SHEARMAN & STERLING LLP

A QUARTERLY NEWSLETTER FOR CORPORATES

Governance & Securities Law Focus

APRIL 2015/EUROPE

In this newsletter, we provide a snapshot of the principal European, US and selected international governance and securities law developments of interest to European corporates.

The previous quarter's Governance & Securities Law Focus newsletter is available here.

Financial regulation developments are available here.

In this issue (please click on any title to go directly to the corresponding discussion):

EU DEVELOPMENTS

Adoption of Action Plan on Company Law and Corporate Governance

The European Commission has included in its Work Programme for 2015, which was adopted on 16 December 2014, the codification of seven Company Law Directives as one of the actions the Commission intends to take over the course of 2015. This exercise was first announced in the Commission's Action Plan for 2012 (which was discussed in the April 2012 edition of this newsletter).

The European Commission's 2015 Work Programme is available at:

http://ec.europa.eu/atwork/pdf/cwp_2015_refit_actions_en.pdf.

European Commission Green Paper: Building a Capital Markets Union

A Green Paper was published by the European Commission on 18 February 2015, in relation to possible measures for creating a single deeper and more integrated market for capital for all EU member states by 2019.

Amongst others, the Green Paper identifies the following key principles which should underpin a Capital Markets Union:

- It should create a single market for capital for all 28 EU member states by removing barriers to cross-border investment within the EU and fostering stronger connections with global capital markets;
- It should be built on firm foundations of financial stability, with a single rulebook for financial services which is effectively and consistently enforced; and
- It should ensure an effective level of investor protection.

The European Commission seeks views on the following topics:

- Is there any value in developing an EU-level accounting standard for small- and medium-sized companies traded on multilateral trading facilities?
- The main company law, insolvency law and corporate governance obstacles to integrated capital markets.
- Are there any changes to the rules on securities ownership which could contribute to the creation of better integrated capital markets within the EU?
- The powers of the European Supervisory Authorities to supervise capital markets.
- Mechanisms to improve the functioning and efficiency of equity markets.

The consultation closes on 13 May 2015. On the basis of the outcome of this consultation, the European Commission will adopt an Action Plan later in 2015 identifying the actions necessary to achieve the following objectives:

- Improve access to finance for all businesses and infrastructure projects across Europe by removing barriers to cross-border investments;
- Help small and medium sized enterprises ("SMEs") raise finance as easily as large companies; and
- Diversify the funding of the economy and reduce the cost of raising capital.

A copy of the Green Paper is available at:

http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf.

A copy of our client publication: "Capital Markets Union: The EU's Next Focus for Reforms" is available at:

http://www.shearman.com/~/media/Files/NewsInsights/Publications/2015/04/Capital-Markets-Union-the-EUs-Next-Focus-for-Reforms-FIA-040115.pdf.

European Commission Publishes Consultation Paper on Prospectus Directive

A review of the Prospectus Directive was launched by the European Commission on 18 February 2015. The purpose of the review is to address the shortcomings of the Prospectus Directive, in particular:

- Whether the principle that a prospectus is required whenever securities are admitted on a regulated market or offered to the public is still valid; and
- The costs of producing and getting a prospectus approved.

The European Commission has identified a number of the following fundamental aspects of the Prospectus Directive which are the subject of the review, including:

- When is a prospectus is needed and what information should it include:
    - Potential adjustment of the existing exemption thresholds so that a larger number of offers can be carried out without a prospectus;
    - Potential harmonisation in areas such as the flexibility of member states to require a prospectus for offers of securities with a total consideration below €5 million;
    - Potential wider range of securities to be covered in the Prospectus Directive;
    - Potential extension of the Prospectus Directive to the admission of securities to trading on multilateral trading facilities;
    - Potential extension of the scope of the exemption from the requirement to issue a prospectus provided to employee share schemes to non-EEA private companies wishing to offer their shares to employees in the EU;
    - Potential modification and extension of the proportionate disclosure regime;
    - Streamlining of the disclosure requirements under the Transparency Directive, the Market Abuse Directive and the Prospectus Directive;
    - Potential reassessment of the rules regarding the summary and maximum length of the prospectus; and
    - Reassessment of the adequacy of liabilities and sanctions under the Prospectus Directive.
- Prospectus approval:
    - Assessment of the involvement of national competent authorities in relation to prospectuses, the material differences in the way national competent authorities assess draft prospectuses and the scrutiny and approval procedures applied;
    - Potential relaxation of the prohibition on marketing activities by the issuer in the period between the first submission of a draft prospectus and its final approval, providing that no legally binding purchase takes place until the prospectus is approved, coupled with potential publication of draft prospectuses;
    - Potential simplification of the notification procedure between the competent authorities of home and host EU member states;

- Potential extension of the base prospectus facility for all types of issuers; and
- Creation of a single integrated EU filing system for all prospectuses produced in the EU.

The consultation closes on 13 May 2015.

A copy of the consultation paper is available at:

http://ec.europa.eu/finance/consultations/2015/prospectus-directive/docs/consultation-document_en.pdf.

A copy of the Prospectus Directive (2003/71/EC) is available at:

http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1424435617380&uri=CELEX:32003L0071.

GERMAN DEVELOPMENTS

Gender Quota of at least 30% on Listed Corporations' Supervisory Boards

On 6 March 2015, the German Parliament approved a compulsory gender quota of at least 30% in supervisory boards of certain types of corporations, which was also approved by the German Federal Council on 27 March 2015. The nationwide and sector-independent quota applies for all corporations that are (i) listed on the stock exchange and (ii) co-determined on the basis of parity (*i.e.* employ more than 2,000 employees). From 1 January 2016, these types of corporations need to allocate at least 30% of their supervisory seats to the underrepresented gender.

In contrast to the ministerial draft bill, on which we reported in our October 2014 newsletter, the compulsory quota now applies to the supervisory board as a whole. Only in the event of a protest are stakeholders and employee representatives obliged to fulfill the quota separately. Furthermore, corporations not meeting the quota shall be required to leave the respective seats vacant which may bear the risk of invalid resolutions if the corresponding votes are decisive. The empty seats must be staffed with a person of the underrepresented gender in a court proceeding.

In addition, listed corporations as well as co-determined corporations (*i.e.* corporations with more than 500 employees) shall define quota targets as from 30 September 2015. The self-imposed quotas shall not fall below the status quo or below 30% if this has been achieved already. Such quotas will be binding on corporations' supervisory boards and management boards as well as to the first and second management levels and are to be achieved by 30 June 2017. There will be no further consequences if companies fail to achieve such self-imposed quotas. However, the target quotas and the level of achievement must be publically announced.

