

GOVERNANCE & SECURITIES LAW FOCUS

A quarterly newsletter for European corporates and financial institutions

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

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EU DEVELOPMENTS

[Review of the Prospectus Directive: Commission Proposal Calls for the Harmonization of Transparency Rules and the Reduction of Unjustified Burdensome Requirements](#)

In September 2009, the European Commission ("Commission") published its proposals for amending the Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading ("Prospectus Directive") and 2004/109/EC on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market ("Transparency Directive"). The proposal is part of a simplification exercise within the scope of the "Action Program of the European Commission for the Reduction of Administrative Burdens in the European Union". As this proposed directive is subject to the "co-decision procedure", both the Commission and the European Parliament ("Parliament") are involved in the review process. The apparent intention is to agree and enact an amending directive sometime later this year.

The Prospectus Directive had been identified by the Commission as one area containing a number of legal uncertainties and unjustified burdensome requirements that increase costs and create inefficiencies. The proposal aims towards a simplification and an improvement of its application, increasing its efficiency and enhancing the EU's international competitiveness, bearing in mind the importance of enhancing the level of investor protection and ensuring that the information provided is sufficient and adequate to cover the needs of retail investors, particularly in the context of the financial market turbulence that started in 2007.

The underlying idea of the review process in terms of efficiency is that the current "one size fits all" approach of the prospectus regime lacks flexibility and might be too costly in certain cases. In the Commission's view, the cost of producing a full prospectus might not be justified with respect to investor protection in cases of, *inter alia*, employee share schemes, government guarantee schemes and rights issues. Furthermore, the proposal aims to improve legal certainty by giving guidance with regard to the application of certain rules (e.g., the obligation to supplement a prospectus and the exercise of the right of withdrawal) and the interpretation of certain terms (e.g., alignment of the definitions of qualified investors under the Prospectus Directive and the definition of professional clients as set out in the Market in Financial Instruments Directive). Moreover, the Commission's proposal is designed to harmonise the assessment of certain rules by the Member States (such as the calculation of maximum offering amounts for the purposes of the Prospectus Directive) and to align the liability regime of the Member States.

In addition to these measures, the proposal includes the requirement to produce a more substantial summary document. In the Commission's view, the content of the summary should be determined in a way that ensures comparability with a wide range of other investment products that are comparable to the investment proposal described in the prospectus. A

more detailed summary document is expected to strike a better balance between the need for investor protection and the need for comprehensibility for retail investors. Furthermore, a more substantial summary is designed to help prospective investors to make informed investment decisions. As a consequence of the increasing importance of the summary document, the proposal attaches civil liability on the basis of the summary not only if it is misleading, inaccurate or inconsistent, when read together with the other parts of the prospectus, but also if it does not provide key information enabling investors to take informed investment decisions and to compare the securities with other investment products.

The proposal contains, in its Article 2, some amendments to the Transparency Directive. The current Prospectus Directive imposes a restriction on the choice of the "home Member State" for issues of non-equity securities. The choice is available only for debt securities with a denomination above €1,000. Below this threshold the home Member State mandated by the Directive is the one where the issuer has its registered office. The Commission proposes to remove the limitation on the determination of the home Member State for issues of non-equity securities with a denomination below €1,000. Accordingly, it is proposed to amend the mechanism for the determination of the home and the host Member States in the Transparency Directive.

In January 2010, the Rapporteur to the Committee on Economic and Monetary Affairs of the Parliament published a draft report on the Commission's proposed directive in which it presents the Parliament's compromise proposal. The most significant changes proposed relate to the prospectus summary. While the Rapporteur does support the replacement of the summary with "key information", he leaves it until later (so-called level two measures) to decide what should constitute "key information" for these purposes. It is the Parliament's concern that, when taken together with the abolition of the current 2,500 word limit, this could well lead to extremely

detailed and extensive “summaries” which could come to resemble prospectuses in their own right. Having in mind that the Commission’s proposal also provides for a toughening of the liability regime for the summary, issuers would not want to take the risk of omitting any information that could be considered “key information” – namely, information necessary to take investment decisions on an informed basis. According to the draft report, it is difficult to see how lengthy and detailed “summaries” would enhance the protection of investors and they would only increase the administrative burdens on issuers (and competent authorities who have to review them). Another aspect of significant importance is the amendment of the rules regarding the validity period of prospectuses. Currently a prospectus may be valid for up to 12 months after its publication. The Commission proposes that this 12-month period should instead run from the date of approval of the prospectus. However, the Rapporteur proposes extending the validity period to 36 months for a base prospectus for a program and to 24 months for any other prospectus.

The procedure file of the Parliament, which reflects the current status of the review and amendment process and contains the main documents, is available at:

<http://www.europarl.europa.eu/oeil/FindByProcnum.do?lang=2&procnum=COD/2009/0132>.

The Spector Photo Case: European Court of Justice Rules on the Interpretation of the Market Abuse Directive

On 23 December 2009, the European Court of Justice (“ECJ”) handed down a judgment in the Spector Photo case on the interpretation of Article 2(1) of the Market Abuse Directive, which contains a pan-European prohibition on insider dealing. The ECJ held that, in relation to insider dealing market abuse, it is not necessary for national authorities to demonstrate that the person accused of insider dealing had “used” inside information “with full knowledge”. Instead, embedded in the definition of insider dealing is a presumption that a person who is in possession of

inside information and who deals in financial instruments to which the information relates, shall be deemed to “use” that information in contravention of the insider dealing prohibition. Thus, the key implication of the Spector Photo decision is that the definition of insider dealing under EU law is an objective one. However, it is possible for such a person to rebut this presumption.

The judgment is available at:

<http://curia.europa.eu/jurisp/cgi-bin/gettext.pl?where=&lang=en&num=79908776C19080045&doc=T&ouvert=T&seance=ARRET>.

For more detail, please see our client publication at: <http://www.shearman.com/the-spector-photo-case--ecj-rules-on-the-interpretation-of-the-market-abuse-directive-02-05-2010/>.

European Corporate Governance Forum Statement on Empty Voting Rights and Transparency of Shareholder Positions

On 20 February 2010, the European Corporate Governance Forum suggested amendments to the Transparency Directive to require the disclosure of not only voting rights, but also rights that are held within “empty voting” arrangements (such that the holder of the voting rights does not have any economic interest in the underlying securities). The Forum recommended a reassessment of the Transparency Directive since, in the Forum’s view, empty voting and hidden ownership techniques increasingly exercise significant influence on companies, mostly listed companies, and the key decisions shareholders can take. The Forum is of the opinion that this deserves special attention in order to safeguard the integrity of the governance of European – especially listed – companies and the markets on which their shares are traded.

The Forum is a body of independent experts that provides high-level policy advice on corporate governance to the Commission. The statement is available at:

http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf_empty_voting_en.pdf

UK DEVELOPMENTS

UK Corporate Governance Code

At the end of 2009, the Financial Reporting Council (“FRC”), which is the independent UK regulator responsible for promoting confidence in corporate governance and reporting, published a report on the changes it is proposing to make to the existing UK corporate governance code (for historic reasons, called the “Combined Code” and proposed to be renamed the “UK Corporate Governance Code” (the “Code”).

