

# GOVERNANCE & SECURITIES LAW FOCUS

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 July 2018.

The previous quarter’s Governance & Securities Law Focus newsletter is available [here](#).  
Financial regulatory developments are available [here](#).

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## HONG KONG DEVELOPMENTS

### Hong Kong Stock Exchange Publishes Guidance on Suitability for Continued Listing and Proposals to Tighten the Reverse Takeover Rules

On 29 June 2018, The Stock Exchange of Hong Kong Limited (**HKSE**) published a Guidance Letter (GL96-18) on listed issuer's suitability for continued listing (**Guidance Letter**) along with its Consultation Paper on Backdoor Listing, Continuing Listing Criteria and other Rule Amendments (**Consultation Paper**). The Guidance Letter and the Consultation Paper form part of the three-pronged approach of the HKSE to curb shell activities: firstly, by tightening its suitability review of new applicants to prevent shell creation through IPOs; secondly, by enhancing the continuing listing criteria to deter the maintenance of listed shells; and thirdly, by tightening the reverse takeover rules to address backdoor listings.

#### **Listed issuers with "Shell" Characteristics**

The Guidance Letter enumerated the circumstances under which the HKSE may question an issuer's suitability for continued listing, such as where its directors are involved in fraud, where there have been repeated breaches of laws or material internal control failures, or where there has been excessive reliance on key customers or suppliers. In particular, the Guidance Letter drew attention to situations where issuers may be taken as carrying on "shell maintenance" activities in cases where controlling shareholders sold down their interests, the existing management resigned and/or the issuers undertook a series of actions that led to a diminution of their original businesses and the operation of new businesses. These new businesses may have a very low barrier to entry and, in some cases, it is unclear whether the new businesses have substance or are sustainable in the longer term.

The Guidance Letter took effect on 29 June 2018 and is available at:

- [http://en-rules.hkex.com.hk/net\\_file\\_store/new\\_rulebooks/g/l/GL96-18.pdf](http://en-rules.hkex.com.hk/net_file_store/new_rulebooks/g/l/GL96-18.pdf).

#### **Proposals Regarding the Reverse Takeover Rules**

The reverse takeover rules are anti-avoidance provisions to prevent circumvention of new listing requirements through an acquisition or a series of acquisitions by a listed issuer. In the Consultation Paper, the HKSE proposed to tighten both the definition and the compliance requirements for reverse takeovers:

Current Listing Rules/Guidance Letters	Proposals
<b>Definition of reverse takeover – principle based test and bright line tests</b>	
LR 14.06(6), GL78-14	<p>Six assessment criteria for the principle based test, including the nature and scale of the issuer's business, the size of the acquisition, quality of the acquisition target, any fundamental change in the issuer's principal business, and:</p> <ul style="list-style-type: none"> <li>▪ other events and transactions which, together with the acquisition, form a series of arrangements to circumvent the reverse takeover rules ("series of arrangement" criterion);</li> <li>▪ whether the vendor would acquire de</li> </ul>
	<p>Codify the assessment criteria into the Listing Rules.</p> <p>Clarify the "series of arrangement" criterion:</p> <ul style="list-style-type: none"> <li>▪ acquisitions and other transactions or arrangements may be taken as a series if they take place in a reasonable proximity (which normally refers to a period of three years or less) or are otherwise related;</li> <li>▪ the last transaction in the series need not be an acquisition. A proposed disposal may result in an earlier acquisition being subject to the reverse takeover rules.</li> </ul>

	facto control of the issuer through holding restricted convertible securities (“issue of restricted convertible securities” criterion).	Extend the “issue of restricted convertible securities” criterion to include change in control (as defined in the Takeovers Code).
LR 14.06(6)	Bright line tests involving (i) a change in control and acquisition(s) constituting a very substantial acquisition (as defined in Chapter 14 of the Listing Rules), or (ii) acquisition(s) constituting a very substantial acquisition from the new controlling shareholder (and/or its associates) within a 24-month period after the change in control.	Extend the aggregation period from 24 months to 36 months.
LRs 14.92, 14.93	To prevent an issuer from circumventing the bright line tests by resequencing the transactions, an issuer is restricted from disposing of its existing business for a 24-month period after a change in control, unless the assets acquired from the new controlling shareholder (and/or its associates) and any other assets acquired after the change in control can meet the track record requirements under LR 8.05.	Extend the restriction period from 24 months to 36 months.  Disapply the restriction if the remaining business (and not only assets acquired after the change in control) can meet the track record requirements for new listing under LR 8.05 (or LR 8.05A or LR 8.05B).  The HKSE has the discretion to apply the restriction after a change in the single largest substantial shareholder.
<b>Acquisition target must be able to meet the track record requirements for new listing</b>		
LR 14.54	The enlarged group <u>or</u> the acquisition target must meet the track record requirements under LR 8.05.  The enlarged group must meet all the listing conditions under Chapter 8 of the Listing Rules.	The acquisition target on its own must meet the track record requirements for new listing under LR 8.05 (or LR 8.05A or LR 8.05B).  Both the acquisition target and the enlarged group must be suitable for listing under LR 8.04.

#### **Proposals Regarding the “Extreme VSA” Rules**

Under Guidance Letter (GL78-14), the HKSE, when applying the principle based test, may classify a transaction as a reverse takeover or, where the acquisition target can meet the track record requirements and circumvention of new listing requirements would not be a material concern, as an extreme very substantial acquisition (**extreme VSA**). While an issuer proposing an extreme VSA will not be taken as a new listing applicant, the issuer will be required to prepare a transaction circular with enhanced disclosures, and to appoint a financial adviser to conduct due diligence on the acquisition.

The HKSE proposed to codify the extreme VSA requirements, rename such transactions as “extreme transactions” and limit the use of this category to issuers that:

- operate a principal business of a substantial size. As a general guidance, “substantial size” means a principal business with annual revenue or total asset value of HK\$1 billion or more, excluding any revenue or assets not attributable to the issuer’s original principal business; or

- have been under the control of a large business enterprise for a long period (normally not less than three years), and the transaction forms part of a restructuring with no change in control.

Accordingly, the extreme transaction category may no longer be available to small-cap issuers if the proposals are adopted. Furthermore, by requiring the acquisition target to meet the track record requirements for new listing whether the transaction is classified as a reverse takeover or an extreme transaction, the HKSE will effectively bar all backdoor listings of “unqualified” assets.

#### ***Proposals Regarding the Rule on Sufficiency of Assets and the Cash Company Rules***

In addition to tightening the reverse takeover rules, the HKSE proposed to enhance the continuing listing criteria to address market activities involving listed shells, including:

- requiring issuers to carry out a business with a sufficient level of operations and have assets of sufficient value to support its operations (and not sufficient operations or assets as set out in current LR 13.24). Trading and/or investment in securities will be excluded when considering whether an issuer has complied with this rule;
- extending the definition of “short-dated securities” in the cash company rules to cover “short-term investments” so that an issuer will not be regarded as suitable for listing under LR 14.82 if its assets consist wholly or substantially of cash and/or short-term investments such as bonds, bills or notes which have less than one year to maturity, investments in listed securities and other investments that are readily convertible to cash;
- codifying Guidance Letter (GL84-15) to regulate backdoor listings through large scale issue of securities; and
- codifying Listing Decision (LD75-4) to impose additional requirements on significant distribution in specie of unlisted assets.

The consultation period ended on 31 August 2018 and the consultation conclusions are yet to be issued. For more details and information on the other proposals, please see the Consultation Paper which is available at:

- <https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/June-2018-Backdoor-and-Continuing-Listing/Consultation-Paper/cp201806.pdf>.

## **US DEVELOPMENTS**

### **SEC and NYSE/Nasdaq Developments**

#### **SEC Adopts Amendments to Simplify and Update Disclosure Requirements**

On 17 August 2018, the U.S. Securities and Exchange Commission (**SEC**) adopted amendments to simplify and update disclosure requirements that have become duplicative, overlapping or outdated in light of other SEC disclosure requirements, U.S. Generally Accepted Accounting Principles (**GAAP**) or “changes in the information environment.” The amendments affect annual reports on Form 20-F, as well as registration statements on Form F-1, Form F-3 and Form F-4.

The noteworthy changes affecting foreign private issuers include:

- Exchange Rate Data. Form 20-F will no longer require foreign private issuers to provide exchange rate data when financial statements are prepared in a currency other than the U.S. dollar as such data is widely available. This change also affects registration statements on Form F-1 and Form F-4, which currently refer to the same disclosure requirement in Form 20-F.

