SHEARMAN & STERLING LLP

Governance & Securities Law Focus

A QUARTERLY NEWSLETTER FOR CORPORATES AND FINANCIAL INSTITUTIONS

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In this newsletter, we provide a snapshot of the principal US and European governance and securities law developments of interest to corporates and financial institutions, both with and without a US listing.

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US Developments

US Congressional Initiatives: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

In March, we reported on two major pieces of financial reform legislation that were pending before the US Congress: the Wall Street Reform and Consumer Protection Act of 2009 and the Restoring American Financial Stability Act of 2010. The legislation was ultimately reconciled into a final bill known as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Reform Act"). Both the US House of Representatives and the US Senate would have to pass the legislation, and the President would have to sign it, before it becomes law. The Reform Act was approved by a House-Senate Conference Committee on 25 June and was passed by the House on 30 June. Our current understanding is that the Senate vote on the bill will occur the week of 12 July.

The Reform Act is primarily aimed at financial reform, but it contains a number of executive compensation and corporate governance regulations that will apply to public companies. The following is a summary of the key points of the legislation.

Executive Compensation Reforms

- ***Compensation Committee Independence***. The SEC must direct the national securities exchanges and associations, such as the NYSE and Nasdaq,

to prohibit the listing of securities of any issuer whose compensation committee is not comprised exclusively of independent directors. Rather than setting explicit independence standards, the Reform Act tasks listing authorities with defining independence. In formulating the definition, factors to be considered include: the source of compensation of the director, including any consulting, advisory, or other fees paid by the issuer; and whether a director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

The compensation committee independence requirements do not apply to foreign private issuers listed on the NYSE and Nasdaq as long as they disclose why they do not have an independent committee.

- ***Compensation Consultant Independence***. A compensation committee (1) may, in its sole discretion, obtain advice of consultants, legal counsel and other advisors and (2) must be directly responsible for the appointment oversight and compensation of these advisers. Any committee that elects to retain a consultant, however, will not be compelled to follow the adviser's advice and must exercise its own judgment in fulfilling its duties and making compensation decisions. Companies are required to provide funding for the adviser chosen by the compensation committee. In selecting its advisers, a compensation committee must take into account factors affecting independence. The Reform Act directs the SEC to identify independence factors that are competitively neutral among categories of consultants, legal counsel and other advisors and provides the following partial list of considerations:
  - provision of other services by the adviser's employer;
  - the amount of fees paid to the adviser's employer, considered as a percentage of the employer's total revenues;
  - the policies and procedures of the adviser's employer that are designed to prevent conflicts of interest;
  - any business or personal relationship between the adviser and a member of the compensation committee; and
  - the adviser's ownership of stock of the issuer.

  Within one year following enactment of the Reform Act, the SEC must adopt rules that require the listing authorities to prohibit the listing of securities of any issuer that does not comply with the consultant and adviser independence rules. The listing authorities must also set forth procedures providing companies with a reasonable opportunity to cure any defect before a delisting.

  The Reform Act does not expressly exclude foreign private issuers from this rule, although later rulemaking may provide for such an exception.

- ***Clawback Policies***. National securities exchanges and associations, such as the NYSE and Nasdaq, will require that all listed companies implement an incentive compensation recoupment policy. When a company prepares an accounting restatement on account of its material noncompliance with any financial reporting requirement, the company must recoup all incentive-based compensation (including stock options) paid to current or former executives during the three years preceding the date on which the restatement is required. The amount of compensation recoverable would be the excess of what was actually paid to the executive over the amount that would have been paid under the accounting restatement. Companies must also disclose their policies on incentive-based compensation that is based on their financial reports.

  The Reform Act does not expressly exclude foreign private issuers from this provision,

although later rulemaking may provide for such an exception.

- ***Mandatory Say-on-Pay***. US companies must provide shareholders with the right to cast a nonbinding vote approving their executive compensation as disclosed in the Compensation Discussion and Analysis ("CD&A") section of their proxy statement and accompanying disclosure. Unlike certain prior proposals calling for an annual vote, the Reform Act requires a vote to occur at least once every three years. In the first instance, shareholders must be given the opportunity to vote on both (1) the say-on-pay resolution and (2) a separate resolution to determine whether the company's say-on pay-vote will be held every one, two or three years. Thereafter, shareholders must be given the opportunity to redetermine whether the say-on-pay vote will be held every one, two or three years at least once every six years. The say-on-pay vote is nonbinding and will not be construed as (i) overruling the board's compensation decisions, (ii) imposing additional fiduciary duties on the board, or (iii) limiting shareholders' ability to make compensation-related proposals for inclusion in proxy statements. The Reform Act also requires all institutional investors subject to Section 13(f) of the Securities Exchange Act of 1934 (the "Exchange Act") to report at least annually how they voted on any say on pay matter.

  This requirement applies only to US issuers and not to foreign private issuers.

- ***Disclosure and Vote on Golden Parachutes***. Proxy statements and consent solicitations filed by US companies in connection with mergers, acquisitions, and major asset sales must describe, in clear and simple form, the arrangements with any named executive officers ("NEOs") of the company or the acquiring issuer concerning all compensation (whether present, deferred or contingent) that is related to the transaction. Companies would also be required to disclose the aggregate amount of compensation that will be paid or may become payable to the NEOs (together with the conditions to payment) as a result of the transaction. The SEC is directed to promulgate regulations governing the specifics of this disclosure. The proxy statement must also provide shareholders the opportunity to cast a separate non-binding vote to approve these payments unless the arrangements have been previously subject to a say-on-pay vote. As is the case with the say-on-pay vote, the golden parachute vote is nonbinding and will not overrule the board's compensation decisions impose additional fiduciary duties on the board.

  This requirement applies only to US issuers and not to foreign private issuers.

- ***Additional Disclosure***. The SEC will require additional compensation-related proxy disclosure from US issuers regarding:

  - The relationship between compensation actually paid and the financial performance of the issuer, taking into account any change in the stock value and dividends paid. Issuers may use a graph to illustrate the relationship.
  - Internal pay equity. Specifically, issuers would be required to disclose the median total annual compensation of all employees (other than the CEO), the annual total compensation of the CEO, and the ratio of these two amounts. Total compensation would be calculated in the same manner as the summary compensation table.
  - Whether employees (not only executive officers) or directors (or their designees) can hedge against decreases in the value of company stock granted as compensation or otherwise directly or indirectly held by the employee or director.

This requirement applies only to US issuers and not to foreign private issuers.

Corporate Governance Reforms

- ***Proxy access***. The Reform Act makes clear that the SEC may promulgate rules permitting the use by a shareholder of company proxy materials to nominate director candidates. The Reform Act does not require the SEC to adopt proxy access rules, and it explicitly authorises the SEC to exempt companies from any requirements that it does adopt after taking into account considerations such as whether the requirements would disproportionately burden small companies. The SEC appears to be moving forward with proxy access rules.

  These rules apply only to US issuers and not to foreign private issuers.

- ***No majority voting for director elections***. In a compromise, the requirement for all public companies to adopt majority voting as the standard for director elections has been eliminated. Notwithstanding the elimination, companies should continue to evaluate whether this standard is appropriate for their boards.

- ***Chairman and CEO disclosures***. The Reform Act directs the SEC to issue rules requiring US companies to disclose in their annual proxy statements the reasons why the company has chosen to combine or separate the board chair and CEO positions. Similar disclosure is required under current SEC rules, so it is unclear whether this provision will result in any additional disclosure requirements.