Amendment to the German Stock Corporation Act

On 18 March 2015, the German Federal Government published a draft bill to slightly amend the German Stock Corporation Act (*Aktiengesetz*). Certain of the proposed amendments have already been included in previous draft bills and presented in our January 2011 and January 2012 newsletters. These comprise, among others:

- Restrictions on bearer shares to prevent money laundering: listed as well as non-listed companies still may issue registered or bearer shares; however the issuance of bearer shares by a non-listed company shall require excluding the right to demand issuance of individual share certificates and the deposition of global certificates; such restrictions will not apply to companies listed with a regulated market since such companies are subject to the provisions on disclosure of major holdings of voting rights;
- The issue of non-voting preference shares will no longer require a mandatory cumulative preference right (*Zwingende Nachzahlung*) which currently prevents their treatment as regulatory core capital;

- The permissibility of at least such mandatory convertible bonds that allow for a conversion right of the issuer shall be explicitly stipulated; and
- The right of individual shareholders to bring legal action to declare void corporate resolutions shall be partially restricted.

In addition, the new draft bill provides for a record date for registered shares in order to avoid share blocking and increase participation in general meetings. Currently, a record date only exists for listed companies that issued bearer shares. To attend and participate in a general meeting, owners of bearer shares have to prove that they have been shareholders of the company at the beginning of the 21st day prior the general meeting. For registered shares there is currently no corresponding provision. It is therefore common practice that listed issuers of registered shares will stop execution of share transfers in the share register several days prior to the general meeting. Pursuant to the draft bill, ownership on the 21st day preceding the general meeting shall in future also decide the right to attend and participate in the general meeting of companies that have issued registered shares.

Currently, dividend obligations of the company become immediately due. Pursuant to the draft bill, the right of dividend payments shall only become due on the third business day following the date of the general meeting. The intention is to align the German practice to international market standards.

UK DEVELOPMENTS

Small Business, Enterprise and Employment Act 2015

On 26 March 2015, the Small Business, Enterprise and Employment Bill received the Royal Assent. It will come into force in various stages, starting two months after Royal Assent.

Register of Persons having Significant Control (the "PSC Register")

All companies will be required to maintain and keep open for public inspection a PSC register. The principal objective is to increase transparency around who controls UK companies and deter and sanction those who hide their interests. A person having significant control of a company will be any individual who:

- holds, directly or indirectly, 25% or more of a company's shares or voting rights;
- has the right, directly or indirectly, to appoint or remove the majority of the board; or
- exercises, or has the right to exercise, significant influence or control over the company. The meaning of "significant influence or control" will be detailed in guidance to be published in October 2015.

The obligation to maintain a PSC register will apply to all companies other than those to which Chapter 5 of the Disclosure and Transparency Rules ("DTRs") apply and Limited Liability Partnerships (although the Department for Business, Innovation and Skills ("BIS") has confirmed delegated legislation will introduce the same requirements for LLPs) and any other entities as the Secretary of State specifies. Companies obliged to maintain the register will have duties to take reasonable steps to investigate and obtain up-to-date information on registrable persons ("PSCs") as well as serve notices on persons they know, or have reasonable cause to believe, may have information on the identity of such PSCs.

The Bill also proposes introducing obligations on the PSCs to supply the relevant information to the company. Where an individual fails to comply with its disclosure obligations, the company has the right to serve a restrictions notice which has the effect of preventing the individual from exercising any rights associated with their shares. This means that any proposed transfer of the interests associated with the shares will be void and the company may not pay any sums due to the person in respect of the shares other than in liquidation.

Shadow Directors

The Bill provides that the general duties of directors (as set out in the Companies Act 2006) shall apply to shadow directors "where and to the extent they are capable of applying". Further, the definition of shadow director is to be amended so that a person will not be a shadow director if the board acts in accordance with instructions or directions given by that person in the exercise of a function conferred by or under legislation.

Corporate Directors

The appointment of corporate directors will be prohibited so that all directors must be natural persons. Any appointment made in contravention of this requirement will be void and existing corporate directors will automatically cease to be directors a year after the new legislation comes into force. Unless they are replaced with individual directors before then, companies will need to consider the impact on quorum requirements and provisions in the Articles of Association as to the minimum number of directors.

However, the Act gives the Secretary of State the power to make regulations regarding exemptions, such as where having a corporate director represents a low risk or where high standards of corporate governance or disclosure apply.

Company Filing Requirements

The Bill also introduces provisions designed to simplify company filing requirements and make the administration of larger groups easier. These changes include:

- replacing the requirement to complete an annual return with the ability to deliver a confirmation statement in each 12-month period stating that there have been no changes to the information on record;
- the ability to keep information on a central register at Companies House instead of maintaining the relevant statutory registers;
- amending the information required in statements of capital so that companies will only be required to show the aggregate amount unpaid on shares; and
- shortening the procedure for striking off a company to two months.

Further Provisions

The Act also makes certain changes with regards to directors' disqualification and liability to compensation orders and to UK insolvency procedures.

A copy of the Act and relevant explanatory notes can be seen here:

http://services.parliament.uk/bills/2014-15/smallbusinessenterpriseandemployment/documents.html.

The Government has also produced a number of fact sheets to give further information on certain aspects of the Act. A copy of the following fact sheets is available as follows:

- Companies Transparency Fact Sheet

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/417328/bis_15_266_SBEE__Act_companies-transparency-fact-sheet.pdf.

- Companies Filing Requirements Fact Sheet

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/417335/bis-15-265-SBEE-Act-company-filing-requirements-fact-sheets.pdf.

Large Companies Required to Reveal Payment Practices

On 20 March 2015, the BIS announced plans to implement new reporting requirements for large companies in order to solve the "significant problem" of late payment to suppliers, *etc.* which currently stands at £41.5 billion. It noted that small business takes the majority of the burden, and large organisations should lead the way in improving the "corporate culture" in terms of fair payment practices.

BIS stated under the new rules, large businesses would be required to disclose their payment terms in addition to their:

- average time taken to pay;
- proportion of invoices paid beyond agreed terms;
- proportion of invoices paid in 30 days or less, between 31–60 days and beyond 60 days; and
- any late payment interest owed or paid.

The press release can be found here:

https://www.gov.uk/government/news/hancock-large-firms-must-publish-payment-practices.

The proposed format for reporting payment practices is available here:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/415028/bis-prompt-payment-implementing-the-duty-on-large-companies-to-report-on-payment-practices-and-policies.pdf.

Pre-Emption Group Publishes Revised Statement of Principles

On 12 March 2015, the Pre-Emption Group published a revised statement of principles for the disapplication of the UK's statutory pre-emption rights. The principles are not strict rules but rather are intended to provide guidance to companies and shareholders on the factors to take into account when considering whether to disapply pre-emption rights. The key changes to the last version of the principles are set out below.

- The new guidelines clarify that the Statement applies to both UK and non-UK incorporated companies with a Premium Listing. In addition, companies with a Standard Listing or which are listed on Alternative Investment Market or the High Growth Segment of the Main Market of the London Stock Exchange are encouraged to adopt the principles.
- The Statement has also been amended to clarify that the principles apply to all issues of equity securities that are undertaken to raise cash for the issuer or its subsidiaries, irrespective of the legal form of the transaction. This means that "cashbox" transactions, although falling outside the statutory pre-emption regime, should be regarded as being issues of equity securities for cash for the purposes of the Statement.
- The guidelines retain the principle that shares should not be issued for cash on a non-pre-emptive basis at a discount of more than 5% of the prevailing market price but clarify how this should be calculated and in particular that the company's expenses (including fees and commissions) in connection with the issue need to be included in the calculation.
- Companies are now permitted to seek authority by special resolution to undertake non-pre-emptive issues of equity securities to finance expansion opportunities. A company may seek to issue non-pre-emptively for cash up to 5% of its issued ordinary

share capital in any one-year period in connection with an acquisition or specified capital investment. The company would be required to confirm this in the circular for the annual general meeting at which such additional authority is to be sought. This is in addition to its ability to seek authority for a non-pre-emptive issue of up to 5% of its issued ordinary share capital for purposes other than a specified capital investment.