- Earnings Per Share Calculation. The requirement to file as an exhibit a statement explaining how any earnings per share information presented in a filing was calculated has been eliminated. This change affects annual reports on Form 20-F, as well as registration statements on Form F-1, Form F-3 and Form F-4.
- Ratio of Earnings to Fixed Charges. The amendments eliminate the requirement to include historical and pro forma ratios of earnings to fixed charges and the related exhibit when registering debt securities or preferred stock. GAAP already covers disclosure of the components commonly used to calculate these ratios, and the SEC recognizes that debt investors are more focused on the information readily available from the financial statements and EBITDA or similar metrics. These amendments are implemented through the changes to Instruction 7 of “Instructions as to Exhibits” to Form 20-F, as well as in registration statements on Form F-1, Form F-3 and Form F-4 through amendments to Items 503(d) and 601(b)(12) of Regulation S-K.
- Eliminate Trading Price History. Companies with common equity traded in an established trading market no longer need to disclose high and low trading prices for each quarter in the last two full fiscal years and interim periods, given that such information is easily accessible to investors, so long as the company’s trading symbol and principal trading markets are disclosed. Additionally, issuers with common equity that is not traded on an exchange are required to indicate, as applicable, that any over-the-counter quotations reflect inter-dealer prices and may not necessarily represent actual transactions. These changes affect annual reports on Form 20-F, as well as registration statements on Form F-1, Form F-3 and Form F-4, which refer to Item 9.A.4 of Form 20-F.
- Research and Development Expenditures. Companies will no longer be specifically required to disclose research and development expenditures, since such information is already required in the notes to the financial statements. However, companies should continue to consider whether disclosure regarding research and development expenditures is appropriate in the context of describing material trends in the “Operating and Financial Review and Prospects” section. These amendments are implemented through changes to Item 5.C of Form 20-F, as well as in registration statements on Form F-1 and Form F-4, which refer to Item 5.C of Form 20-F.
- Dividend Restrictions. Requirements to disclose any dividend restrictions and any limitations on the payment of dividends have been eliminated through changes to Items 10.F and 14.B of Form 20-F, namely because foreign private issuers are already required to disclose dividend restrictions in the financial statements.
- Invitation for Competitive Bids. The requirement to file as an exhibit any invitation for competitive bids has been eliminated, because it was deemed that such information would be of little interest to investors. This change is implemented through an amendment to Item 601(b)(26) of Regulation S-K, which is incorporated by reference into registration statements on Form F-1, Form F-3 and Form F-4.
- Age of Financial Statements in IPOs. In IPOs, foreign companies doing an SEC-registered offering have had to include in their registration statement audited financial statements not older than 12 months at the date of filing. Under the new rules, companies may include audited financials that are no older than 15 months at the time of the offering or listing, if the company represents that it is not required to comply with the 12-month age requirement in its home jurisdiction and that complying would be impracticable or involve undue hardship. Companies are no longer required to obtain a waiver from the SEC.

The amendments will become effective on 5 November 2018. In advance of upcoming filing deadlines, companies are advised to understand how to reflect such changes in their public reporting and in new registration statements and update their procedures accordingly.

To assist with understanding the amendments that were adopted, the SEC prepared a “demonstration version” of the adopted amendments, which presents the added and deleted text in the affected rules.

The SEC’s demonstration version is available at:

- <https://www.sec.gov/rules/proposed/2018/33-10532-demonstration.pdf>

The SEC final rule release adopting the amendments is available at:

- <https://www.sec.gov/rules/final/2018/33-10532.pdf>

Our related client publication is available at:

- <https://www.shearman.com/perspectives/2018/09/simplification-rules>

### **SEC Proposes Rules to Simplify and Streamline Disclosures in Certain Registered Debt Offerings**

On 24 July 2018, in line with its efforts to ease disclosure and capital formation obligations applicable to public companies while ensuring that investors have access to material information, the SEC proposed rule amendments that would simplify the financial disclosure requirements for registered debt offerings with regard to guarantors and issuers of guaranteed securities, as well as for affiliates whose securities collateralize a registrant’s securities. The SEC is proposing to amend Rules 3-10 and 3-16 of Regulation S-X and relocate part of Rule 3-10 and all of Rule 3-16 to new Article 13 in Regulation S-X, which would comprise proposed Rules 13-01 and 13-02.

Proposed Amendments to Rule 3-10:

- As proposed, Rule 3-10 would continue to permit the omission of separate financial statements of subsidiary issuers and guarantors; provided that certain conditions are met and the parent company provides supplemental financial and non-financial disclosure about the subsidiary issuers and/or guarantors and the guarantees. The requirements regarding disclosures would be provided by proposed Rule 13-01, which would principally:
  - require that subsidiary issuers or guarantors be consolidated in the parent company’s consolidated financial statements rather than be 100% owned by the parent company, as is currently required;
  - replace condensed consolidating financial information as required under the current rule with certain proposed financial and non-financial disclosures: (i) the financial disclosures would consist of summarized financial information of the issuers and guarantors, which may be presented on a combined basis, and reduce the number of periods presented, and (ii) the non-financial disclosures would expand the qualitative disclosures regarding the guarantees and the issuers and guarantors, as well as require disclosure of additional information that would be material to holders of the guaranteed security; and
  - allow the disclosures to be provided outside the footnotes contained in the parent company’s financial statements in the registration statement covering the offer and sale of the subject securities and any related prospectus, as well as in certain Exchange Act reports filed shortly thereafter.

Proposed Amendments to Rule 3-16:

- In line with the SEC’s view that separate financial statements of affiliates whose securities are pledged as collateral are not material in most situations, the proposed amendments to Rule 3-16 would notably:
  - replace the current requirement to provide separate financial statements with regard to each affiliate whose securities are pledged as collateral with financial and non-financial disclosures about the affiliate(s) and the collateral arrangement as a supplement to the consolidated financial statements of the registrant that issues the collateralized security; and

- permit the proposed financial and non-financial disclosures to be located in filings in the same manner as described above for the disclosures related to guarantors and guaranteed securities.

The SEC press release announcing the proposed rule is available at:

- <https://www.sec.gov/news/press-release/2018-143>

### **SEC Announces Settlement with Tesla and Elon Musk Regarding Misleading Tweet**

On 7 August 2018, Tesla CEO and Chairman Elon Musk tweeted “Am considering taking Tesla private at \$420. Funding Secured.” Musk initially released no details regarding the purported funding, but six days later he tweeted again, citing discussions with Saudi Arabia’s sovereign wealth fund and work with financial advisors. On 27 September 2018, the SEC filed a complaint against Musk, alleging that this series of tweets was false and misleading, and that Musk had not in fact discussed or confirmed key deal terms with any potential funding source. On 29 September 2018, the SEC and Musk announced a settlement, which has not yet been finalized. Under the terms of this settlement:

- Musk neither admits nor denies the allegations in the agency’s lawsuit against him;
- Musk will step down as Tesla’s Chairman and be replaced by an independent Chairman. Musk will be ineligible to be re-elected Chairman for three years;
- Tesla will appoint a total of two new independent directors, establish a new committee of independent directors and put in place additional controls and procedures to oversee Musk’s communications; and
- Musk and Tesla will each pay a separate \$20 million penalty. The \$40 million in penalties will be distributed to harmed investors under a court-approved process.

Tesla’s share price has experienced extreme volatility as a result of these events, rising initially to nearly \$380 as a result of the privatization tweet, and falling most recently to under \$262.

Notably, on 4 October 2018 U.S. District Judge Alison Nathan demanded that Musk and the SEC justify their settlement, asserting that the court needs to see justification that the settlement is “fair and reasonable.” The parties have until 11 October 2018 to submit a joint letter explaining why the deal should be cleared. Federal courts have previously refused to accept SEC settlements if they think the agency is too lenient.

This episode exemplifies the potential pitfalls of the use of social media by public companies. Companies should ensure that disclosures made by senior executives on social media are subject to disclosure controls and procedures, as companies are subject to anti-fraud liability for such disclosures.

### **SEC Announces New Filing Fees**

On 24 August 2018, the SEC announced that in fiscal year 2019 the fees that public companies and other issuers pay to register their securities with the SEC will be set at \$121.20 per million dollars of securities registered.

Effective 1 October 2018, the Section 6(b) fee rate applicable to the registration of securities, the Section 13(e) fee rate applicable to the repurchase of securities and the Section 14(g) fee rates applicable to proxy solicitations and statements in corporate control transactions decreased from \$124.50 per million dollars to \$121.20 per million dollars.

### **Shearman Releases 16th Annual Corporate Governance & Executive Compensation Survey**

On 18 September 2018, Shearman & Sterling published its annual Corporate Governance & Executive Compensation Survey (**Survey**). While the Survey focuses on corporate governance and executive compensation practices applicable to U.S. domestic companies, it may also be a good resource for non-U.S. companies. Corporate governance and executive compensation practices of public companies continue to draw intense shareholder



scrutiny and regulatory focus, and Shearman's annual survey of the 100 largest public companies in the United States provides important benchmarking information in these critical areas.

This year's Survey considers corporate governance topics that have emerged as key board-level issues, including:

- corporate culture;
- CEO pay ratio;
- cybersecurity;
- sexual misconduct; and
- board diversity.

The Survey also examines the evolution of topics we have reviewed in prior surveys, including:

- proxy access;
- shareholder engagement;
- shareholder proposals;
- director compensation;
- shareholder activism; and
- governance practices of newly public companies.

The Survey is available at:

- <https://www.shearman.com/perspectives/2018/corpgovsurvey/shearman-releases-16th-annual-corporate-governance-and-executive-compensation-survey>

### **Shearman publishes its Q3 2018 Sanctions Roundup**

On 16 October 2018, Shearman & Sterling published its quarterly Sanctions Roundup report, which highlights developments in U.S. sanctions laws and enforcement trends.

As is further detailed in the Sanctions Roundup, among the highlights from the third quarter of 2018 were:

- U.S. maintained pressure against Russia, imposing sanctions in response to the Skripal attacks, issuing a new Executive Order aimed at election meddling, and targeting multiple entities and individuals under CAATSA;
- Markets reacted to the possibility of new sanctions on Russian sovereign debt following the U.S. November elections;
- U.S. began the first phase of its Iran sanctions snap-back, while the EU and others pursued strategies to salvage the JCPOA;
- OFAC resumed sanctions pressure against North Korea, focusing on Russian and Chinese targets in particular; and
- The Trump Administration settled its first enforcement action against a financial institution, resulting in a \$5.2 million settlement.

The Sanctions Roundup is available at:

- <https://www.shearman.com/perspectives/2018/10/sanctions-round-up-third-quarter-2018>

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

On 10 July 2018, Shearman & Sterling published its bi-annual Trends and Patterns in FCPA Enforcement report (**FCPA Enforcement Report**), 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 FCPA and global anti-corruption compliance programs.