The Code is published and kept under review by the FRC and contains a number of main and supporting principles and more detailed best practice provisions. It provides the corporate governance standard for all companies with premium listings in the UK (see “New UK Listing Regime” below) by virtue of the FSA’s Listing Rules that require annual financial reports to disclose compliance (or to give reasons for non-compliance) with the provisions of the Code.

The FRC said that it would only be adopting those recommendations of the Walker Review (a separate UK review of corporate governance in financial institutions carried out following the financial crisis) that it considered appropriate to all listed companies. It is not, therefore, proposing to include any sector specific provisions in the revised Code, such as any of the specific time commitment recommendations that the Walker Review made for chairmen and NEDs on the boards of certain banks or other financial institutions.

The FRC will implement these and other recommendations through (A) revisions to the Code, (B) revisions to its other associated corporate governance guidance (see the Turnbull and Higgs Guidance mentioned below), and (C) the development

of a Stewardship Code for institutional investors (as recommended by the Walker Review).

Amendments to the Code

The following are the main proposed amendments to the Code:

- Changes in the layout of the Code, particularly to reflect the importance of an effective board, the leadership responsibilities of the chairman and removing the section addressed to institutional shareholders; it is proposed that this section will be replaced by the new Stewardship Code, about which, see below. Some supporting principles (*e.g.*, the time commitment required from directors) are to be given greater prominence and importance by being recast as Main Principles.
- Changes to the Main Principles (and some supporting principles) relating to the leading role required of the Chairman, the requirement that non-executive directors (“NEDs”) should constructively challenge and help develop strategy, a requirement that the board should have an appropriate balance of skills, experience, independence and knowledge of the company to enable it to discharge its duties effectively, the need for directors to have appropriate knowledge of the company and access to its operations and staff, a requirement that the performance-related elements of executive directors’ remuneration should be stretching and geared to the long term success of the company and the board’s responsibility for setting and overseeing risk management and setting risk appetite and tolerance.
- New Code provisions which (as with all relevant provisions of the Code) will be subject to the “comply or explain” requirement of the FSA’s Listing Rules and which include a proposal (on which the FRC is consulting) that either the chairman and/or the entire board should be subject to annual re-election, requiring the board to satisfy itself that there are appropriate systems to identify, evaluate and manage risks, the

inclusion in the annual report of an explanation of the company's business model and overall financial strategy, a requirement that evaluation of the performance of the board should be externally facilitated at least every three years and personalised training and development approaches for each director.

Higgs Guidance Review

Some of the Walker Review recommendations may be implemented through revisions to the Turnbull Guidance on internal control (on which the FRC has said it will be consulting later this year) and to the Higgs Guidance (on the role of chairmen, NEDs and board committees). The FRC has tasked the Institute of Chartered Secretaries and Administrators ("ICSA") with carrying out a review of the Higgs Guidance and a consultation, "Improving Board Effectiveness", was launched in early March 2010 which focuses on practical guidance to boards on applying the Code so as to enhance their effectiveness.

Consultation on a new Stewardship Code

The Walker Review recommended that the FRC should adopt and assume responsibility for the Code on Responsibilities of Institutional Investors prepared by the Institutional Shareholders' Committee, renaming it the Stewardship Code. The FRC is currently consulting on: whether this Code should be adopted in its current form or amended, which institutional investors and agents should be encouraged to apply the code on a "comply or explain" basis, disclosure requirements and monitoring arrangements.

Next Steps

The FRC expects to publish a final revised Code by May 2010, which will apply to financial years beginning on or after 29 June 2010. ICSA will be issuing a response to its consultation on the Higgs Guidance in June and the final updated Guidance will be submitted to the FRC in October 2010. The outcome of the consultation on the Stewardship Code is expected to be announced in May/June this year.

For more details on the Code review, please see the following:

<http://www.frc.org.uk/images/uploaded/documents/Consultation%20on%20the%20Revised%20Corporate%20Governance%20Code1.pdf>

<http://www.frc.org.uk/images/uploaded/documents/2009%20Review%20of%20the%20Combined%20Code%20Final%20Report1.pdf>

For more details on the Higgs Guidance review, please see the following:

<http://www.icsa.org.uk/assets/files/pdfs/consultations/ICSA%20Review%20of%20the%20Higgs%20Guidance%20-%20first%20consultation.pdf>

For more details on the Stewardship Code consultation, please see the following:

<https://www.frc.org.uk/images/uploaded/document/s/Stewardship%20Code%20Consultation%20January%2020101.pdf>

New UK Listing Regime

From 6 April 2010, significant changes have been made to the UK's listing regime for securities admitted to trading on UK regulated markets (such as the Main Market of the London Stock Exchange). These changes follow a series of consultations and reviews that the FSA has carried out over the past two years and were preceded by a relaxation of the rules in October 2009. This relaxation enabled UK issuers to apply for the less onerous form of listing that overseas issuers can apply for (meeting only the minimum EU directive requirements for a listing, rather than the additional, so-called "super-equivalent" requirements applicable to what will now be called "premium listings").

The key changes involve:

- ***Re-labelling:*** what were previously called "primary listings" will be re-named "premium listings". Premium listings will still require a three year track record before listing, appointment of a sponsor and various additional continuing obligations, such as those relating to corporate

governance compliance disclosures, pre-emption rights and significant or related party transactions. Premium listings will be restricted to full voting equities, with existing primary listed preference (or other non/limited voting) shares being allowed until 31 May 2012 to change their listing to the new “standard” category.

All other securities (and including equities for which a premium listing is not considered necessary) will be listed with a “standard listing” (previously called a “secondary listing”).

- **Non-UK issuers:** there are two important changes here, relating to:
 - **Pre-emption rights:** from 6 April 2011, all premium listed non-UK issuers will have to comply with the Listing Rules requirements with respect to pre-emption in the case of further share issues for cash. Where the law of their place of incorporation does not confer equivalent rights to these on the issuer’s shareholders, these rights will have to be enshrined in the issuer’s constitution.
 - **Corporate governance:**
 - **Disclosure of compliance with UK Corporate Governance Code:** Non-UK issuers with a premium listing will now have to include in their annual financial report, a statement similar to that of UK issuers with respect to their compliance (or reasons for non-compliance) with the Code.
 - **Corporate governance statements:** non-UK issuers with a listing of shares (or GDRs representing shares) will have to comply with Disclosure and Transparency Rule (“DTR”) 7.2 and include in their directors’ report (or in a separate statement) the disclosure with respect to their corporate governance practices that DTR 7.2 requires.

For more details on the new listing regime, please see the following:

http://www.fsa.gov.uk/pubs/cp/cp09_24.pdf

http://www.fsa.gov.uk/pubs/cp/cp09_28.pdf

http://www.fsa.gov.uk/pubs/policy/ps10_02.pdf

Extension of Issuer Liability for Untruthful Statements

In March 2010, HM Treasury announced final proposals for an extension of the UK statutory regime under the UK’s Financial Services and Markets Act 2000 (“FSMA”) in respect of issuer liability for fraudulent misstatements. The extended regime will apply to statements or announcements made on or after 1 October 2010.