  This requirement applies only to US issuers and not to foreign private issuers.

- ***Risk committees at certain non-bank financial companies and bank holding companies***. The Reform Act requires public non-bank financial companies supervised by the Federal Reserve and bank holding companies with assets of $10 billion or more to establish a risk committee. The Federal Reserve may at its option extend these requirements to bank holding companies with assets of less than $10 billion.

  Risk committees must be responsible for the oversight of the enterprise-wide risk management practices of the company and must include (1) a number of independent directors that the Federal Reserve determines appropriate and (2) at least one risk management expert having experience in identifying, assessing and managing risk exposures of large, complex firms.

- ***Broker discretionary voting***. The Reform Act requires the national securities exchanges to prohibit proxy voting by a broker in connection with the election of directors (other than a vote with respect to the uncontested election of a member of the board of any registered investment company), executive compensation or any other significant matter, as determined by the SEC, unless the underlying shareholder has specifically instructed the broker to vote in such way. Broker discretionary voting was eliminated by the NYSE for director elections starting this proxy season, and this new provision will extend the prohibition to say-on-pay votes, among other matters.

SEC Developments

Updated Compliance and Disclosure Interpretations. On 4 June 2010, the SEC updated its "Compliance and Disclosure Interpretations" regarding various sections of the Securities Act of 1933 and the Exchange Act. These updates include, among other things, clarification that Regulation FD does not categorically prohibit directors from speaking privately to a shareholder or group of shareholders; rather, the prohibition relates to what is disclosed and whether the company and the shareholder have entered into a confidentiality undertaking. Regulation FD prohibits selective disclosure by US issuers, although its principles would broadly apply to foreign private issuers as well.

The comprehensive set of Compliance and Disclosure Interpretations as updated is available at: http://sec.gov/divisions/corpfin/cfguidance.shtml

Noteworthy US Securities Law Litigation

- ***US Supreme Court curbs overseas reach of US securities laws: Morrison v. National Australia Bank.*** In a major decision of interest to every non-US issuer of securities, on 24 June 2010 the United States Supreme Court held that the anti-fraud provisions of the US securities laws do not apply to foreign plaintiffs suing foreign defendants for misconduct in connection with securities traded on foreign exchanges – so-called "foreign-cubed" cases. The Court said that, because Congress did not clearly express its intent to give Section 10(b) of the Exchange Act extraterritorial reach, there is a presumption that the statute applies only to domestic securities fraud. In determining whether the securities fraud is domestic, the key enquiry is a new "transactional" test concerning the location of the securities trade, not the location of the alleged misconduct. As a result, the Court ruled that Section 10(b) reaches deceptive conduct only in connection with the purchase or sale of securities listed on a US exchange, or the purchase or sale of any other securities in the US. This bars foreign plaintiffs from suing foreign issuers of securities for violations of US securities laws based upon transactions in foreign countries. Because none of the plaintiffs in Morrison purchased securities on a US exchange, the Court ruled that the plaintiffs failed to state a claim upon which relief can be granted and affirmed the dismissal of their suit.
- Further information on the Morrison case is available in our news release at: http://www.shearman.com/US-Supreme-Court-Curbs-Overseas-Reach-of-US-Securities-Laws-07-01-2010/.
- ***US Supreme Court clarifies securities fraud statute of limitations: Merck & Co. v. Reynolds.*** In April 2010, the United States Supreme Court held that the two-year "discovery" statute of limitations governing federal securities fraud claims under Section 10(b) does not begin to run until a plaintiff actually discovers, or a reasonably diligent plaintiff would have discovered, facts constituting a securities fraud violation. The issue in Merck was what type of information a plaintiff had to have in order for the two-year limitations period to begin running. Merck asserted that the two-year statute of limitations should begin to run when the facts would lead a reasonably diligent person to investigate further. The Court rejected this "inquiry notice" standard and instead ruled that the statute required the discovery of facts constituting a securities law violation. Moreover, the Court stated that, because scienter – which essentially means knowledge or fraudulent intent – is "an important and necessary element of a Section 10(b) violation," it would frustrate the purpose of the statute if the limitations period began to run regardless of whether a plaintiff had discovered any facts suggesting scienter on the part of the defendant. The Court therefore ruled that the two-year statute of limitations for Section 10(b) claims does not begin to run until the plaintiff discovers or a reasonably diligent plaintiff would have discovered facts related to the element of scienter.
- ***Safe harbour standard for forward-looking statements clarified: Slayton v. American Express Co.*** In May 2010, the Second Circuit issued its first opinion analysing the Private Securities Litigation Reform Act's ("PSLRA") safe harbour provision, which protects issuers and officers and directors from liability for forward-looking statements where certain conditions are met. In Slayton, the Court considered whether this safe harbour protected American Express in the case of a forward-looking statement that it made in its Form 10-Q that later

turned out to be incorrect. The Second Circuit initially applied the plain language of the PSLRA's safe harbour, which provides that a forward-looking statement cannot support a claim of securities fraud if any of the following is true: (1) it is identified and accompanied by meaningful cautionary language, (2) it is immaterial, or (3) the plaintiff fails to plead that it was made with actual knowledge that it was false or misleading. Of note, the Court's first observation was that the defendant's forward-looking statement was not protected by the first limb because the cautionary language in the Form 10-Q was too "vague", "boilerplate" and static to be "meaningful." This highlights the importance of specific, robust and regularly customised cautionary language as the best defence to a hindsight review of forward-looking statements.

Ultimately, the Second Circuit held that American Express was not liable because the plaintiff failed to plead that the forward-looking statement was made with actual knowledge that it was false or misleading. The Second Circuit also ruled that the relevant pleading standard for actual knowledge is whether a reasonable person, based on the facts alleged, would infer that "the defendants (1) did not genuinely believe the [forward-looking] statement, (2) actually knew they had no reasonable basis for making the statement, or (3) were aware of undisclosed facts tending to seriously undermine the accuracy of the statement, 'cogent and at least as compelling as any opposing inference.'"

- ***Limitation on securities fraud for secondary actors: Pacific Investment Management Co. LLC v. Mayer Brown LLP***. In May 2010, the US Court of Appeals for the Second Circuit held that secondary actors (e.g., lawyers, investment bankers, and accountants) can be held liable in a private securities fraud action pursuant to Section 10(b) only for false statements attributed to the secondary actor at the time of dissemination. In this case, plaintiffs alleged that attorneys at Mayer Brown drafted portions of Refco Inc.'s security offering documents that contained false statements. Plaintiffs urged the court to adopt a "creator standard," in which a secondary-actor defendant can be liable for creating a false statement that investors rely on, regardless of whether that statement is attributed to the secondary-actor defendant at the time of dissemination. The Court, however, rejected the "creator standard" for secondary actors, and instead, held that secondary actors can be liable in a private action under Section 10(b) only for those statements that are explicitly attributed to them.