The FCPA Enforcement Report is an invaluable compendium of all FCPA-related developments in the first half of 2018, including U.S. foreign bribery proceedings and criminal prosecutions, 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 the first half of 2018 were:

- nine corporate enforcement actions with total sanctions of approximately \$1.03 billion. Although only slightly more enforcement actions than the eight that had been brought at this time last year, the total sanctions thus far in 2018 are significantly higher than the total sanctions of \$272 million at this point in time last year;
- after a significant period of time without bringing any enforcement actions, the DOJ brought four actions in a two-month span;
- 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;
- as in recent years, two outlier enforcement actions distort the picture, raising the average corporate sanction for 2018 to \$114.2 million, whereas the true average, with outliers excluded, is significantly less than this figure (\$23.1 million). The median sanction of \$9.2 million is broadly in line with those from recent years (\$29.2 million in 2017, \$14.4 million in 2016, and \$13.4 million in 2015); and
- the DOJ announced a new policy addressing situations where enforcement actions involve penalties imposed by more than one regulator or law enforcement authority that is designed to avoid the “piling on” of fines and penalties.

The FCPA Enforcement Report is available at:

- <https://www.shearman.com/perspectives/2018/07/fcpa-trends--patterns>

### Noteworthy US Securities Litigation

#### Resolving Circuit Split, Supreme Court Rules That Successive Class Actions Are Not Tolled Under American Pipe

On 11 June 2018, the U.S. Supreme Court held in *China Agritech, Inc. v. Resh* that the tolling rule first stated in *American Pipe & Construction Co. v. Utah* cannot salvage otherwise untimely successive class claims.

In *American Pipe*, the U.S. Supreme Court had held that the timely filing of a class action tolls (suspends) the limitations period for all persons covered by the class complaint. The issue in *China Agritech* was whether *American Pipe* tolling can salvage an untimely successive class claim – in other words, a claim filed on behalf of a putative class after the expiration of the limitations period, but before the time when the limitations period would expire if the court were to exclude time during which a previous proposed class action was pending. The Sixth Circuit (which hears appeals from Kentucky, Michigan, Ohio and Tennessee) and the Ninth Circuit (which hears appeals from Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington, Guam and the Northern Mariana Islands) had ruled that *American Pipe* tolling applied to successive class action lawsuits, while certain other circuits, including the First, Second, Fifth, and Eleventh, had said it did not. Here, the Court resolved the circuit split and unanimously held that, upon denial of class certification, a putative class member may only intervene as an individual plaintiff or

commence an individual suit, but may not commence a new class action beyond the time allowed by the applicable statute of limitations.

The plaintiff was a purchaser of the stock of China Agritech and had filed the third iteration of “materially identical” claims against the company under the Securities Exchange Act of 1934 (**Exchange Act**). The district court had denied class certification in the two prior putative class actions that had been brought by different plaintiffs in 2011 and 2012, respectively. In June 2014 (a year and a half after the statute of limitations had expired), someone who would have been a member of the class in those two cases if the court had certified it, but had not previously applied to be a lead plaintiff, filed a third putative class action. The district court, dismissing the class action as untimely, held that the previous two class actions did not toll the time to bring class claims. The Ninth Circuit reversed and held that the reasoning of *American Pipe* extended not only to individual claims, but to successive class claims.

The Supreme Court reversed and remanded the Ninth Circuit’s decision and held that a putative class member may not commence a new class action beyond the time allowed by the statute of limitations. The Court emphasized that *American Pipe* addressed only putative class members that wished to sue individually after class certification was denied. The Court noted that, under the Federal Rules of Civil Procedure and the Private Securities Litigation Reform Act of 1995, early resolution of class issues is preferred. Early assertion of competing class representative claims, the Court added, allows district courts to select the best lead plaintiff or deny certification at the outset of the case, as appropriate.

The Court emphasized that plaintiffs must demonstrate diligence in pursuit of their claims to benefit from equitable tolling, and stated that a purported class representative who commences suit after expiration of the class period “can hardly qualify as diligent in asserting claims and pursuing relief.” The Court noted that holding otherwise “would allow the statute of limitations to be extended time and again; as each class is denied certification, a new named plaintiff could file a class complaint that resuscitates the litigation.”

The Court further noted that its holding did not “run afoul of the Rules Enabling Act by causing a plaintiff’s attempted recourse to Rule 23 to abridge or modify a substantive right” because “[p]laintiffs have no substantive right to bring their claims outside the statute of limitations.” Rejecting the argument that declining to toll the limitations period for successive class suits would lead to a profusion of protective class-action filings, the Court noted that such a trend has not emerged in the Second and Fifth Circuits, where the Courts of Appeals had already declined to read *American Pipe* as permitting successive class actions outside the limitations period. The Court concluded that “allowing no tolling for out-of-time class actions [] will propel putative class representatives to file suit well within the limitation period and seek certification promptly,” and thereby increase the “efficiency and economy of litigation,” a principal goal of *American Pipe* and Rule 23, the class action rule.

In light of this decision and others limiting the scope of *American Pipe* tolling, plaintiffs may try to protect their opportunity to file additional class claims by pressing for class certification earlier than they have typically done in the past. This decision may also result in more cases brought by a group of several plaintiffs to avoid the risk that the inadequacy of a single plaintiff will be fatal to a class claim.

## Second Circuit Underscores That Contractual Obligations Reached in the US Can Establish That a Transaction Is “Domestic” Under the Exchange Act

On 19 June 2018, the Second Circuit Court of Appeals (which hears appeals from Connecticut, New York and Vermont) held in *Giunta v. Dingman* that allegations that parties had reached an agreement within the United States for the sale of foreign securities established a “domestic transaction” sufficient to bring related fraud claims within the scope of the U.S. securities laws under *Morrison v. National Australia Bank Ltd.*

The plaintiff alleged that, while the parties were in New York, he conducted meetings and phone calls with the defendant (the operator of restaurant companies in the Bahamas) regarding an investment in a holding company that owned a restaurant in the Bahamas. The plaintiff further alleged that the defendant made a number of misrepresentations, including that the holding company owned 100 percent of the restaurant, that the plaintiff would receive a 50 percent equity stake in the holding company, that the defendant had personally invested more than \$600,000, that the holding company was profitable, and that the holding company would have only three shareholders. Although the investment agreement was never reduced to writing, the plaintiff allegedly wired more than \$300,000 to the defendant. Eventually, the defendant allegedly sent a letter to investors stating that the restaurant had closed, and revealing to the plaintiff for the first time that there were additional investors, and that the defendant was not a 50 percent owner.

Construing the requirement in *Morrison* that Section 10(b) claims apply only to transactions listed on domestic exchanges and “domestic transactions in other securities,” the district court concluded that, because Bahamian law required approval by the Bahamian Investments Board and the Central Bank of the Bahamas before shares could be issued to a foreign investor, the investment was not consummated in the United States and did not constitute a “domestic transaction.” The plaintiff therefore was not “irrevocably bound” to his investment through a U.S. transaction.

The Second Circuit reversed and relied on its earlier decision in *Choi v. Tower Research Capital LLC*, where it held that if trades were “matched” with counterparties in the United States but “cleared and settled” in Korea the following day, irrevocable liability attached in the United States and established a domestic transaction under *Morrison*. In the new case, the Second Circuit found that the oral investment agreement was a domestic transaction because, like in *Choi*, the parties agreed to be obligated to each other in the United States even if those obligations were still subject to a condition subsequent.

The court also rejected the defendant’s argument that, even if the agreement were a domestic transaction, the claims were so predominantly foreign as to render them “impermissibly extraterritorial” under the Second Circuit’s prior decision in *Parkcentral Global HUB Ltd. v. Porsche Automobile Holdings SE. Distinguishing Parkcentral*, which involved conduct primarily in Germany that was already the basis of foreign investigations and enforcement actions, the Second Circuit held that the circumstances cited by the defendant—the defendant’s permanent residence in the Bahamas, the Bahamian focus of the business venture, the incorporation of the entities in the Bahamas, the presence of witnesses, books and records in the Bahamas, and the potential applicability of Bahamian regulations—did not render the claims impermissibly extraterritorial. Thus, based on the plaintiff’s allegations that the agreement between the parties in the United States was a contract, the court held that Section 10(b) would apply.

As reflected in this decision, the Second Circuit continues to elaborate on the contours of extraterritoriality for Section 10(b) claims. Here the Court held that, where parties reach an agreement for the sale of securities within the United States, the transaction will be considered a “domestic transaction” for purposes of the U.S. securities laws, with any additional considerations of foreign government involvement to be considered on a case-by-case basis.

## Second Circuit Amends but Arguably Weakens the “Meaningfully Close Personal Relationship” Test for Tips in Insider Trading Cases

On 25 June 2018, a divided three-judge panel of the Second Circuit amended its decision in *United States v. Martoma* (covered previously in this newsletter), which held that the Supreme Court in *Salman v. United States* had abrogated the “meaningfully close personal relationship” test articulated by the Second Circuit in *United States v. Newman*.

The panel’s amended opinion, in contrast, holds that *Newman*’s “meaningfully close personal relationship” test is still valid for determining whether an insider tipper received a personal benefit (and thus breached a fiduciary duty), but also holds that the test will be satisfied upon a showing that (1) the “tipper and tippee shared a relationship suggesting a *quid pro quo*” or (2) “the tipper gifted confidential information with the intention to benefit the tippee.”