The Statement is available here:

http://www.pre-emptiongroup.org.uk/getmedia/655a6ec5-fecc-47e4-80a0-7aea04433421/Revised-PEG-Statement-of-Principles-2015.pdf.aspx.

Regulations Prohibiting Cancellation Schemes of Arrangement Now in Force

On 4 March 2015, regulations were published that amend the UK Companies Act 2006 to prevent takeovers being effected by a cancellation scheme of arrangement. This thereby removes the stamp duty saving which had been obtained by coupling the takeover scheme of arrangement with a reduction and cancellation of the target's share capital so as to avoid any transfer of shares under the scheme.

However, the prohibition will not apply where the scheme amounts to a restructuring that inserts a new holding company, provided that “all or substantially all of the members of the company become members of the parent undertaking".

There are transitional provisions aimed at excluding from this prohibition takeovers which, before 4 March 2015, were either "firm" Code offers or non-Code offers the terms of which (including that they would be made by way of a scheme) had been agreed between target and bidder.

The Regulations are available here:

http://www.legislation.gov.uk/uksi/2015/472/pdfs/uksi_20150472_en.pdf.

Financial Promotions: Exemption for Strategic Report Now in Force

On 25 February 2015, regulations were published that came into force on 18 March 2015 and, amongst other things, extend the current financial promotion exemption in connection with a company's annual accounts or a directors' report to communications that are accompanied by a strategic report prepared and approved in accordance with the Companies Act 2006, or the equivalent under the law of another EEA State.

The Order is available here:

http://www.legislation.gov.uk/uksi/2015/352/pdfs/uksi_20150352_en.pdf.

FCA Policy Statement on the Implementation of the Transparency Directive Requirements for Reports on Payments to Governments

In August 2014, the Financial Conduct Authority (“FCA”) published a consultation paper on the early implementation of the Transparency Directive's requirements for reports on payments to governments by issuers in the extractive or logging industries under the Transparency Directive. The consultation paper was followed by the FCA’s DTRs (Reports on Payments to Governments) Instrument 2014 which came into force on 22 December 2014. On 2 January 2015, the FCA published its response to the consultation and the final text of the 2014 Instrument.

In its response statement, the FCA has confirmed the following items:

- The FCA will not impose a prescribed reporting format that must be used for Companies House filings and Regulatory Information Service ("RIS") announcements, as the revised Transparency Directive does not specify the format for reports on payments to governments.
- The FCA considers a report on payments to governments which is prepared in accordance with the UK Reports on Payments to Governments Regulations 2014 (SI 2014/3209) (which implement Chapter 10 of the EU Accounting Directive (2013/34/EU) in the UK) to be in compliance with the Accounting Directive. However, the requirement for payments to governments on a consolidated basis cannot be met through the Accounting Directive. The policy statement does not provide any guidance on consolidation under the Transparency Directive at this stage.
- The FCA will treat reports on payments to governments as regulated information under the Transparency Directive. The FCA will consider further whether a RIS announcement containing a link to the report on the company's website should satisfy the publication requirements in relation to payments to governments.
- The FCA will apply the new country-by-country reporting requirements to listed companies who are required to comply with periodic financial reporting requirements as if they were an issuer for the purposes of the DTRs, and to issuers of securitised derivatives who the FCA considers should comply with periodic financial reporting requirements as if they were an issuer of debt securities as defined in the DTRs.
- Decisions on equivalence within the Accounting Directive framework remain outside the scope of the Transparency Directive.

A copy of FCA's policy statement is available at:

http://www.fca.org.uk/static/documents/policy-statements/ps15-01.pdf.

FRC Report on Implementation of the UK Corporate Governance and Stewardship Codes 2014

On 15 January 2015, the Financial Reporting Council ("FRC") published a report on developments in corporate governance during 2014, reviewing the impact and implementation of the UK Corporate Governance and Stewardship Codes over the last 12 months.

As regards the UK Corporate Governance Code, the report's key findings are set out below.

- Overall compliance rates: Compliance with the Code remains high with over 90% of FTSE 350 companies reporting that they were complying with the vast majority of its provisions. However, the FRC notes that the standard of explanations by those who deviate from the Code continues to be variable.
- Succession planning and appointment: There should be a focus on improving the reporting of succession planning to address the more strategic issues around the long-term composition of boards for both executive and non-executive positions.
- Diversity: Data shows that 85% of FTSE 100 companies had a clear diversity policy whereas for FTSE 101-201 companies the figure was only 56%. The FRC notes that this is an area where more improvement is required. More positively, the headline figures for female directorships and executive directors in FTSE 100 companies are up from 18.9% to 22.8% and 6% to 8.4% respectively.
- Election of directors: It was noted that a significant number of companies gave no detail other than the name of the relevant director when passing resolutions for the election of directors. The FRC recommends that an explanation of how individual directors contribute to the effectiveness of the board as a whole should be disclosed.

As regards the Stewardship Code, the report notes that there are indicators that wider engagement is taking place between larger companies and their major shareholders. However, across the rest of the listed sector, the FRC has concerns regarding the state of

signatories' commitment to the Code and, that for some, signing up to the Code is seen as a "box ticking exercise" rather than a "basis for good quality engagement".

The report is available here:

https://www.frc.org.uk/Our-Work/Publications.aspx?searchtext=&searchmode=anyword&searchfilter=0&searchfilter1=0&searchfilter2=2;&searchfilter3=0&frcdaterangesmartsearchfilter=201501150000;201504152359.

Share Buybacks: Draft Regulations Amending Companies Act 2006

On 13 January 2015, regulations were published which amend and clarify the buyback provisions of the Companies Act 2006 to ensure that the changes introduced in 2013 (including payments out of cash for "small" buybacks (*i.e.* the lower of £15,000 or 5% of share capital) and reduced requirements for buybacks for employee share schemes) operate effectively. The changes made by the draft Regulations are set out below.

The draft Regulations are available here:

http://www.legislation.gov.uk/ukdsi/2015/9780111127094/pdfs/ukdsi_9780111127094_en.pdf.

The explanatory memorandum is available here:

http://www.legislation.gov.uk/ukdsi/2015/9780111127094/pdfs/ukdsiem_9780111127094_en.pdf.

Listing Rules Updates

Institutional Shareholder Services Proxy Guidelines 2015

Institutional Shareholders Services ("ISS") published its first standalone UK and Ireland Proxy Voting Guidelines: 2015 Benchmark Policy Recommendations on 7 January 2015. The Voting Guidelines contain vote recommendations for UK and Irish listed companies, as well as companies incorporated in the Isle of Man, Jersey and Guernsey. Smaller companies and investment companies are dealt with separately.

