SHEARMAN & STERLING

JANUARY 2020/EUROPE

GOVERNANCE & SECURITIES LAW FOCUS

Below is a summary of the main developments in US, EU, UK and Italian corporate governance and securities law since our last update in October 2019.

Financial regulatory developments are available here.

IN THIS ISSUE

EU DEVELOPMENTS

Corporate and Capital Markets

Institutional Investment: ESMA Report on Undue Short-Term Pressure on Corporations (Corporate Aspects)

On 18 December 2019, the European Securities and Markets Regulator (**ESMA**) published a report on undue short-term pressure on corporations in securities markets. On environmental, social and governance (**ESG**) disclosures, ESMA recommends that the European Commission take action on setting a minimum level of comparability, relevance and reliability for ESG disclosures, amending the Non-Financial Reporting Directive (**NFRD**) to establish principles for high quality non-financial information, assess the feasibility of achieving international convergence and consolidation of disclosure frameworks, including a non-financial statement in the issuer's financial reports, and establishing consistency between the NFRD and Transparency Directive. The Transparency Directive was issued in 2004, later revised in 2013, and aims to ensure the transparency of information for investors through effective financial reporting.

With regards to institutional investor engagement, ESMA recommends:

- reviewing ESMA's November 2013 Public Statement on information on shareholder cooperation and acting in concert under the takeover bids directive; and
- that the European Commission considers whether requiring a vote on whether or not to include the non-financial statement in each company's annual financial report could serve as an effective tool for investors to express the investors views on how investee companies address sustainability risks.

ESMA has considered the views of financial markets participants, and its report summarizes their input on investment strategy, the impact of the International Financial Reporting Standards (**IFRS**) definition for fair value measurement on financial reporting, the impact of undue short-termism on remuneration policy, ESMA's analysis of the remuneration of corporate directors and how the remuneration packages may have affected director's incentives to pursue short or long term performance.

View ESMA's announcement here.

View ESMA's full report here.

Financial Reporting: ESMA Report on EU issuers' Use of Alternative Performance Measures

On 20 December 2019, ESMA published a report on the use of alternative performance measures, such as EBIT and EBITDA, as an EU issuer's measure of financial performance.

ESMA's report finds that alternative performance measures are widely used, and the majority of issuers have not complied with ESMA's guidelines in their use of management reports and prospectuses issued on or after July 2016. ESMA's 2016 guidelines require that an APM's reliability is explained, and reconcilable line items are identified between the financial statements and earnings results and prospectuses produced by the issuer.

ESMA finds that there is significant room for improvement in complying with its guidelines, and has also noted that the ratios and subtotals inside a financial statement may fall under the umbrella of an APM and their presentation should therefore comply with its 2016 guidelines.

View ESMA's announcement here.

View ESMA's full report here.

European Commission Announces European Green Deal and Zero Carbon Target by 2050

On 11 December 2019, the European Commission announced the European Green deal. The European Green deal is a growth strategy to cut carbon emissions in a way which benefits the European Union's economy. In relation to the corporate aspects of the deal, the commission will review the NFRD to require companies and financial institutions to disclosure more climate and environmental data. A reason for this is to allow investors to choose to invest in financial institutions and companies which have a positive impact on the environment.

More generally, the "European Climate Law" which sets a statutory target of the EU being carbon neutral by 2050, will be accompanied by proposed legislation in March 2020. The Commission will also review existing environmental legislation such as the EU Emissions Trading System (**EU ETS**) and Energy Efficiency Directive (2012/27/EU). One of the material changes that is being considered by the Commission is to extend the EU ETS to the maritime sector to reduce maritime emissions of greenhouse gases.

View the European Commission's Green Deal overview here.

SME Growth Market Reform Regulation: Publication in Official Journal

On 11 December 2019 a new Regulation amending the revised Markets in Financial Instruments Directive (**MiFID II**), Market Abuse Regulation (**MAR**) and Prospectus Regulation (**PR**) was published in the Official Journal of the European Union, introducing changes to support small- and medium-sized enterprise growth markets as trading venues. SME growth markets are a new sub-category of multilateral trading facility introduced by MiFID II in January 2018 to facilitate access to capital for SMEs. In October 2019, the EU brought in a new regulation supplementing MiFID II to address regulatory barriers to the take-up of SME growth markets. This amending Regulation furthers those efforts.

The key change to MiFID II is the introduction of an expert stakeholder group that should be established by the European Commission by 1 July 2020 to monitor the functioning and success of SME growth markets. The group will publish a report on its conclusions by 1 July 2021.

The key changes to MAR include: (i) an exemption from the market soundings regime that means disclosures of inside information in the context of a private placement of bonds to qualified investors will not be deemed to be a market sounding, provided that an adequate non-disclosure agreement is in place; (ii) an exemption from the market manipulation regime that means issuers of securities admitted to an SME growth market may enter into a liquidity contract for their shares, subject to satisfaction of certain conditions; and (iii) reducing the burden of maintaining insider lists for issuers whose securities are admitted to an SME growth market, but allowing them to maintain only a list of persons who have regular access to inside information (e.g. directors and in-house counsel), although it is open to Member States to introduce a requirement for such issuers to provide more extensive insider lists including all persons who have access to inside information.

The key changes to the PR include: (i) a requirement that unlisted companies seeking admission to trading on a regulated market following an exchange offer, merger or division should publish a prospectus; (ii) extension of the simplified disclosure regime to benefit issuers that issue securities on SME growth markets; and (iii) amendments to the PR to allow issuers seeking an initial public offer with a tentative market capitalization below €200,000,000 to draw up an EU Growth prospectus.

The amending Regulation entered into force on 31 December 2019 and applies directly in all EU Member States from that date, with the exception of the amendments to the MAR, which will apply from 1 January 2021.

View the regulation to amend MIFID II, MAR and the PR here.

New Prospectus Regulation: ESMA Final Report on Draft Amendments to Prospectus Regulation RTSs

On 4 December 2019, ESMA published its final report on the draft Regulatory Technical Standards (**RTS**) amending delegated Regulation EU 2019/979. The report contains RTS under the new PR. Minor errors were amended in the draft RTS, such as forgoing the requirement on issuers of securities convertible or exchangeable into third party shares to publish a supplement to their prospectus. The intention of Regulation EU 2019/979 was not to increase legal requirements for issuers by requiring the publishing of supplements. The final draft RTS also amend certain clerical and typographical errors.

View ESMA's final report on the draft RTS here.

New Prospectus Regulation: Updated ESMA Questions and Answers (December 2019)

On 4 December 2019, ESMA published the third version of its questions and answers on the PR which entered into force on 20 July 2017, and applied in full from 21 July 2019. The Q&A relates to the inclusion of pro forma summaries in base prospectuses, with ESMA's view being that it is not possible to include a pro forma summary in a base prospectus. The last Q&A published by ESMA on the PR was on 12 July 2019.

The Q&A also relates to the application of the PR disclosure annexes where securities do not fall neatly within a specific disclosure regime. ESMA's view is that annexes which are already applicable to certain securities should be applied to the prospectus for comparable securities. Additionally, ESMA has taken the view that issuers and competent authorities should identify any additional information that need to be disclosed in order to satisfy the "necessary information test" and which might, for example, be required under another securities note or additional information annex under the PR. Issuers should therefore contact authorities in their Member State to better understand what qualifies as necessary information to be disclosed for a security where they are not certain as to which PR annexes should apply to their prospectus.

View ESMA's Q&A report here.

Prospectus Regulation: ESMA Publishes Updated List of Thresholds Below Which an EU Prospectus is Not Required

On 2 December 2019, ESMA published an updated list of thresholds for offers below which no prospectus is required under the PR, in addition to a summary of the national rules applying to offers below that threshold and hyperlinks to the relevant national legislation and rules.

View ESMA's updated list of thresholds here.

Publication of Amending Directive Relating to Cross-Border Conversions, Mergers and Divisions

On 18 November 2019, the Council of the European Union (**Council**) announced that it had formally adopted at first reading the proposal for a directive to amend Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions ("**Directive**"). The Directive was adopted at first reading by the European Parliament on 18 April 2019, as amended by a corrigendum approved by the European Parliament on 29 October 2019. The changes made in the corrigendum were mainly corrections or of a stylistic or linguistic nature.

On 12 December 2019, the Directive was published in the Official Journal. The text of the Directive is substantially the same form as that adopted by the Council in November. The Directive entered into force 20 days after its publication in the Official Journal. Member states must bring into force the laws, regulations and administrative provisions required in order to comply with the Directive by 31 January 2023.

We discussed the content of the amending directive as first adopted in April 2019 in the July edition of this newsletter.

View the corrigendum here.

View the Official Journal which published the Directive here.

View the Directive here.

ESMA Guidelines on Risk Factors

On 1 October 2019, ESMA published on its website its guidelines on risk factors under the Prospectus Regulation. The guidelines are addressed to each Member State's competent authority to assist their review of risk factors in a prospectus and/or a supplement. However, ESMA encourages those responsible for the preparation of a prospectus to consider the guidelines when preparing documents for submission in relation to the specificity, materiality and presentation of risk factors.

There are 12 areas of guidance set out across six categories in the guidelines: specificity, materiality, corroboration, categorisation, conciseness and the summary. There are also illustrative examples included in Annex I which set out what ESMA considers appropriate risk factors to be, as well as explanations as to how they adhere to the Guidelines.

