FCA warned that inside information may have still been transmitted in responding to the invitation.
- Insider lists
  - The standard of insider lists is an area in which the industry needs to improve, according to the FCA's review. The use of permanent insider lists should be limited to employees who have access to inside information at all times.

Issue 58 of Market Watch can be found here.

NEX Exchange Publishes Growth Market Rules for Consultation

On 20 December 2018, NEX Exchange published for consultation proposed amendments to the NEX Exchange Growth Market Rules (the "**Rules**") in order to comply with the Markets in Financial Instruments Directive 2004/39/EC ("**MiFID II**").

The consultation paper proposes, among others that:

- Rules 10 and 75 be amended to require that admission documents or prospectuses, regulatory announcements, annual reports and information disclosed in accordance with Article 17 of MAR be publicly available for at least five years following publication. The current Rules require an issuer to maintain any such documents for at least one month following publication.
- Rule 71, which currently requires issuers to adopt a code of dealings, be amended to expressly refer to MAR and to clarify the procedures that issuers, persons discharging managerial responsibilities (**PDMRs**) and persons closely associated with PDMRs must have in place to comply with MAR. Briefly, under the proposals, such policies and procedures must:
  - identify when the issuer is in a closed period;
  - establish procedures by which the issuer will announce dealings pursuant to MAR and for maintaining insider lists;
  - set out circumstances where PDMRs and persons closely associated to them must obtain clearance to deal, the process for obtaining clearance and circumstances when clearance will be refused; and
  - establish procedures by which PDMRs, persons closely associated to them and insiders will notify the issuer and the FCA of any dealing.
- Appendix 2 be amended to require fast-track applicants from non-SME growth markets to include a prescribed statement in their admission announcements to the effect that any historic admission document referred to, and the admission announcement itself, are to be treated as the admission document for the purposes of admission, and that it has not been approved or reviewed by NEX Exchange or the FCA.

The NEX Exchange consultation paper can be accessed here.

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