As background, *Martoma* was convicted in 2014 on various insider trading charges. According to the government, in July 2008, *Martoma* learned from doctors who worked on a clinical trial of an experimental Alzheimer’s drug that tests had gone poorly. At the time, *Martoma* was employed as a portfolio manager at SAC Capital Advisors LP (**SAC**), and had arranged for paid consultations with the doctors, sometimes at a rate of \$1,000 per hour, which he used to learn inside information. According to the government, *Martoma* used this information to cause SAC to enter into short sales and other trading shortly before results of clinical trials became public, and thereby netted large gains and avoided losses. *Martoma* appealed his conviction on the grounds that the jury instructions were improper and there was insufficient evidence to convict him.

Under the U.S. Supreme Court’s decision in *Dirks v. United States*, tipplers can be liable for insider trading only when they receive a personal benefit. Tippee liability derives from tipper liability, and also requires a finding of a “personal benefit” for the tipper. In *Newman*, the Second Circuit held that the requisite personal benefit could not be inferred from friendship alone without “proof of a meaningfully close personal relationship [between tipper and tippee] that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.” Shortly thereafter, the Supreme Court, in *Salman v. United States*, called *Newman*’s emphasis on pecuniary gain into question. Under the facts of *Salman*, where there was unquestionably such a meaningfully close relationship between the tipper and tippee, the Court held that a tipper who gives inside information to a relative or friend receives a personal benefit because “giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds.”

As we previously reported, in its original opinion, the *Martoma* panel went further than the Supreme Court. It held not only that *Newman*’s emphasis on pecuniary gain was inconsistent with *Salman*, but that the “reasonably close personal relationship” test also did not survive. Numerous commentators questioned the decision because it seemed to overturn a portion of the *Newman* decision without an en banc hearing or explicit support in the *Salman* decision. *Martoma* then petitioned for rehearing.

In its amended opinion, the panel revised its original decision in a way that makes clear that it no longer challenges *Newman* directly. Instead, the panel wrote that it “need not decide” whether *Newman*’s interpretation of the gift theory of tippee liability survives *Salman*, because in any event the “meaningfully close personal relationship” test can be satisfied where the tipper and tippee share a relationship suggesting a *quid pro quo*, or the tipper gifted the inside information with the intent to benefit the tippee. Indeed, the panel noted that it agreed with *Martoma* that the jury instructions were inconsistent with *Newman* and therefore incorrect. The panel, however, also found that the incorrect instructions did not constitute an obvious error, and in any event did not impair *Martoma*’s substantial rights because there was “compelling evidence” that at least one tipper received the benefit of \$70,000 in consulting fees – which would suggest a *quid pro quo* and thus a meaningfully close relationship. It therefore affirmed *Martoma*’s conviction.

A significant aspect of the panel's amended decision is its holding that, although *Newman's* "meaningfully close personal relationship" test survives, evidence of the intent to benefit a tippee alone can be enough to satisfy that test. In dissent, one judge criticized this approach for permitting the test to be satisfied without any objective evidence as to the relationship between the tipper and the tippee. The holding may thus give prosecutors another option for satisfying *Newman's* requirements, although obtaining a conviction will remain highly dependent on the facts of each case.

Perhaps more important, neither the original panel decision in *Martoma* nor the amended panel decision do anything to call into question the more significant holding in *Newman* – that a remote tippee cannot be convicted in the absence of proof that he or she knew of the personal benefit received by the tipper. That holding remains unquestioned and stands as a significant limitation on the government's ability to prosecute alleged remote tippees.

### **Ninth Circuit Reverses Dismissal of Securities Fraud Class Action and Rules That the Purchase and Sale of American Depository Receipts Traded on an Over-the-Counter Market Can Be a Domestic Transaction under Morrison**

On 17 July 2018, the Ninth Circuit reversed the dismissal of *Automotive Industries Pension Trust Fund, et al. v. Toshiba Corp.*, a putative securities class action, which alleged that the defendant and its current and former chief executive officers engaged in fraudulent accounting in violation of Sections 10(b) and 20(a) of the Exchange Act, as well as Japanese securities law. In its ruling, the Ninth Circuit analysed the second prong of the transaction test articulated in *Morrison v. National Australia Bank* (previously discussed in this newsletter) and adopted the Second and Third Circuits' "irrevocable liability" test, which evaluates where the purchasers incurred the liability to take and pay for securities, and where the seller incurred the liability to deliver the securities. The Ninth Circuit remanded the case to the district court so that the plaintiffs could amend their complaint to try to meet this standard.

At issue in the case was the scope of the U.S. Supreme Court's decision in *Morrison*, where the Court held that the Exchange Act did not apply extraterritorially and thus is limited to deceptive conduct in connection with the purchase or sales of any securities (i) registered on a national securities exchange, or (ii) domestic transactions in other securities not so registered. In the district court, the defendant argued that, under *Morrison*, the putative securities fraud class action should be dismissed because the lead plaintiff, a U.S.-based pension fund, bought the company's American Depository Receipts (ADRs) on an over-the-counter market. The defendant further argued that the over-the-counter market on which the ADRs were sold is not a "national exchange" within the meaning of *Morrison*, and there was therefore no domestic transaction between the ADR purchaser and the company. The district court agreed and dismissed the case.

On appeal, the Ninth Circuit first ruled that the lead plaintiff could not satisfy the first prong of the *Morrison* test because the over-the-counter market on which the Company's ADRs traded is not an "exchange" under the Exchange Act. With regard to the second prong of the *Morrison* test (i.e., domestic transactions in other securities not so registered), the Ninth Circuit adopted the Second and Third Circuits' "irrevocable liability" test, which looks to where purchasers incurred liability to take and pay for securities, and where sellers incurred the liability to deliver the securities. The Court noted that the lead plaintiff purchased the ADRs in the United States and the depository bank sold the ADRs in the United States. Missing from the complaint, however, were specific factual allegations regarding where the parties to the transaction incurred irrevocable liability. As a result, the Ninth Circuit remanded the case to the district court to allow the plaintiffs to file an amended complaint.

This decision is significant because it establishes, at least in the Ninth Circuit, that non-U.S. companies can be subject to liability under the Exchange Act in connection with the purchase and sale of ADRs, even when the ADRs do not trade on a U.S. exchange.

### **Ninth Circuit Addresses Consideration of Evidence Outside the Complaint**

On 13 August 2018, the Ninth Circuit, in *Khoja v. Orexigen Therapeutics*, ruled on the kinds of evidence, outside the complaint, that a court may rely on when considering a motion to dismiss a securities case. The general rule is that a court, in deciding a motion to dismiss, must assume that the facts alleged in the complaint are true and cannot consider evidence outside the complaint. The *Khoja* opinion provides important guidance as to the scope of the exceptions to that rule (at least in the Ninth Circuit).

The court addressed two means by which courts may consider outside evidence: (1) judicial notice of matters of public record; and (2) incorporation by reference, a doctrine that allows courts to consider a document upon which a plaintiff relies so significantly in its complaint that it is appropriate to treat the document as if it were incorporated by reference in the complaint. On the first point, the Ninth Circuit held that courts may take judicial notice of matters in the public record, but only as to facts not in dispute. On the second, the court held that documents that form the basis of a plaintiff's complaint, or are relied upon heavily by the plaintiff, may be treated as if they were incorporated by reference. But if a document does not "necessarily" form the basis of the complaint and instead just creates a defence to the plaintiff's allegations, the "incorporation by reference" doctrine will not apply. In other words, defendants may not rely on that doctrine to "present their own version of facts at the pleading stage." If they were permitted to do so, said the court, it would become "nearly impossible for even the most aggrieved plaintiff to demonstrate a sufficiently 'plausible' claim for relief."

### **Sixth Circuit Reverses Dismissal of Putative Securities Class Action Against Pharmaceutical Company, Finding Statements about Future Events Not Covered by the PSLRA Safe Harbour Provisions**

On 27 September 2018, the Sixth Circuit Court of Appeals reversed the dismissal of *Dougherty v. Esperion Therapeutics, Inc., et al.*, a putative securities class action against pharmaceutical company Esperion Therapeutics, Inc. and its CEO. The plaintiffs, investors in Esperion, had alleged that the defendants violated Sections 10(b) and 20(a) of the Exchange Act by falsely stating that, based on feedback received by the company at a meeting with the Food and Drug Administration (**FDA**), the FDA would not require additional testing of the company's pre-approval anti-cholesterol drug ETC-1002. Esperion's stock price allegedly plummeted when, over a month later, the company issued a press release indicating that, according to the FDA's own final meeting minutes, which had just been provided to the company, additional testing would be required prior to any approval of the drug. The district court, dismissing the plaintiffs' complaint, found that the plaintiffs had failed to adequately plead a strong inference of fraudulent intent (*scienter*) because they failed to identify facts demonstrating that the defendants actually understood the FDA's communications in a way that was different from what the company had publicly disclosed. The plaintiffs appealed, and the Sixth Circuit reversed.

The Sixth Circuit considered the defendants' argument that the company's August statements regarding the FDA meeting fell within the safe harbour provisions of the Private Securities Litigation Reform Act (**PSLRA**), under which, the court noted, the defendants are not liable for material forward-looking statements if either the statement is accompanied by meaningful cautionary language identifying important factors that could cause actual results to differ materially, or the plaintiffs fail to prove that it was made with actual knowledge that the statement was false or misleading. The defendants contended that, because the August statements that the FDA had confirmed it would not require completion of additional cardiovascular outcome trial testing (**CVOT**) prior to approving ETC-1002 occurred prior to the publication of the FDA's minutes, the statements were forward-looking. The court disagreed, and noted that, while Esperion's statements concerned a future event, "that alone does not automatically make them forward-looking statements," and Esperion's statement—that "[w]e know that [ETC-]1002 will not require a [CVOT test] to be completed prior to approval"—was not forward-looking. The Sixth Circuit also disagreed with the district court's conclusion that the contested statements were "assumptions underlying or relating to" a forward-looking statement, and found that, where a defendant makes mixed statements of present fact and future prediction, the statement of

present fact can be separated from surrounding forward-looking statements. The Sixth Circuit concluded that Esperion could have ascertained the truth or falsity of its August statements prior to the issuance of those statements, and therefore held that the statements fell outside of the PSLRA safe harbour provisions.