Key Changes

The key changes involve extending liability:

- from the financial reporting or trading disclosures currently required by the UK’s DTRs, to effectively all disclosures or announcements made to the market (generally by recognised information services);
- for the benefit of the holders and sellers (as well as acquirers) of the securities affected by the untruthful statements, etc., entitling them to bring claims against the issuer;
- to dishonest delays in making an announcement;
- to issuers of securities traded on multi-lateral trading facilities (“MTFs”), such as the LSE’s AIM or Professional Securities Market, as well as regulated markets, either where the MTF or market operates within the UK or, if it operates outside the UK, where the UK is the issuer’s home state. Thus, for example, the extended liability could attach to a UK issuer with securities trading on a relevant US market;
- where the securities have been admitted to trading on the relevant market with the consent of the issuer. Where the securities concerned are

depository receipts (“DRs”) or derivatives, etc. and the issuer of the underlying securities did not consent to the admission to trading of the DRs, etc., it will be the DR issuer who potentially has liability in respect of untrue or misleading statements, etc. affecting the relevant securities; and

- while at the same time protecting investor rights to sue for breach of contract or under the Misrepresentation Act 1967 and preserving potential issuer liability for civil or criminal penalties or certain other forms of compensation provided for under FSMA or arising under the law of negligent misstatement.

What Doesn't Change

Five key components of this issuer liability regime that will not change are:

- the basis of liability which will remain one of fraud, rather than simply negligence;
- there will have to have been at least a director or other “person discharging managerial responsibilities” within the issuer who either knew that the relevant statement (or omission) was untrue or misleading (or was reckless as to whether it was so) or acted dishonestly in delaying publication of the relevant statement, etc.;
- the investor seeking compensation will have to show that it relied on the relevant statement, etc.;
- except for the other possible grounds of liability referred to above, the issuer will be protected from having any other liability in respect of such statements or delays, etc.; and
- it will remain the case that it is the issuer (and not its directors) which will face liability under the extended statutory regime. Of course, directors could also face liability in respect of breach of their duties (owed to the issuer), individual securities laws offences (*e.g.* market abuse) or where this arises in other jurisdictions as a result (for example) of being named as persons

responsible for the accuracy of a particular statement (*e.g.*, as is required by the DTRs for annual and half-yearly financial reports).

While the new statutory regime will extend to a much wider range of publications or announcements by an issuer (and to delays in making required announcements), issuers can nevertheless take some comfort from the fact that the new regime: (i) clarifies and limits the circumstances in which an issuer could face liability in respect of misstatements or delays in making announcements to the markets, and (ii) requires that in order for liability to arise, these will have to have been fraudulently, recklessly or dishonestly made.

For more details on the statutory extension of liability, please see the following:

http://www.opsi.gov.uk/si/si2010/pdf/uksi_20101192_en.pdf

http://www.opsi.gov.uk/si/si2010/em/uksiem_20101192_en.pdf

http://www.hm-treasury.gov.uk/d/consult_issuerliability_response.pdf

Bribery Act 2010

The UK’s new Bribery Act (the “Act”) was enacted in April 2010, although its main provisions will only come into effect on a later date when the Secretary of State so orders.

The Act creates four offences that are summarised below: bribing another person, offences relating to being bribed, bribery of foreign public officials and the failure of a commercial organisation to prevent bribery.

General Bribery Offences

The first two bribery offences (the “Core Bribery Offences”) are broadly drafted to catch a very wide variety of bribery situations, criminalising both payment and receipt of a bribe. The bribe may be paid to the person performing the improper act or to a third party. The bribe can be paid either before the improper

act (by way of inducement) or after it (by way of reward). Such reward payments are criminalised, even if there was no understanding prior to the improper act being done that that bribe would be paid. For the purposes of the Core Bribery Offences, no distinction is drawn between bribery in the public and private spheres.

Bribery of Foreign Public Officials (the “FPO Offence”)

There is a further offence specifically concerned with bribing a foreign public official (“FPO”). The Act provides a detailed definition of FPO that includes officials or agents of public international organisations; *i.e.*, it is not limited to state employees. Unlike the equivalent FCPA definition, the Act does not define FPO to include candidates for such positions.

The exact requirements of the offence are complicated, but essentially, it is committed where someone bribes a FPO with the intention of influencing the FPO in his capacity as a FPO in order to obtain or retain business/a business advantage. The FPO must be “neither permitted nor required by the written law applicable to [the FPO] to be influenced in [the FPO]’s capacity as a [FPO] by the offer, promise or gift”.

Failure of Commercial Organisations to Prevent Bribery (the “Failure to Prevent Offence”)

Under the Act, a “relevant commercial organisation” (C) commits an offence where a person (A) associated with C bribes another with the intention of obtaining or retaining business or a business advantage for C. It is a defence for C to prove that it had in place “adequate procedures designed to prevent persons associated with C from undertaking such conduct”. Person A must be someone who performs services for or on behalf of C.

This offence is a radical departure from the very limited circumstances in which a company can currently be found guilty of a bribery offence under English law. A company may commit this new offence with very serious reputational and financial consequences,

without the prosecution having to show any fault on the part of the company.

Jurisdictional Reach

For the Core Bribery and the FPO Offences, there are two alternative jurisdictional footings. The first is where any act or omission which forms part of the offence has taken place in the UK. The second is where the person accused of committing these offences has a “close connection” with the UK and carries out any act or omission abroad, which would have formed part of a bribery offence in the UK if it had been carried out in the UK. “Close connection” has a detailed definition, but in summary it is principally concerned with British citizens or companies incorporated/individuals ordinarily resident in the UK or similar.

The Failure to Prevent Offence can be committed by, amongst other things, a company incorporated anywhere in the world which carries on a business or part of a business in the UK, even though the person making the bribe has no connection with the UK and no act or omission occurs in the UK.

Prosecution

A prosecution cannot be commenced under the Act in England and Wales unless (subject to an exception concerning availability) one of the following individuals “personally” gives their consent: the Director of Public Prosecutions, the Director of the Serious Fraud Office or the Director of Revenue and Customs Protection.

Penalties

The maximum penalties for these offences under the Act are ten years’ imprisonment and/or an unlimited fine for the Core Bribery and the FPO Offences, while the Failure to Prevent Offence is punishable by an unlimited fine.

For a copy of the Act and an explanatory memorandum on it, please see the following:

http://www.opsi.gov.uk/acts/acts2010/pdf/ukpga_20100023_en.pdf

http://www.opsi.gov.uk/acts/acts2010/en/ukpgaen_20100023_en.pdf

US DEVELOPMENTS

US Congressional Initiatives

On 15 March 2010 Senator Christopher Dodd introduced the Restoring American Financial Stability Act of 2010 for US Senate consideration. This financial services reform bill contains numerous provisions aimed at enhancing corporate governance and executive compensation practices. Many of the compensation-related provisions in the Dodd bill were also included in the Wall Street Reform and Consumer Protection Act of 2009, which was passed in the US House of Representatives on 11 December 2009 but which has not been passed by the US Senate to date.

The Dodd bill was approved by the Senate Banking Committee on 22 March 2010. Next, the full Senate will debate and offer amendments to the bill. If the Senate passes the bill, it will then be considered by the US House of Representatives to deal with the differences from the Wall Street Reform and Consumer Protection Act of 2009 or be sent to a conference of the House of Representatives and Senate for final resolution.