The Voting Guidelines cover the following five core areas:

- Operational items;
- Board of directors;
- Remuneration;
- Capital structure; and
- Other items including approvals of M&A transactions, related-party transactions, incorporation and shareholder proposals.

The Voting Guidelines raise several other points:

- Information regarding the voting outcomes on the resolutions presented at the annual general meeting should be made available as soon as reasonably practicable after the annual general meeting. The information should include the number of votes for and against the resolution, the number of shares in respect of which the vote was directed to be withheld and the overall percentages for each group.

- The Voting Guidelines refer to the new recommendation in the 2014 UK Corporate Governance Code that when, in the opinion of the board, a significant proportion of votes have been cast against a resolution at any general meeting, the company should explain when announcing the results of voting what actions it intends to take to understand the reasons behind the vote result. The FRC does not provide a threshold for significant dissent but ISS predicts that most investors will consider 20% a significant enough level.

The Voting Guidelines are intended to apply to company meetings from 1 February 2015.

A copy of the Voting Guidelines is available at:

http://www.issgovernance.com/file/policy/2015ukandirelandproxyvotingguidelines.pdf.

Amendments to the Listing, Prospectus and DTRs

The FCA published the Listing, Prospectus and DTRs (Miscellaneous Amendments No. 3) Instrument 2015 on 30 January 2015 following feedback received on its quarterly consultation paper No. 6 (CP14/18). The feedback and FCA's response to it are set out in Handbook Notice No. 18.

The amendments to the Listing, Prospectus and DTRs include:

- Narrowing the scope of circulars requiring prior approval by the FCA. Prior approval is still required for circulars relating to Class 1 transactions, related-party transactions, buybacks, reconstructions or refinancings, cancellations of premium listing and transfers of listing category;
- Amending LR 13.5.4R(2) (*Accounting policies*) to clarify the application of the requirement to disclose all financial information using accounting policies adopted in the latest annual accounts;
- Clarifying the application of the insignificant subsidiary exemption in LR 11 Annex 1R (*Transactions to which related party transaction rules do not apply*);
- Updating the requirements for auditors to review parts of the annual report;
- Clarifying the requirements with respect to mineral expert's reports on class transactions for certain mineral companies;
- Clarifying the permitted accounting policies for profit forecasts included in Class 1 transaction circulars; and
- Updating various definitions.

The majority of these changes took effect on 1 February 2015. The new rules relating to the approval of circulars will take effect on 1 April 2015.

A copy of Handbook Notice No. 18 is available at:

http://www.fca.org.uk/static/documents/handbook-notices/fca-handbook-notice-18.pdf.

A copy of the Listing, Prospectus and DTRs (Miscellaneous Amendments No. 3) Instrument 2015 is available at:

http://media.fshandbook.info/Legislation/2015/FCA_2015_3.pdf.

UK Listing Authority Guidance Notes

The FCA published Primary Market Bulletin No. 10 on 30 January 2015 which updates UK Listing Authority's ("UKLA") Knowledge Base with two new Technical Notes on sponsors' compliance with competence requirements.

The first Technical Note (UKLA/TN/714.1) contains guidance on LR 8 and the level of skills, knowledge and expertise expected from sponsors, and the responsibilities and obligations of a sponsor.

The second Technical Note (UKLA/TN/715.1) aims to assist sponsors, or applicants who wish to become sponsors, in considering whether they meet, or continue to meet, the competence requirements.

A copy of Primary Market Bulletin No. 10 is available at:

http://www.fca.org.uk/news/fg15-02.

A copy of Technical Note (UKLA/TN/714.1) is available at:

http://www.fca.org.uk/your-fca/documents/ukla/technical-note-714-1.

A copy of Technical Note (UKLA/TN/715.1) is available at:

http://www.fca.org.uk/your-fca/documents/ukla/technical-note-715-1.

US DEVELOPMENTS

SEC Developments

NYSE Amends Late Filer Rule

Effective 2 March 2015, the New York Stock Exchange (the "NYSE") amended its rules applicable to NYSE listed companies that do not timely file their periodic reports with the US Securities and Exchange Commission ("SEC").

Previously, a listed company was deemed noncompliant with the NYSE's late filer rule and subjected to a maximum 12-month cure period only if it failed to timely file its annual report on Form 10-K, Form 20-F or Form 40-F, as applicable. Under the late filer rule as recently amended, however, the NYSE will also subject a listed company to these procedures if (i) it fails to timely file its quarterly report on Form 10-Q (for US domestic issuers) or (ii) an annual report or Form 10-Q is defective in certain material respects.

The specific changes to the NYSE's late filer rule include:

- The rule as amended has expanded to cover quarterly reports on Form 10-Q in addition to annual reports (Forms 10-K, 20-F, 40-F or N-CSR). Accordingly, any listed company that fails to file a quarterly or annual report by the date on which it is due to be filed with the SEC will be subject to the compliance procedures set forth in Section 802.01E of the NYSE Listed Company Manual.
- The rule as amended has expanded to cover annual or quarterly reports that are deemed to be defective either at the time of their filing with the SEC or subsequently. Among the reasons that a periodic report may be deemed defective are: (i) an annual report that was filed without a financial statement audit report from its independent auditor for any or all periods included in the report, (ii) a company's independent auditor subsequently withdraws its audit report from a previously filed report or (iii) a company discloses that previously filed financial statements should no longer be relied upon. If a listed company's periodic report is deemed to be defective for one of the foregoing reasons, such company will be subject to the compliance procedures set forth in Section 802.01E of the NYSE Listed Company Manual.
- Listed companies will have a maximum of 12 months to cure a delinquent or defective filing and regain compliance. In order to be deemed back in compliance, listed companies must have cured the initial delinquent or defective filing and be current with all subsequent filings within the maximum 12-month cure period.

The NYSE's notification to NYSE listed company executives can be found here:

https://www.nyse.com/publicdocs/nyse/regulation/nyse/NYSE_Late_Filer_Rule_20150305.pdf.

Flexibility for Debt Refinancings – New SEC No-Action Letter

On 23 January 2015, the SEC staff issued a no-action letter that will allow some companies to refinance their debt using tender and exchange offers shorter than the 20 business days required in the SEC tender offer rules. The letter extends to high-yield debt tender offers and to exchange offers pre-existing guidance that allowed shorter tender offers for investment grade debt. The letter also imposes a number of new limitations on and requirements for shorter tender offers.

The no-action letter gives limited relief from the 20-business day requirement for "any and all" self-tenders for non-convertible debt, but partial tenders do not benefit. Tenders as part of restructurings and tenders with exit consents will also not benefit.

Previous no-action letters allowed 7-10 calendar day issuer self-tenders for any and all non-convertible investment grade debt securities. The new no-action letter uses five business days instead, but adds a number of new requirements and limitations.

The no-action letter allows five business day self-tenders for any and all non-convertible debt securities subject to the same restrictions as investment grade debt. However, high-yield debt issuers that want to use the shorter tender period will not be able to strip covenants with a concurrent consent solicitation.