## EU DEVELOPMENTS

### European Commission Publishes Amending Proposal to Reinforce Market Supervisory Powers

On 12 September 2018, the European Commission published amendments to a pending 2017 proposal to review the Regulations which govern the European Supervisory Authorities (an **Amending Proposal**).

The fight against money laundering and terrorist financing has been a priority for the EU, with recent efforts having been made through the adoption of the 4th and 5th Anti-Money Laundering Directives. The amendments introduced by the European Commission are intended to reinforce the mandate of the European Supervisory Authorities to prevent and combat money laundering and terrorist financing in the financial services sector.

The 2017 proposal will give the European Banking Authority a leading and coordinating role in pursuing the European Commission's stated objectives to prevent money laundering and terrorist financing, and the Amending Proposal is intended to extend and strengthen this mandate. Under the amended provisions, the European Banking Authority will be able to:

- collect information from competent authorities relating to weaknesses identified in the processes and procedures of financial sector operators put in place to prevent money laundering and terrorist financing, as well as measures put in place by competent authorities;
- develop and promote the implementation of common standards for combating money laundering and terrorist financing; and
- monitor market developments and assess vulnerabilities to money laundering and terrorist financing in the financial sector.

Changes put forward by the European Commission also envisage enabling the European Banking Authority to take individual decisions addressed to financial-sector operators even where the material rules relating to the anti-money laundering and terrorist financing are not directly applicable to those financial-sector operators, including rules enshrined in national legislation transposing European directives and national legislation exercising options granted to Member States in the Regulations governing the European Supervisory Authorities.

The Amending Proposal also foresees that an Anti-Money Laundering Committee, composed of heads of Member States national competent authorities and bodies and observers from various EU institutions will be integrated into the European Banking Authority, with the purpose of coordination and cooperation on issues relating to anti-money laundering and terrorist financing.

The proposal will now be discussed by the European Parliament and the Council.

The Amending Proposal can be found here:

- <http://data.consilium.europa.eu/doc/document/ST-12111-2018-INIT/en/pdf>



## UK DEVELOPMENTS

### Changes to AIM Rules for Nominated Advisors (Nomads)

On 4 July 2018, the LSE published AIM Notice 52, which confirmed changes to the AIM Rules for Nominated Advisors, following a consultation launched on 26 April 2018, and previously covered in the April 2018 edition of this newsletter. The notice confirmed that responses to the consultation were supportive of the proposed changes.

The LSE has largely implemented all changes proposed, except that:

- New criteria for seeking approval as a Nomad have been amended to remove the proposed requirement requiring the entity to provide evidence of adequate risk management systems. It was noted that this requirement is already included as part of a Nomad's obligations pursuant to Rule 23.
- Examples of changes which a Nomad must inform the LSE's AIM Regulation arm has been amended to remove the commencement of an investigation by a regulatory body or law enforcement authority relating to the conduct of Nomad's employees.

AIM Notice 52 also included guidance that it intends to include on the revised form NA1.

The changes took effect on 30 July 2018.

AIM Notice 52 can be found here:

- <https://www.londonstockexchange.com/companies-and-advisors/aim/advisers/aim-notices/aim-notice-52.pdf>

### London Stock Exchange Announces Changes to the Admission and Disclosure Standards

On 17 September 2018, following limited response to consultation launched 10 July 2018, the London Stock Exchange (LSE) announced that proposed changes to the Admission and Disclosure Standards would become effective from 1 October 2018.

The changes primarily relate to the launch of the Shanghai-London Stock Connect Segment and the admission to the Main Market of Chinese A-shares' depository receipts. The Shanghai-London Connect Segment is a collaboration between the LSE and the Shanghai Stock Exchange. It allows investors to access Chinese A-shares through a DR programme listed on the London Stock Exchange and qualifying LSE-listed issuers may also access Chinese investors in Shanghai by listing a DR on the Shanghai Stock Exchange. A new schedule is proposed to be inserted into the Admission and Disclosure Standards to regulate the admission criteria for issuers seeking entry to the Shanghai-London Stock Connect Segment.

Other proposed changes include:

- amendments to continuing obligations to clarify that issuers are required to publish price-sensitive information in accordance with the Market Abuse Regulation via a regulatory information service;
- a new rule requiring an applicant for admission to trading to provide the LSE with a copy of the registration document, prospectus, listing particulars, admission particulars or similar as soon as electronically available; and
- amendment to the existing rules on cancellation of listings to clarify that the LSE may cancel admission to trading of securities if it is satisfied that there are special circumstances that preclude normal dealings in those securities, e.g. where the listing has been suspended for more than six months.

The original consultation can be found here:

- <https://www.londonstockexchange.com/traders-and-brokers/rules-regulations/change-and-updates/stock-exchange-notices/2018/n1318.pdf>

The results of the consultation can be found here:

- <https://www.londonstockexchange.com/traders-and-brokers/rules-regulations/change-and-updates/stock-exchange-notices/2018/n1518.pdf>

The new Admission and Disclosure Standards came into effect on 1 October 2018.

### Briefing Paper on Corporate Insolvency Consultations

On 9 July 2018, the House of Commons published a briefing paper entitled “Corporate insolvency: consultations on reform,” considering in detail three consultations on insolvency and corporate governance launched since May 2016.

The three separate consultations are reported to have been launched in light of the high profile failures of BHS Ltd and Carillion plc, and with the specific purpose of seeking to ensure the highest standards of behaviour in those who lead and control companies in or approaching insolvency. The three consultations are as follows:

Date launched	Consulting Entity	Proposals considered
May 2016	Insolvency Service	Creating a new moratorium, helping businesses to continue trading through the restructuring process, developing a flexible restructuring plan, and exploring options for rescue financing.
March 2018	Department for Business, Energy & Industrial Strategy	Holding directors responsible for the sale of an insolvent subsidiary of a corporate group to take proper account of the interests of the subsidiary’s stakeholders; reversal of value extraction schemes; investigation into the action of directors of dissolved companies, and strengthening corporate governance in pre-insolvency situations.
April 2018	HMRC	Discussion papers regarding ways to tackle those who deliberately abuse the insolvency regime to avoid/evade tax liabilities.

The full briefing paper can be found here:

- <https://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-8291#fullreport>

### The Financial Reporting Council (FRC) Publishes the Revised UK Corporate Governance Code

On 16 July 2018, the FRC published a new U.K. Corporate Governance Code (**2018 Code**), a revised Guidance on Board Effectiveness, and feedback on its December 2017 consultation, previously covered in our Q1 2018 newsletter. A notice published alongside the revised 2018 Code confirmed that responses to the consultation were supportive of the proposed changes.

The 2018 Code is shorter than the previous U.K. Corporate Governance Code and comprises 18 Principles and 41 Provisions. The previous supporting Principles have been removed and in some cases incorporated into the new Principles and Provisions, or moved to the revised Guidance on Board Effectiveness.

The main changes made in the 2018 Code include:

- Board engagement with the workforce: insertion of a new Provision to facilitate greater board engagement with the workforce. The 2018 Code provides for certain methods of communication with the workforce, and companies will need to explain failure to use any of the methods provided for in the 2018 Code. Boards are also asked to describe how they have considered stakeholder interests when performing their duty pursuant

to section 172 of the Companies Act 2006 (the duty to promote the success of the company for the primary benefit of its shareholders).

- Workplace policies and practices: Boards are asked to ensure that workforce policies and practices align with company values and support its long-term sustainable success.
- Succession planning: the 2018 Code emphasises the need to refresh boards and requires that the maximum length of service for the chair be nine years. The 2018 Code does acknowledge that transitional arrangements may be required and that the nine year limit may be extended from time to time, particularly where the chair was an existing NED on appointment. The 2018 Code also highlights the importance of external board evaluation.
- Remuneration: Remuneration committees should take into account relevant remuneration policies when setting director remuneration in order to ensure that remuneration is proportionate and supports long term success. The 2018 Code sets more demanding criteria for remuneration policies and practices, and provides that reporting on remuneration should be clearer, setting out how it delivers company strategy, long-term success and its alignment with workforce remuneration.

Key changes in the 2018 Code which differ from what was proposed by the FRC proposed in its 2017 consultation include:

- Companies may, in addition to using one of the three workforce engagement mechanisms specified in the original consultation, use alternative mechanisms provided they justify its use.
- The chair need not continue to qualify as independent following appointment and previous board independence requirements were retained instead of amended.
- The final 2018 Code narrows down the provisions whereby the “smaller company” exemptions have been removed, and the exemption has only been removed in relation to provisions regarding board independence and re-election of directors.

The 2018 Code will apply to accounting periods beginning on or after 1 January 2019, so the first reporting will not be until 2020 (unless companies decide to adopt all or part of the 2018 Code early).

The FRC will monitor the development of governance practices and reporting following implementation of the 2018 Code. The Financial Conduct Authority is also reviewing its Handbook and considering changes in line with the 2018 Code.

The 2018 Code can be found here:

- <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf>

Feedback published on the December 2017 consultation can be found here:

- <https://www.frc.org.uk/getattachment/90797f4b-37a1-463e-937f-5cfb14dbdcc4/2018-UK-Corporate-Governance-Code-Feedback-Statement-July-2018.pdf>

Our related client publication can be found at:

- <https://www.shearman.com/perspectives/2018/08/new-uk-corporate-governance-code>

### Revised Guidance on Board Effectiveness

On 16 July 2018, the FRC published the 2018 Code, a revised Guidance on Board Effectiveness (the **Guidance**), and feedback on its December 2017 consultation. The Guidance is intended to assist companies in applying the principles of the 2018 Code and it aims to support companies in achieving high standards of governance.