Within two months of the date of publication of the guidelines, competent authorities are required to notify ESMA whether they comply, do not comply but intend to comply or do not comply and do not intend to comply with the guidelines. The competent authorities must include reasons for their non-compliance.

The guidelines have applied since 1 December 2019.

View ESMA's guidelines here.

ESMA Publishes 2020 Work Programme

On 1 October 2019, ESMA issued a press release stating it had published its 2020 Work Programme ("**Work Programme**"). The Work Programme sets out ESMA's priorities and areas of focus for the next year in support of its mission to enhance investor protection and promote stable and orderly financial markets.

The main issue facing ESMA in 2020 is the implementation of its new mandates and enhanced role in areas including direct supervision, supervisory convergence, investor protection, relations with third countries, sustainability and technological innovation. Given the then uncertainty surrounding Brexit, ESMA said it continues to prepare for both a no-deal Brexit scenario and a scenario where a withdrawal agreement is in place.

In addition to implementing ESMA's new mandates, the key areas of focus under ESMA's activities of supervisory convergence, assessing risks, single rulebook and direct supervision will be:

- strengthening the convergence of powers based on the new ESMA Regulation, while ensuring consistency in the application of MiFID II and the Markets in Financial Instruments Regulation (**MiFIR**) for secondary markets;
- publication of its annual statistical report series based on the European Market Infrastructure Regulation (**EMIR**), the Alternative Investment Fund Managers Directive and MiFID II data promoting cooperation on risk analysis;
- contributing to the implementation of the Capital Markets Union, Fintech and Sustainable Finance Action Plans, developing the necessary rules under EMIR 2.2/EMIR Refit and reviewing MiFID II/MiFIR; and

- ensuring effective supervision of credit rating agencies, trade repositories, entities under Securitisation Regulation and the Securities Financing Transactions Regulation and Tier 2 Central Counterparties (**CCPs**) under EMIR 2.2, along with the recognition of third-country CCPs.

View the press release here.

View ESMA's Work Programme here.

ESMA Publishes SMSG Advice on Draft Disclosure Guidelines

On 28 October 2019, ESMA published advice provided by the Securities and Markets Stakeholder Group (**SMSG**) on 3 October 2019. The advice responded to ESMA's consultation on draft disclosure guidelines under the Prospectus Regulation ("**Draft Guidelines**"). The Draft Guidelines update the CESR's recommendations for capital markets to take into account the Prospectus Regulation and subsequent developments. The Draft Guidelines aimed to ensure a uniform understanding of disclosure requirements in the Commission Delegated Regulation (2019/980/EU), assist the assessment of prospectus information by competent authorities and promote consistency of interpretation of the Commission Delegated Regulation.

The SMSG generally welcomed the draft Guidelines, particularly the following: using other information than pro forma information and which events to cover with pro forma information (Guidelines 24 and 25); rules for calculation of working capital (Guideline 31); credit institutions and (re)insurance undertakings (Guidelines 34 and 35); and statement of indebtedness (Guideline 39).

SMSG did note some areas that it considers need to be addressed by ESMA, including principles and content of the Operating and Financial Review (Guidelines 2 and 3), due care and diligence (Guideline 9), pro forma financial information (Guideline 18), accountant/auditor reports (Guideline 25) and related party transactions (Guideline 41).

View ESMA's advice here.

FATF Publish Report on Best Practice on Beneficial Ownership for Legal Persons

On 24 October 2019, the Financial Action Task Force (**FATF**) published a report on Best Practices on Beneficial Ownership for Legal Persons. This follows the FATF's guidance on transparency and beneficial ownership which explain what the FATF standards on beneficial ownership require. However, given the challenges in effectively implementing these measures, the FATF found there was a need to outline more practical advice and examples on the effective measures to ensure legal persons are prevented from being used for criminal purposes, and that information on their beneficial ownership is available to competent authorities. The report therefore suggests ways jurisdictions can ensure compliance with recommendation 24 (enhancing the transparency of legal persons) and provides advice on how to implement approaches in the most effective way.

The report found risk assessments, accurate and timely information on beneficial ownership, access to information by competent authorities, forbidding or immobilising bearer shares and nominee arrangements, and effective, proportionate and dissuasive sanctions to all be elements of an effective system. The report also puts forward suggestions on ensuring authorities can access information on beneficial ownership of overseas entities.

View the full report on beneficial ownership for legal persons here.

View the 2014 guidance on transparency and beneficial ownership here.

UK DEVELOPMENTS

Corporate Governance: FCA Feedback Statement on Stewardship Regulatory Framework

On 24 October 2019, the FCA published feedback it received to its discussion paper on Building a Regulatory Framework for Stewardship (DP19/1), published jointly with the Financial Reporting Council (**FRC**).

The discussion paper considered how to improve stewardship in the UK capital markets, identifying minimum expectations for stewardship and the standards that the UK should aspire to.

The barriers to effective stewardship across the institutional investment community were revealed in the feedback statement. The barriers include:

- regulatory uncertainties under MAR and competition law that may discourage engagement between issuers and investors;
- investment mandates, voting guidelines and other arrangements between asset owners and asset managers may not be fully aligned with asset owners' and beneficiaries' investment and stewardship objectives ;
- firms' governance arrangements may not put enough emphasis on the value of effective stewardship;
- the information firms disclose on their stewardship may not be detailed enough for investors to distinguish between firms based on the quality of their stewardship; and
- service providers (such as proxy advisors and investment consultants) may not adequately support investors' stewardship.

The FCA is proposing to take steps to remove these barriers, which include:

- considering outcomes as the new regulatory regime for proxy advisors settles in; and
- taking action to focus on the arrangements between asset owners, asset managers and service providers and how these support stewardship objectives.

The FCA's feedback statement can be found here.

Discussion paper (DP19/1) can be found here.

National Security and Endorsement Bill—Queen's Speech December 2019

On 19 December 2019, the Queen's Speech to Parliament referred to legislation that the Government proposed to bring forward in the first session of the new Parliament. Included in this legislation will be a National Security and Investment Bill (**Bill**) to strengthen the powers of the Government to intervene in takeovers and mergers that may affect national security interests and to ensure that hostile parties are not able to circumvent these protections by purchasing an asset rather than the entity owning or controlling the asset which is of national security interest (e.g. purchasing intellectual property instead of purchasing shares in the company that holds the IP).

The Government proposes a notification system where sensitive transactions with security implications need to be flagged, allowing the Government to block these transactions or make them subject to certain conditions. The Bill will include a mechanism for appeal where necessary. The Bill represents the second stage of the reforms that the previous Government first proposed in October 2017 and further consulted on in 2018. We discussed the 2018 consultation in our October 2018 Governance & Securities Law Focus.

Details of the Government's legislative programme as outlined in the Queen's Speech can be found here.

Financial Reporting: Updated FRC Practice Aid on Audit Quality for Audit Committees

On 19 December 2019, the FRC reissued its practice aid to help audit committees evaluate audit quality. This is reissued guidance the first version of which was issued by the FRC in 2015. The guidance requires a premium listed company's audit committee to review the effectiveness of the audit process. The re-issued guidance's background material has been consolidated and shortened, with new sections addressing the audit tender process and the matters that the audit committee report must cover.

The FRC's practice aid can be found here.

Private Equity: PERG 12th Report on Conformity With Walker Guidelines and Updated Good Practice Reporting by Portfolio Companies

On 6 December 2019, the Private Equity Reporting Group (**PERG**) published its 12th annual report on the conformity of the private equity industry with the Walker Guidelines. These are Guidelines, recommended by Sir David Walker in 2007, designed to encourage transparency through enhanced reporting and disclosure by the largest UK portfolio companies and their private equity owners. The PERG's 12th Report found that only 53% of its sampled companies and firms have prepared disclosure to a good standard under the Walker Guidelines, in comparison to 73% from the previous year. Additionally, only 80% of portfolio companies published annual reports in a timely manner on their website and only 68% published a mid-year update in a timely manner on their website. 7% of companies did not comply with any of the three components of the Guidelines that applied to them.

Alongside its report, PERG (in conjunction with PwC) also published an updated version of its Good Practice Reporting Guide for portfolio companies. This Guide highlights examples of good disclosures to help support portfolio companies with their narrative reporting and, for example, points out that the inclusion of gender pay gap reporting in disclosures should not be seen as a replacement for a broader gender diversity discussion by portfolio companies.

PERG's 12th Report can be found here.

The Good Practice Reporting Guide can be found here.

Prospectuses: FCA Primary Market Bulletin No. 26 and Amended Knowledge Base

On 17 December 2019, the FCA published its 26th Primary Market Bulletin in which it noted that it was in the process of updating a number of the technical and procedural notes that it maintains in its "Knowledge Base" providing guidance in relation to its prospectus rules to reflect the new EU Prospectus Regulation. Pending updates to guidance that require more substantive changes than simply updating terminology, etc., the FCA says that the existing guidance should be applied to prospectuses drawn up under the Prospectus Regulation to the extent that the guidance is compatible with that Regulation.

The FCA Bulletin can be found here.