As related to executive compensation, the Dodd bill provides for, among other things:

- mandatory disclosure in the issuer's annual proxy statement showing the relationship between executive compensation and the performance of the issuer, taking into account any change in the value of shares of stock and dividends of the issuer;
- introduction of a "clawback" policy that, in the event of an accounting restatement, allows the issuer to recover compensation from any current or former executive officer who received excess incentive-based compensation as a result of erroneous financial data during the three-year period preceding the date that the issuer is required to prepare an accounting restatement;
- mandatory disclosure in the issuer's annual proxy statement relating to whether employees or

directors of the issuer are permitted to purchase financial instruments designed to hedge or offset any decrease in the market value of equity securities granted to employees or directors of the issuer as compensation;

- mandatory disclosure in the issuer's annual proxy statement of the (i) median of the annual total compensation of all employees (except the chief executive officer) of the issuer, (ii) annual total compensation of the chief executive officer, and (iii) ratio of the amount described in (i) to the amount described in (ii);
- only votes cast by beneficial owners of a security or by members given specific voting instructions by the beneficial owner to vote the proxy will be included in the vote tally for advisory shareholder votes on executive compensation; and
- the Board of Governors of the Federal Reserve System to establish standards prohibiting as an unsafe and unsound practice any compensation plan of a bank holding company that (i) provides for excessive compensation or (ii) could lead to material financial loss to the company.

As related to corporate governance, the Dodd bill provides for, among other things:

- A requirement for listing US exchanges to impose a majority vote standard in uncontested director elections for all listed companies, reverting to the plurality standard in contested elections. Any director receiving less than a majority vote would be required to tender his or her resignation. The board could determine not to accept the resignation, but if so, it would be required to explain its decision within 30 days;
- In a shift from the previous Dodd bill, an allowance, rather than a requirement, for the SEC to prescribe rules permitting shareholders to use company proxy solicitation materials to nominate director candidates. The SEC appears to be moving forward with these rules in any event;

- A requirement for the SEC to issue rules requiring companies to disclose in the proxy statement why the same or different persons serve as chairman and CEO. The SEC already has issued similar rules; and
- All publicly traded non-bank financial companies that are supervised by the Board of Governors of the Federal Reserve System, and all publicly traded bank holding companies with assets over \$10 billion, to have a risk committee. The Board of Governors will determine the number of independent directors required on the committee, and the committee must include one risk management expert having experience in risk management at large complex firms.

The Dodd bill's corporate governance and executive compensation provisions would not apply to foreign private issuers.

Other federal bills intended by the US Congress to advance corporate governance reforms, particularly in the areas of shareholder proxy access and executive compensation, have not yet been enacted into law and there still has been little legislative movement on them that would indicate their imminent finalisation.

- *The Shareholder Bill of Rights Act of 2009*, which New York State Senator Charles Schumer introduced last May, is still being debated.
- *The Investor Protection Act of 2009*, which was delivered by the US Department of the Treasury to Congress in July, has not been scheduled for consideration by the House of Representatives.

Proposed Rulemaking by the Federal Deposit Insurance Corporation

On 12 January 2010, the Federal Deposit Insurance Corporation ("FDIC") Board of Directors issued an advance notice of proposed rulemaking seeking comment on how the FDIC's risk-based insurance assessment system could be changed. By doing this, the FDIC hopes to provide incentives for institutions that are subject to the FDIC's authority to adopt

compensation programs that align employees' interests with the long-term interests of the institution and its stakeholders. The questions set forth in the advance notice generally address how to best implement a risk-based assessment scheme for executive compensation. Comments were due on 18 February 2010. The FDIC is currently reviewing the comments and will determine the scope of the final rule, if any. The FDIC proposed the following compensation-related features in the advance notice:

- a significant portion of compensation for employees whose business activities may present greater risk to the institution should be comprised of restricted, non-discounted company shares;
- significant awards of company shares should only become vested over a multi-year period and be subject to a look-back (i.e., clawback) in order to address the outcome of risks assumed in the earlier period;
- the compensation program should be administered by a committee of the board of directors composed of independent directors with input from independent advisers; and
- if the FDIC determines that the compensation program creates additional risk for the company, the risk-based deposit insurance rates for that company would increase to adequately compensate the Deposit Insurance Fund for the risks inherent in the design of certain compensation programs.

These measures would not apply to corporations that are not regulated by the FDIC.

SEC Developments

Safe Harbour for Issuer Stock Repurchases.

On 26 January 2010, the SEC issued a release proposing amendments to Rule 10b-18 of the Securities Exchange Act of 1934. Rule 10b-18 provides an issuer and its affiliated purchasers with a safe harbour from liability for market manipulation in connection with the repurchase of the issuer's shares if

certain manner, timing, price and volume conditions are met. The proposed amendments would:

- allow repurchases at a volume-weighted average price per share;
- further limit the ability of a special purpose acquisition company or its affiliated purchasers to use the rule's safe harbour during merger or acquisition activity;
- ease the price condition of the rule so that if a repurchase is made at a price that is too high due to fast-moving price quotations, other repurchases on that day will not be disqualified from using the safe harbour; and
- expand the current prohibition on Rule 10b-18 qualifying purchases at the opening. Not only will the prohibition apply to repurchases being the opening transaction reported on the consolidated system, but also the opening transaction on the principal market for the security and on the market where the transaction is effected.

Comments were due by 1 March 2010. For more details, please see our client publication at:

<http://www.shearman.com/SEC-Proposes-Amendments-to-the-Safe-Harbor-for-Issuer-Stock-Repurchases-02-04-2010>

Interpretive Guidance on Climate Change. On 2 February 2010, the SEC issued an interpretive guidance concerning climate change-related disclosure by SEC-reporting companies. The guidance does not change existing SEC disclosure requirements, nor is it intended to change long-standing interpretations of materiality. Nonetheless, the fact that the SEC has issued it indicates that climate change disclosure is a growing area of focus for the SEC and an area where many companies may need to expand their disclosure.

For more details, please see our client publication at:

<http://www.shearman.com/files/Publication/c3e25b2b-1b2e-4498-99f2-b0598b40a529/Presentation/PublicationAttachment/d84a7027-4ab1-42c2-b58b-bf8ed77ab39e/EV-012910-SEC-Votes-to-Issue-Interpretive-Guidance-on-Climate-Change-Disclosure.pdf>

Updated Non-GAAP Interpretations. On 15 January 2010, the Staff of the SEC's Division of Corporation Finance updated its guidance regarding use of non-GAAP financial measures in SEC filings and other public disclosures. The updated guidance, contained in newly issued "compliance and disclosure interpretations", supercedes the Staff's prior guidance on this topic issued in 2003. In this updated guidance, the Staff has, among other things, moderated some of its prior positions on use of Adjusted EBITDA and add-backs of recurring items. Consequently, SEC filers should have more flexibility to use non-GAAP measures like Adjusted EBITDA.

For more details, please see the compliance and disclosure interpretations at:

<http://www.sec.gov/divisions/corpfin/guidance/nongAAPinterp.htm>

To view the SEC's Financial Reporting Manual, revised in March 2010 to include changes to its non-GAAP financial measures discussion, please see:

<http://sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf>

SEC Views on Cautionary Statements About Forward-Looking Statements. Under both the US Private Securities Litigation Reform Act of 1995 and US case law, cautionary language that accompanies an issuer's forward-looking statements and meets certain standards can protect an issuer in securities fraud litigation based on the forward-looking statements. In a securities fraud action currently pending before the US federal Court of Appeals for the Second Circuit, the Court invited the SEC to file a brief addressing the agency's views on the

proper application of the Reform Act of 1995 as related to such cautionary language.