The Guidance is not mandatory nor prescriptive, but contains questions to stimulate board discussion and suggestions of good practice to support directors and their advisors in applying the 2018 Code.

The Guidance covers the sorts of practices that should help boards function more effectively and also includes some of the procedural aspects of governance which were previously included in the U.K. Corporate Governance Code which have become established good practice. Key changes to the Guidance in response to the December 2017 consultation include:

- changes to tone of the Guidance so that it is less prescriptive;
- changes to the introduction to emphasise the importance of the Guidance to encourage its use alongside the 2018 Code;
- highlighting the intent to update the Guidance more frequently as practice develops;
- changes to section one of the Guidance to adjust its focus on an effective board and relations with stakeholders;
- a new section on externally facilitated board evaluations; and
- changes to section five to reflect changes made in the 2018 Code and other feedback on remuneration.

The full text of the Guidance can be found here:

- <https://www.frc.org.uk/getattachment/61232f60-a338-471b-ba5a-bfed25219147/2018-Guidance-on-Board-Effectiveness-FINAL.PDF>

Feedback published on the December 2017 consultation can be found here:

- <https://www.frc.org.uk/getattachment/90797f4b-37a1-463e-937f-5cfb14dbdcc4/2018-UK-Corporate-Governance-Code-Feedback-Statement-July-2018.pdf>

### Publication of the Companies (Miscellaneous Reporting Regulations) 2018

On 19 July 2018, the Companies (Miscellaneous Reporting) Regulations 2018 were published. These introduce mandatory requirements for some companies to report on employee and stakeholder engagement, and provide information on the ratios between CEO and average staff pay. They also require large private and public companies to expand the required content of their strategic report. Specifically, the strategic report will be required to include a “Section 172(1) statement” describing how directors have had regard to the matters set out in section 172 of the Companies Act.

The regulations come into force on 1 January 2019 and apply in relation to the financial years of companies beginning on or after 1 January 2019.

The Companies (Miscellaneous Reporting) Regulations 2018 have also been considered in greater detail in a Shearman & Sterling client briefing entitled “New UK Corporate Governance Code and other Governance Developments,” which can be found [here](#).

The Companies (Miscellaneous Reporting) Regulations 2018 can be found here:

- [http://www.legislation.gov.uk/uksi/2018/860/pdfs/uksi\\_20180860\\_en.pdf](http://www.legislation.gov.uk/uksi/2018/860/pdfs/uksi_20180860_en.pdf)

### **Publication of the Draft Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018**

On 18 July 2018, the draft Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018 were published.

The draft Energy and Carbon Report Regulations 2018 introduces new requirements to disclose information about emissions, energy consumption and energy efficiency action by quoted companies, large unquoted companies and large LLPs in their directors' (or equivalent) reports.

Quoted companies will be required to make statements in the directors' report concerning the company's 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 the company's greenhouse gas emissions, energy use for which the company is responsible and action taken to increase energy efficiency within the U.K..

Large LLPs will be required to prepare an equivalent report to the directors' report (an "energy and carbon report") for each financial year. The contents requirements mirror the disclosure requirements that apply to large unquoted companies.

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 only a small amount of energy (40,000 kilowatt hours or less) has been used in the relevant financial year.

If approved by Parliament, 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. Detailed guidance on how to comply with these new obligations is expected to be published by January 2019.

The draft Energy and Carbon Report Regulations 2018 can be found here:

- <https://www.legislation.gov.uk/ukdsi/2018/9780111171356>

### **Regulations Come into Force Amending Prospectus Threshold**

On 21 July 2018, the Financial Services and Markets Act 2000 (Prospectus and Markets in Financial Instruments) Regulations 2018 came into effect. The draft regulation was published in 30 June 2017 and was covered in the July 2017 issue of this newsletter.

The Regulations include amendments to the Financial Services and Markets Act 2000, to implement Articles 1(3) and 3(2) of the Prospectus Regulation ((EU) 2017/1129), which also applied from that date.

Article 1(3) provides an exemption to the requirements of the Prospectus Regulation where the offer of securities to the public has a total consideration in the EU of less than €1 million, calculated over 12 months.

Article 3(2) gives Member States the option of increasing this exemption to €8 million (calculated over 12 months) but prospectuses taking advantage of this increased exemption will not have the benefit of the EU prospectus passporting regime.

We have covered the new EU Prospectus Regulation in greater detail [here](#), including the coming into effect of the increased threshold for exempting additional issuances of less than 20% of existing listed securities from publishing a prospectus, which came into effect on 20 July 2017.

The regulation can be found here:

- [http://www.legislation.gov.uk/ukxi/2018/786/pdfs/ukxi\\_20180786\\_en.pdf?\\_sm\\_au\\_=iVVM5DMRPQTJQZTQ](http://www.legislation.gov.uk/ukxi/2018/786/pdfs/ukxi_20180786_en.pdf?_sm_au_=iVVM5DMRPQTJQZTQ)

**Takeover Panel 2017/2018 Annual Report and Accounts**

On 23 July 2018, U.K.’s Takeover Panel (**Panel**), which oversees mergers and acquisitions, published its Annual Report and Accounts for the year ended 31 March 2018.

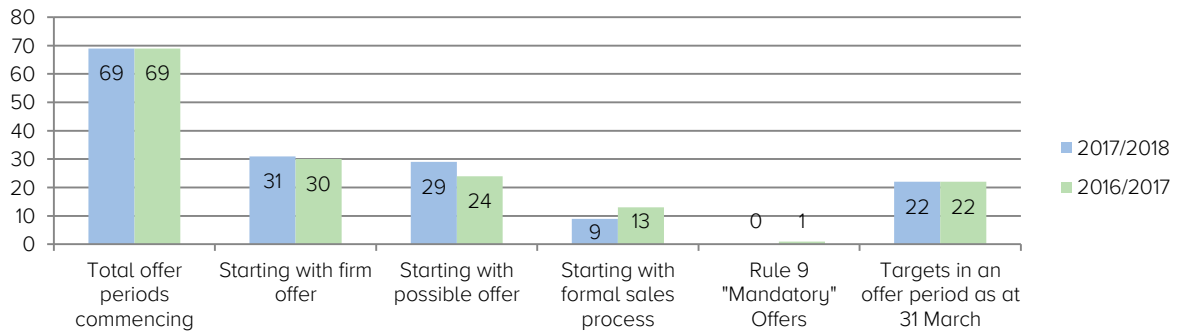
The report states that 2017/2018 saw a higher level of public M&A than the previous year. The number of firm takeover offers made was 57 (compared to 52 in 2016/2017), and of those, 51 offers became unconditional (compared to 58 in 2016/2017). Thirteen firm offers of over £1 billion in value were announced.

Four letters of private censure and seven “educational/warning letters” were issued.

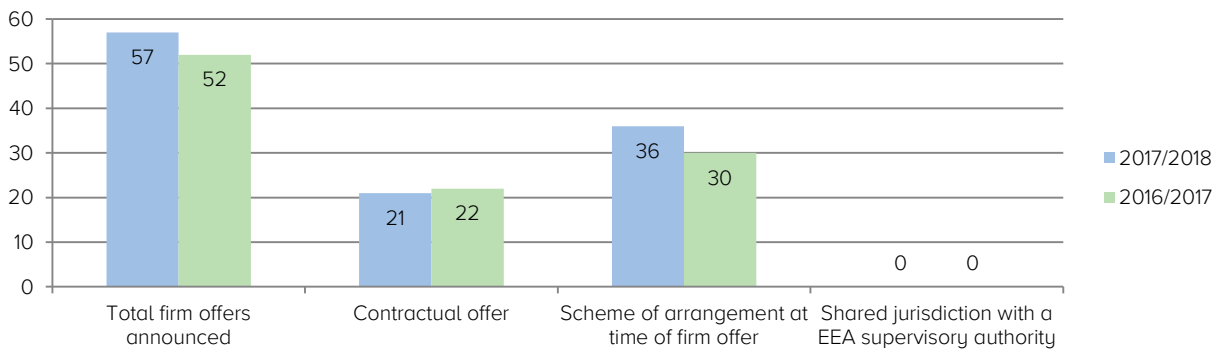
One case came before the Hearings Committee – the Rangers International Football Club case, where the Panel refused a request for an extension of time to publish a “mandatory bid” offer document to Rangers shareholders. The Panel refused the request on the grounds that the request was notified out of time and stood no reasonable prospect of success. This case was previously covered in the October 2017 issue of this newsletter.

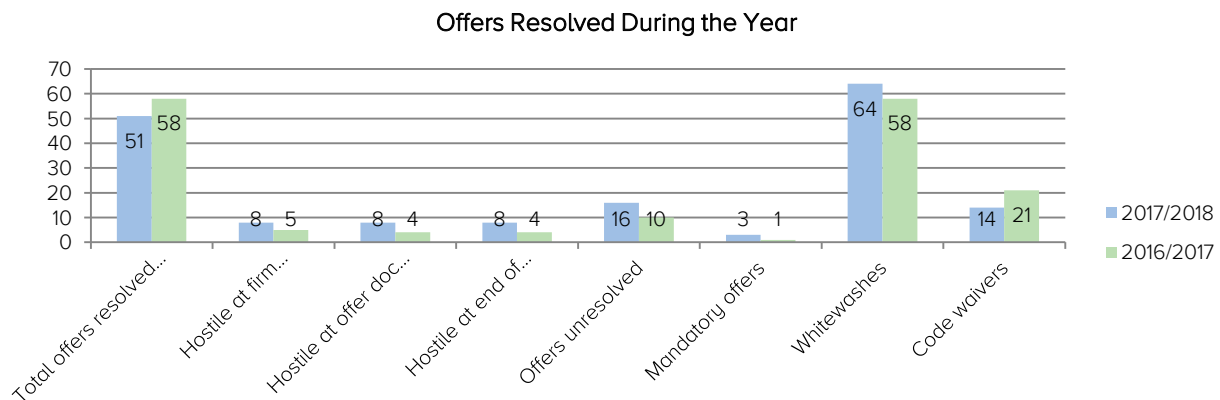
The charts below demonstrate the key offer statistics:

**Offer Periods Commencing During the Year**



**Firm Offers Announced**





The 51 offers that became unconditional during the year were made in respect of 50 offeree companies.

