SHEARMAN & STERLING LLP

Governance & Securities Law Focus

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

In This Issue

ASIAN DEVELOPMENTS

HK Stock Exchange amends Corporate Governance Rules

Public Consultation

On 28 October 2011, The Stock Exchange of Hong Kong Limited (the "Stock Exchange") published conclusions to its 2010 Consultation Paper on Review of the Code on Corporate Governance Practices and Associated Listing Rules. The Stock Exchange received a total of 118 submissions from stakeholders. Given the broad market support, the Stock Exchange decided to adopt most of the proposals outlined in the Consultation Paper, to align Hong Kong market practices with international best practices. We welcome this initiative as Hong Kong cements its position amongst the most successful global fundraising arenas, topping the IPO tables in 2009, 2010 and for the third year in a row in 2011 according to latest industry data. The Stock Exchange takes the established view that high standards of corporate governance will translate into premium valuations for issuers.

Most of the amendments to the Listing Rules took effect on 1 January 2012 and the revised Code on Corporate Governance Practices (renamed the Corporate Governance Code) will be effective from 1 April 2012.

The Regulatory Framework

The regulatory framework will continue to comprise mandatory rules and non-mandatory recommended best practices:

- requirements under the Listing Rules ("rules");
- code provisions set out in the Corporate Governance Code ("code provisions"); and

- recommended best practices set out in the Corporate Governance Code ("recommended best practices").

The regulatory framework is designed to give flexibility to issuers while protecting investors and the integrity of the market. With respect to the rules, the required standard of corporate governance is mandatory for all issuers and breaches may lead to sanctions. The Corporate Governance Code is not mandatory in nature. An issuer may choose not to adopt a code provision but must give considered reasons for any deviation in its Corporate Governance Report, the annual report to shareholders on implementation and deviation from the corporate governance regulatory framework. Recommended best practices are for guidance only and issuers are not required to explain non-compliance.

Highlights of the Changes

The Stock Exchange has tightened a number of requirements in the Listing Rules and the Corporate Governance Code, with particular emphasis on directors' responsibilities and involvement. Some of the code provisions in the Corporate Governance Code have been promoted to rules because of their importance and a number of recommended best practices have been upgraded to code provisions. The more important changes are briefly summarised below.

New rule on the number of independent non-executive directors ("INEDs"). In addition to the current requirement for a minimum of three INEDs, an issuer must appoint INEDs representing at least one-third of the board and every issuer must comply with the new rule on or before 31 December 2012.

New rule on establishment of remuneration committee. With effect from 1 April 2012, an issuer must establish a remuneration committee chaired by an INED and comprising a majority of INEDs.

Other Amendments to the Listing Rules - effective on 1 January 2012:

- *Directors' duties*. Amendments were made to emphasise directors' duties. Directors must take an active interest in an issuer's affairs and satisfy the required levels of skill, care and diligence. Directors would not satisfy the required levels if they only pay attention to the issuer's affairs at formal meetings. Delegating their functions is permissible but does not absolve them from their responsibilities.
- *Disclosure of chief executive's remuneration*. An issuer must disclose in its financial statements all relevant details on remuneration of its chief executive.
- *Company secretary*. The requirement for the company secretary of an issuer to be ordinarily resident in Hong Kong was removed. The Stock Exchange has clarified the factors it will take into account in assessing the qualifications and "relevant experience" of a company secretary. Company secretaries are required to have at least 15 hours professional training in a financial year. Transitional arrangements apply to the training requirement depending on the date of appointment of the company secretary.
- *Removal of auditor*. An issuer must obtain shareholders' approval for removal of its auditor before the end of its term of office. An issuer must send a circular to shareholders proposing the removal with any written representations from the auditor before the general meeting.