The SEC has raised the following main points in its brief, none of which digress from common understanding of the scope of the protection. The Second Circuit has not yet issued its decision, which would be the binding law on the parties. Nonetheless, the SEC's brief at least provides a glimpse of what the agency's position is on the scope of the protection afforded by such cautionary statements:

- The Reform Act of 1995 excludes from its safe harbour forward-looking statements that are included in financial statements prepared in accordance with GAAP. The SEC's view is that MD&A is separate and distinct from financial statements. As such, forward-looking statements in an MD&A section should not be considered automatically excluded from the safe harbour.
- The SEC does not believe that all forward-looking statements should appear in a separate section of an issuer's report or be labelled as forward-looking statements. Cues like "we expect" or "we believe", coupled with an explanatory note of the issuer's intention to designate a statement as forward-looking, are generally sufficient.
- Misleading risk disclosure cannot be considered "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement" under the safe harbour.
- A forward-looking statement contains at least three implicit factual assertions, namely that (1) the statement is genuinely believed, (2) there is a reasonable basis for that belief, and (3) the speaker is not subjectively aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. A forward-looking statement made in a case in which any of these implicit representations is false would not benefit from the safe harbour and would be actionable under federal securities antifraud laws. A speaker has actual knowledge that a forward-looking

statement is misleading if the speaker actually knows that one or more of these implicit factual representations is not true.

Other Corporate Governance Developments

RiskMetrics Group's New Governance Risk Indicators. On 10 March 2010, RiskMetrics Group published its new scoring system to measure corporate governance practices, which it has named "Governance Risk Indicators", or GRId. RiskMetrics has announced that all US public companies that it follows will begin to receive ratings under GRId on 17 March 2010, although non-US companies eventually will be rated as well. GRId will replace RiskMetrics's former "Corporate Governance Quotient" ratings, which will be eliminated by the end of June 2010.

GRId will measure risk in the following four corporate governance areas, which will be expressed as three different colour-coded levels of concern: low, medium and high (blue, yellow and red, respectively):

- audit;
- board structure;
- shareholder rights; and
- compensation.

For more detail, please see the attached RiskMetrics press release:

http://www.riskmetrics.com/press/20100303_grid

Noteworthy US Securities Law Litigation

In re Vivendi Universal, SA Securities Litigation. The Vivendi securities class action trial started in federal court in New York in October 2009 – a rare event because securities class actions typically settle before trial. On 29 January 2010, a jury returned a verdict for the plaintiffs, finding that Vivendi made 57 false or misleading statements regarding its financial condition between 2000 and 2002. The defendants have asked the trial court to overturn the verdict and have indicated that, if their request is denied, they will appeal the verdict. The

plaintiffs have asserted in news reports that, if the verdict is upheld, the damages may reach as high as \$9.3 billion.

In re Cadbury Shareholder Litigation. In January 2010, a federal court in New Jersey dismissed a purported derivative class action involving Cadbury plc based on the doctrine of forum non conveniens. The suit – which the plaintiffs filed in federal court in New Jersey – challenged the actions of the Board of Directors of Cadbury in connection with the hostile takeover bid by Kraft Foods, Inc. The defendants moved to dismiss the case with prejudice, arguing that England was a more appropriate forum because Cadbury is an English company, English law governed the Board's conduct and the bidding process, and none of the parties resided in New Jersey. The court agreed, ruling that England provided an adequate alternative forum and that the plaintiffs' choice of New Jersey was entitled to little deference because neither the defendants nor the plaintiffs had any connection with New Jersey and none of the evidence or witnesses were in New Jersey.

This case is of interest because it highlights an effective argument that foreign corporations can make to avoid burdensome and costly litigation in the United States.

For more details on this case, please see our client publication at:

<http://www.shearman.com/files/Publication/7a922db7-7f05-4121-bb88-24cea3e93719/Presentation/PublicationAttachment/48dd7763-11d9-41b6-8c41-3203ae58cd55/LT-021210-Forum-Non-Conveniens-Another-Arrow-for-Foreign-Corporations-Haled-into-U%20S%20-.pdf>

In re Lehman Brothers ERISA Litigation. In February 2010, a federal court in New York dismissed an ERISA class action filed by former Lehman employees, who alleged that the administrator of their retirement plan acted imprudently by continuing to offer Lehman stock as an investment option when the administrator knew or should have known about Lehman's impending collapse. The district court

rejected this argument and ruled that the administrator of the ERISA plan was entitled to a presumption that she acted consistently with her fiduciary duties when she offered the company's stock as an investment option. The court stated that this presumption can be overcome by showing that the fiduciary abused her discretion, which typically requires the plaintiffs to show that the administrator either knew that the company was facing imminent collapse or recklessly disregarded facts showing a sufficiently dire situation to justify discontinuing the company's stock as an investment option.

In recent years, there has been a plethora of ERISA class actions brought by employees who seek to recover because their retirement plan invested in their company's stock and lost value following the disclosure of negative news about the company. This case is significant because it underscores the burden that plaintiffs face in seeking to bring such claims.

For more details on this case, please see our client publication at:

<http://www.shearman.com/files/Publication/a1e54d9a-c406-4d64-820a-01ac190d4685/Presentation/PublicationAttachment/cc2fecf9-dd62-4f72-bf0d-685260235b49/LT-021610-Another-Dismissal-of-an-ERISA-Class-Action-Arising-From-the-Financial-Crisis.pdf>

Levie v. Sears Roebuck & Co. In late December 2009, a federal court in Illinois dismissed a securities class action filed against Sears in connection with its merger with Kmart. The plaintiffs alleged that certain public statements that Sears made prior to the announcement of its merger with Kmart were materially misleading because they failed to disclose the existence of the merger negotiations. The Court rejected the plaintiffs' arguments, finding that Sears' public statements did not refer to the merger negotiations, did not imply that Sears was not engaged in such discussions and were not inconsistent with a potential merger. Moreover, the Court ruled that, when some of Sears' public statements were made, the negotiations were "preliminary in nature" and,

therefore, not material. With regard to one of Sears' later statements, the Court ruled that it was not inaccurate and that, under SEC guidelines, Sears did not have to discuss the impact of its merger negotiations in its quarterly financial statements if doing so would jeopardise completion of the transaction.

This case provides useful guidance regarding when a company is required to disclose merger negotiations under the federal securities laws. In general, a company is not under a duty to disclose preliminary merger negotiations. Even when the negotiations have progressed to a more advanced stage, a company is still not under a duty to disclose merger negotiations unless it makes a public statement that is related to or contradicted by the merger discussions.

For more details on this case, please see our client publication:

http://www.shearman.com/files/Publication/c2ca77e9-7f5e-4bde-b73f-64417c284e9e/Presentation/PublicationAttachment/d12ffbcd-f673-407e-b26f-66332c2d266b/MA_012810_Federal_Court_Provides_Guidance_on_Timing_of_Disclosure_of_Merger_Nego.pdf

Morrison v. National Australia Bank Limited.