The full report can be accessed here:

- <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2018/07/ar18final.pdf>

### **Consultation on Reforms to the Government's Powers in Relation to Protecting National Security from Hostile Actors' Acquisition of Control**

On 24 July 2018, the U.K.'s Department for Business, Energy and Industrial Strategy (**BEIS**) published a White Paper consultation seeking views on proposed reforms to the government's powers in relation to protecting national security from hostile actors' acquisition of control over entities and assets.

This White Paper is the next stage in the reform of the government's powers regarding the protection of national security and follows the National Security and Infrastructure Investment Review Green Paper, published in October 2017 and takes account of the responses to that consultation. The Green Paper was considered in a Shearman & Sterling client briefing entitled "Foreign Investment Control: Trade Protectionism or Reasonable Control over a Nation's Industries?" which can be found [here](#).

The proposals for legislative reforms would give the U.K. government significantly greater powers to intervene in U.K. transactions on national security grounds. The government will encourage businesses and investors to notify on a voluntary basis, in advance of transactions that might give rise to national security risks. The new regime would give new powers to scrutinise a far wider range of transactions than existing legislation, such as the purchase of intellectual property. Transactions which may be scrutinised include any investment or activity that involves the acquisition of:

- more than 25% of an entity's shares or votes;
- significant influence or control over an entity; or
- further significant influence or control over an entity beyond the above thresholds.

The proposed regime also empowers the Government with a view of enabling it to prevent the proposed reforms from being subverted or evaded. The regime envisages the Government being able to assess control gained over assets, which would include acquisitions of:

- more than 50% of the asset(s); or
- "significant influence or control" over the asset(s).

The proposed package of reforms aims to strike an appropriate balance between maintaining the attractiveness of the U.K. as a destination for inward investment, while also providing the government with greater powers needed to protect the country.

The consultation closed on 16 October 2018 and the government will use the responses to the White Paper to refine the proposals ahead of the introduction of primary legislation.

The White Paper consultation can be found here:

- <https://www.gov.uk/government/consultations/national-security-and-investment-proposed-reforms>

### **The FRC Publish Revised Guidance on the Strategic Report**

On 31 July 2018, the FRC published revised Guidance on the Strategic Report (the **Guidance**), as well as feedback received under a consultation launched August 2017. The feedback received from the consultation was broadly supportive of the proposed changes.

The revised Guidance now places particular focus on the directors' duty to promote the success of the company under section 172 of the Companies Act 2006 and this should be reflected in the non-financial reporting that directors must include in their annual strategic reports.

Principal revisions to the Guidance include:

- Encouragement of best practice reporting of non-financial information;
- Clarification that the primary audience of the strategic report remains the shareholders, but directors are encouraged to consider how they have had regard for the interests of wider stakeholders as part of their section 172 duty; and
- Encouragement of boards to give due consideration to their section 172 duty and to report on relevant matters relating to that duty.

The revised Guidance can be found here:

- <https://www.frc.org.uk/getattachment/fb05dd7b-c76c-424e-9daf-4293c9fa2d6a/Guidance-on-the-Strategic-Report-31-7-18.pdf>

The feedback on the August 2017 consultation can be found here:

- <https://www.frc.org.uk/getattachment/a90a8376-ff90-4427-8d03-7f81a61819b8/Feedback-statement-Guidance-on-Strategic-Report-31-7-18.pdf>

### **NEX Exchange Publishes Feedback on Proposed Amendments to the NEX Exchange Growth Market Rules**

Following a consultation in June 2018, NEX Exchange has published feedback on proposed amendments to the NEX Exchange Growth Market Rules for Issuers for Fast Track Applicants. The NEX Exchange Growth Market is a Multilateral Trading Facility (**MTF**) and a designated Recognised Growth Market, similar to AIM, rather than a regulated market like the London Stock Exchange.

Changes were proposed to the NEX Exchange Growth Market Rules for Issuers, the Corporate Adviser Handbook and the Due Diligence Practice Note, with the purpose of ensuring parity between fast track and non-fast track applicants by changing the fast track admission process.

Certain companies of good standing admitted to certain qualifying markets may apply to join the NEX Exchange Growth Market without publishing a NEX Exchange Admission Document (i.e. via the fast track admissions process). To ensure that the same amount of information is available to investors in respect of fast track and non fast-track



issuers, it was proposed that an applicant seeking fast-track admission should review and confirm that all information required by Appendix 1 of the NEX Exchange Growth Market Rules for Issuers (regarding information for an admission document) is publicly available in English, whether by an admission or prospectus document, announcement or other regulatory filing in the issuer's home market. Any gaps of information must be included in the NEX Exchange admission application announcement.

Corporate advisers will also be asked to submit a checklist evidencing that the Appendix 1 information requirements are satisfied.

The feedback received by NEX Exchange was largely supportive of the approach proposed, and also suggested clarification of the criteria to be applied when deciding whether a new market should be considered a qualifying market for the purposes of the fast track admission process. Markets from reputable jurisdictions that have at least analogous regulatory frameworks and disclosure standards to that of the NEX Exchange Growth Market should be accepted as "qualifying markets."

The NEX Exchange also agreed to publish a template checklist for corporate advisers to use to evidence that Appendix 1 information requirements are satisfied.

The revised rules came into effect at midnight, one 31 July 2018.

The feedback can be found here:

- <https://www.nexexchange.com/assets/pdfs/Fast%20Track%20Consultation%20-%20Feedback%20July%202018.pdf>

### **House of Commons Business, Energy and Industrial Strategy Committee Published Report on Gender Pay Gap Reporting**

On 2 August 2018, the House of Commons' Business, Energy and Industrial Strategy Committee published a report on gender pay gap reporting. The report states that the U.K. has one of the highest gender pay gaps in Europe, which is a major contributory factor to the continuing failure to fully utilise the talents of women.

The report is the result of an inquiry into executive pay and the gender pay gap in the private sector, launched by the Committee on 23 March 2018 and the introduction of new reporting requirements obliging employers with at least 250 employees to publish their first gender pay gap report by 4 April 2018. The launch of the enquiry was discussed in the April 2018 edition of this newsletter.

The report notes that, business by business, men dominate both the highest paid sectors of the economy and the highest paid occupations within each sector. While median pay across the economy is 18% in favour of men, gender pay gaps over 40% are not uncommon in certain sectors and approximately 78% of organisations report gender pay gaps in favour of men.

In recognition that the pay gap is higher in smaller businesses, the report calls on the Government to widen the net of organisations caught by the reporting requirements and to require organisations with over 50 employees to publish gender pay gap information.

Further, the report also recommends that organisations be required by the Government to publish alongside any gender pay gap report, an explanation of any gender pay gap together with an action plan for closing the gap, against which they should report progress each year as part of normal reporting requirements.

Finally, the report also finds that the Government failed to clarify the legal sanctions available to the Equalities and Human Rights Commission to sanction those who fail to comply with reporting requirements and recommends that this error be rectified.

The full report can be found here: <https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/928/928.pdf>

The associated press release can be found here: <https://www.parliament.uk/business/committees/committees-a-z/commons-select/business-energy-industrial-strategy/news-parliament-2017/gender-pay-gap-report-published-17-19/>

### **Association for Financial Markets in Europe and European Association for Independent Research Providers Publish Guidance for Unconnected Analysts Seeking to Access Information about Prospective Issuers**

On 20 August 2018, the Association for Financial Markets in Europe and the European Association for Independent Research Providers published guidance for unconnected analysts (those not employed by the underwriting syndicate) seeking to access information about prospective issuers relating to an initial public offering.

The guidance is being published in connection with the U.K. Financial Conduct Authority's new rules governing initial public offerings, effective from 1 July 2018. The new rules are designed to ensure that before any "connected research" (i.e. research from analysts at banks which are part of the underwriting syndicate) is published, a prospectus (or the registration document part of the prospectus giving details of the issuer and its business) is published and that unconnected analysts have had access to the issuer's management. The guidance aims to facilitate communication between issuer teams and interested unconnected analysts and sets out how unconnected analysts can register their interest to be in communication with the issuer team, and the manner and form any such communication should take.

The guidance can be found here:

- <https://www.afme.eu/globalassets/downloads/industry-guidelines/afme-ecm-ipo-reform-unconnected-analysts-process-and-guidelines.pdf>

The Association for Financial Markets in Europe's associated press release can be found here:

- <https://www.afme.eu/en/news/press-releases/2017/afme-and-euro-irp-publish-guidance-on-how-unconnected-research-analysts-can-access-issuer-information-in-uk-ipos/>

### **Response to the BEIS Insolvency and Corporate Governance Consultation**

On 26 August 2018, the Government published a response to the Insolvency and Corporate Governance consultation launched in March 2018 (**Response**).