Corporate Governance: Principles-Based Guidance for Board Risk Committees in the Financial Services Sector

On 4 December 2019, the Risk Coalition—an association of not-for-profit professional bodies and membership organisations committed to raising the standards of risk management in the UK—published its final principles-based guidance for board risk committees and risk functions in the UK financial services sector. The guidance—contained in a document entitled "Raising the Bar"—comprises eight principles for risk committees and nine principles for risk functions. The Risk Coalition notes that many of these principles are well-established and that the guidance is intended to emphasise the key role, seniority and independence of the chief risk officer ("**CRO**") within the corporate function. The guidance is not prescriptive but does provide detailed practical guidance on the implementation of the good practice principles. It also assumes that firms will adopt a "Three Lines of Defence" approach to their risk management function under which risk will be managed, in the first instance, by management, and in the second by the robust, independent oversight and challenge of management's risk-taking activities (headed by the CRO) and thirdly by the work of the internal audit function. The guidance is intended to be used on an "apply or explain" basis, with firms encouraged to disclose publicly the extent of their application of the guidance.

The Risk Coalition's Guidance can be found here.

MAR: FCA Primary Market Bulletin No. 25

On 27 November 2019, the FCA published its 25th Primary Market Bulletin. The bulletin discusses the best practices for government departments, public bodies and industry regulators in identifying inside information, controlling and handling that information, disclosing it and dealing with leaks.

Additionally, the bulletin acts as a reminder that David Cunningham King, the chair of Rangers International Football Club PLC, has been cold-shouldered by the Panel on Takeovers and Mergers for a period of four years from the date of the ruling on 2 October 2019. This means that under FCA rules, firms should not have any dealings with Mr. King with respect to any transaction subject to the Takeover Code during this period.

The FCA bulletin can be found here.

LR and DTR: FCA Quarterly Consultation No. 26 (Corporate Aspects)

On 6 December 2019, the FCA published its quarterly consultation paper (No. 26) which proposes two particular changes to the Listing Rules.

The first is to make it clear that the Listing Rules' requirements in relation to shareholder circulars that certain documents must be "put on display" does not require a copy of a sale and purchase agreement in respect of a transaction requiring shareholder approval (for example) to be made available online but only to be made available for physical inspection at a designated location. The second is to require issuers to keep publicly available in the UK's National Storage Mechanism while ever they have securities admitted to the Official List a document allowing investors ready access to information about the securities' terms and conditions, or a description of the securities' rights and how the rights can be exercised.

The FCA Quarterly Consultation paper No. 26 can be found here.

Corporate Governance: QCA Publishes AIM Good Governance Review 2019/20

On 10 December 2019, the Quoted Companies Alliance (**QCA**) in conjunction with UHY Hacker Young published the AIM Good Governance Review 2019/2020.

The review looks at AIM company corporate governance disclosures following the AIM Rule 26 changes in September 2018 that required AIM companies to disclose which corporate governance code they have adopted. The review notes that the most common code followed is the QCA Corporate Governance Code—in the survey mentioned below the QCA says that 90% of AIM companies have adopted the QCA Code—and that generally the quality of corporate governance disclosures has continued to improve.

On 26 November 2019, YouGov published a survey ("**Corporate Governance on AIM**"), of 139 AIM companies about their experience of having to adopt a corporate governance code following the AIM Rule change mentioned above. The QCA noted that 39% of companies said that adopting the QCA Code has helped their business and that as a result of adopting the QCA Code, 40% of companies have disclosed more information to the market.

The AIM Good Governance Review can be found here.

The Corporate Governance on AIM survey can be found here.

Corporate Governance: ICGN Launches Consultation on Global Stewardship Principles

On 11 October 2019, the International Corporate Governance Network (**ICCN**) launched a consultation on proposed revisions to its Global Stewardship Principles. The Global Stewardship Principles were first published in 2003 and provide a framework for investors to adhere to their fiduciary duties to clients and beneficiaries.

The latest version of the principles was revised in 2016, reflecting ICGN's views on what constitutes best practices in relation to investor stewardship obligations, policies and processes. The key changes now being proposed include a focus on systemic risks relevant to institutional investors, protecting voting rights against dual class shares and a greater focus on stewardship outcome versus inputs in stewardship reporting.

The ICCN's revised principles can be found here.

Brexit: BEIS Publishes Guidance on the Impact of Brexit on UK Company Law

On 25 October 2019, the Department for Business Energy & Industrial Strategy (**BEIS**) published guidance setting out the changes to the Companies Act 2006 and to the wider framework of UK corporate law and accounting and audit regulations in the case of a "no-deal" Brexit.

The guidance essentially summarizes all previous government guidance on the changes arising from Brexit to UK company law. In nearly all cases the changes, which are largely minimal, will only impact businesses that have a cross-border relationship with EU, whether by conducting business operations in the EU, by being an EU company operating in the UK or by being a UK subsidiary or branch with an EEA parent, for example.

The guidance sets out the different aspects of UK company law affected by Brexit, which companies may be impacted, and what action each affected company should consider taking.

The BEIS guidance can be found here.

UK Annual Report on Modern Slavery

On 17 October 2019, the Government published the 2019 UK Annual Report on Modern Slavery. It provides an overview of modern slavery concerns and issues in the UK and sets out the UK's response to modern slavery over the past 12 months. The response is structured around the "four Ps" framework used in the Modern Slavery Strategy, published in 2014:

- Pursue: prosecuting and disrupting individuals and groups responsible for modern slavery.
- Prevent: preventing people from engaging in modern slavery, either as victims or offenders.
- Protect: strengthening safeguards against modern slavery by protecting vulnerable people from exploitation and increasing awareness of and resilience against modern slavery.
- Prepare: reducing the harm caused by modern slavery through improved victim identification and enhanced support.

The strategy also commits the Government to develop its international response to modern slavery.

The activity from the past 12 months highlighted in the report includes the following:

- An uplift in operational activity to tackle modern slavery, with over 1,479 active law enforcement investigations in June 2019.
- A £10 million investment from the Government to establish a new Modern Slavery Policy and Evidence Centre.

- The Home Office's commitment to an ambitious programme of work to strengthen the effectiveness of the transparency in supply chain provisions following the Independent Review of the Modern Slavery Act.
- Progress in the UK Government's delivery of reforms to the National Referral Mechanism (**NRM**), a system for identifying and supporting victims of modern slavery.

The report notes that the UK will continue its efforts over the next year. This includes working towards implementing the NRM reform programme and embedding an end-to-end needs-based approach to better respond to the needs of victims and provide appropriate support. Other efforts include the UK utilising legislation to tackle modern slavery and the Government continuing to drive the global response against modern slavery by working with multilateral organisations, governments, the public and private sector and local communities.

The full report can be found here.

Investment Association's Principles of Remuneration for 2020

On 1 November 2019, the Investment Association (**IA**) published its annual list of over-arching principles and general guidance relating to executive remuneration. This sets out the issues that influence whether IA members will support a company's remuneration policy or approve the adoption or amendment of a particular share plan or incentive structure. These principles are intended to apply to companies listed on the London Stock Exchange's Main Market but may also be relevant for companies listed on other venues.

The areas of focus highlighted by IA members include the following:

- IA members increasingly view long term incentive schemes as ineffective and having the potential to result in concerning outcomes, such as increasing grant levels or volatile and significant vesting outcomes. Remuneration Committees are encouraged to evaluate the remuneration strategies to ensure they are aligned with the implementation of the company's strategy. IA members are also committed to working with stakeholders to see when alternative remuneration structures could be more widely implemented in the UK.
- Vested long-term incentives can lead to significant value being paid to a small number of individuals, which has a reputational impact on the company, its directors and shareholders. To address this, the discretion section of the Principles of Remuneration has been updated to include a suggestion that Remuneration Committees introduce discretion into their incentive schemes allowing them to limit the vesting outcomes if a specific monetary value is exceeded. Remuneration Committees should set the threshold and determine how it should be implemented on an individual basis.
- The IA's approach in 2020 will continue to reflect its underlying aim of aligning pension contributions for executive directors with the majority of the workforce.
- Companies should justify to investors the level of remuneration paid to executives. Members are particularly concerned about incremental increases to fixed pay and variable pay opportunity, which, on aggregate, can lead to substantial increases in overall remuneration.
- The IA's members' clients continue to seek explanations as to why remuneration pay-outs are supported. There must be transparency of financial, strategic and personal targets so that the link between pay and performance is clear. IA members request that strategic and personal targets and outcomes are separately disclosed.

The principles of remuneration can be found here and a letter written to remuneration committee chairs can be found here.

Fourth Hampton-Alexander Report on Gender Balance in FTSE 350 Leadership Roles

On 13 November 2019, the Hampton-Alexander report published its fourth annual report on improving the gender balance of FTSE 350 boards. The report notes that 2019 has been the strongest year of progress since 2011 when the targets were set to achieve long-term gender balance. FTSE 100 companies are on track to reach the 33% target for women boards ahead of the 2020 deadline whilst FTSE 250 companies made strong gains during the year and with sustained effort will also meet the 2020 deadline. The main findings of the report were:

- 32.4% of FTSE 100 board positions are held by women, a 2.2% increase from 2018. However, 51 FTSE 100 companies have not yet achieved the 33% target.
- 29.6% of FTSE 250 board positions are held by women, a 4.7% increase from 2018. However, 139 FTSE 250 companies have not yet achieved the 33% target.
- There are still two all-male boards in the FTSE 350, down from five in 2018. There are 39 companies that only have one woman on the board, 28 of which have only had one woman for the second year running.
- Women's representation in senior leadership positions of FTSE 100 companies has increased 1.5% from 2018 to 28.6%. The FTSE 250 has seen a stronger increase, with women's representation increasing 3% to 27.9%. However, there are still 44 all-male executive committees. Despite the improved results compared with 2018, unless half of all available leadership roles go to women this year, the FTSE 350 will not achieve its 2020 target for women in leadership positions.