Revised Corporate Governance Code - code provisions effective on 1 April 2012:

- *Directors' time commitments*. The board should regularly review the contribution by a director and whether he is spending sufficient time performing his duties. Directors should inform the issuer of any change to their significant commitments in a timely manner. Attendance records will be required to be disclosed to shareholders in the Corporate Governance Report.
- *Directors' training*. All directors should participate in continuous professional development to develop and refresh their knowledge and skills. An issuer should be responsible for arranging and funding suitable training for directors.
- *Chairman's responsibilities*. Code provisions will place greater emphasis on the role and responsibilities of the chairman. The chairman should take primary responsibility for ensuring good corporate governance practices. The chairman should promote a culture of openness and debate, facilitate effective contribution of non-executive

directors and should at least annually hold meetings with non-executive directors without the executive directors present.

- *Reappointment of an INED who has served more than nine years*. Serving more than nine years could be relevant to the determination of a non-executive director's independence. If an INED has served more than nine years, his further appointment should be subject to a separate shareholders' resolution.
- *Nomination committee*. Issuers should establish a nomination committee which is chaired by the chairman of the board or an INED and comprises a majority of INEDs.
- *Responsibility for corporate governance*. The board should be responsible for corporate governance. An issuer should establish terms of reference on corporate governance duties that should be performed by the board or committees delegated by the board.
- *Disclosure of senior management remuneration*. Issuers should disclose details of remuneration payable to members of senior management by bands in their annual reports.
- *Monthly information to board members*. Management should provide monthly updates to board members giving a balanced and understandable assessment of the issuer's performance, position and prospects.
- *Communication with shareholders*. Issuers should establish a shareholder communication policy and review it on a regular basis.
- *Company secretary*. The revised Corporate Governance Code contains a new section on the role and responsibilities of a company secretary. The selection or dismissal of the company secretary should be a board decision and the company secretary should report to the chairman and/or the chief executive.

The full version of the amendments to the Listing Rules and the Corporate Governance Code is available at: http://www.hkex.com.hk/eng/rulesreg/listrules/mbrulesup/Documents/mb105.pdf.

US DEVELOPMENTS

SEC Developments

In our 2010 and 2011 Newsletters, we reported on the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Reform Act") that was signed into law on 21 July 2010. The Reform Act requires rulemaking by the SEC to implement certain of its provisions:

SEC Hosts Roundtable on Conflict Minerals; Updated Adoption Schedule

On 18 October 2011, the SEC held a public roundtable on the agency's required rulemaking under Section 1502 of the Reform Act, which relates to reporting requirements regarding conflict minerals originating in the Democratic Republic of the Congo and adjoining countries.

The roundtable included representatives from industries that manufacture products using conflict minerals, as well as institutional investors, mining companies and metals industry groups and human rights non-governmental organisations. The roundtable addressed four primary topics:

- scope of the rule and definition of terms;
- tracking the supply chain;
- audit of conflict minerals reports; and
- form and timing of conflict minerals information and report.

The roundtable helped to further define the concerns of the various stakeholders involved, highlighted the areas of consensus and identified concrete challenges faced by issuers in complying with the new rules. In doing so, the roundtable provided insight regarding the issues the SEC considers important and the shape that the final rules may take.

Our related client publication is available at: http://www.shearman.com/sec-hosts-roundtable-on-dodd-frank-conflict-minerals-rules-10-19-2011/.

Although scheduled to be adopted by the end of 2011, the SEC has recently amended its rulemaking schedule and is now planning to adopt the final rules during the period from January to June 2012.

SEC Adopts Mine Safety Disclosure Rules

On 21 December 2011, the SEC adopted final rules implementing Section 1503 of the Reform Act, which relates to disclosure requirements for mining issuers regarding mine health and safety. In particular, Section 1503 requires issuers that operate mines in the United States to disclose specified information about compliance with the safety and health requirements under the Federal Mine Safety and Health Act of 1977 (the "Mine Act"), which is administered by the US Department of Labor's Mine Safety and Health Administration ("MSHA").

The final rules amend the SEC periodic and current reporting forms to incorporate the mine safety disclosure requirements of Section 1503, which was self-implementing and came into effect in August 2010. The final rules reflect the SEC's consideration of the comments received in response to the proposed rules issued by the SEC on 15 December 2010, on which we reported in our January 2011 Newsletter. The final rules largely adopt the proposed rules, although the SEC decided not to adopt certain proposed additional amendments not expressly contained in Section 1503.