- ***US Supreme Court harmonises application of "honest services" statute: Skilling v. United States***. In June 2010, the United States Supreme Court vacated the conviction of former Enron Corporation CEO Jeffrey Skilling, and remanded his case to the federal appeals court for further proceedings consistent with the Supreme Court's decision. At the Skilling trial, the former Enron executive had been convicted of a conspiracy to commit fraud that was based in part on the prosecutors' claim that Skilling had denied his company of his "honest services." The Court ruled that the "honest services" statute, which explicitly prohibits any scheme or artifice to deprive another of the intangible right to honest services, is unconstitutionally vague and can be applied only to bribery and kickback schemes. On remand, prosecutors will likely argue that there was sufficient evidence to sustain the conspiracy

conviction and any argument or jury instruction regarding honest services was "harmless error." Defence attorneys, on the other hand, will likely argue that every count of his conviction was tainted by the "honest services" fraud charge, so all parts of his guilty verdict should fall.

On the same day, the Supreme Court also vacated the judgments against two other defendants who had been convicted under the honest services statute: Conrad Black, a Canadian businessman and former executive at Hollinger International Inc., and Bruce Weyhrauch, an Alaska state representative. News reports have indicated that these rulings will likely impact numerous corruption cases that are pending or on appeal including the conviction of former New York State Senate Majority Leader Joseph Bruno.

- ***US Supreme Court upholds constitutionality of the Sarbanes-Oxley Act with one narrow exception: Free Enterprise Fund v. Public Company Accounting Oversight Board***. On the last day of the Supreme Court's 2009-10 term, the United States Supreme Court upheld the Sarbanes-Oxley Act of 2002 against a constitutional challenge on separation of powers grounds, but struck down a narrow provision of the Act. The Court said that Sarbanes-Oxley remains "fully operative as law," with one exception: the SEC will now be able to remove at will members of the Public Company Accounting Oversight Board (the "PCAOB"), which Congress established to oversee and regulate auditors of publicly traded companies. Until the Supreme Court's decision in *Free Enterprise Fund*, PCAOB members could be removed by the SEC only for good cause, and the SEC commissioners could also be removed by the President only for good cause. The Court held that this "dual for-cause limitation" violated constitutional separation-of-powers principles by conferring executive power on PCAOB members without subjecting them to presidential oversight and, if necessary, removal. The petitioners' position was that this constitutional infirmity should invalidate Sarbanes-Oxley in its entirety, because the act contains no "severability" clause – no provision permitting the rest of the statute to survive if any part was struck down. Instead, the Court unanimously held that the unconstitutional removal provisions are severable from the rest of the law and that the establishment of the PCAOB was not by itself unconstitutional. As a result, the PCAOB will continue to function as before, except that its five board members will now be removable at will by the SEC.

Recent SEC/DOJ Enforcement Matters

- ***FCPA anti-corruption/anti-bribery settlement: Technip S.A***. In June 2010, the Department of Justice filed a criminal information in the US District Court for the Southern District of Texas against Technip S.A., a global engineering, construction and services company based in Paris, France, charging the company with one count of conspiracy and one count of violating the Foreign Corrupt Practices Act ("FCPA"). In the criminal information, the Department of Justice alleges that Technip participated in a decade-long scheme to bribe Nigerian government officials to obtain engineering, procurement and construction contracts to build liquefied natural gas facilities in Nigeria valued at more than $6 billion.

  In order to resolve the charges, Technip agreed to enter into a deferred prosecution agreement and to pay a $240 million penalty. Under the terms of the deferred prosecution agreement, Technip agreed to retain an independent compliance monitor for a two-year period to review the design and implementation of Technip's compliance program and to cooperate with the Department in ongoing investigations. If Technip abides by the terms of the deferred prosecution agreement, the Department will dismiss the criminal information upon expiration of the agreement.

On the same day, Technip also reached a settlement of a related civil complaint filed by the SEC charging Technip with violating the FCPA's anti-bribery, books and records, and internal controls provisions. As part of the settlement, Technip agreed to pay $98 million in disgorgement of profits related to those violations.

- ***Expanded reach of US enforcement involving US sanctions legislation: ABN AMRO Bank***. In a significant case involving US legislation against sanctioned countries in May 2010 the Department of Justice filed a criminal information against ABN AMRO in the US District Court for the District of Columbia charging the bank with one count of violating the Bank Secrecy Act, and one count of conspiracy to defraud the United States and violate the International Emergency Powers Act and the Trading with the Enemy Act. In the criminal information, the Department of Justice alleged that from 1995 through 2005, ABN AMRO removed or altered names and references to sanctioned countries from payment messages in order to circumvent the laws of the United States. The information alleges that ABN AMRO and the sanctioned entities knew and discussed the fact that, without such alterations, the automated filters at US banks would likely have rejected or blocked the sanctions-related transactions and reported the transactions to the Office of Foreign Assets Control. Based on these allegations, ABN AMRO agreed to enter into a deferred prosecution agreement and to forfeit $500 million. Assuming ABN AMRO fully cooperates and abides by the terms of the deferred prosecution agreement, the Department of Justice has agreed to recommend the dismissal of the criminal information in one year.

  This case reflects a growing trend by the Department of Justice and other US enforcement agencies to prosecute foreign financial institutions that clear US dollar transactions through the United States involving countries, entities, or individuals that are the target of US sanctions legislation. The expanded reach of US enforcement to such activities presents a serious compliance risk to foreign financial institutions.

- ***SEC enforces CEO compensation disgorgement for company's misleading financial statements: Diebold, Inc.*** In June 2010, the SEC entered into a settlement agreement with Diebold's former CEO Walden O'Dell, in which O'Dell agreed to reimburse cash bonuses, stock, and stock options he received during the time when his company issued misleading financial statements. The SEC alleged that from 2002 through 2007, Diebold manipulated its earnings to meet financial performance forecasts and made dozens of misstatements in its SEC filing and press releases. The SEC pursued O'Dell under Section 304 of Sarbanes-Oxley, which deprives corporate executives of certain compensation received while their companies were misleading investors. The SEC's action against O'Dell is noteworthy because the SEC did not allege that O'Dell engaged in any fraudulent activity himself. Instead, the SEC pursued O'Dell under a broad interpretation of Section 304 that permits reimbursement of compensation from the CEO and CFO based on any misconduct at the company. The SEC's enforcement action against O'Dell highlights the need for CEOs and CFOs to ensure that they have sufficient internal controls in place in order to minimise the likelihood of restatements due to misconduct.

Climate-Related Developments: Senators Kerry and Lieberman Release "Discussion Draft" of American Power Act

On 12 May 2010, Senators John Kerry and Joseph Lieberman released a "discussion draft" of the American Power Act to the Senate. Under this draft bill, allowances to emit greenhouse gases would, for the first time under US federal law, be purchased and sold on a regulated market in a manner similar to the EU

regime. The federal government would initially issue a percentage of the required allowances free of cost, gradually phasing those out by 2030. The bill would pre-empt greenhouse gas regulation by the US Environmental Protection Agency ("EPA") as well as state cap-and-trade regimes. The House of Representatives has already passed a climate change bill, the American Clean Energy and Security Act, which has similar provisions, although the Kerry-Lieberman draft differs in some of its timetables and incentives.

Meanwhile, the EPA has also finalised, during the last quarter, significant rules curbing greenhouse gas emissions from large stationary emitters and from certain motor vehicles. In addition, there have been significant recent climate-related developments in Europe, particularly the approach of the registration deadline under the UK Carbon Reduction Commitment Energy Efficiency Scheme.