We covered the Government's update to the Hampton-Alexander Review in our Q3 2019 G&SL newsletter at page 5.

The Hampton-Alexander review can be found here.

The Hampton-Alexander review press release can be found here.

Revised UK Stewardship Code

On 24 October 2019, the Financial Reporting Council launched a substantial revision to the UK Stewardship Code ("**Code**"). We covered the FRC's consultation on proposed revisions to the Code in our Q1 2019 G&SL newsletter at page 20 and noted that the revised Code was to be published by the end of 2019 in our Q3 2019 G&SL newsletter at page 9.

The revision to the Code sets higher expectations for how money is invested on behalf of UK savers and pensions. This is achieved by ensuring money is managed responsibly, particularly in relation to creating long-term value and considering beneficiary and client needs. Revision of the Code follows the introduction of the new UK Corporate Governance Code for reporting periods starting in January 2019 as part of the comprehensive revision of the UK's corporate governance framework.

Key changes to the Code include the following:

- An extended focus that includes asset owners and service providers as well as asset managers. This will help align the approach of the whole investment community in the interest of end-investors and beneficiaries.
- A requirement to report annually on stewardship activity and outcomes. Signatories' reports should show what has actually been done in the previous year and what the outcome was, including their engagement with the assets they invest in.
- Environmental, social and governance factors, including climate change, should be considered and signatories should ensure their investment decisions are aligned with the needs of their clients.

- Signatories must explain how they have exercised stewardship across asset classes beyond listed equity and in investments outside of the UK.
- Signatories must explain their organisation's purpose, investment beliefs, strategy and culture. They should show how they are demonstrating this commitment through appropriate governance, resourcing and staff incentives.

The Code aims to strengthen the UK's position as a destination for long-term, sustainable investment. It also aims to promote transparency and integrity in business, in turn benefitting the economy, environment and society.

The press release can be found here and the feedback statement on the consultation can be found here. The Code can be found here.

IoD Manifesto for Corporate Governance

On 22 November 2019, the Institute of Directors (**IoD**) published a manifesto on corporate governance. It contains ten policy initiatives to reinforce the UK's pre-eminent position in the global corporate governance space. The IoD believes high standards of corporate governance to be an essential part of public trust in UK businesses. The report sets out the three main objectives of its policy proposals, listing which policy proposals correspond to the relevant objective.

The following policy proposals aim to increase the accountability of the UK corporate governance system:

- Supporting the development of an industry-led Code of Conduct for Directors, applying to members of significant corporate entities (i.e. companies exceeding a certain size threshold or level of importance for stakeholders and the wider UK economy).
- Delivering reforms proposed to regulate auditors, such as those recommended in the Kingman Review.
- Establishing an independent Corporate Governance Commission to oversee the corporate governance and stewardship code framework.
- Transforming the operation and function of Companies House, such as with regards to better scrutiny of information so as to improve data accuracy.

The second objective, increasing the competence and professionalism of UK board members, would be achieved by the following policy proposals:

- Introducing minimum requirements for director training to ensure directors have a full and clear understanding of their responsibilities.
- Encouraging the adoption of a Code of Practice for Board Evaluation to increase consistency and improve the value of evaluations for stakeholders.

The final objective is to encourage a longer-term, sustainable approach to business behaviour and would be met by the following policy proposals:

- Creating a framework through which companies can project their business purpose, e.g. having clearly defined objects or a "business purpose" statement, allowing companies to communicate their expected social impact beyond merely maximising profits.
- Encouraging a consistent approach to climate-related corporate disclosures.
- Exploring opportunities to establish an ESG-oriented sovereign wealth fund to invest in green and sustainable companies of the future, thereby embedding the highest standards of corporate governance across the economy.

- Establishing a newly-defined corporate form—the Public Service Corporation, through which the outsourcing of public services and related activities could be delivered.

The full manifesto can be found here.

Glass Lewis 2020 UK Proxy Paper Guidelines

On 4 November 2019, Glass Lewis published its 2020 proxy paper guidelines for the UK. These guidelines incorporate global corporate governance best practice and are reviewed annually to ensure they reflect current market practice, regulations and governance codes.

Changes from the previous 2019 version of these guidelines include amendments to the following policies:

- Gender diversity: it will consider recommending against the chair of the nomination committee of any FTSE 350 board which has not met the 33% gender diversity target set out by the Hampton-Alexander Review where no explanation nor plan to address the issue is given.
- Board skills: it will include board skills matrices in its analysis of director election proposals of all FTSE 350 companies (previously FTSE 100), excluding externally managed investments trusts. It also may recommend voting against the chair of the nomination committee if a board has not addressed major issues of board composition.
- Audit committee meetings: it will consider recommending against the election of the chair of the audit committee at any FTSE 350 company (excluding investment trusts) where the audit committee has not held a minimum of three meetings during the year under review without explanation.
- Smaller premium listed companies: in line with the latest UK Corporate Governance Code, it expects boards at premium-listed companies outside the FTSE 350 to be at least 50% (rather than 33%) independent and to hold annual, rather than staggered, director elections. Where the board has failed but still intends to meet the enhanced board independence elections, it will generally accept explanations in lieu of compliance.
- Salaries and pensions: the guidelines have been updated to reflect current best practice in relation to salaries and pensions. It generally expects salary increases and pension contribution levels to be in line with those of the company's wider workforce.
- Incentive plan limits: it expects all incentive plans to include clear and transparent award limits, preferably expressed as a multiple of base salary per employee.
- Post-exit shareholding requirements: post-employment shareholding requirements are included among the best practice features generally expected of remuneration policies.
- Threshold vesting under LTI plans: it expects that long-term incentive plans will allow for no more than 25% vesting for threshold performance.
- Remuneration committee discretion: remuneration committees should consider exercising downward discretion where a company has suffered an exceptional negative event, even if formulaic targets have been met.

The 2020 Proxy Paper Guidelines can be found here.

BEIS Committee's Corporate Governance Recommendations

On 4 November 2019, the BEIS Committee published a letter of recommendations to the Secretary of State. Among other things, the letter covered corporate governance, audit reform and executive pay and bonuses following its public evidence sessions which examined the collapse of Thomas Cook.

The Committee's recommendations included that:

- Pension contributions are changed to create a fairer system. The Committee expects the Financial Reporting Council's replacement to have a role in this reform, alongside pressure from stakeholders, investors and remuneration committees.
- There should be greater transparency in executive bonus scheme arrangements. Pre-defined measures which are not ambiguous nor open to interpretation should be used.
- An enforceable clawback provision for a suitable period should be included in all future performance bonus arrangements, covering all elements of the bonus.
- The new Government should prioritise implementing legislation to ensure all FTSE 100 companies publish their workforce data, broken down by ethnicity and by pay band. This recommendation reiterates the recommendation in its predecessor's April 2017 report on corporate governance.
- A review of accounting practices relating to the use of goodwill and its impairment should take place. The Committee calls for graduated findings to be implemented swiftly to ensure that serious doubts over issues such as goodwill are reflected in audit opinions. This reiterates its recommendations from its April 2019 report and Sir John Kingman's review of the FRC.
- Audit firms should clearly separate the audit and non-audit parts of their business. The Committee recommends urgent reform of the sector and expresses disappointment in the Government's failure to implement reforms aimed at tackling conflicts of interest and improving audit quality.

The letter from the BEIS Committee to the Secretary of State can be found here. The annex to the letter can be found here. The press release can be found here.

FRC Future of Corporate Reporting Survey

On 17 October 2019, the Financial Reporting Council (**FRC**) announced that it would be launching a survey on corporate reporting. This is part of the FRC's project which aims to inspire the future of corporate reporting by challenging the FRC to think more broadly in promoting greater brevity, comprehensibility and usefulness in corporate reporting. By surveying stakeholders' views, the FRC intends to shape and improve information for all users of corporate reports.

The survey focused on stakeholders' personal experience and expectations when seeking and using company information. Responses will be used as the basis of the FRC's recommendations for improvements to current regulation and practice.

The survey closed on 15 November 2019 and a summary of the results, along with the Future of Corporate Reporting leadership paper, will be published this year.

The press release can be found here.

BEIS Report on the Non-Financial Reporting Regime

On 22 October 2019, the BEIS published a report exploring stakeholder perceptions of the non-financial reporting regime in the UK. The non-financial reporting section of these reports includes: a fair review of the company's business and the principal risks and uncertainties it faces; the company's corporate governance (e.g. diversity on boards); their environmental behaviours; and corporate social responsibility. The report analyses the effect of additional duties placed on public interest entities (e.g. listed companies or credit and insurance entities) under the EU Non-financial Reporting Directive by researching the impact of the regulations on businesses and wider stakeholders.

Stakeholders generally believed corporate reporting had improved since the Companies Act 2006 was enacted. There was also consensus that non-financial reporting is becoming more engaged with non-financial risks. While generally respondents believed corporate reporting and governance in the UK was strong, some suggested that companies may struggle to keep up with the pace of regulatory change. There was also a strong view that the quality of reporting varies greatly among companies and that compliance may be viewed as more of an exercise in compliance than a meaningful assessment of risks.