Periodic Reporting Disclosure. All issuers that operate, or that have subsidiaries that operate, mines in the United States must include in their periodic reports filed with the SEC under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure in response to certain specified line items, to the extent applicable to those mines. The disclosure requirements apply to any "coal or other mine", as that term is defined in the Mine Act, and only apply to mines located in the United States. However, to the extent that mine safety issues with respect to an issuer's or its subsidiaries' mines located outside the United States are material to the issuer, disclosure may be required under the SEC's existing rules. Issuers that are "operators", or that have subsidiaries that are "operators", of such mines are subject to the disclosure requirements. An issuer that owns a mine for which an independent contractor is the operator is not subject to mine safety reporting with respect to that mine, but rather the independent contractor would be, if it is an SEC reporting issuer.

For foreign private issuers, these disclosure requirements apply to their annual report on Form 20-F. In the body of the Form 20-F, the issuer must include brief disclosure stating that it has matters to report in accordance with Section 1503 and that the disclosure is included in an exhibit to the report. In the exhibit, the issuer must disclose, on a mine-by-mine basis, certain information, in each case with respect to the period covered by the report, including:

- the total number of certain violations of mandatory health or safety standards;
- the total number of certain orders issued;
- the total dollar value of proposed assessments from the MSHA under the Mine Act; and
- the total number of mining related fatalities.

Current Reporting Disclosure. The final rule also adds a new item to the current report on Form 8-K, imposing a filing obligation upon the receipt of certain notices from the MSHA. That current reporting requirement does not apply to foreign private issuers.

The SEC final rules are available at: http://www.sec.gov/rules/final/2011/33-9286.pdf.

Our related client publication is available at: http://www.shearman.com/sec-adopts-dodd-frank-mine-safety-disclosure-rules-12-22-2011/.

SEC's Division of Corporation Finance Issues Disclosure Guidance on Cybersecurity

In our June 2011 Newsletter, we reported on a request by the US Senate Committee on Commerce, Science and Transportation that the SEC issue interpretive guidance regarding the disclosure of information security risk and the related response by SEC Chairman Mary Schapiro.

On 13 October 2011, the staff of the SEC's Division of Corporation Finance issued guidance on the disclosure obligations relating to cybersecurity risks and cyber incidents. The guidance does not impose new disclosure requirements, but instead analyses cybersecurity risk like any business risk that may require disclosure under a number of existing disclosure obligations. Registrants should therefore review on an ongoing basis the adequacy of their disclosure relating to cybersecurity risks and cyber incidents. The guidance clarifies, however, that detailed disclosure that itself would compromise a company's cybersecurity, for example by providing a "roadmap" for those seeking to infiltrate a company's network security, is not required.

- "Cybersecurity" is defined as the body of technologies, processes and practices designed to protect networks, systems, computers, programmes and data from attack, damage or unauthorised access.

- The SEC points out that cyber incidents can result both from deliberate attacks or unintentional events and often involve gaining unauthorised access to digital systems for purposes of misappropriating assets or sensitive information, corrupting data, or causing operational disruption. The objective of cyber attacks may include the theft of financial assets, intellectual property, or other sensitive information not only belonging to the company, but also to its customers or other business partners.
- As a consequence of a successful cyber attack, companies may incur substantial costs and suffer other negative consequences, including remediation costs, increased cybersecurity protection costs, lost revenues, litigation and reputational damage.