Five-business day exchange offers are now possible for a pure refinancing where the type and features of the debt do not change.

The no-action letter is available at:

http://www.sec.gov/divisions/corpfin/cf-noaction/2015/abbreviated-offers-debt-securities012315-sec14.pdf.

Our related client publication is available at:

http://www.shearman.com/en/newsinsights/publications/2015/02/flexibility-for-debt-refinancings-new-sec.

SEC Charges Corporate Insiders for Failing to Update Disclosures Involving "Going Private" Transactions

US securities laws require beneficial owners of more than 5% of the stock of a public reporting company to promptly file an amendment when there is a material change in the facts previously reported by them on Schedule 13D, commonly referred to as a "beneficial ownership report". The disclosure requirements include plans or proposals that would result in certain transactions, such as a going private transaction.

On 13 March 2015, the SEC charged eight officers, directors or major shareholders for failing to update their stock ownership disclosures to reflect material changes, including steps to take the companies private. Each of the respondents, without admitting or denying the SEC's allegations, agreed to settle the proceedings by paying a financial penalty.

While an acquisition or disposition of 1% or more of the stock of an issuer is deemed to be a "material" change in the facts set forth in Schedule 13D requiring an amendment, the SEC's orders make clear its position that an amendment is also required in order to update qualitative disclosures regarding the beneficial owner's plans for its investment. In particular, the SEC has stated that generic disclosures that simply reserve the right to engage in certain corporate transactions do not suffice when there are material changes to those plans, including actions to take a company private.

The SEC's orders find that the respondents took steps to advance undisclosed plans to effect going private transactions. Some determined the form of the transaction to take the company private, obtained waivers from preferred shareholders and assisted with shareholder vote projections, while others informed company management of their intention to privatize the company and formed a consortium of shareholders to participate in the going private transaction. As described in the SEC orders, each

respective respondent took a series of significant steps that, when viewed together, resulted in a material change from the disclosures that each had previously made in their Schedule 13D filings.

Public companies and other filers should make certain that they have robust policies and procedures in place to ensure that their filings comply with all applicable SEC disclosure requirements and are made within the required deadlines. Companies should also have policies requiring compliance with reporting obligations by their officers, directors and major shareholders, particularly if the company has agreed to provide assistance to insiders. Public companies should view the announcement of these enforcement actions as an opportunity to remind their officers, directors and major shareholders of their reporting obligations.

The related SEC press release is available at:

http://www.sec.gov/news/pressrelease/2015-47.html.

Securities Enforcement 2014 Year-End Review and Focus for 2015

In March 2015, in testimony before the US Congress, the Director of the SEC's Division of Enforcement outlined the SEC's enforcement priorities, which include the following:

- financial reporting, accounting and disclosure;
- investment advisers;
- market structure, exchanges and broker-dealers;
- municipal securities and public pensions;
- insider trading;
- microcap fraud/pyramid schemes;
- complex financial instruments;
- gatekeepers; and
- the Foreign Corrupt Practices Act ("FCPA").

For further information, the Director's testimony can be found here:

http://www.sec.gov/news/testimony/031915-test.html.

In January 2015, we published our *Securities Enforcement 2014 Year-End Review*.

Fiscal year 2014 proved to be another eventful and record-breaking year for the SEC's Division of Enforcement. Indeed, the SEC recently described the fiscal year, which ended on 30 September 2014, as a "very strong year" for enforcement, and by certain measures it certainly was. This description of the SEC's performance and approach, however, is not without controversy as various aspects of the SEC's enforcement approach have been criticised in some quarters, including by certain of the SEC's own commissioners.

Our *Securities Enforcement 2014 Year-End Review* is available at:

http://www.shearman.com/en/newsinsights/publications/2015/01/securities-enforcement-2014-year-end-review.

Noteworthy US Securities Law Litigation

Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund: US Supreme Court Sets Standard for Opinion Statement Liability Under Section 11

On 24 March 2015, in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, a widely anticipated decision, the US Supreme Court resolved a conflict among the federal appellate courts concerning the standard of liability that applies to statements of opinion under Section 11 of the Securities Act of 1933. The Court held that for a statement of opinion to constitute an affirmative misstatement under Section 11 (which applies to statements made in offering materials), it must be not only "objectively false" in the sense that the opinion is incorrect, but also "subjectively false" in that the speaker did not honestly believe the statement to be true when made. The Court separately held that the omission of information, where that omission causes an opinion to be misleading, can give rise to liability under Section 11 if the omitted information is contrary to what a reasonable investor would assume was the basis for the stated opinion, even if the opinion was not subjectively false.

Omnicare is the US's largest provider of pharmacy services to nursing homes. The plaintiffs' claims stemmed from statements in a registration statement for a public stock offering that the company "believe[d]" its contractual arrangements were in compliance with law. The plaintiffs claimed these opinions were false because the company allegedly engaged in illegal kickback schemes with pharmaceutical manufacturers and submitted false claims for reimbursement to governmental medical programs.

The plaintiffs in *Omnicare* conceded that the company's statements of opinion concerning legal compliance were honestly held beliefs, but argued that because Section 11 does not impose any requirement to show a defendant's intent, the fact that the opinion statements were "objectively false" was enough to hold the company liable. The Court, disagreeing, explained that Section 11 imposes liability for "untrue statement[s] of . . . fact" and the factual component of an opinion is that "the speaker actually holds the stated belief." The mere fact that the opinion turns out to be incorrect is not sufficient to show an "untrue statement of material fact" under Section 11. The plaintiffs' claim that Omnicare's opinions about legal compliance were misstatements was therefore insufficient.

The Court went on to rule, however, that the omission of factual information can lead to liability for a statement of opinion under Section 11's prohibition on omissions that render affirmative statements misleading, even if the opinion was honestly held. Because "a reasonable investor may . . . understand an opinion statement to convey facts about how the speaker has formed an opinion," an omission concerning material facts "going to the basis for the issuer's opinion" might give rise to liability if that omission makes the opinion statement misleading. But not all facts going against an opinion need to be disclosed because "[r]easonable investors understand that opinions sometimes rest on a weighing of competing facts." Rather, the assessment about whether an omission is actionable must be done on a case-by-case basis to determine whether the omission genuinely "call[s] into question the issuer's basis for offering the opinion."

The Court's ruling in *Omnicare* that plaintiffs must show statements of opinion to be subjectively false under Section 11 clarifies this previously uncertain point of law. On the other hand, the Court's ruling that certain omissions can render an opinion statement misleading, even if the statement is an honestly held belief, is likely to create a new avenue for plaintiffs to raise securities claims. The plaintiffs' bar will undoubtedly file additional cases in this area, which in turn will illuminate how lower courts will interpret this new rule.

For more information on the *Omnicare* decision, please see our client note at:

http://www.shearman.com/en/newsinsights/publications/2015/03/opinion-statement-liability-in-omnicare-ruling.