Feedback from companies showed regulations to have had a positive impact generally, given prior to the regulations only four in ten companies reported publishing non-financial information. Understanding the regulatory requirements and data collection were both key costs to companies during their first year of compliance. However, overall the regulations do not seem to have been a major burden on the companies sampled.

The report generally found stakeholders and businesses to be in favour of non-financial reporting. Both stakeholders and businesses were also generally very positive about the strength of the corporate governance regime in the UK. Stakeholders also agreed that the importance of non-financial reporting would only increase as influential investors push for greater transparency, and the recommendations of the Financial Stability Board (**FSB**)'s Task Force on Climate-related Financial Disclosures and the focus on the UN's Sustainable Development Goals become embedded in the regime. Several stakeholders highlighted a growing interest from wider society in non-financial reporting.

The full report can be found here.

FCA's Discussion Paper on Climate Change and Green Finance

On 16 October 2019, the Financial Conduct Authority (**FCA**) published a feedback statement setting out its proposals to improve climate change disclosures by issuers and information to consumers on green financial products and services. This is a response to its discussion paper, Climate Change and Green Finance ("**Discussion Paper**") issued in October 2018, which sought views on potential FCA action on climate change and green finance in line with the objective of ensuring relevant financial markets function well. This was covered in our Q4 2018 G&SL newsletter on page 7.

The statement sets the FCA's approach following the Discussion Paper and identifies the relevance of climate change as an issue for the financial services sector, a summary of feedback to the Discussion Paper and the FCA's responses and the FCA's actions and next steps.

The responses to the Discussion Paper include the following:

- There are significant challenges in determining the materiality of climate change risks, with investors requiring consistent, comparable and high-quality disclosures to take account of the risks.
- Respondents were generally supportive of introducing climate change disclosure requirements for regulated firms. However, proportionality was a concern, with some respondents favouring an approach proportionate to a firm's size and risk profile.
- Some respondents were concerned with the difficulty of identifying genuinely green investments and were supportive of internationally agreed standards for defining the sustainability characteristics of financial products.
- A variety of concerns were expressed by stakeholders, including the short-term results culture of finance, the absence of common standards and a lack of action from Government and regulators to incentivise actively the emergence of innovative green finance products.

In response to the feedback, the FCA intends to publish a consultation paper in early 2020 proposing new disclosure rules for certain issuers and clarify existing disclosure obligations relating to climate change risks. It also intends to publish a feedback statement on stewardship with the Financial Reporting Council, in which it will show its continued supervisory and policy interest in firms' integration of climate change risk and will set out actions to address barriers to effective stewardship. The FCA also sets out actions it intends to take in relation to expectations around green financial products and services, such as challenging firms where there is potential greenwashing and carrying out further policy analysis on greenwashing. It also intends to continue its joint work with Government, other regulators and industry.

The Discussion Paper can be found here. The feedback statement can be found here and the press release can be found here.

FRC's Financial Reporting Lab: Climate-Related Corporate Reporting

On 22 October 2019, the FRC's Financial Reporting Lab published a report on climate-related corporate reporting. It contains guidance for companies on how they can improve their reporting of climate change information in order to meet the expectations of investors and the broader financial system, allowing for more informed decisions about capital allocation and the ability to price risk.

The report highlights areas of reporting which investors believe could be more effective and comprehensive, including how boards consider and assess climate change, operational risks and strategies to capitalise on the changing climate and related opportunities.

The report also discusses the Task Force on Climate-related Financial Disclosures (**TCFD**), which was established by the Financial Stability Board with a focus on how the financial sector can take account of climate-related issues. The report recommends companies use the TCFD as a framework for thinking about and reporting on climate change. The Lab has also developed a series of questions companies should ask to address the areas that investors seek to understand.

The report views investors as part of the solution to managing climate change, since investors are also under pressure to report on climate change issues under new regulations and client requests. Easier access to information will aid investors carrying out their own reporting.

Regulatory requirements are also considered in the report, such as the requirement of boards to consider the company's long term success in relation to environmental matters, for example when discharging their duties under the Companies Act 2006 and under the UK Corporate Governance Code.

The full report can be found here.

Report on Citizens' Views on the FRC's Work

On 2 October 2019 the Financial Reporting Council (**FRC**) published its final report following independent research into the views of the public on its work on corporate reporting, corporate governance and audit. The research was undertaken with the aim of better understanding the views of the general public who, as investors, have a stake in the work of the regulator. The research was collected from citizens' juries of 18-20 members of the public reflecting the local population in London, Edinburgh and Coventry. The findings will be used by the FRC to inform its board discussions and decision-making, and to feed into current projects.

The citizens' initially tended to have negative views of corporations, but these usually changed when considering the impact companies can have on the UK, particularly on the economy and local areas. Employment, production of products and services and investment were positive perceptions which citizens tended to hold in relation to companies.

The results showed the citizens believed the FRC should have more power to hold companies to account, but any increase in regulation should not affect companies' ability to operate and flourish. They believed the FRC should hold individuals and companies to account to deter wrongdoing and that it should operate in the public interest, considering the views of wider audiences. The citizens also believed it should improve diversity on boards and should maintain its independence from those it regulates at all costs.

The press release can be found here and the final report can be found here.

ISS Proxy Voting Guidelines Updates for 2020

On 11 November 2019, the Institutional Shareholder Services group of companies (**ISS**) published updates to its 2020 benchmark proxy voting policies. The updated policies will generally be applied for shareholder meetings on or after 1 February 2020.

Amendments include changes to the following policies:

- Director elections: inclusion of a new policy on board gender diversity noting that both appointments and succession plans should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds and cognitive and personal strengths. The policy on chair tenure has also been amended to clarify that tenure will be considered as one of several key indicators relevant to the re-election of chairs.
- Board and committee composition: removal of the exception for companies below the FTSE 350 in relation to independent directors forming 50% of the board and the exception allowing chairs to sit on the audit committee. These reflect the changes made to the UK Corporate Governance Code in 2018.
- Remuneration: amendment of the pension contribution policy to provide that pension arrangements for new directors should be aligned with the wider workforce and that companies should disclose whether or not this is the case. For incumbents, contribution rates should be aligned with the workforce overtime. Changes were also made to the policy on service contracts, clarifying that long-term incentive awards should be pro-rated for time served as an executive and for performance.
- Remuneration report: The bonus policy has been amended so that where bonus targets are not disclosed, the ISS will normally (rather than may) recommend a vote against a remuneration report. A negative vote recommendation may occur where a company chooses to disclose one or more years in arrears after the relevant reporting year. The exit payments policy has been amended to state that generally formal notice should be served no later than the day on which the executive's leaving date is announced. If notice is not served at this time, an explanation for this should be provided in the subsequent remuneration report. The policy on the use of discretion by remuneration committees has also been amended to include disclosure of how environmental, social and governance matters are considered by the committee when determining remuneration outcomes.

The policy updates can be found here and an executive summary of the updates can be found here.

BEIS Review of the PSC Register

On 30 October 2019, the BEIS published a report following its review of the "people with significant control" (**PSC**) register regime created under the Companies Act 2006 in 2016 and discussed in our client newsletters of March 2016 (found here) and July 2017 (found here). The Government's previous review of the PSC Register was covered in our Q3 2019 G&SL newsletter on page 15.

The new statutory regime aimed to improve corporate transparency by showing who ultimately owns and controls UK companies and certain other entities. The review aimed to establish whether the objectives of the new regime remain appropriate and have achieved their original goals, whether there is a less onerous regulatory way to achieve the objectives and whether the regime is still required and remains the best option for achieving the objectives.

The review found that the PSC regime has been effective in meeting the original objectives and the costs to businesses have been proportionate and in line with original estimates. It has helped stop companies being used for criminal activities, has a positive economic effect and is widely used. However, BEIS notes that the reliability of information contained on the public PSC register is unclear and needs to be analysed as part of a wider review of the corporate transparency and register reform.

The written statement announcing publication of the report can be found here and the full report can be found here.

Law Society and CLLS Q&A on the PSC Register

On 8 November 2019, the Law Society and City of London Law Society released a Q&A on the regime for the Register of People with Significant Control ("**PSC Register**"). The Q&A aims to highlight certain complexities within the PSC regime which are not specifically covered by primary and secondary legislation or guidance issued by the BEIS.

The full Q&A can be found here.

US DEVELOPMENTS

SEC and NYSE/Nasdaq Developments

SEC Proposes Changes to Accredited Investor Definition to Broaden Access to Investments

In December 2019, the Securities and Exchange Commission (**SEC**) proposed updates to its rules regulating participation by investors in private placements. The proposal seeks to update and improve the definition of "accredited investor" to more effectively identify institutional and individual investors that have the knowledge and expertise to participate in securities offerings made other than by way of an SEC-registered public offering. Accredited investors are eligible to participate in private placements structured under the Regulation D safe harbour, which provides an exemption from SEC registration.

Under the SEC's rule proposal, the accredited investor definition would be expanded to include the following categories of natural persons and entities:

- natural persons who have certain professional certifications and designations, such as a Series 7, 65 or 82 license, or other credentials issued by an accredited educational institution;
- with respect to investments in a private fund, "knowledgeable employees" of the fund;
- limited liability companies (**LLCs**) that meet certain conditions, registered investment advisers and rural business investment companies (**RBICs**);
- any entity, including Indian tribes, owning "investments", as defined in Rule 2a51-1(b) under the Investment Company Act, in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered; and
- "family offices" with at least $5 million in assets under management and their "family clients", as each term is defined under the Investment Advisers Act.