The following existing disclosure requirements may impose an obligation on companies to disclose cybersecurity risks and incidents:

- *Risk Factors*. Disclosure about risks of cyber incidents would be required if these issues are among the most significant factors that make an investment in the company speculative or risky. Companies should consider the probability of cyber incidents occurring and the quantitative and qualitative magnitude of those risks. In this context, companies should take into account prior cyber incidents and their severity and frequency and the adequacy of preventative actions taken to reduce cybersecurity risks.
- Any risk factor disclosure should be tailored to the specific facts and circumstances of the company and appropriate disclosure may include a discussion of:
  - the aspects of the business or operations giving rise to material cybersecurity risks and the potential costs and consequences;
  - outsourced functions that have material cybersecurity risks and how those risks are addressed;
  - experienced or threatened cyber incidents that, individually or in the aggregate, are material and the related costs and consequences;
  - risks related to cyber incidents that may remain undetected for an extended period of time; and
  - relevant insurance coverage.
- *MD&A*. MD&A disclosure is required if the costs or other consequences associated with one or more known cyber incidents or the risk of potential incidents represent a material event, trend, or uncertainty that is reasonably likely to have a material effect on the company's results of operations, liquidity, or financial condition or would cause reported financial information not to be necessarily indicative of future operating results or financial condition. Examples cited in the guidance include the theft of material intellectual property that is reasonably likely to have a material effect, such as reduced revenues or an increase in cybersecurity protection costs.
- *Business Description and Legal Proceedings*. Disclosure is required if one or more cyber incidents materially affect a company's products, services, relationships with customers or suppliers, or competitive conditions, and such disclosure should consider the impact on each of the company's reportable segments. Additionally, any material pending legal proceeding involving a cyber incident may also have to be disclosed.
- *Financial Statement Disclosure and Disclosure Control and Procedures*. The guidance also contemplates that costs relating to cyber incidents may have an impact on a company's financial statements. Items that may have to be accounted for include costs to prevent cyber incidents, or, during or after a cyber incident, incentive payments to customers to maintain the business relationship, losses from asserted and unasserted claims or diminished future cash flows. In addition, to the extent a cyber incident poses a risk to a company's ability to record, process, summarise, and report information that is required to be disclosed in SEC filings, appropriate disclosure of the conclusions on the effectiveness of its disclosure controls and procedures may have to be made.

The full CF Disclosure Guidance is available at: http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.

SEC's Division of Corporation Finance Issues Disclosure Guidance on European Sovereign Debt Exposures

On 6 January 2012, the staff of the SEC's Division of Corporation Finance issued guidance setting out its views on the disclosure obligations regarding financial institutions' direct and indirect exposures to the debt of certain European countries.

Although directed at financial institutions, registrants that are not financial institutions that are exposed, directly or indirectly, to European sovereign debt affected by the current crises should take note of the Division of Corporation Finance's guidance as a guide for assessing their disclosure relating to this topic. In addition, registrants should consider updating or including in their MD&A and risk factors information relating to risks and uncertainties created by the current economic and fiscal climate.

In its guidance, the Division of Corporation Finance advises that disclosure on registrants' exposure to European debt should be:

- provided on a country-by-country basis;
- segregated by sovereign and non-sovereign exposures; and
- segregated by financial statement category to arrive at gross funded exposure, as appropriate.

The guidance also suggests that registrants should consider:

- disclosing gross unfunded commitments; and
- providing information regarding hedges in order to present an amount of net funded exposure.

In addition, the guidance includes a detailed list of considerations that registrants are encouraged to take into account when preparing disclosure on this topic.

In determining which countries to focus on, registrants should concentrate on those that are experiencing significant economic, fiscal and/or political tension that the company believes increases the likelihood of default. Companies should also consider disclosing the rationale for choosing the countries they have included.

The full CF Disclosure Guidance is available at: http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic4.htm.

Our related client publication is available at: http://www.shearman.com/european-sovereign-debt-crisis-sec-staff-publishes-disclosure-guidance-regarding-european-sovereign-debt-exposures-01-09-2012/.

SEC Approves New Rules to Toughen Listing Standards for Reverse Merger Companies

On 9 November 2011, the SEC approved new rules of the three major US securities markets, namely the New York Stock Exchange ("NYSE"), NASDAQ and NYSE Amex, which toughen the listing standards for companies going public through a reverse merger with an existing public shell company. We reported on the proposed NYSE rules in our October 2011 Newsletter and on the proposed NASDAQ rules and the SEC bulletin warning investors about reverse merger companies in our July 2011 Newsletter.