Our client publication about these developments is available at: http://www.shearman.com/climate-law-update-05-26-2010/

EU Developments

Three key elements of the EU's securities law framework – the so-called Financial Services Action Plan – have now reached different stages in their scheduled, post-implementation and European Commission ("Commission") led reviews.

Amendments to the EU Prospectus Directive

On 17 June 2010, the EU Parliament approved certain key changes to the EU Prospectus Directive (2003/71/EC). The EU Member States are required to implement the amending Directive into national law within 18 months following its entry into force. Therefore, depending on when the amending Directive finally comes into force, issuers of securities, in both the primary and secondary markets, are unlikely to be impacted until at least 2012. The amending Directive includes a number of changes to the offer and admission related exemptions from the requirements of the Prospectus Directive:

- ***Increase of wholesale debt minimum denominations to €100,000***. Under the current Prospectus Directive, issuers of debt securities with minimum denominations of €50,000 can offer these securities to the public without publishing a prospectus. Issuers who seek to list wholesale debt securities on an EU-regulated exchange have to publish a prospectus, but can do so in accordance with the lighter disclosure regime applicable for wholesale securities. The amending Directive increases the minimum denomination per security to €100,000, or its equivalent in another currency.
- ***Increase of 100 person exemption***. There is currently no obligation to publish a prospectus if an offer to the public of securities is addressed to fewer than 100 natural or legal persons per Member State (other than qualified investors). The amending Directive increases the threshold of this exemption to fewer than 150 natural or legal persons per Member State.
- ***Merger exemptions expanded***. Securities offerings to the public or listings on an EU-regulated market in connection with a merger are exempt from the obligation to publish a prospectus under the current regime, provided that a document is available containing information which is regarded by the home Member State regulator as being equivalent to that of the prospectus. These exemptions have been extended to include securities offered or listed in connection with a "division", such as a demerger.
- ***Thresholds for offers outside the scope of the Prospectus Directive***. Under the current Prospectus Directive, offers of securities below a certain size are outside of the scope of the Directive. The amending Directive increases these limits as follows:
  - Securities in an offer where the total consideration of the offer in the EU is less than €5 million over a 12-month period (increased from currently €2.5 million); and

  - Non-equity securities issued in a continuous or repeated manner where the total consideration of the offer in the EU is less than €75 million (increased from currently €50 million).

- ***Extension of the exemption for employee share schemes***. The current exemption in the Prospectus Directive for offers of securities to employees requires that the issuer must have securities admitted to trading on a regulated market; and a document must be available containing information on the number and nature of the securities and the reason for and the details of the offer. The requirement to produce a full prospectus for offers of securities to employees was thought to impose excessive costs which were unjustified in terms of investor protection. Therefore the amending Directive extends this exemption to issuers that do not have securities admitted to trading on a regulated market (e.g. third country issuers or unlisted Member State issuers) provided that the market to which the relevant shares are admitted are deemed by the Commission to be equivalent to the EEA regulated markets in terms of their legal and supervisory framework.

- ***Elimination of annual information update***. The current obligation to publish an annual information statement, which contains or refers to all information made available by the issuer to the public over the preceding 12 months, has been eliminated, as it was duplicative of the requirements under the Transparency Directive (2004/109/EC). Periodic disclosure requirements will continue to apply under the Transparency Directive.

- ***Summary of the prospectus***. The amending Directive has made some changes to the contents and format of the summary. It requires certain "key information" to be included in the summary, which consists of the essential characteristics of, and risks associated with, the issuer, any guarantor, and the securities offered, the general terms of the offer, including estimated expenses, and the risk associated with an investment. In addition, a summary will have to be comparable to summaries of similar products by ensuring that equivalent information always appears in the same position in the summary. The details of the proposed format will have to be specified by EU legislation. Further, a new provision has been added permitting civil liability if the summary does not "provide, when read together with the other parts of the prospectus, key information in order to aid investors when considering whether to invest in such securities". The 2,500 word limit of the prospectus summary has not been abolished.

- ***Reduced disclosure regime for rights offerings***. The amending Directive implements a lighter "proportionate disclosure regime" for rights offerings. Currently, rights offerings are subject to the detailed disclosure requirements under the share schedule set out in Annex I to the Prospectus Regulation. Application of the regime is subject to the conditions that the shares offered are of the same class as shares of the issuer admitted to trading on a regulated market, and that pre-emptive rights of existing shareholders are not excluded.

- ***Prospectus supplements and withdrawal rights***. The amending Directive clarifies the requirements with regard to prospectus supplements and withdrawal rights. Under the Prospectus Directive, an issuer must publish a prospectus supplement if a significant new factor, material mistake or inaccuracy relating to the information included in a prospectus arises which is capable of affecting the assessment of the securities to which that prospectus relates, after approval of the prospectus and before the final closing of the offer or the time when trading on a regulated market begins. The supplement to the prospectus has to be approved by the home Member State regulator in a maximum of seven working days. Investors who have already agreed

to purchase the securities before the supplement is published are allowed to withdraw their acceptances within a certain time limit not shorter than two working days. The amending Directive clarifies that:

- the period during which the publication of a prospectus supplement is triggered ends at the later of the closing of the offer and beginning of trading in the securities;
- investors have withdrawal rights only in relation to a public offer, not in the context of prospectuses that have only been prepared in connection with an admission to listing;
- withdrawal rights are only available where the circumstances which gave rise to the publication of the supplement arose before the close of the public offer and delivery of the securities;
- the period during which withdrawal rights may be exercised is set at two working days after publication of the supplement in all EU Member States (previously Member States could provide for a longer period), and the supplement has to state the final date of the right of withdrawal.

- ***Retail cascades***. Subsequent re-sales of securities by financial intermediaries constitute separate offers under the Prospectus Directive and require a separate exemption from the original offer, or publication of a prospectus. Under the new regime, a new prospectus is not required in a subsequent resale or final placement of securities through financial intermediaries as long as a valid prospectus is available and the issuer or person responsible for the prospectus consents to its use by means of a written agreement.
- ***Electronic publication***. The amending Directive requires the electronic publication of the prospectus on the issuer's or the financial intermediary's website, if the prospectus is also published in a newspaper or in printed form made available at the offices of the market or at the registered offices of the issuer and the financial intermediaries. Home Member States currently have the choice of electronic publication in case issuers choose these methods.
- ***Qualified investors definition***. The amending Directive contains a new definition of the term "qualified investors". A qualified investor is defined as those persons that are classified as professional clients or eligible counterparties in accordance with Annex II of the Markets in Financial Instruments Directive (Directive 2004/39/EC) ("MiFID"). In practice this means that investment firms can rely on their register of qualified investors under MiFID.
- ***Passporting notifications***. The Prospectus Directive provides that once the home Member State has approved a prospectus, it is valid for a public offer or admission to trading in any number of host Member States, only subject to notification of the competent authority of each host Member State by the competent authority of the home Member State (at the request of the issuer or person responsible for the prospectus). The only additional requirement is a translation of the summary into the official language of the host Member State, where applicable. In the context of this passporting procedure, the amending Directive imposes a new obligation on the competent authority of the home Member State to notify the issuer at the same time as it notifies the competent authority of the host Member States that a certificate of approval of a prospectus has been issued. This provides clarity to issuers as to when a notification has actually been made. In the past only the host Member State competent authority needed to be notified.
- ***Choice of home Member State***. Currently, issuers of non-equity securities can choose their home Member State for offerings of securities whose denomination is at least €1,000 on an issue-by-issue basis. The amending Directive provides that the Commission will review this

limitation, following calls by the Commission and the Parliament to remove the €1,000 threshold. Currently, for equity securities and non-equity securities below €1,000, issuers incorporated outside the EEA effectively have a one-time choice depending on where the initial public offer or initial application for admission to trading is made. That initial choice will determine the home Member State for non-EU issuers.