The rule changes would also add the term "spousal equivalent" to the accredited investor definition, so that spousal equivalents may pool their finances for the purpose of qualifying as accredited investors.

The SEC is also proposing to update the definition of "qualified institutional buyer" (or **QIB**) for purposes of the Rule 144A safe harbour, which allows large institutional investors with an investment portfolio of at least $100 million to participate in private offerings. The rule change would add LLCs and RBICs to the types of entities eligible to qualify as QIBs, as well as a catch-all for other institutional accredited investors that meet the $100 million investment threshold.

The 60-day public comment period on the proposed rule is now open. Changes to the SEC's rules will not take effect until the SEC publishes a final rule.

View our related client publication here.

SEC Staff Provides Guidance on Role of Audit Committees

On 30 December 2019, the SEC's Chairman, Chief Accountant and Director of the Division of Corporation Finance issued a public statement on the role of audit committees in financial reporting and key reminders regarding their oversight responsibilities. The general observations discussed in the statement include, among others:

- *Tone at the top*—Audit committees are encouraged to focus on the "tone at the top" with the objective of creating and maintaining an environment that supports the integrity of the financial reporting process and the independence of the audit. In this regard, it is important for the audit committee to set an expectation for clear and candid communications to and from the auditor, and likewise to set an expectation with both management and the auditor that the audit committee will engage as reporting and control issues arise. It is similarly important for audit committees to proactively communicate with the independent auditor to understand the audit strategy and status, and ask questions regarding issues identified by the auditor and understand their ultimate resolution.
- *Auditor independence*—Audit committees are encouraged to maintain appropriate oversight over the company's and the auditor's processes for monitoring factors that may affect the auditor's independence. Among other items, these processes should address corporate changes or other events that could affect auditor independence (*e.g.* changes or events that may result in new affiliates or business relationships) and facilitate the timely communication of these events and changes to the audit firm.
- *Generally accepted accounting principles* (**GAAP**)—With regard to the implementation of new accounting standards, audit committees are encouraged to engage proactively with management and the auditors in the implementation process to understand management's implementation plan, including whether the plan provides sufficient time and resources to develop well-reasoned judgments and accounting policies. It is also important for an audit committee to understand management's processes to establish and monitor controls and procedures over adoption and transition.
- *Internal control over financial reporting* (**ICFR**)—Audit committees should have a detailed understanding of identified ICFR issues and engage proactively to aid in their resolution. If material weaknesses exist, it is important for audit committees to understand and monitor management's remediation plans and set an appropriate tone that prompt, effective remediation is a high priority.

The statement also reminds audit committees of their oversight responsibilities in respect of:

- *Non-GAAP financial measures*—Audit committees should ensure they understand how management uses such measures to evaluate performance, whether they are consistently prepared and presented from period to period and the company's related policies and disclosure controls and procedures.

- *LIBOR transition*—Audit committees are encouraged to understand management's plan to identify and address the risks associated with reference rate reform, and specifically, the impact on accounting and financial reporting and any related issues associated with financial products and contracts that reference LIBOR.
- Critical audit matters (**CAMs**)—Starting in 2019, the auditors of certain public companies will be required to include CAMs in the auditor's report. Audit committees are reminded that the discussion of the CAM in the auditor's report should capture and be consistent with the auditor-audit committee dialogue regarding the relevant matter.

SEC Tries Once Again to Implement Government Payments Disclosure Rule

In December 2019, the SEC issued a proposed rulemaking to implement Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**"). Enacted nearly a decade ago as Section 13(q) of the Securities Exchange Act of 1934, Section 1504 directs the SEC to make rules to mandate transparency by SEC-reporting companies in the resource extraction sector (oil and gas and mining) of the payments they make to governments. The SEC has tried to implement rules under Section 13(q) twice in the past: the first rulemaking was vacated by federal courts, and the second time the SEC's rules were overturned by Congress shortly after the start of the Trump Administration. Given this rocky history, doubts remain whether the third time really will prove the charm. In the meantime, Canada and the EU have adopted government payments transparency rules substantially similar to what the SEC had originally proposed.

The proposed rules would require "resource extraction issuers", meaning issuers that are required to file annual reports on Forms 10-K, 20-F or 40-F with the SEC and that engage in the commercial development of oil, natural gas or minerals, to file a Form SD on an annual basis that includes information about payments related to the commercial development of oil, natural gas or minerals that are made to a foreign government or the U.S. federal government. The SEC is proposing to exempt the following companies from the disclosure requirements:

- newly public companies until the fiscal year immediately following the year their IPO registration statement became effective;
- emerging growth companies; and
- smaller reporting companies.

The proposed new rules include several significant changes compared to the SEC's prior rulemaking attempt (see our client publication summarising the 2016 rule), intended to ease the compliance burden on companies and address concerns that companies would be compelled to disclose potentially competitively sensitive information. For example, the proposed rules would:

- revise the definition of the term "project" to require aggregated disclosure at the national and subnational (eg, state or provincial) level, as opposed to for each contract;
- revise the "de minimis" threshold below which disclosure is not required to include both a project threshold and an individual payment threshold;
- add two new conditional exemptions for situations in which a foreign law or a contract in place prior to the new rule's effective date prohibits the required disclosure;
- add an exemption for smaller reporting companies and emerging growth companies;
- revise the definition of "control" to exclude entities or operations in which an issuer has a proportionate interest;

- limit the liability for the required disclosure by deeming the payment information to be furnished to, but not filed with, the SEC;
- add an instruction in Form SD that would permit an issuer to aggregate payments by payment type made at a level below the major subnational government level;
- add relief for issuers that have recently completed their U.S. initial public offerings; and
- extend the deadline for furnishing the payment disclosures—companies with a December 31 fiscal year-end would have until March 31 in the second calendar year following their most recent fiscal year to file their reports under Form SD.

The SEC is also proposing to recognise the equivalence of similar transparency regimes adopted by other jurisdictions. If, for example, the SEC were to determine that the Canadian or EU extractive industry payments disclosure rules satisfy the transparency objectives of Section 13(q), companies subject to those rules would be able to file the reports they prepare under the alternative disclosure regime in satisfaction of their obligations under the SEC rules.

Extractive industry companies subject to the new rules would be required to submit government payments reports starting with the first fiscal year ending no earlier than two years after the new rule's effective date.

The 60-day public comment period on the proposed rule is currently underway. The new rules will not take effect until after the SEC publishes a final rule.

US Chamber of Commerce Publishes Best Practices for Voluntary ESG Reporting

The U.S. Chamber of Commerce's Project for Growth and Opportunity, or Project GO, has published best practices for voluntary reporting of environmental, social and governance (**ESG**) information. The report suggests that ESG reporting can be best advanced through disclosure on a voluntary basis, rather than through additional regulation and mandatory "one-size-fits-all" disclosure regimes.

The best practices are intended to incorporate flexibility in the approach to ESG disclosure, recognising that the relevance of certain ESG factors differs across companies and across industries. The report identifies the following best practices, among others:

- ESG disclosures should focus on a company's risks and opportunities with sufficient potential to impact the company's long-term operational and financial performance in light of its business and should discuss the company's approach to risk management, making the connection, to the best of their ability, between the ESG topics on which they report and the company's long-term value creation strategy.
- Companies should consider the intended audience for the ESG disclosure and tailor reporting to include the most useful information for that audience.
- Companies should clearly define in plain English technical terms that do not have a universally accepted definition.
- Companies should explain why they selected the metrics and topics they ultimately disclose in ESG reports, including why management believes those metrics and topics are important to the company.
- Companies should consider including in voluntary ESG reports a description of internal review and audit processes or any external verification of the information that the company received.

SEC Updates Guidance on Confidential Treatment Applications

On 19 December 2019, the SEC's Division of Corporation Finance published an update to its guidance with respect to the SEC's procedures for confidential treatment applications. In April 2019, the SEC adopted new rules amending Regulation S-K to allow filers to redact confidential information from most exhibits to their filings without submitting a request for confidential treatment, provided that the redacted information is not material and that public disclosure would likely cause competitive harm. Although most filers now rely on those new provisions, the Division of Corporation Finance has updated its guidance regarding the "classic" procedure involving confidential treatment applications. Indeed, for certain filings, such as Schedule 13D or filings whose exhibit requirements are set out in Item 1016 of Regulation M-A, the confidential treatment application remains the only available method to protect private information in filed exhibits.

Under the updated guidance, companies must file the required exhibit and omit confidential information, and then separately provide the SEC with an unredacted copy of the document identifying the confidential information. They must also identify the Freedom of Information Act (**FOIA**) exemption on which they are relying to object to public disclosure of the redacted information, explain why the information is not necessary to protect investors and justify the time period of the confidential treatment. According to the guidance, the SEC staff may request an amendment with more circumscribed omissions and an amended application if the applicant omits information beyond what it customarily and actually treats as private or confidential, and may also request additional information, in particular to assess the impact of the proposed omissions.

The guidance specifically refers to the U.S. Supreme Court's recent decision in *Food Marketing Institute v Argus Leader Media*, which addresses the definition of "confidential" in the context of the FOIA exemption for "commercial or financial information obtained from a person and privileged or confidential."