United States v. Georgiou: Court Holds Foreign Entities' Transactions for Securities of US Issuer Through US Market-Maker Are Domestic Transactions Under Section 10(b)

On 20 January 2015, the federal appellate court based in Pennsylvania addressed whether a criminal defendant based outside the United States could be subject to liability for manipulative securities transactions under Section 10(b) of the Securities and Exchange Act of 1934 in light of the US Supreme Court's landmark decision in *Morrison v. National Australia Bank* precluding extraterritorial applications of Section 10(b). In *Morrison*, the Supreme Court ruled that Section 10(b) does not apply extraterritorially to so-called "foreign-cubed" claims—*i.e.*, claims where "(1) *foreign* plaintiffs [are] suing (2) a *foreign* issuer in an American court for violations of American securities laws based on securities transactions in (3) *foreign* countries." The court in *Georgiou* addressed what it described as a question of first impression: "whether the purchases and sales of securities issued by U.S. companies through U.S. market makers acting as intermediaries for foreign entities constitute 'domestic transactions' under *Morrison*."

The defendant Georgiou was convicted of securities fraud, conspiracy to defraud the US and wire fraud, sentenced to 300 months of prison time, and ordered to pay over $55 million in restitution. These charges were based on his manipulation of the markets for four stocks by artificially inflating their share prices, selling shares at inflated prices and using shares as collateral to fraudulently borrow funds on margin.

In *Morrison*, the Court limited the application of Section 10(b) to transactions involving the purchase or sale of a security that (1) is "listed on an American stock exchange" or (2) takes place "in the United States." The Court here agreed with Georgiou's argument that because all of the stocks at issue were listed and traded in the over-the-counter market, they did not qualify as being listed on "national securities exchanges."

The Court held, however, that the transactions at issue qualified under *Morrison*'s second prong, for transactions that take place in the US. Adopting the approach taken by courts in several other jurisdictions, the Court held that the location of a securities transaction is determined by the place where "irrevocable liability to carry out the transaction" is incurred. Factors relevant to "irrevocable liability" include the location of contract formation or execution, order placement, passing of title, the exchange of funds and the location of the defendant's business. On the other hand, marketing in the US, a party's US residency or citizenship, and the deception's origination in the US have been held to be insufficient to subject a defendant to liability under Section 10(b). Two key factors that distinguished this case from *Morrison* were that the transactions here involved shares of US companies and that at least one transaction (and likely many) for each of the stocks was executed through a US market maker (sometimes at the defendant's direction).

While the Court held that a transaction's being conducted in the US over-the-counter market does not subject the transaction to Section 10(b), it noted that courts in other jurisdictions have suggested otherwise. How a court assesses this factor will therefore depend on the jurisdiction in which the case is litigated. On the other hand, the Court's adoption of the "irrevocable liability" test goes along with courts in several other jurisdictions that have already taken this approach and thus reflects a more common standard for how *Morrison* is applied. More fundamentally, as we have explained in past editions of this newsletter, courts consider context-specific factors rather than taking a mechanical approach to applying the standard set forth in *Morrison*. The overall connection of the transactions to the US played an important role in the Court's decision here and should do so in future cases as well.

Fire and Police Pension Association of Colorado v. Abiomed, Inc.: Non-Compliance with Food and Drug Laws Does Not Necessarily Constitute Violation of Securities Law

On 6 February 2015, in *Fire and Police Pension Association of Colorado v. Abiomed, Inc.*, the federal appellate court based in Massachusetts addressed claims that a medical device manufacturer and some of its high-level executives violated Section 10(b) of the Securities and Exchange Act of 1934 based on alleged misrepresentations and omissions related to the company's

marketing practices. The Court affirmed the lower court's dismissal of the plaintiffs' claims because, even if the defendants' actions violated federal regulations prohibiting "off label marketing" (the marketing of medical devices and pharmaceutical products for uses that have not been approved by the Food and Drug Administration (the "FDA")), "this case is not about whether or not defendants violated [a federal statute or regulations]. It concerns alleged violations of securities laws," which the plaintiffs failed to properly allege.

According to the plaintiffs, Abiomed made several material misstatements and omissions concerning the company's illegal off-label marketing of its core product, a micro heart pump, and its failure to address the FDA's concerns related to these practices. The Court concluded that the plaintiffs failed to allege with particularity that the defendants acted with the requisite level of intent concerning these statements. As the Court reasoned, "[t]he question of whether a plaintiff has pled . . . a strong inference of scienter [fraudulent intent] has an obvious connection to the question of" the materiality of the omitted information. If a fact is only arguably material or its materiality is of only marginal import, that detracts from the assertion that the defendants acted with scienter. Because the materiality of omitted information concerning the company's marketing practices "depend[ed] on a long chain of [unsubstantiated] inferences" concerning an impact on the company's results, much less its share price, that "marginal materiality . . . weigh[ed] against" a finding that the defendant possessed the requisite level of intent.

The plaintiffs' argument was further weakened by warnings that the company provided about possible regulatory enforcement it might face and the company's public disclosure that the FDA was concerned about the company's marketing practices. Abiomed was not required to go further and admit wrongdoing related to pending governmental inquiries because "[t]here must be some room for give and take between a regulated entity and its regulator." The Court here also held that even if evidence that the company did not take the FDA's warnings seriously enough "plausibly suggest[s] that Abiomed was acting improperly, [that does] not show" that the defendants acted with scienter.

Overall, the Court explained, "[n]ot all claims of wrongdoing by a company make out a viable claim that the company has committed securities fraud. This case is an example." This case provides a useful illustration (at least within the jurisdiction of this Court) of how potential securities liability related to legal concerns about a company's underlying practices can be addressed with proper disclosures explaining the situation to investors and warning of the potential risks associated with the activity at issue.

Recent SEC/DOJ Enforcement Matters

United States of America v. Fokker Services B.V., No 14-cr-121 (D.D.C.): Federal Judge Rejects Deferred Prosecution Agreement Related to Export Violations as "Overly Lenient"

On 5 February 2015, a judge in the US federal district court for the District of Columbia refused to approve a deferred prosecution agreement ("DPA") between Fokker Services B.V. and the US Department of Justice (the "DOJ"). The agreement related to charges that the company violated sanctions restricting the exporting of goods and services to Iran, Sudan and Burma. While the Court acknowledged that its supervisory powers over such agreements "are to be exercised 'sparingly'" and that this was "not a typical case for the use of such powers," it rejected the DPA because it found the agreement to be "grossly disproportionate to the gravity of Fokker Services' conduct."

Fokker Services is a Dutch aerospace services provider. It was accused of violating US export laws and sanction regulations from 2005 until 2010 by participating in the export of over 1,153 shipments of aircraft parts with an origin in the US, primarily to Iran (but also to Burma and Sudan). The company was alleged to have deliberately taken steps, with the knowledge of high-level management, to conceal its violations of these laws. In 2010, the company self-reported these activities to the US government and cooperated with an effort to remedy its compliance flaws. The DPA was set to last for 18 months and required the company to pay $21 million (including amounts to other US regulators), accept responsibility for its violations, continue to cooperate with US authorities, implement a compliance program and comply with US export laws in the future. The Court reviewed the DPA

under the statutory requirement that the Court approve the parties' requested delay of a trial date, as well as the Court's inherent supervisory powers.