- The text of the European Parliament's amendments is available at: http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2010-0227&language=EN&ring=A7-2010-0102

Commission Consultation on the Transparency Directive

On 28 May 2010 the Commission opened a public consultation on the modernisation of the Transparency Directive, with a cut-off date of 23 August 2010. The Commission is consulting on the following areas:

- The impact of the Transparency Directive (especially its periodic financial reporting obligations) on the attractiveness of regulated markets for small listed companies and whether a "lighter" disclosure regime, but retaining appropriate investor protection safeguards, for such companies should be introduced.
- Whether there should be greater disclosure with respect to holdings of voting rights, including disclosure of:
  - cash-settled derivatives (required by some Member States, e.g. the UK, but not a EU-wide Transparency Directive requirement);
  - so-called "empty voting" rights positions, where the holder of the voting rights no longer has an economic interest in the underlying shares, whether through normal stock lending activities or other stock ownership changes between the record date for a meeting and the meeting itself;
  - future intentions with respect to significant holdings of votings rights (as is already required by some Member States, such as France and Germany); and
  - aggregation of holdings of voting rights with holdings of financial instruments i.e. carrying rights to acquire voting shares (required in 19 Member States but not in others).
- Related to the last point and the fact that, as a minimum harmonisation directive, the voting rights notification and other disclosure obligations resulting from the Transparency Directive tend to vary between different Member States, whether there should be greater harmonisation across the EU with respect to the subject matter of the Transparency Directive, including an EU-wide (or at least maximum harmonisation) regime for:
  - major holdings of voting rights disclosures; and
  - periodic financial reporting disclosures.

Further background information on the Transparency Directive and the work which the Commission has recently undertaken with respect to it is available at: http://ec.europa.eu/internal_market/securities/transparency/index_en.htm

The Commission's consultation paper only is available at: http://ec.europa.eu/internal_market/securities/docs/transparency/directive/consultation_questions_en.pdf

Commission Consultation on the Market Abuse Directive

On 28 June 2010 the Commission announced a public consultation on certain possible revisions to the Market Abuse Directive (2003/6/EC) ("MAD"), which will end on 23 July 2010. Proposed revisions to the MAD implementing regulation will follow later.

This consultation follows on from the scheduled review of the operation of the MAD that the Commission carried out last year and is driven by concerns about:

- perceived gaps that have appeared in the regulation of certain instruments and markets;
- the uneven effectiveness in enforcement against market abuse across Member States; and
- some SME issuers facing undue burdens under the MAD regime.

The Commission is focusing its consultation around three sets of proposed rule changes:

- Extending the scope of MAD:
  - to cover instruments which are admitted and/or traded on an MTF but not traded on a regulated market;
  - to cover market manipulation by the use of OTC instruments that can influence the prices of a financial instrument traded on a regulated market or an MTF;
  - to prohibit attempts of market manipulation; and
  - to align the definition of inside information for commodity derivatives with the general definition of inside information.
- Enhancing enforcement under MAD by:
  - enhancing the powers of supervisors to investigate market abuse, including the power to request a court to authorise the seizure of documents;
  - extending the scope of suspicious transaction reports to include suspicious orders and suspicious OTC transactions; and
  - introducing effective and deterrent sanctions, including appropriate administrative measures to eliminate breaches and the imposition of fines and penalty payments.
- Enhancing the level of harmonisation and coordination among regulators, including creating a single rulebook, by:
  - ensuring better cooperation between national supervisors with the assistance of the European Securities and Markets Authority ("ESMA"); and
  - ensuring better cooperation with third country supervisors.

Of particular interest here is the consultation's proposals with respect to the right of issuers to delay disclosure of inside information where they have a legitimate interest in so doing, the delay will not be likely to mislead the public and the information can be kept confidential.

The consultation raises the question whether the option which MAD allows for Member States to require issuers who decide to delay disclosure in these circumstances to notify this fact to their regulator, should be removed. This would mean that delays would always have to be notified. The Commission is also consulting on whether it should be the regulator, rather than the issuer, who decides on whether disclosure of inside information should be delayed where the issuer concerned needs emergency, public body, lending assistance.

A copy of the MAD consultation is available at: http://ec.europa.eu/internal_market/consultations/docs/2010/mad/consultation_paper.pdf

Public Consultation on Short Selling and Credit Default Swaps

Under pressure from recent market volatility and Member States' lobbying, the Commission has launched a public consultation, while accelerating its timeline in order to adopt new stand-alone market legislation by September 2010, on short-selling and credit default swaps ("CDS"). The consultation is open until 10 July.

- ***Member State measures***. During the financial crisis and in the context of market volatility in euro denominated sovereign bonds, Member States have reacted differently and with a variety of measures to short selling issues. These measures include, *inter alia*, the prohibition of naked short sales in certain government bonds of the Member States of the European Monetary Union and naked short sales in the shares of the

ten largest German financial institutions and certain CDS by the German regulator *Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)* in May 2010. The Commission now strives for a coherent and harmonised EU approach.

- ***Issues***. The following are the issued raised in the consultation paper: firstly, whether the rules should be applied uniformly to every type of instrument which could be subject to short-selling or whether certain differentiations will be required. Secondly, the paper focuses on transparency and seeks to establish whether all net-short positions traded on and off market, including those created by the use of derivatives, should be covered under the disclosure regime, or whether it should only apply to EU shares and EU sovereign bonds. Thirdly, the Commission is considering whether short selling should be subject to conditions, or whether trading venues should be required to implement rules ensuring that where a person who enters into a short sale is not able to deliver the shares for settlement within a specified period, procedures are triggered to buy in the shares for settlement. Fourthly, the paper discusses exemptions for market-making activities. Finally, the Commission suggests that national authorities might be given the power to prohibit or impose conditions on short selling and the use of credit default swaps in an emergency. It also proposes that ESMA, which is expected to evolve from the current Committee of European Securities Regulators ("CESR"), could require national authorities to take actions or address decisions to financial institutions themselves.

Further information is available at: http://ec.europa.eu/internal_market/securities/short_selling_en.htm

CESR Technical Details for an EU Short Selling Disclosure Regime

On 18 May 2010 CESR published its Technical Details of the Pan-European Short Selling Disclosure Regime. The Technical Details are complementary to CESR's Report on a Pan-European Short Selling Disclosure Regime issued in March 2010. The Technical Details cover:

- Determination of economic exposure in calculating a short position;
- Calculation of changes in net short positions;
- Mechanics for disclosure, in which regard CESR is considering the possible establishment of a centralised EU repository and publication mechanism; and
- Applicable exemptions.

Amendments to the Rules on Credit Rating Agencies

On 2 June 2010, the Commission put forward amendments to the European Regulation on Credit Rating Agencies (No. 1060/2009) as part of its efforts to strengthen the financial system and prevent a future financial crisis. The Commission's objectives with regards to credit rating agencies ("CRAs") are improved supervision at the European level, increased transparency, increased competition and improved investor protection.