SEC Proposes Updates to Auditor Independence Rules

On 30 December 2019, the SEC issued a rulemaking proposal to codify positions taken by the SEC staff in consultations and modernise certain aspects of the SEC's auditor independence rules, which are set out in Rule 2-01 of Regulation S-X. The rule change principally addresses the situation of "sister" companies within private equity funds and investment companies that have investments in large numbers of portfolio companies. In this context, auditor independence issues frequently arise under the current rules in respect of an auditor of one portfolio company because such audit firm or its affiliates may also be providing non-audit services to other, non-material portfolio companies within the fund family that do not practically risk impacting the objectivity and impartiality of the auditor in conducting the audit.

The 60-day public comment period on the proposed rule is now open. Changes to the SEC's rules will not take effect until the SEC publishes a final rule.

IASB Proposes Changes to Presentation and Disclosure of IFRS Financial Statements

In December, the International Accounting Standards Board (**IASB**) published an exposure draft proposing changes to the rules governing the presentation of financial statements prepared in accordance with International Financial Reporting Standards (**IFRS**). The three main changes proposed are:

- *New subtotals in the statement of profit or loss*—The proposed rule change would require three new profit subtotals to be included in the statement of profit or loss, including "operating profit". Given that many companies already report operating profit, this change is intended to enhance comparability between companies.
- "*Non-GAAP*" transparency—Companies would be required to disclose management performance measures—subtotals of income and expenses that are not specified in IFRS standards—in a single note to the financial statements. In this note, companies would be required to explain why the measures provide useful information,

how they are calculated and to provide a reconciliation to the most comparable profit subtotal specified under IFRS. These proposed requirements are similar to the existing rules regarding disclosure of non-GAAP measures to which SEC-reporting companies are already subject. However, by requiring such measures to be disclosed in a note to the financial statements, they would technically not be "non-GAAP" measures for purposes of (and thus not subject to) the SEC's non-GAAP rules.

- *Improved disaggregation of information*—The proposed rule change includes new guidance to help companies disaggregate information in the most useful way for investors. Companies would also be required to provide better analysis of their operating expenses and to identify and explain in the financial statement notes any unusual income or expenses.

SEC Proposes to Modernise Filing Fee Disclosure

On 24 October 2019, the SEC proposed changes that would modernise filing fee disclosure and payment methods, by amending the fee-bearing forms, schedules, statements and related rules, including registration statements for making public securities offerings. The current methods by which filers and the SEC staff process and validate EDGAR filing fee information within filings are highly manual, labour-intensive and, further, are not machine readable. Under existing rules, the calculation of filing fees can be difficult, particularly in complex transactions or situations in which a company is engaged in several transactions.

The amendments would require the fee table on the cover page of a filing and all related explanatory notes to (i) include all required information for the applicable fee calculations and (ii) be presented in an Inline eXtensible Business Reporting Language (**Inline XBRL**) format. The Inline XBRL format would eliminate the need to include fee data in several places within a filing and the related EDGAR submission header, thereby reducing data input error risks and enabling more efficient automated processing of fee calculation information by the SEC.

The proposal would add to the fee table:

- a "Reliance on Rule(s)" column to show (with checkboxes) whether the filer is planning to carry forward or include an equivalent amount of unsold securities, use a combined prospectus, offset a fee paid in connection with the same or a prior transaction or is calculating a fee based on maximum aggregate offering price;
- a requirement for basic fee calculation information (for certain forms);
- a "fee rate" column (for certain forms, mainly for business combinations); and
- various clarifying instructions regarding fee table presentation, calculations and related disclosure content and presentation.

The proposed rule would allow the payment of filing fees via Automated Clearing House and discontinue the option to pay fees by paper cheques and money orders.

SEC Rejects NYSE Proposal to Allow Companies to Raise Capital in Direct Listings

In November 2019, the New York Stock Exchange (**NYSE**) filed a proposed rule change seeking to modify its listing rules to allow companies to use direct listings to raise capital and issue new securities. In a direct listing, a company's existing shares are publicly listed on a stock exchange without an underwritten initial public offering. This option has received attention recently due to the high profile direct listings of companies such as Spotify, although the number of direct listings has remained limited.

The NYSE sought to make direct listings available to companies wishing to raise capital in a primary offering, in addition to resales by existing shareholders in the secondary market. The NYSE rule change would also have eased compliance with the initial listing distribution requirement to have at least 400 round lot holders by giving companies meeting certain market capitalisation thresholds a 90-day grace period to meet the distribution criteria.

However, in December, the SEC rejected the proposed rule change. The NYSE plans to revise its rule change proposal and resubmit it to the SEC. It is reported that Nasdaq is considering a similar change to its listing rules.

Noteworthy US Securities Litigation and Enforcement

Second Circuit Affirms Dismissal of Putative Class Action for Failure to Allege With Particularity Illegal Acts Underlying Alleged Mispresentations

On 10 December 2019, the U.S. Court of Appeals for the Second Circuit affirmed the dismissal of a putative class action asserting claims under Section 10(b) of the Securities Exchange Act of 1934 against a chicken producing company and certain of its executives. The decision is significant because it confirms that securities fraud plaintiffs within the Second Circuit (which hears appeals from Connecticut, New York and Vermont) are required to allege with particularity the elements of the alleged illegal conduct supposedly giving rise to a securities violation, and is likely to serve as persuasive authority outside of the Circuit.

In Gamm v. Sanderson Farms, Inc., the plaintiffs had alleged that defendants' SEC filings contained misrepresentations because they failed to disclose an illegal antitrust conspiracy to drive up chicken prices by reducing supply and to manipulate a chicken price index. The court held that the complaint was properly dismissed because the plaintiffs failed to plead with sufficient particularity facts supporting the alleged antitrust conspiracy, explaining that "when a securities fraud complaint claims that statements were rendered false or misleading through the nondisclosure of illegal activity, the facts of the underlying illegal acts must be pleaded with particularity in accordance with the requirements of Rule 9" of the Federal Rules of Civil Procedure and the Private Securities Litigation Reform Act (**PSLRA**).

The plaintiffs acknowledged that their allegations of misstatements and omissions had to be pleaded with particularity under the PSLRA and Rule 9(b), but they argued that facts of the underlying antitrust conspiracy only needed to meet the plausibility standard of Rule 8 of the Federal Rules of Civil Procedure. The court rejected that argument, holding that, because the plaintiffs' nondisclosure and material omission claims were entirely dependent upon the predicate allegation that the defendants participated in a collusive antitrust conspiracy, the plaintiffs' allegations "must also provide particularized facts about the underlying conspiracy" in order to properly allege with the requisite particularity "*all facts*" upon which their securities fraud claim was based. The court reasoned that "[u]ntil and unless they have done so, [the] appellants' complaint had not met the burden of explaining what rendered the statements materially false or misleading."

Next, the Second Circuit assessed whether the plaintiffs had alleged the basic elements of an antitrust conspiracy. With respect to the alleged collusive activities to reduce supply, the court determined that "[a]lthough appellants do allege that [the defendants] engaged in 'anticompetitive' conduct, there is virtually no explanation as to how that collusive conduct occurred, and whether and how it affected trade." It further noted that the plaintiffs failed to allege that the defendants or any other chicken producers were successful in reducing the supply of chicken, or that any reduction in supply resulted from an anticompetitive agreement. Moreover, the court emphasized that the plaintiffs failed to allege "when [the company] decided on its course of supply reduction, *which* industry peers were a part of that decision, *how* specific supply reductions were performed by each of the different poultry producers, *what* information [the company] knew about its peers' supply reductions, if any, and — perhaps most basic of all — whether [the company] *actually reduced* chicken supply, and if so, by what volume."

With respect to the alleged conspiracy to manipulate the chicken price index, the plaintiffs alleged that the company and other chicken producers submitted artificially high prices to the government agency that maintained the index, and coordinated these activities by learning about the prices other producers were submitting through a service that collected such information for the industry. The court held, however, that the plaintiffs' allegations failed to show "when and how" the company used this service, or to allege what communications the company had with the government agency that maintained the index, when that information was provided, and whether it was false. Finally, the court concluded that "[t]he complaint is entirely silent" as to whether the alleged manipulative conduct "unreasonably restrained trade, and whether that restraint affected interstate commerce."

Assistant Attorney General Reviews FCPA Enforcement in 2019

On 4 December 2019, Assistant Attorney General Brian A. Benczkowski provided a synopsis of Foreign Corrupt Practices Act (**FCPA**) enforcement in 2019 generally and emphasized two key points—an increased focus on charging individuals, and the Department of Justice's (**DOJ**) interpretation of agency theory under the FCPA.

Benczkowski noted that the DOJ had a record year in terms of FCPA enforcement, particularly in the number of individuals charged and criminal resolutions reached. According to Benczkowski, there was an unprecedented number of FCPA convictions in 2019—with juries returning guilty verdicts in four trials. He added that the increased number of indictments and trials in 2019 resulted from the DOJ's "continued dedication to holding individual wrongdoers accountable across the board." From 2010 to 2015, the DOJ charged an average of ten individuals per year, whereas from 2016 to 2019, the average increased to nearly twenty-five individuals. It is worth noting that the DOJ's *FCPA Corporate Enforcement Policy* (formally incorporating some of the policies in the 2015 Yates Memorandum on Individual Accountability for Corporate Wrongdoing) incentivizes corporations to provide the DOJ with "all relevant facts about all individuals substantially involved in or responsible for the violation of law," which may be a contributing factor to these increased numbers.