While the government could have exercised its discretion not to prosecute the case at all, once it chose to charge the company criminally and seek court approval of its agreement, the Court deemed itself duty-bound to consider whether approval was appropriate. The Court found the amount of the company's fine (which was equal to the amount of its ill-gotten revenue), the DPA's relatively short length, the fact that no individuals were charged, and the lack of independent oversight to be factors that made the DPA inadequate in light of the company's "egregious conduct" of knowingly engaging in a lengthy conspiracy to hide violations of export laws in a way that implicated serious national security and anti-terrorism concerns related to Iran. The Court stated that it would be open to considering a modified agreement, but its decision is currently being appealed to the federal appellate court in the District of Columbia.

We previously wrote in this newsletter (in the second quarter of 2014) about *SEC v. Citigroup Global Markets, Inc.*, where a different appellate court reversed the lower court's refusal to approve a civil settlement between the SEC and a financial institution because of the limited nature of a court's review of such agreements. It will be informative to observe whether the appellate court here agrees with the district court's rejection of the parties' DPA or, rather, determines that here too the district court overstepped its bounds by becoming too involved in the terms of an independent agreement between a private party and government regulator. If the appellate court upholds the disapproval of the DPA here, the district court's observations about what was deficient with the agreement might provide a roadmap for what parties can consider including in future agreements—at least within the District of Columbia and in scenarios raising the type of national security concerns at issue here.

In the Matter of William Slater, CPA and Peter E. Williams, III, Administrative Proceeding File No. 3-16381: CEOs and CFOs Are Required to Return Payments From When Company Materially Misstated Financial Results Even if They Did Not Participate in the Fraud

On 10 February 2015, the SEC reached a settlement with two former chief financial officers of Saba Software, Inc., related to materially false financial results that the company reported over a four-year period related to conduct spanning late 2007 until early 2012. The CFOs were required to forfeit approximately $500,000 combined to repay the company their bonuses and profits from sales of the company's stock from the year following the first public issuance or filing with the SEC of each financial reporting misstatement. The SEC explained that the provision of the Sarbanes-Oxley Act at issue here requires these payments even where the officers were not involved in the misconduct at issue.

Saba Software provides cloud-based computer services. Approximately one third of the company's revenue comes from professional services, including customer-facing consultants in North America and Europe and consultants based in India that assist these customer-facing employees at a lower cost. According to the SEC settlement, employees in India billed for professional services in advance of when they were performed in order to accelerate revenue recognition and meet quarterly targets (pre-booking) and both sets of employees failed to report time in excess of what was allotted in order to conceal budget overruns (under-booking). Because of these accounting errors, the company was required to calculate its revenue in a different manner that did not depend on hourly billing and to restate its financial results for 2008 through 2012. These pending restated results, amounting to approximately $70 million total, will show that the company overstated gross revenue and profit by more than 5% annually from 2008 through 2011 and that its inflated revenue sometimes allowed the company to meet quarterly analyst expectations or avoid reporting an annual net loss.

Last year, Saba Software, the two vice presidents that were responsible for the improper accounting practices and the CEO reached settlements with the SEC. The CFOs that reached the current settlement, like the CEO, were required to repay funds even though they were not personally charged with any misconduct because the Sarbanes-Oxley Act requires the CEO and CFO of any issuer that is "required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of

misconduct, with any financial reporting requirement under the securities laws" to reimburse the issuer for the amounts at issue here. According to the SEC, this provision applies to these high-level officers even if they did not participate in the misconduct because the improper activity still occurred "on their watch."

Commerzbank AG, Schlumberger Oilfield Holdings, Ltd. and PayPal, Inc. Reach Regulatory Settlements Related to Allegations of Economic Sanctions, Bank Secrecy Act and Anti-Money Laundering Violations

In March 2015, various US regulatory agencies reached settlements with Commerzbank AG ("Commerzbank"), Schlumberger Oilfield Holdings, Ltd. ("Schlumberger"), and PayPal, Inc. ("PayPal") related to claims that these companies violated laws and regulations prohibiting transactions involving certain foreign countries or individuals. While each action dealt with its own unique circumstances, there are also common themes among these matters that highlight the US government's increased regulation of prohibited transactions with foreign parties.

On 12 March 2015, Commerzbank reached a $1.45 billion settlement with several criminal and civil governmental agencies, including the DOJ, the US Treasury Department's Office of Foreign Assets Control ("OFAC"), the New York State Department of Financial Services ("DFS"), and other federal and state agencies. Commerzbank, a German bank, was accused of violating economic sanctions regulations by conducting approximately 60,000 transactions worth over $253 billion through Commerzbank's New York branch on behalf of Iranian and Sudanese entities from 2002 to 2008. Commerzbank was accused of several practices in which it concealed the involvement of prohibited parties. In addition, Commerzbank was alleged to have violated the Bank Secrecy Act by failing to comply with anti-money laundering ("AML") regulations requiring the monitoring, investigation, and reporting of certain suspicious transactions. These alleged violations related to "correspondent banking" practices, whereby a party conducts transactions through an intermediary bank that makes it more difficult to ascertain the origin or ultimate beneficiary of a transaction, and other types of suspicious activity. Commerzbank resolved these claims through deferred prosecution agreements or consent orders with the regulators. In addition to the payment described above, some of these agreements held individual employees responsible for violations, required substantial remedial measures and imposed an independent monitor to review the compliance of the company's New York branch with the laws and regulations at issue. While Commerzbank admitted to certain underlying violations, it did not plead guilty to any criminal violations.

On 25 March 2015, Schlumberger, an oilfield services company, pleaded guilty and agreed with the DOJ and other governmental agencies to pay an approximately $238 million penalty (including a record $155 million criminal fine) for engaging in business with Iran and Sudan and enabling others to do the same. Schlumberger pleaded guilty to willfully violating US sanctions programs through deliberate steps to conceal its US business unit's dealings with Iran and Sudan by disguising communications and evading the company's internal programs checking for such activity. The company also agreed to a three-year probationary period and to continue to cooperate with the government. In addition, Schlumberger's parent company agreed to several conditions during the probationary period, including continuing to not operate in Iran and Sudan, hiring an independent consultant to review compliance policies, and reporting compliance-related information to the government.

On 23 March 2015, PayPal reached a settlement with OFAC related to transactions that the company processed allegedly in violation of US sanctions programs related to Cuba, Iran, and Sudan, as well as sanctions covering individuals on OFAC's Specifically Designated Nationals ("SDN") list naming particular people subject to sanctions. OFAC alleged that PayPal should have discovered the involvement of prohibited parties based on language in transaction documents. PayPal was also alleged to have failed to investigate several instances where its screening software detected SDN transactions. PayPal's agreement with OFAC covers almost 500 prohibited transactions worth approximately $44,000. While most of these alleged violations were deemed "non-egregious," OFAC considered the SDN claims to be egregious and therefore subject to a $17 million penalty for transactions totaling a mere $7,000. PayPal agreed to pay $7.66 million in the settlement and did not admit or deny any of OFAC's allegations.