The US Supreme Court agreed to hear the appeal of a US federal appellate court's decision, which held that US federal courts generally do not have jurisdiction to adjudicate securities fraud claims brought by non-US investors who purchased non-US securities of a non-US company, where the allegedly false or misleading statements emanated from outside the US. This type of case is often referred to as a "foreign-cubed" action. The Court heard oral arguments in this case on 29 March and a decision is expected before the end of June 2010.

Shearman & Sterling represented the Republic of France in filing an amicus brief with the US Supreme Court in this case. According to the Republic of France, principles of comity, the text and history of the Securities Exchange Act of 1934 and the Court's own

longstanding canons of construction all strongly favour a blanket rule against US jurisdiction over foreign-cubed lawsuits.

Recent SEC/DOJ Enforcement Matters

Daimler AG. In March 2010, the DOJ and SEC entered into a proposed settlement with Daimler AG to resolve charges that Daimler had violated the Foreign Corrupt Practices Act by allegedly paying bribes to foreign officials to assist in securing contracts with government customers for the purchase of Daimler vehicles. The government alleged that Daimler made hundreds of improper payments worth tens of millions of dollars to foreign officials in at least 22 countries and that Daimler allegedly hid the bribe payments by recording them on their books as "commissions" and "special discounts". As part of the settlement, Daimler agreed to pay \$185 million in fines and penalties. A federal court in Washington, DC has scheduled a hearing on 1 April 2010 to discuss the proposed settlement.

DEVELOPMENTS SPECIFIC TO FINANCIAL INSTITUTIONS

EU DEVELOPMENTS

European Legislative Proposals on Remuneration

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") in late 2008 in response to the financial crisis. The proposals have been put forward by the Commission in three sets, now commonly referred to as CRD II, CRD III and CRD IV. The proposals in CRD III include the following proposals on remuneration and require:

- credit institutions and investment firms to have remuneration policies and practices which are consistent with and promote sound and effective risk management, are in the long-term interests of the financial institution;

- firms to review their remuneration policies at least annually;
- the fixed and variable components of remuneration to be appropriately balanced;
- payments related to the early termination of a contract to reflect performance over time and not to be designed in a way that rewards failure;
- the measurement of performance used to calculate bonuses to include an adjustment for risks and the cost of capital and liquidity requirements;
- deferral of bonuses; and
- that remuneration policies are brought within the scope of supervisory review so that supervisors identifying problems in remuneration policies could require the firm to amend its remuneration structure or require the firm to hold additional own funds against the risk posed by its remuneration structure.

Additionally, the CRD III proposals allow supervisors to impose financial or non-financial penalties on non-complying firms.

The Parliament is expected to hold a first reading on CRD III in June 2010. The indicative date for adoption is 20 September 2010.

In April 2009 the Commission adopted two recommendations; on remuneration of risk-taking staff in financial institutions and on the structure and determination of directors' remuneration. The proposals in CRD III are intended to complement those recommendations. The Commission's recommendations on remuneration would apply to EU authorised credit institutions and investment firms but would only cover staff whose activities have a material impact on the risk profile of their employer financial institution.

In addition, the Committee of European Banking Supervisors ("CEBS") High Level Principles for Remuneration Policies, which were required to be implemented by Q3 2009, will also be taken into

account when a firm's remuneration policies are being assessed.

On 6 April 2010 the Parliament published a draft report on the recommendations and proposals on remuneration put forward by the Commission with regard to remuneration of directors of listed companies and remuneration policies in the financial services sector. The Parliament supports the proposals and requests the Commission to adopt strong binding principles on remuneration policies in the financial sector, including a naming and shaming procedure for listed companies that do not comply with the principles, to carry out an impact assessment on the feasibility of instituting a European bonus tax and to set up an insurance system fed by contributions from financial institutions in order to avoid a new financial crisis.

European Corporate Governance Forum

The European Corporate Governance Forum which was originally set up in 2004 had its mandate renewed in 2008. The work program of this Forum includes consideration of issues such as empty voting and transparency of investors' positions, cross-border voting and rules on acting in concert in relation to corporates. In its Communication "Driving European Recovery" of 4 March 2009, the Commission made a commitment to produce a report on corporate governance practices in financial institutions. The Forum is involved in the Commission's work in this area. Following a study of a selection of financial institutions the Commission has indicated that it would publish a report by the end of Q1 2010.

CEBS Principles for Risk Management

On 16 February 2010, CEBS published its new high-level principles for risk management for institutions and supervisors. The guidelines are aimed mainly at large and complex financial institutions. However, they could be adapted to any institution providing its size, nature and complexity are taken into account. The guidelines include governance and risk culture, risk appetite and tolerance, the role of the chief risk officer and risk management functions and risk models and

the integration of risk management areas. CEBS expects its members to implement the high-level risk management principles into their procedures by 31 December 2010.

UK DEVELOPMENTS

The UK Government called for a review of corporate governance in banks following the financial crisis. The final Walker recommendations were published in November 2009. The actions taken by the FSA described below are a result of those recommendations.

FSA Consultation

The FSA published a consultation paper in January 2010, which sets out its latest initiatives to improve the quality of corporate governance in financial institutions and to increase the intensity of its supervisory approach to this issue. The following are the key FSA proposals:

- A new framework of classification of significant influence functions. The FSA proposes to introduce nine new significant influence functions (comprising six new governing functions and three new systems and controls functions) in order to segregate the key roles within governance structures. Under the current regime, a person approved for one significant influence function may perform a role falling within another significant influence function without further vetting from the FSA. The FSA now considers that an individual should be assessed for each of the separate roles he may undertake within a firm that have a significant influence on that firm.
- Changes to the approved persons regime. The consultation paper sets out proposals on the approved persons regime that build on previous changes implemented by the FSA, including extending the regime to capture more individuals who are based outside a UK-regulated firm but who exert a significant influence upon that UK-regulated firm.
- New guidance on the FSA's expectations in relation to NEDs. The FSA's key message remains

that NEDs have a pivotal role to play in the active governance of firms. Where it appears that an executive has persistently made poor decisions, the FSA will look closely at a NED's performance if it feels that the NED has not intervened in a timely and sufficient way. The FSA proposes to delete current guidance in the FSA Handbook that discusses the limits of NED liability because the FSA is concerned that the existing guidance in the FSA Handbook could be misinterpreted to mean that the FSA would not hold NEDs responsible for, for example, failing to intervene and challenge the executive. The FSA sees challenge and intervention as a key part of any NED's responsibilities. The FSA also intends to make it clear that in assessing individuals for NED roles, it will assess an individual's capability with regard to the extent to which they are able to meet the level of time commitment specified by the firm in its contract terms of appointment for the role.

- New guidance for firms, particularly FTSE 100-listed banks and insurers, to consider establishing risk management committees.
- New guidance for firms on the appointment of a chief risk officer who will be responsible for ensuring the board receives balanced and accessible information and advice on high-level risk issues.
- In line with the FRC's developments on the Stewardship Code, the FSA will consult on a new disclosure rule whereby firms will be required to publicly disclose the extent to which they comply with the Stewardship Code.