- ***New supervisory authority***. The Commission's proposal of a more centralised system of supervision for CRAs at the European level reflects the fact that rating services are not linked to a particular territory and that ratings issued by CRAs can be used by financial institutions across Europe. Exclusive supervision power over CRAs registered in the EU (including European subsidiaries of global CRAs such as Fitch, Moody's and Standard & Poor's) would be assigned to a new European supervisory authority, ESMA. The new supervisory authority would have powers to request information, to launch investigations and to perform on-site inspections. The change would mean that the CRAs would operate under a simpler centralised supervisory environment rather than the existing varied national environments.

- ***Increasing competition and reducing conflicts of interest***. In order to increase transparency, credit institutions, banks, investment firms, and other issuers of structured finance products would have to provide all CRAs that are interested in issuing unsolicited ratings with access to the information they give the CRA they have hired, provided they have the systems and organisational structure in place to ensure the confidentiality of this information and they provide ratings on a yearly basis for at least 10% of the relevant structured finance instrument. Such proposed requirements would be similar to the US SEC Rule 17g-5.
- ***Increased transparency and conflict of interest risks***. The background for the new proposal is the recognition that CRAs contributed to the financial crisis by underestimating the risk that issuers of certain more complicated financial instruments might not be able to repay their debts. The Regulation on Credit Rating Agencies, which created a common regulatory regime for the issuance of credit ratings, came into force in December 2009. Under these rules all CRAs need to apply for registration by 7 September 2010 if they want their credit ratings to be used in the EU. These rules should increase transparency and allow investors to perform better due diligence, since CRAs will need to disclose the methodology, internal models and key rating assumptions used to make their ratings. The rules also address conflict of interest risks. For example, a CRA cannot also offer consultancy services.

The Commission's proposal will now pass to the European Council of Ministers and the European Parliament for consideration. If adopted, the new rules would be expected to come into force during 2011.

No Legal Professional Privilege for In-house Communication

Advocate General of the European Court of Justice Kokott considered in a recent opinion (*Akzo Nobel and others v. Commission - C-550/07*) that the legal professional privilege of protection under EU law applies solely to communications between a client and an independent lawyer. A salaried in-house lawyer, notwithstanding any membership of a Bar or Law Society, does not - in Justice Kokott's opinion - enjoy the same degree of independence from his employer as a lawyer working in an external law firm does.

At present, only a small number of the 27 Member States (mostly common law states) apply the legal professional privilege to communications with in-house lawyers, which is not sufficient to argue for a need to harmonise EU and national laws. Further, Kokott's opinion is in line with a judgment of the European Court of Justice in 1982 (*AM&S Europe Limited v. Commission – C-155/79*) and although the Court still has to decide the new case, there seems to be no impetus to change the rules at present as the Court will, in most cases, follow the opinion of the Advocate General.

Although legal professional privilege is normally a (national) procedural law question, the uniform application of EU law mandates for a judgment in the light of EU law. However, this applies only to competition proceedings and investigations conducted by the Commission, and does not affect the law governing national proceedings.

Commission Publishes Synthesis of Public Consultation Replies on the Interconnection of Business Registers

On 12 April 2010, the Commission published its synthesis of public consultation replies on the Interconnection of Business Registers, stating approval of all 27 Member States. Many respondents pointed out that a legal requirement for the participation of all Member States should be envisaged, while a significant proportion of the respondents insisted on the implementation of standards securing data quality. With regards to improving the communication between business registers in cross-border procedures, two thirds considered building on the results of the BRITE project (Business Register Interoperability Throughout Europe), an integrated project co-funded by the

Commission, which addresses cross-border interoperability.

The synthesis and further information is available at: http://ec.europa.eu/internal_market/company/business_registers/index_en.htm

Commission Consultation on Derivatives and Market Infrastructures

On 14 June 2010 the Commission published a public consultation paper on derivatives and market infrastructures. The consultation period will close on 10 July 2010, with the proposed legislation scheduled to be adopted in September 2010. The Commission is seeking views on:

- Processes that would take account of all potential risks connected with mandatory clearing and, in particular, establish the eligibility criteria for clearing of OTC contracts. The Commission is proposing a two-pronged approach to determining the eligibility of OTC contracts for clearing: firstly, a central counterparty ("CCP") would be able to decide to clear certain types of contracts and would submit an application for approval to its national supervisor; and secondly, ESMA, together with the European Systemic Risk Board ("ESRB"), would determine which contracts would be eligible for CCP clearing. These proposals would give significant powers to ESMA;
- Arrangements for risk controls and resources that should be applied to CCPs in order to mitigate market risk and ensure that CCPs do not ultimately become a potential source of systemic risk themselves;
- Interoperability between systems and, in particular, ways in which cross-system execution of transactions involving multiple CCPs could be achieved through pan-European legislation; and
- Reporting obligations for market participants to trade repositories, and the suitability of registration and/or regulatory requirements for trade repositories.

Review of European Company Statute

In May 2010, the Commission received replies to a consultation and held a high level conference to discuss respective input on issues relevant for the assessment of the European Company Statute, which gives companies operating in more than one Member State the possibility to reorganise their cross-border business under one European label: Societas Europaea ("SE"). The SE has proved to be very popular in some Member States, in particular Germany and the Czech Republic, but has not taken off in others. Under the European Company Regulation, the Commission is required to report on its practical application five years after its entry into force and put forward amendments where appropriate. In December 2008, the Commission had launched an external study, which raised issues, including the high formation costs of an SE, lack of public recognition of its legal form and the legal questions arising out of applicability of national or supranational law. In many Member States where the national legislation applicable to public limited liability companies does not provide for a compulsory employee participation regime, the need for negotiations regarding the future employee involvement under the European Company Statute is viewed as too inflexible. Further, it has been criticised that private limited companies aiming to become an SE have to transform to a public limited company before they can transform into an SE.

However, this external study presented only recommendations and it will remain for the Commission to decide whether and which amendments of the European Company Statute, if any, to propose.

Further information is available at: http://ec.europa.eu/internal_market/company/se/index_en.htm

UK Developments

New Corporate Governance Code for the UK

As from 29 June 2010, the UK has a new corporate governance code. Previously called the Combined Code on Corporate Governance, the renamed Corporate Governance Code is a revision of the earlier code that takes into account certain aspects of the 2009 Walker Review on corporate governance in UK financial institutions.

Key points about the new code include the following:

- It is not a fundamental re-write but some significant changes have been made, highlighted below.
- It will be the new corporate governance benchmark against which both UK and non-UK-incorporated companies with premium equity listings on the LSE will have to disclose their corporate governance regimes and practices.
- Compliance (or non-compliance) with it will have to be disclosed in annual reports for periods beginning on or after 29 June 2010.
- Key changes include:
  - new principles – e.g. the role of non-executive directors in challenging and developing strategy;
  - amendments to existing principles – e.g. boards should consider the benefits of gender and other diversity when making appointments; and
  - amendments to the code provisions – perhaps the most notable of which is a new recommendation for the annual re-election of all (FTSE 350) directors.
- The code's provisions dealing with the responsibilities of institutional shareholders with respect to their investments, etc. have been removed and are now included in a Stewardship Code (please see below).