While each of these three regulatory actions involves its own set of unique facts, including different types of transactions, companies in different lines of business and connections to the US and varying levels of severity, they also contain common elements. These matters show that US regulatory agencies actively investigate and enforce potential violations of US restrictions on transactions involving prohibited foreign countries and parties. These actions also show that US governmental agencies pursue these actions even against foreign companies that have only a portion of their operations in the US. In addition, these three agreements show that more serious violations (such as consciously ignoring or deliberately concealing prohibited transactions in order to evade US sanctions), generally call for larger financial penalties and more extensive remedial measures for a settlement to be reached. Some of these settlement agreements are subject to court approval. As discussed concerning the *Fokker Services* action above, the extent of remediation in a regulatory settlement relative to the severity of the government's allegations might impact whether a court will approve the terms of the agreement.

Executive Compensation & Employee Benefits Developments

SEC Proposes Equity Hedging Disclosure Rules Under Dodd-Frank

On 9 February 2015, the SEC proposed long awaited equity hedging disclosure rules to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). The proposed rules adopt Item 407(i) of Regulation S-K, which would require issuers to disclose in any proxy or information statement relating to the election of directors whether any employee, officer or director (or the designee of any employee, officer or director) is permitted to purchase financial instruments (including prepaid forward variable contracts, equity swaps, collars and exchange funds) or otherwise engage in transactions that are designed to hedge or offset any decrease in the market value of equity securities (1) granted to the employee or director as compensation, or (2) held directly or indirectly by the employee or director. Foreign private issuers would not be subject to the disclosure requirements.

- Statutory Purpose:
    - Based on its review of the legislative history, the SEC interpreted the statutory purpose of Section 14(j) of the Exchange Act, as being to "provide transparency to shareholders if action is to be taken with respect to the election of directors, about whether employees or directors are permitted to engage in transactions that mitigate or avoid the incentive alignment associated with equity ownership." The proposed rules provide for a "principles based" approach, rather than a "rules based" approach, to allow for more flexibility to fulfil this legislative purpose. The proposed rules would not require an issuer to prohibit hedging transactions or to otherwise adopt a policy addressing hedging. Moreover, the proposed rules do not require disclosure of actual hedging activity, although the SEC has requested comments as to whether it should so require. While there is no requirement to provide a detailed list of outstanding hedging activity, disclosure of many hedging instruments is currently required pursuant to Section 16(a) of the Exchange Act. Similarly, Item 403(b) of Regulation S-K requires the disclosure of hedging transactions that involve the pledging of issuer equity securities as collateral.
- Relationship to Existing CD&A Obligations:
    - The SEC proposed to include the hedging disclosures in Item 407 of Regulation S-K, which focuses on corporate governance matters, as opposed to Item 402, which focuses on the compensation of directors and executive officers. Item 402(b) requires disclosure in the Compensation Discussion and Analysis (the "CD&A") of any issuer policies regarding hedging the economic risk of stock ownership, if material. To minimize duplicative disclosure, the SEC has proposed to amend Item 402(b) to permit an issuer to satisfy its CD&A disclosure obligations by cross-referencing to Item 407(i).

- Covered Issuers:
    - Section 14(j) requires hedging disclosures by all "issuers." While the SEC has broad authority to exempt certain categories of issuers, it did not provide for many exemptions from Section 14(j). As proposed, Item 407(i) would apply to substantially all US issuers, including emerging growth companies ("EGCs"), smaller reporting companies ("SRCs") and listed closed-end investment companies. Foreign private issuers and unlisted investment companies (including exchange-traded funds and mutual funds) would not be subject to the disclosure requirements.
- Covered Transactions:
    - Section 14(j) expressly refers only to the "purchase of financial instruments intended to offset decreases in the market value of equity securities (such as prepaid variable forward contracts, equity swaps, collars and exchange funds)." The proposed rules would also require disclosure of transactions with "economic consequences" comparable to the purchase of the specified financial instruments. Thus, all policies relating to transactions that establish downside protection—whether by purchasing or selling a security or derivative security or otherwise—must be disclosed.
    - The SEC requested comments on the scope of covered transactions. For instance, the SEC noted that there is a "meaningful distinction" between an index fund that includes a broad-range of equity securities, one component of which is the issuer's equity, and a financial instrument, even one nominally based on a broad index, designed to or having the effect of hedging the economic exposure to issuer equity. The SEC questioned whether an issuer that prohibited hedging generally, but permitted the purchase of broad-based indices should nonetheless be able to disclose that it prohibits hedging. A failure to exclude these types of indices from the definition of covered transactions would likely complicate both the administration of hedging policies and the required disclosures.
    - The proposed rules clarify that a pledge or loan of equity securities would not be considered a hedging transaction covered by the proposed rules, notwithstanding the fact that such transactions may be viewed as "offers or sales" for purposes of the Securities Act of 1933.
- Covered Employees and Directors:
    - Section 14(j) requires disclosure with respect to any "employee or member of the board of directors of the issuer, or any designee of such employee or member." The proposed rules clarify that the term employee also includes officers.
- Covered Equity Securities:
    - The proposed rules define "equity securities" to mean any equity securities (as defined in the Exchange Act) that are issued by the issuer, its parents and subsidiaries or subsidiaries of its parents (*e.g.*, brother and sister companies) that are registered under Section 12 of the Exchange Act. The SEC is seeking specific comments on whether to include affiliate securities in the definition.
    - Section 14(j) provides that the disclosure rules would apply to equity securities that are (1) granted to the employee or director as compensation or (2) held directly or indirectly by the employee or director in any proxy or information statement relating to the election of directors. The proposed rules retained this language. The SEC is seeking comments on whether to define "held directly or indirectly" or "designee" or use the more common concept of "beneficial ownership" under the securities laws.

  - The SEC also requested comments as to whether the disclosures should be further expanded to cover debt securities.

- Required Disclosures:
  - Given the broad definition of covered transactions, an issuer must disclose both the categories of transactions it prohibits, as well as which categories it permits. If an issuer discloses that it specifically prohibits certain categories of transactions, the issuer could then disclose that it permits all other types of transactions in lieu of providing a complete listing of specific permitted transactions, and vice versa. Similarly, if an issuer either prohibits or permits all types of hedging transactions, it would not be required to describe the permitted or prohibited transactions by category. The issuer would, however, need to provide sufficient detail to explain the scope of any permitted transactions. Finally, if the issuer's hedging policy covers some, but not all, of the categories of persons subject to the disclosure requirements, the issuer would need to disclose both the categories of those persons who are permitted to hedge and those who are not.

The SEC has requested comments on numerous provisions of the proposed rules. Comments are due on or before 20 April 2015.

The proposed rules can be found at:

http://www.sec.gov/rules/proposed/2015/33-9723.pdf.

Our client publication discussing the proposed equity hedging disclosure rules is available at:

http://www.shearman.com/en/newsinsights/publications/2015/02/sec-proposes-equity-hedging-disclosure-rules.

CONTACTS

This newsletter is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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