Under the new rules, all three exchanges would prohibit reverse merger companies from applying for listing until:

- the company has completed a one-year "seasoning period" by trading in the US over-the-counter market or on another regulated US or foreign exchange following the reverse merger, and filed all required reports with the SEC, including audited financial statements; and
- the company maintains the requisite minimum share price for a sustained period, and for at least 30 of the 60 trading days, immediately prior to its listing application and the exchange's decision to list.

Exemptions from these requirements apply if the listing occurs in connection with a substantial firm commitment underwritten public offering, or the reverse merger occurred long ago so that at least four annual reports with audited financial information have been filed with the SEC.

SEC Adopts Changes to Net Worth Standard for Determining Accredited Investor Status

On 21 December 2011, the SEC adopted changes to the net worth standard for determining accredited investor status, which now excludes the value of a person's primary residence. These changes were made to conform the definition of "accredited investor" to the requirements of Section 413(a) of the Reform Act, which became effective on its enactment. We reported on the proposed rules in our April 2011 Newsletter.

- SEC rules permit certain private and limited offerings, most notably under Regulation D, to be made without registration, and without requiring specified disclosures, if sales are made only to "accredited investors". One way individuals may qualify as "accredited investors" is by having a net worth, alone or together with their spouse, of at least US$1 million.

For purposes of the calculation of net worth under the amended rules, a person's primary residence will not be included as an asset and any indebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, will not be included as a liability. However, any indebtedness that is secured by the person's primary residence in excess of its estimated fair market value will be included as a liability.

In a change from the proposed rules, any indebtedness secured by the primary residence that has been incurred in the 60 days prior to the sale of the securities, will also be included as a liability, unless it was incurred in connection with the acquisition of the property. The aim of this provision is to prevent investors from artificially inflating their net worth by incurring incremental indebtedness secured by their primary residence, thereby effectively converting their home equity, which is excluded from the net worth calculation, into cash or other assets that would be included in the net worth calculation.

The final rules also contain a grandfathering provision for certain follow-on investments, allowing a person to rely on the prior net worth standard if the person (i) held a right to purchase securities prior to 20 July 2010, the day before the enactment of the Reform Act, (ii) qualified as an accredited investor on the basis of applicable net worth standard when they acquired the right, and (iii) held securities of the issuer (other than the right to purchase) on 20 July 2010.

The final rules will become effective on 27 February 2012. Beginning in 2014, and every four years thereafter, the Reform Act requires the SEC to review the "accredited investor" definition in its entirety and to engage in further rulemaking to the extent it deems appropriate.

The final rules are available at: http://www.sec.gov/rules/final/2011/33-9287.pdf.

SEC Changes its Policy regarding Confidential Filings by Foreign Issuers

On 8 December 2011, the SEC announced that, effective immediately, it will review initial registration statements of a foreign issuer on a confidential basis only if such issuer is:

- a foreign government registering its debt securities;
- a foreign private issuer that is listed or is concurrently listing its securities on a non-US securities exchange;
- a foreign private issuer that is being privatised by a foreign government; or
- a foreign private issuer that can demonstrate that the public filing of an initial registration statement would conflict with the law of an applicable jurisdiction.

Confidential submissions by issuers that do not fall within these four categories and that were received by the staff of the SEC before 8 December 2011 will continue to be reviewed without a public filing. However, the next draft of the registration statement, whether in response to SEC staff comments or otherwise, must be filed publicly on EDGAR.

- Prior to this change in policy, foreign issuers were able to submit initial registration statements to the SEC for review on a confidential basis. The confidential review procedure arose to permit corrections or changes to first-time SEC disclosure and also to accommodate foreign offering schedules, where often the disclosure in the home country prospectus cannot be changed.

The SEC announcement is available at: http://sec.gov/divisions/corpfin/internatl/nonpublicsubmissions.htm.

Our related client publication is available at: http://www.shearman.com/sec-changes-its-policy-regarding-confidential-filings-by-foreign-issuers-12-12-2011/.