Our client publication about the new code is available at: http://www.shearman.com/files/Publication/38d659ca-f80f-4295-854e-1f9a6ccafd5a/Presentation/PublicationAttachment/b6a52451-cd0e-4e1e-bc66-25e240d7c990/CM-061110-New-Corporate-Governance-Code-for-the-UK.pdf. A copy of the code itself is available at: http://www.frc.org.uk/corporate/ukcgcode.cfm.

UK Takeover Code Review

On 1 June 2010, the UK Panel on Takeovers and Mergers announced a wide-ranging review of a number of fundamental principles of UK takeover regulation contained in the Panel's City Code on Takeovers and Mergers. Responses are required by 27 July 2010. This review has been prompted in part by the debate - both in the press and among politicians - generated by the highly controversial and ultimately successful bid by Kraft for Cadbury earlier this year. Shearman & Sterling acted as US counsel to Cadbury in this battle. Key points of the review are as follows:

- The Panel is consulting on nine principal issues.
- Most controversial are a possible:
  - raising of the minimum voting rights acceptance condition from 50% plus one; and
  - "disenfranchisement" of voting securities acquired in the target during an offer period.
- Other issues include possible:
  - greater disclosure in offer documents (including with respect to advisory fees);
  - disclosure of offer acceptance/scheme voting intentions;
  - tightening up of some code rules (e.g. the so-called "put up or shut up" rule or rules permitting payment of inducement fees in recommended bids or other deal protection measures); and
  - shortening of the code timetable.

Our client publication is available at: http://www.shearman.com/files/Publication/61a08dc0-e284-401d-9411-879baf6470ca/Presentation/PublicationAttachment/5bc03e38-aa39-4ad7-8d66-96206c73bc80/FIA-062310-Review-of-the-UK-Takeover-Code.pdf.

Our publication notes certain positions adopted in France, Germany or Italy on some of the issues raised by the review, which may be of relevance to the review. A copy of the review itself is available at: http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/PCP201002.pdf.

New Stewardship Code for the UK

In our previous issue of this newsletter we reported on the consultation that the Financial Reporting Council ("FRC") was conducting on a new code of best practice with respect to institutional shareholder engagement with the companies they invest in. This code has now been published as the UK Stewardship Code and a copy of the code is available at: http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf. The FRC has also published a background paper on the code which explains its approach to the code and its plans for a further review of the code in the second half of 2011. It is available at: http://www.frc.org.uk/images/uploaded/documents/Implementation%20of%20Stewardship%20Code%20July%2020103.pdf.

The code contains seven broad principles, requiring institutional investors:

- To publicly disclose their policy on how they discharge their stewardship responsibilities (i.e. monitoring, interacting with and voting, etc with respect to their investee companies);
- To have a robust and publicly disclosed policy on managing conflicts of interest;
- To monitor regularly their investee companies, including attending shareholder meetings and raising concerns with the board, where appropriate;
- To establish clear guidelines on when and how they will actively intervene as an investor (whether an active or passive investment policy is being followed);
- To be willing to act collectively with other investors where this is appropriate;
- To have a clear policy on voting and disclosure of voting activity; specifically they should not support the board automatically and should abstain or vote against a resolution where their concerns have not been addressed; and
- To report at least annually to their clients on their voting and other stewardship activities, while recognising that no disclosures should be made that are counterproductive or create confidentiality issues.

Like the Corporate Governance Code, this code will operate on a "comply or explain" basis and the FRC emphasises that it does not mandate engagement between all investors and their investee companies.

The code applies to all asset managers acting on behalf of institutional shareholders but the FRC encourages all institutional investors to follow it and hopes that non-UK based investors will commit to the code (though recognises that compliance with such investors' own national or international standards may impact their ability or wish to comply with this code). In a similar spirit, the FRC expects UK investors to use their best efforts to apply the code to their overseas investments.

The FRC expects institutions to make the required disclosures in respect of the code and their compliance (or non-compliance with it) on their websites. From October 2010, the FRC will list on its website all investors who have published a code compliance statement and so is encouraging all affected investors to publish their statements by that date and to notify the FRC of this and of any updates to those statements.

Following the publication of the new code, the FSA is consulting on the introduction in its Conduct of

Business sourcebook of a "comply or explain" requirement in respect of the code. This would apply to all UK-authorised firms managing investments on behalf of professional clients (that are not natural persons) but not to venture capital firms. Responses to this issue (covered in chapter 5 of the consultation paper) are due by 6 September 2010. A copy of the consultation paper is available at: http://www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_15.shtml .

FSA Levies Largest Ever Fine for Inside Information Breach

A reminder of the importance that the FSA attaches to compliance with the UK's market abuse/inside information rules (derived from MAD and contained in the FSA's Disclosure and Transparency Rules ("DTRs"), in particular, DTR 2), was provided last month when the FSA handed out the largest ever fine it has levied for a breach of the rules.

The UK listed Photo-Me International plc was fined £500,000 for failing to update the market with news of a significant change in the likelihood of it winning a new large order for its products and in its meeting the sales targets required to underpin its forecast "strong" second half-year results. The FSA found that it had delayed in updating the market with news of these negative developments for 44 days and that this had led to a false market in its shares, leading to a 24% price fall when a profit warning was finally released. The FSA did not find any of Photo-Me's directors guilty of any regulatory breaches in relation to this matter. The previous highest fine for a DTR 2 breach was a fine of £350,000 levied against the former Woolworths Group plc in June 2008.

A copy of the FSA's final notice against Photo-Me in relation to this breach is available at: http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/102.shtml .

The *Winterflood* Case: No Actual Intent Required in Market Abuse Cases

On 22 April 2010 the UK Court of Appeal gave judgment in *Winterflood Securities Ltd & ors. v. Financial Services Authority* [2010] EWCA Civ 423, in which it made certain rulings relevant to the test for market abusive behaviour and the interpretation of the FSA's Code of Market Conduct. The Court of Appeal emphasised that the test for market abuse was wholly objective and did not require any particular state of mind on the part of the accused, and rejected Winterflood's argument that any descriptions of behaviour that are treated as amounting to market abuse by the code necessarily led to the conclusion that any behaviour not falling within those descriptions is not market abuse. Following the judgment, the FSA imposed on Winterflood Securities Ltd its largest ever fine (£4 million) for market abuse.

Our client publication on the case, which includes a discussion of related developments is available at: http://www.shearman.com/The-UK-and-the-US-Market-Abuse-Divide-the-Winterflood-Appeal-and-Other-Developments-06-25-2010/.

FSA Consultation on Implementing its Enhanced Short Selling Powers

On 26 April 2010 the FSA published a consultation paper which includes proposals to implement the enhanced short selling powers given to it by the Financial Services Act 2010. The FSA intends to maintain the current regime until an EU-wide framework is put in place. Key changes that are proposed for the interim period include:

- Replacing the current short selling disclosure rules in the code with a new Handbook module to be known as the Financial Stability and Market Confidence sourcebook;
- Reducing the scope of the rights issue regime so that it only applies to UK-incorporated companies, and non-UK companies where a UK prescribed market is the main or sole venue for trading in the company's securities; and

- Amending the scope of the disclosure obligation. It is proposed that the disclosure obligations should continue to apply to the holder of a net short position. However, where an investment manager or authorised fund manager manages on a non-discretionary basis, the disclosure obligation should apply to the client, although it would be possible for the client to arrange for the investment manager to make the disclosure on its behalf. In the case of discretionary management, the disclosure obligation would apply at both the level of the beneficial holder of the net short position (the client) and at the level of the investment manager or authorised fund manager. The latter would be required to disclose its aggregated net short position across all of the funds it manages on a discretionary basis.