FSA Remuneration Code

The FSA's Remuneration Code came into force on 1 January 2010 for large banks, building societies and broker dealers and applies to any remuneration awards made by such firms for the 2009 performance year. Under the Remuneration Code such firms must establish remuneration policies and procedures that are "consistent with and promote effective risk

management. Currently, the Remuneration Code does not apply to firms outside of the top 26 financial institutions in the UK.

The FSA plans to publish a statement during the third quarter of 2010, which will assess the effectiveness of the Remuneration Code and provide an update on international implementation of remuneration policies. The timing of this statement will take into account discussions at an EU level.

The transitional arrangements within the Remuneration Code, for firms required to self-amend employment contracts, ended on 31 March 2010. However, firms required to terminate employment contracts in accordance with the Remuneration Code have until 31 December 2010 to comply with their transitional arrangements.

Financial Services Act 2010

The Financial Services Act 2010 (the "FS Act 2010") was passed on 8 April 2010 and provides HM Treasury with the power to lay regulations in relation to the preparation, approval and disclosure of executives' remuneration reports. These provisions come into immediate effect. Such remuneration reports will detail the remuneration and "anything connected with the remuneration" of certain officers, employees and "other individuals" (which is wide enough to encompass third party contractors and employees of group companies). The FS Act 2010 extends the company law disclosure regime, under which companies disclose details of directors' remuneration, stipulating that the regulations make provision for the filing of executives' remuneration reports with the registrar for companies or with the FSA and for the publication by the FSA of reports filed with it.

The FS Act 2010 clearly states that where a provision of a remuneration policy contravenes the FSA's remuneration rules, the FSA can find that such a provision is void and require the recovery of any remuneration payment made or property transferred. However, the provisions of the FS Act 2010 do not discuss, where a particular provision is rendered void,

the process by which the contracting parties may appeal such a decision. Therefore, it is likely that firms will call for further guidance as remuneration policies and reports are prepared in accordance with the FS Act 2010.

Furthermore, the FS Act 2010 requires the FSA to make general rules requiring authorized persons to have to act in accordance with a remuneration policy. These provisions come into effect on 8 June 2010. Such policies must be consistent with (i) the effective management of risks; and (ii) the Financial Stability Board's (the "FSB") Principles for Sound Compensation Practices (the "FSB Principles") and Implementation Standards (the "FSB Implementation Standards") (further detail on the FSB measures is set out below). HM Treasury may direct the FSA to consider whether such policies comply with the requirements imposed by the FSA's rules, as to the contents of the remuneration policies, and the FSA must take such "steps as it considers appropriate" to deal with any policies that fail to comply with such requirements. For example, the FS Act 2010 provides that firms would not be able to remunerate by certain methods, that any agreement in contravention would be rendered void and that all payments made or property transferred in contravention could be recovered. However, remuneration provisions in place before the FSA's rules are made may not be rendered void under the FS Act 2010, unless such provisions are subsequently amended in contravention of the FS Act 2010 provisions.

HM Treasury Draft Regulations

On 10 March 2010, HM Treasury published a draft of the Executives' Remuneration Reports Remuneration 2010 Regulations. The draft regulations were published as part of the scrutiny of the Financial Services Bill, before the FS Act 2010 was enacted. The draft regulations will be further refined before a full public consultation takes place. The FS Act 2010 provides HM Treasury with a power to lay regulations requiring greater disclosure of banker's pay.

The draft Regulations require:

- Disclosure of executives whose remuneration in the preceding financial year exceeded £500,000 (the corresponding threshold is £1 million in the Walker Review);
- Narrow disclosure bands which start from £500,000 and increase in £500,000 increments to £5 million; and
- That executives' remuneration reports include information on the aggregate amounts earned by executives with regard to their basic salaries, expense allowances, bonuses and other benefits.

Furthermore, in addition to setting out the duty to prepare executives' remuneration reports, draft Regulation 5 stipulates that criminal sanctions may be imposed upon breach of such duty.

Draft Regulation 6 and the Schedule to the Regulations set out the information which must be included in such a remuneration report, and under paragraph 2 of the Schedule, the report must contain a statement of the banking institutions' policy on executives' remuneration (including an explanation of any performance conditions attached to the executives' remuneration) and a full explanation of how the institution's policy takes account of the risks to which it is subject.

Bank Payroll Tax

The 2009 pre-budget report announced a "one-off" 50 percent tax levied on any variable remuneration awarded in excess of £25,000 for the period 9 December 2009 to 5 April 2010 (the "Bank Payroll Tax" or "BPT"). The BPT applies to banks, building societies and certain other financial sector firms that pay variable remuneration (i.e., bonuses) comprising money or money's worth, including shares, benefits and loans. However, on 12 March 2010, HM Revenue & Customs announced that financial institutions that are not deposit takers and that have a capital resources requirement ("CRR") of less than £100 million (and which do not belong to a group where the aggregate

CRR is £100 million or more), will be excluded from the scope of the BPT.

The BPT is levied on all UK-resident banks and UK branches of foreign banks and such banks will be charged on the aggregate amount of "chargeable relevant remuneration" paid to their "relevant banking employees", i.e., persons who provide banking services and whose duties relate to activities that are regulated activities. Such remuneration excludes banking employees' regular salaries and benefits and any fixed remuneration to be provided under a contractual obligation that arose before 9 December 2009. However, spread betting companies and commodities traders outside banking groups will be added to the list of firms excluded from the definition of banks that are subject to the BPT.

The BPT will continue to operate until 5 April 2010 and all payments will become due as at 31 August 2010. All "taxable companies" will be required to keep full records of all "relevant remuneration" payments in excess of £25,000 that are awarded during the chargeable period.

US DEVELOPMENTS

Federal Reserve Proposed Supervisory Initiatives

On 22 October 2009, the Board of Governors of the Federal Reserve ("Federal Reserve") proposed two supervisory initiatives designed to ensure that banking organisations do not encourage excessive risk-taking through incentive compensation policies. The two supervisory initiatives are a (i) horizontal review of the incentive compensation policies and practices of twenty-eight (28) of the largest and most complex US banking organisations, and (ii) review of compensation practices at regional, community and other banking organisations regulated by the Federal Reserve. Each of these supervisory initiatives will be guided by the following three principles:

- Incentive compensation arrangements should balance risk and financial results in a manner that does not provide employees incentives to take

excessive risks on behalf of the banking organisation;

- A banking organisation's risk management process and internal controls should reinforce and support the development of balanced incentive compensation arrangements; and
- Banking organisations should have strong and effective corporate governance, including active oversight by the organisation's board of directors to help ensure sound compensation policies.

Immediately following the release of the supervisory initiatives, banking organisations supervised by the Federal Reserve reviewed the incentive compensation arrangements of (i) senior executive officers and others responsible for oversight of firm-wide activities or material business lines, (ii) individual employees, including non-executive employees, whose activities expose the firm to material risk, and (iii) groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the firm to material amounts of risk (even if no individual employee is likely to expose the firm to material risk). Banking organisations supervised by the Federal Reserve are currently participating in the supervisory initiatives.