Benczkowski also discussed the agency theory of liability that DOJ relied upon in its recent case against Lawrence Hoskins, who was convicted after a trial of FCPA violations in 2019. Benczkowski emphasized that Hoskins, a U.K. citizen, never took any action in furtherance of the bribery scheme in the U.S. Instead, his conviction was based upon "his actions as an agent of Alstom Power, Inc., a U.S. domestic concern." Benczkowski stated that he "wholeheartedly" agrees that the FCPA explicitly provides for agency theories of liability, but acknowledged concerns about the "bounds of agency principles" in the FCPA context. Benczkowski clarified that "the Criminal Division will not suddenly be taking the position that every subsidiary, joint venture or affiliate is an 'agent' of the parent company simply by virtue of ownership status. Conversely, we will also not be taking the position that every parent company should automatically be held liable for the acts of its subsidiaries, joint ventures or affiliates based on an agency theory. Simply put, the law requires more."

The exact contours of what "more" the law requires to establish agency liability remains somewhat unclear in the FCPA context, given the dearth of case law on this topic. However, the DOJ has expressed its view that it can rely upon this theory and appears emboldened by the verdict in the Hoskins case. This will be an area that we will continue to survey going forward.

Second Circuit Reverses $18.5 Million Restitution Order for Lack of Proximate Cause

On 3 December 2019, in *United States v. Calderon*, the Second Circuit affirmed the convictions of two defendants for wire fraud and conspiracy to commit wire and bank fraud, but reversed the lower court's order that defendants pay $18.5 million in restitution to the U.S. Department of Agriculture (**USDA**).

By way of background, on 9 November 2016, Pablo Calderon and Brett C. Lillemoe were convicted after a trial of wire fraud and conspiracy to commit wire and bank fraud for submitting falsified shipping documents to domestic confirming banks so as to obtain loans for foreign banks under the USDA's loan guarantee program. From 2007 to 2012, foreign banks, such as the Russia-based International Industrial Bank (**IIB**), paid the defendants to make false statements on bills of lading that were sent to domestic confirming banks issuing USDA-guaranteed loans. The defendants also created multiple entities and bank accounts in an effort to gain access to more loans. IIB later defaulted on its loans and the USDA reimbursed the confirming banks for 98 percent of the confirming banks' losses. At sentencing, the defendants were ordered to pay $18,501,353 in restitution to the USDA under the Mandatory Victims Restitution Act (**MVRA**), a statute allowing courts to order restitution to victims directly and proximately harmed by an offense resulting in the loss or destruction of property.

On appeal, the Second Circuit upheld the convictions, but reversed the lower court's restitution order. In its decision, the court made clear that a conviction for fraud-related offenses does not automatically entitle a victim to restitution under the MVRA. The government must establish proximate cause, and the Second Circuit will hold the government to that strict standard. In so holding, the court emphasized the distinction between "but-for" causation of a loss and "proximate cause" of a loss, which is a requirement under the MVRA. The court stated that under the MVRA, a misstatement or omission is the proximate cause of a loss if the risk that caused the loss was "within the zone of risk" concealed by the misstatement or omission.

Here, the court found that the lack of creditworthiness of the foreign banks was the proximate cause of the loss, as opposed to the false statements that defendants made on the bills of lading. Specifically, the confirming banks' decision to issue the loans was made after the confirming banks and the USDA had conducted thorough financial analyses on the foreign banks. The bills of lading were sent *after* the confirming banks and the USDA had already pre-approved the loans. The risks concealed by the false statements—*i.e.* that the foreign banks would refuse to honor the letters of credit and the USDA would refuse to reimburse the banks for losses—did not materialize. The only risk that materialized was that the foreign banks would default on the loans, which was not attributable to defendants' false statements.

Notably, the court distinguished this case from *United States v. Paul*, where the defendant made misrepresentations concerning his stock holdings to obtain a loan and later defaulted after the stock price declined. The court held that under those circumstances the defendant proximately caused a loss by making misrepresentations about his own creditworthiness to conceal the risk that he would be unable to repay the loan.

SEC Publishes Annual Report

On 6 November 2019, the SEC announced the publication of its annual report for fiscal year 2019, which details the division's efforts and initiatives, highlights several significant actions, and presents the activities of the division from both a qualitative and quantitative perspective.

As in prior years, the report describes the division's efforts guided by five core principles: (1) focus on the Main Street investor, (2) focus on individual accountability, (3) keep pace with technological change, (4) impose remedies that most effectively further enforcement goals, and (5) constantly assess the allocation of resources.

In releasing the report, the SEC emphasized that it brought a “diverse mix” of 862 enforcement actions, including 526 standalone actions, addressing a “broad range of significant issues,” including issuer disclosure/accounting violations; auditor misconduct; investment advisory issues; securities offerings; market manipulation; insider trading; and broker-dealer misconduct. Through these actions, the SEC obtained judgments and orders totaling more than $4.3 billion in disgorgement and penalties. The SEC also “returned roughly $1.2 billion to harmed investors as a result of enforcement actions.”

DOJ Issues Guidance on Inability to Pay Claims

On 8 October 2019, the DOJ issued a memorandum (“**Memorandum**”) providing guidance on how the DOJ’s prosecutors will handle inability-to-pay claims from companies, intending to provide companies—and prosecutors—with a better understanding of how to evaluate and address these claims. Assistant Attorney General Brian A. Benczkowski announced the Memorandum, stating that it does not provide any new methodology, but rather merely “puts a lot more meat on the bones” of how these claims are analyzed.

Inability-to-pay claims arise when, while seeking to resolve a criminal case, a company may acknowledge that a proposed penalty is appropriate, but simultaneously claims that it cannot pay such a penalty. Prosecutors are only able to consider such an assertion after there has been an agreement both on the form of the resolution—such as a deferred prosecution agreement or corporate guilty plea—as well as the amount of the penalty itself. Prior to this Memorandum, prosecutors have been required to apply sentencing provisions from 18 U.S.C. § 3572(a), as well as federal Sentencing Guidelines, to consider a corporation’s ability to pay a criminal penalty. However, neither of these sources provides much direction in how to analyze the legitimacy of these claims in the corporate criminal enforcement context.

In accordance with the new guidance, in every case where a company makes an inability-to-pay claim, it will be required to complete an eleven-subject questionnaire, which asks for information regarding the company’s recent cash flow projections; operating budgets; capital budgets and projected annual capital expenditures; changes in capital structure; acquisition, divestiture, or restructuring plans; claims to insurers; encumbered assets and liens on company assets; and payments to the business’s top earning executives. The company also is required to provide, among other things, audited financial statements and tax returns for the previous five years, any current credit and loan agreements, and any recent studies or appraisals of the company’s assets. Mr. Benczkowski said the questionnaire is meant to help “flesh out the company’s full financial picture … with a view towards making a fully informed, rational, and fair decision about a company’s ability to pay.”

The Memorandum notes that in many cases, the responses to the questionnaire will be sufficient to decide on the inability-to-pay claim. However, in particularly complex circumstances, the Memorandum notes multiple relevant factors that prosecutors are to consider, including: the company’s ability to raise capital, underlying circumstances that led to the organization’s current financial condition, and whether the fine or penalty will impact the company’s ability to pay restitution, along with some collateral consequences to the company of the fine or penalty. The collateral consequences that the DOJ has stated are relevant include the inability to fund pension obligations, layoffs and significant disruptions to market competition. On the other hand, the DOJ noted that collateral consequences like adverse impacts on growth, future opportunities, planned product lines, future dividends and future executive compensation or bonuses are not relevant.

According to the Memorandum, if, after considering these factors, prosecutors determine that an organisation truly cannot pay the appropriate fine or penalty, prosecutors should recommend a reduction by the amount necessary to avoid the significant risk to the company and allow the company to make victims whole.

Additionally, if the recommended reduction is greater than 25%, the prosecutor is required to obtain approval from the Assistant Attorney General.

This Memorandum is the latest effort by the DOJ to provide transparency to companies regarding its corporate enforcement policies. However, several issues remain uncertain. Notably, this guidance is directed to inability-to-pay claims from corporations, but it is unclear how they may be applied to individuals in similar situations. Additionally, this process may be significantly impacted by the fact that in most cases, according to the Memorandum, prosecutors "will need to consult an accounting expert to examine the financial condition of the business." Lastly, the requirements of the questionnaire raise potentially substantial disclosure questions. Despite these remaining uncertainties, the Memorandum on the whole provides a much more nuanced picture for companies that find themselves facing difficult financial circumstances as a result of a criminal enforcement resolution.

ITALIAN DEVELOPMENTS

Borsa Italiana Amends Rules of the Market and the Related Instructions

Borsa Italiana S.p.A., the managing company of the Italian stock exchange, amended its market rules ("**Rules**") and related instructions. In particular, based on resolution No. 21018, dated 31 July 2019, amendments relating to the MOT market—*i.e.* the *Mercato Telematico delle Obbligazioni e dei titoli di Stato*, the main Italian regulated market for debt securities—enter into force on 20 January 2020, subject to the positive outcome of an initial trial phase.

The amended Rules and the relevant instructions provide for a closing auction, which will determine the reference price for subsequent trading sessions.

The rules governing the functioning of the closing auction and the trading at the closing auction price are identical to those applicable to the MTA market (the main regulated market for shares).

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