The March 2018 consultation sought views on proposals to improve corporate governance in companies in or approaching insolvency, including:

- new measures to enable directors of parent companies to be held accountable and penalised where they make a decision to sell large insolvent subsidiaries where this results in harm to creditors and at the time of the decision could not reasonably believe the sale would lead to a better result for creditors;
- whether new powers should be introduced to undo a transaction/series of transactions where the transaction(s) have unfairly stripped value from a company; and
- whether existing investigative powers of the Secretary of State should be extended to include the power to investigate the conduct of former directors of dissolved companies.

The consultation also sought views on certain aspects of the corporate governance framework and asked for feedback on matters such as whether stronger corporate governance and transparency measures are required and what more could be done through a revised Stewardship Code (the code of best practice published by the FRC with respect to the stewardship by investors of their investments and shareholdings in listed companies).

Respondents, particularly those representing shareholders, argued the need for reform and suggested that a framework is needed to support effective intervention by shareholders and regulators at the first signs of troubles, but also warned that good stewardship alone is not sufficient to prevent insolvency where the underlying business is not viable.

Respondents from professional organisations gave general support to targeted reforms where a regulatory gap was identified but cautioned against wider action until investigations into existing high profile insolvencies have finished, so it can be seen whether existing powers are sufficient.

Many respondents also argued that the existing regime is sufficient, and high profile failures were due to the actions or inactions of directors, in breach of their duties. These respondents instead suggested that more should be done to ensure proper enforcement of the existing regime.

In light of the responses received, the Government announced it would take forward the following specific actions:

- strengthen transparency requirements around group structures to require groups to provide explanations of their corporate and subsidiary structures;
- strengthen shareholder stewardship by working with the investment community, the FRC and other interested parties to incorporate stewardship within the mandates given to asset managers by asset owners and establish safe channels through which institutional investors and others can escalate concerns about directors actions;
- strengthen the U.K.'s framework relating to dividend payments to avoid the practice of companies avoiding an annual shareholder vote on dividends by only declaring interim dividends;
- bring forward proposals to improve boardroom effectiveness and strengthen training and guidance provided to directors;
- take forward measures to ensure greater accountability of directors in group companies when selling distressed subsidiaries;
- legislate to enhance recovery powers of insolvency practitioners in relation to value extraction schemes designed to remove value from a firm at the expense of its creditors; and
- legislate to give the Insolvency Service powers to investigate directors of dissolved companies where they may have breached their legal obligations.

The BEIS stated that the proposed measures will be set out in further detail in Autumn 2018. It is likely that a number of proposals will require additional consultations.

The full Response can be found here:

- [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/736163/IC\\_G\\_-\\_Government\\_response\\_doc\\_-\\_24\\_Aug\\_clean\\_version\\_with\\_Minister\\_s\\_photo\\_and\\_signature\\_AC.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/736163/IC_G_-_Government_response_doc_-_24_Aug_clean_version_with_Minister_s_photo_and_signature_AC.pdf)

### **Guidance to Address Conflicts Of Interest in the Equity Capital-Raising Process Published**

On 18 September 2018, the International Organization of Securities Commissions (**IOSCO**) published Guidance in the form of a package of measures, which reflects the high standards of conduct by market intermediaries in the equity capital-raising process.

A survey found that conflicts of interests and associated conduct risks were present within the equity capital-raising process, with the key risks being:

- conflicts of interest and pressures on “connected analysts” during formation of research on an issuer in the pre-offering phase;
- prominence of conflicted connected research during investor education and price formation in equity IPOs; and
- conflicts of interests during the allocation of securities.

Additional risks also included the management of underwriting risk by firms managing the offering and associated conflicts of interest in the pricing of securities and conflicts associated with personal transactions by staff employed within firms managing the offering.

The measures suggested are:

- Measure 1: requiring firms to take reasonable steps to prevent analysts from facing pressure to take a favourable view of the offering from the issuer’s representatives.
- Measure 2: requiring that once an underwriting/placing mandate has been awarded, firms take reasonable steps to prevent connected analysts from being improperly influenced and ensuring that the analysts remain independent in their judgment and research.
- Measure 3: requiring that once an underwriting/placing mandate has been awarded, firms have appropriate controls to manage potential conflicts of interest and associated conduct risks arising from connected analysts performing an internal advisory role within the firm while also producing research on an equity securities offering.
- Measure 4: encouraging timely provision of information to investors in equity securities offerings.
- Measure 5: requiring firms to maintain an allocation policy that sets out their approach for determining allocations in an equity securities offering and to provide the issuer with an opportunity to be involved in the process.
- Measure 6: requiring firms to maintain records of allocation decisions made.
- Measure 7: requiring firms to manage any conflicts of interest that arise in relation to pricing an equity securities offering, to keep the issuer informed of key decisions/actions, and give the issuer an opportunity to be involved in decisions regarding pricing.
- Measure 8: requiring firms to take reasonable steps to prevent employees with access to confidential information on the issuer or the offering from entering into or facilitating any personal transactions which would involve misuse or improper disclosure of the information.

The guidance is non-binding but the IOSCO encourages members to consider the extent it should be implemented in their legal and regulatory regimes regulation.

The full guidance can be found here:

- <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD612.pdf>

#### **Resolution of the Competitive Bidding for Sky plc and the Disney Chain Principle Offer for Sky plc**

In December 2016, Twenty-First Century Fox Inc. (**Fox**) made a pre-conditional offer for the 61% of Sky plc (**Sky**) that it did not already own. The pre-conditions to Fox’s offer were not satisfied until July 2018. In December 2017 The Walt Disney Company (**Disney**) and Fox announced a merger combination, the effect of which would be to pass control of Fox’s 39% interest in Sky to Disney. At the end of February 2018, Comcast Corporation made a competing and higher pre-conditional offer for Sky and these pre-conditions were satisfied in June 2018.

The Disney/Fox merger and the two competing offers for Sky engaged the application of the U.K. Takeover Code (**Code**) in two important and novel (or unusual) areas – the application of the Code’s so-called “chain principle” with respect to the Disney/Fox merger and the Code’s “auction” procedure for resolving bids that remain competitive in their final stages.

### ***Disney’s Chain Principle Offer***

The Code provides, in general terms, that where a party (e.g. Disney) acquires over 50% of the voting rights in another entity (e.g. Fox) that has a controlling (30% or more) interest in a company governed by the Code (e.g. Sky), the Panel will not normally require that party to make a mandatory bid for the underlying Code company unless either: (i) the other entity has a “significant” (i.e. 50%) interest in the Code company, or (ii) securing control of the Code company might reasonably be considered to be a significant purpose of the party acquiring control of the other entity.

There have only been five previous cases in which this principle and requirement to make a mandatory offer has been invoked and none of those cases resembled the Disney/Fox/Sky situation.

In April 2018, the Panel ruled that limb (ii) above of the chain principle rule applied and that Disney would have to make a chain principle offer for Sky at the same price as Fox’s currently outstanding offer for Sky unless Fox had acquired 100% of Sky or any third party (e.g. Comcast) had acquired more than 50% of Sky. When Disney and Fox announced revised and increased terms for their merger and Fox increased its offer for Sky, the Panel had to revisit its determination of the price at which Disney would be required to make a chain principle offer. Minority shareholders in Sky argued that that offer price should be pitched at a significantly higher level than just the new Fox offer for Sky. However, the Panel fixed the new chain principle offer price at the same level as the new Fox offer.

These arguments—about the basis on which the Panel should properly determine the price at which a chain principle offer should be made—were eventually settled by a ruling of the Takeover Appeal Board (the **TAB**), upholding an earlier ruling of the Hearings Committee of the Panel and issued on 15 August 2018. In its reasoned ruling issued on 29 August 2018, the TAB upheld the Panel’s ruling that the Disney chain principle offer should be made at the same level as the Fox offer for Sky.

The TAB held that the chain principle price did not have to be based on what might be thought to be the true or fair or reasonable value of Fox’s interest in Sky. The Panel had adopted the correct approach by establishing the proportion of the consideration payable under Disney’s acquisition of Fox represented by Fox’s stake in Sky and then fixing a chain principle offer price based on the principle of equivalent treatment so that minority Sky shareholders would be offered the same level of consideration for their stakes in Sky as Fox was to be treated as receiving for its Sky stake.

A copy of the reasoned ruling of the TAB can be found here:

- <http://www.thetakeoverappealboard.org.uk/wp-content/uploads/2018/09/TAB-201804.pdf>

### ***Auction Process***

The other novel (but not unprecedented) feature of the Sky takeover arose because both Fox’s and Comcast’s bids remained in competition and capable of being increased on the last day in the U.K. Takeover Code timetable on which an increase would be permitted (the so-called “day 46”). In order to resolve such a competitive situation, the Code allows the Panel to require the competing bidders to announce final revised offers in accordance with an open auction process. The Code sets out one such procedure but the Panel may agree—as it did with Sky—to another auction process being followed.

In this case, the Panel announced that on day 46 for the two bids (i.e. 22 September 2018) an auction would be run under which the then lowest offeror (which was Fox) would be allowed to make an increased bid, followed by the other bidder (Comcast) and if the auction still remained open, both bidders would be allowed to make their final bids

(which might end up being equal in price). At the end of the day, Fox ended up bidding £15.67 per Sky share and Comcast bid £17.28 per share.

Subsequently, Comcast acquired Sky shares in the market taking its holding over 30% and triggering a mandatory bid (at its £17.28 final offer price) and Fox announced that it would be accepting the Comcast bid in respect of its 39% stake in Sky.

A copy of the Panel's announcement about the auction process for the Sky bids can be found here:

- [http://www.thetakeoverpanel.org.uk/wp-content/uploads/2018/09/2018\\_15\\_2.pdf](http://www.thetakeoverpanel.org.uk/wp-content/uploads/2018/09/2018_15_2.pdf)

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