The Corporate Executive Accountability Act of 2010

On 26 February 2010, Senator Robert Menendez introduced the Corporate Executive Accountability Act of 2010 in the US Senate (the "Executive Accountability Act"). Many of the compensation related provisions in the Executive Accountability Act were also included in the *Wall Street Reform and Consumer Protection Act of 2009* or the financial regulatory bill proposed by *Restoring American Financial Stability Act 2010*. The following compensation related provisions were only proposed in the Executive Accountability Act:

- Issuers will be required to disclose in their annual proxy statement the (i) median annual total compensation of all employees (except the chief executive officer), (ii) annual total compensation

of the chief executive officer and (iii) ratio of amounts in (i) and (ii) above;

- Shareholders are permitted to commence an action on behalf of the issuer to require the chief executive officer or the chief financial officer to reimburse the issuer under Section 304 of the Sarbanes-Oxley Act of 2002 (as slightly modified by the Executive Accountability Act) if the issuer has not taken any action before the expiration of the 120-day period following the date of the accounting restatement and the chief executive officer or the chief financial officer has not reimbursed the issuer;
- Issuers are not permitted to enter into agreements that provide for severance payments to senior executive officers on a termination for Cause (as defined in the Executive Accountability Act); and
- Limitations on the ability of executive officers to sell shares acquired through the vesting of equity compensation for a period of time after the vesting of the equity award.

INTERNATIONAL DEVELOPMENTS

Basel Consultation on Principles for Enhancing Corporate Governance

On 16 March 2010 the Basel Committee on Banking Supervision issued a consultation document, entitled "Principles for Enhancing Corporate Governance", on proposals for updating its principles on corporate governance, which were last updated in 2006. Responses to the consultation are due by 15 June 2010. The proposals include the following principles:

- The board should have overall responsibility for the bank, including approving and overseeing the implementation of the bank's objectives, risk strategy, corporate governance and corporate values. The board is also responsible for providing oversight of senior management;
- Board members should be and remain qualified through training for their positions. Board

members should understand their role in corporate governance;

- The board should define appropriate governance practices for its own work and have in place the means to ensure such practices are followed and periodically reviewed for improvement, including organisational rules;
- The board of a parent company has the overall responsibility for adequate corporate governance across the group and for ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities;
- Senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance and policies approved by the board;
- Banks should have an independent risk management function with sufficient authority, stature, independence, resources and access to the board which includes a chief risk officer;
- Risks should be identified and monitored on an ongoing firm-wide and individual entity basis;
- There should be robust internal communication within the bank about risk, both across the organisation and by reporting the board and senior management;
- The work by internal audit functions, external auditors and internal control functions should be effectively used by the board and senior management;
- The board should oversee the compensation system's design and operation and review and monitor the system;
- An employee's compensation should be effectively aligned with prudent risk taking (see the Remuneration section for more detail);
- The board and senior management should know and understand the bank's operational structure and the risks that it poses;

- Where a bank operates through special-purpose or related structures or in jurisdictions that impede transparency or not meet international banking standards, its board and senior management should understand the purpose, structure and unique risks of such operations and seek to mitigate the risks identified; and
- Governance should be adequately transparent to a bank's shareholders, depositors, other relevant stakeholders and market participants.

The following remuneration principles were included:

- The board should oversee the compensation system's design and operation and review and monitor the system; and
- An employee's compensation should be effectively aligned with prudent risk taking: compensation should be adjusted for all types of risk, compensation outcomes should be symmetric with risk outcomes, payment schedules should be sensitive to the time horizon of risks and the mix of cash, equity and other forms of payment should be consistent with risk alignment.

The consultation also deals with the role of supervisors and states that supervisors should:

- Provide guidance on expectations for sound governance;
- Regularly perform comprehensive evaluations of overall corporate governance policies and practices;
- Supplement the above evaluation by monitoring a combination of internal and prudential reports;
- Require banks to take remedial action to address material deficiencies in its policies and practices; and
- Cooperate with other relevant supervisors including through supervisory colleges, periodic meetings and memorandums of understanding.

Basel Compensation Principles and Standards Assessment Methodology

On 22 January 2010, the Basel Committee on Banking Supervision issued its "Compensation Principles and Standards Assessment Methodology" (the "Methodology"). This Methodology aims to help supervisors assess significant financial firms' (particularly large, systemically important firms, though national supervisors may choose to extend the application to a wider range of financial institutions) compliance with the FSB Principles and FSB Implementation Standards and promotes "appropriate compensation practices that create the right incentives for effective risk management and avoiding excessive risk-taking". The Methodology review framework centres on:

- Effective governance of compensation;
- Effective alignment of compensation with prudent risk-taking; and
- Effective supervisory oversight and engagement by stakeholders.

The Methodology provides considerable flexibility to supervisors to ensure the effective application of FSB Principles and takes into account individual national circumstances, the size and complexity of financial institutions and the nature of each firm's business.

The ultimate intention of the FSB Principles is to reduce individuals' incentives for taking excessive risk. The Methodology therefore focuses on employees whose professional activities have a material impact on banks' risk profiles, including material risk-takers and employees performing risk management and control functions and groups of employees who may together take material risks, i.e., loan officers.

The Methodology has two main components (i) supervisory guidance clarifying how FSB Principles and FSB Implementation Standards should be implemented by firms; and (ii) for each FSB Principle, a "toolkit" that should be adapted to existing supervisory approaches as well as to the institution being reviewed.

FSB Principles for Sound Compensation Practices and FSB Implementation Standards

The FSB published its FSB Principles in April 2009 and the FSB Implementation Standards in September 2009. The FSB Principles and FSB Implementation Standards are internationally agreed objectives and many initiatives are already underway at the national level to implement them. On 30 March 2010 the FSB published its Peer Review Report on the progress of implementation of both the FSB Principles and the FSB Implementation Standards by jurisdictions and significant financial institutions. The Peer Review Report notes that greater progress has been achieved in the areas of governance, establishing supervisory oversight and promoting disclosure of compensation. However, further work is required to raise standards of risk adjustment of pay structures. The Peer Review Report includes further recommendations which include (a) enhanced supervisory cooperation on compensation for cross-border firms; (b) enhanced standards of risk adjustment of pay structures should be raised across the industry; (c) increased coverage of nonbank financial institutions; and (d) active checking by supervisors that the composition of compensation committees meets appropriate standards of expertise and independence. The FSB also recommended that the Basel Committee should issue a consultation by the end of October 2010 on the range of methodologies for risk and performance alignment of compensation schemes and their effectiveness, including: methods for incorporating risk and performance into bonus pool and individual compensation, the design of deferred compensation, the relation between performance measures and ultimate value of deferred compensation instruments, malus triggers, the sensitivity of payout schedules to the time horizon of risk, the funding of deferrals and proportionality in the application of rules.

The FSB and the Basel Committee are also to consider incorporating disclosure requirements for compensation into Pillar 3 of Basel II by the end of 2010. The FSB will conduct a follow-up review on compensation in the second quarter of 2011.

Organisation for Economic Cooperation and Development

On 24 February 2010, the Organisation for Economic Cooperation and Development (the "OECD") published a paper entitled "Conclusions and emerging good practices to enhance implementation of the Principles".

The paper is a result of the OECD's view that its Principles of Corporate Governance provide a good basis but there is an urgent need to encourage and

support the implementation of agreed international and national standards. The conclusions and emerging good practices relate to remuneration, improving risk management and disclosures about risks and risk management, improving board practices and duties of the board and the interaction between shareholders and companies.

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 memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

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