In order to achieve consistency, the FSA intends to apply its current disciplinary and enforcement policy (including the new five-step policy set out in its policy statement PS10/3) when deciding whether to taking action in relation to breaches of the short selling rules.

Developments Specific to Financial Institutions

US Developments

Guidance on Incentive Compensation Arrangements

On 21 June 2010, the Board of Governors of the Federal Reserve, the Office of the Comptroller, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation (the "Agencies") issued final guidance to ensure that incentive compensation arrangements at banking organisations under their supervision do not encourage excessive risk-taking. The final guidance does not contain specific mandates or prohibitions with respect to the use or forms of incentive compensation, but rather takes a principles-based approach. Consistent with the proposed guidance, the Agencies organise the final guidance around three core principles: (1) incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organisations to imprudent risks; (2) a banking organisation's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements; and (3) banking organisations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.

The Agencies make clear that the guidance applies, not just to senior executives, but to any employees who, either individually or as part of a group, have the potential to expose the banking organisation to material amounts of risk. This is a facts and circumstances test.

The Agencies will monitor the actions taken by banking organisations with respect to their incentive compensation arrangements and will review and update the final guidance as appropriate to account for emerging best practice.

EU Developments

Commission Green Paper

On 2 June 2010 the Commission published a Green Paper on corporate governance in financial institutions and remuneration policies. The Green Paper includes a number of proposals to improve corporate governance in financial institutions, including, among others:

- Regulating or restricting stock options and golden parachutes;
- Increasing the legal liability of directors;
- Strengthening the authority of the risk management functions;
- Imposing a stricter duty on auditors to flag serious issues to boards of directors and supervisors; and
- Amending rules as to the composition of boards of directors, particularly as regards expertise and numbers.

The Green Paper is accompanied by a staff working document which describes and analyses weaknesses in corporate governance identified in EU Member States.

The Green Paper is of relevance to all regulated financial institutions, although it centres on banks and life insurance companies. Whilst the Green Paper focuses on large financial institutions, the Commission envisages that substantially the same principles could be applied to smaller institutions.

The Commission intends to launch a broader review on corporate governance within listed companies in the future, particularly on the role of shareholders, the composition of boards of directors, corporate social responsibility and the distribution of duties between shareholders and boards of directors in supervising senior management teams.

More information on the consultation is available at: http://ec.europa.eu/internal_market/consultations/2010/governance_en.htm.

EU Financial Supervisory Framework

In September 2009 the Commission published draft regulations to amend EU supervision of the financial sector. The proposals include:

- Establishment of the ESRB to provide macro-prudential supervision, give early warning of any growing systemic risks and, where necessary, recommend action to deal with such risks; and
- Replacement of the Lamfalussy Level 3 Committees with three new European Supervisory Authorities ("ESAs"): ESMA, European Banking Authority and European Insurance and Occupational Pensions Authority. The ESAs would have certain executive, as well as advisory, powers, and would co-ordinate on micro-prudential supervision with national regulators under a new European System of Financial Supervisors (the "ESFS"). The ESFS would co-exist with the existing system of colleges of supervisors that oversee cross-border financial groups.

Proposals for amendments to existing EU legislation, in order to enable the new ESAs to work effectively, were published on 26 October 2009. The legislative texts are currently scheduled for adoption in early July 2010.

CEBS Revised Consultation

On 23 June 2010 the Committee of Banking Supervisors ("CEBS") published its revised consultation paper on draft guidelines for implementation measures relating to identification, assessment, control and monitoring of operational risk in market-related activities (the "Guidelines"). The Guidelines are intended to complement CEBS's Guidelines on the Application of the Supervisory Review and Evaluation Process under Pillar 2, High Level Principles for Risk Management, and High Level Principles for Remuneration Policies. In the light of responses to its initial consultation paper, CEBS has amended some of its draft principles, in particular in relation to:

- Requirements regarding the detection and prevention of fraudulent behaviour;
- Audit trail requirements;
- Confirmation, settlement and reconciliation processes for executed transactions; and
- Monitoring of nominal values of transactions.

The need for further consultation has pushed back the proposed implementation date for the Guidelines from December 2010 to 30 June 2011.

EU Legislative Proposals on Remuneration

In late 2008 the Commission started consulting on and implementing changes to the Capital Requirements Directive (comprising two directives: Directive 2006/48/EC and Directive 2006/49/EC) (the "CRD"). The proposals were put forward by the Commission in three sets, now referred to as CRD II, CRD III and CRD IV. CRD III includes proposals on remuneration policies that affect banks and investment firms (for details see the Spring Edition of this publication available at: http://www.shearman.com/governance--securities-law-focus-a-quarterly-newsletter-for-european-corporates-and-financial-institutions-spring-

2010-04-29-2010/). The legislative text is scheduled to be adopted in early July 2010.

Remuneration is also a subject of ongoing work in relation to the proposed EU directive on alternative investment fund managers and other legislation concerning the UCITS and insurance sectors.

UK Developments

UK Financial Supervisory Framework

In June 2010 the UK government outlined its proposals to reform the architecture of the UK financial regulatory system. Under these plans, the FSA will be abolished and regulatory and supervisory functions will be reassigned as follows:

- The Bank of England will have control of both macro-prudential regulation, through the establishment of a Financial Policy Committee, and micro-prudential regulation, through the establishment of the Prudential Regulation Authority, which will be a subsidiary of the Bank;
- A new Consumer Protection and Markets Authority will assume responsibility for consumer protection and conduct of business regulation (in respect of both retail and wholesale firms);
- A new, single economic crime agency will deal with serious economic crime (which currently falls within the remit of various different government departments and agencies); and
- The newly-established Independent Commission on Banking (chaired by Sir John Vickers) has been tasked with reporting on the optimal structure of banking businesses and with making certain recommendations, including as to whether and how retail and investment banking can viably be separated, and the promotion of stability and competition in the banking sector.

See our client publication available at: http://www.shearman.com/the-uk-government-proposes-to-change-the-architecture-of-the-uks-financial-regulatory-system-06-21-2010/.

Report of the Future of Banking Commission

On 14 June 2010 the Future of Banking Commission (the "FBC", chaired by David Davis MP) published a report recommending significant changes to the structure, regulation, governance and culture of the banking industry. However, it is currently unclear whether the government will incorporate any of the FBC's recommendations into its plans for financial regulatory reform. On corporate governance, the FBC noted that:

- Greater independence and professionalism amongst those charged with overseeing corporate operations is needed;
- The Stewardship Code for institutional investors should be mandatory for fund managers who own bank shares;
- Auditors should be asked to attest that annual accounts for banks represent a "true, fair and comprehensive statement" of the affairs of the bank in question and that they are prepared in accordance with the spirit as well as the letter of solvency and other regulatory requirements; and
- Remuneration structures for senior executives need to be far longer-term in nature, with rewards for financial measures aligned to return on assets.

The report also recommends the development of a Good Financial Practice Code which should be devised and enforced by a new professional standards body.

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.

If you wish to receive more information on the topics covered in this publication, you may contact your usual Shearman & Sterling representative or any of the following:

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