SEC Staff to Release Filing Review Correspondence Earlier

Beginning from 1 January 2012, the staff of the SEC will release filing review correspondence no earlier than 20 business days following the completion of a filing review to further enhance the transparency of the filing review process.

- The staff of the SEC has been publicly releasing through the EDGAR system comment letters and response letters relating to disclosure filings reviewed by the Divisions of Corporation Finance and Investment Management since 12 May 2005.
- Up to now, the stated goal had been to release the correspondence no earlier than 45 days after the review of the disclosure filing is complete.

The SEC announcement is available at: http://www.sec.gov/divisions/corpfin/cfannouncements/edgarcorrespondence.htm.

Updated Compliance and Disclosure Interpretations

The SEC's Division of Corporation Finance last updated its Compliance and Disclosure Interpretations on 18 October 2011, which are available at: http://www.sec.gov/divisions/corpfin/cfguidance.shtml.

Updated Financial Reporting Manual

The SEC's Division of Corporation Finance last updated its Financial Reporting Manual on 6 October 2011, which is available at: http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf.

Executive Compensation: 2012 Trends

Executive compensation continues to command the centre stage in public discourse about corporate governance. In the context of a troubled worldwide economy, the focus on pay in the financial services industry, most prominently evidenced by the Occupy Wall Street movement in the US, has led to increased scrutiny of executive compensation at all US companies.

US boards of directors are subject to conflicting pressures in making executive pay decisions for this year and in designing compensation programmes for 2012. There is a widespread public sentiment in the US that senior executives of large US corporations are paid too much, and there are newly enacted laws and regulations that emphasise the importance of paying for performance and guarding against excessive risk-taking. Corporate directors, however, continue to have an obligation to foster the future profitability of their corporations, and they see compensation as a key motivating tool.

For non-US companies, whether listed in the US or not, the practices and trends of the largest US companies provide instructive information in an increasingly convergent global corporate governance environment. And today in a continuing period of global economic challenge, the pressure for change in corporate governance practices has intensified.

Against this backdrop, it is helpful to look forward to major legal themes that will be likely to affect US incentive compensation in 2012 and the effect those themes may have on decision-making in US corporate boardrooms.

An article by our partner Linda Rappaport examining the executive compensation issues for 2012 is available at: http://www.shearman.com/executive-compensation-what-to-expect-in-2012-12-16-2011/.

Potential Trends for the 2012 Proxy Season and Beyond

ISS Corporate Policy Updates

On 17 November 2011, the ISS Corporate Governance Services released its 2012 Corporate Governance Policy Updates on voting recommendations. ISS or Institutional Shareholder Services Inc., an influential proxy advisory firm, undertakes an extensive process to review and update the policies that inform its benchmark voting recommendations each year, taking into account emerging issues and trends, the evolution of market standards, regulatory changes, and feedback provided by ISS's institutional clients and corporate issuers. Given ISS's influence, many public companies will want to consider these policies in evaluating their governance and compensation practices. The policy changes will be effective for meetings occurring on or after 1 February 2012.

ISS maintains different policies for the US, Canada, Europe and International, which this year covers Japan, Hong Kong, Brazil and the Philippines. The following are the key changes made to ISS's US and European benchmark corporate governance policies.

The full policy updates are available at: http://www.issgovernance.com/policy.

US Corporate Governance Policy

Advisory Votes on Executive Compensation – Pay-for-Performance Evaluation. In the US, the focus remains on executive compensation with the most significant update to the US policy being ISS's revised pay-for-performance policy relating to the evaluation of executive pay. ISS's new approach aims to provide a long-term view of the alignment of executive pay with company performance. ISS will annually conduct a pay-for-performance analysis to identify strong or satisfactory alignment between pay and performance over a sustained period.

With respect to Russell 3000 index companies, ISS will consider:

- *Peer Group Alignment*. The relative alignment between the company's total shareholder return and the CEO's total pay rank within a peer group, as measured over one and three year periods (weighted 40/60); and the multiple of the CEO's total pay relative to the peer group median.
- *Absolute Alignment*. The absolute alignment between the trend in CEO pay and a company's total share return over the prior five fiscal years, i.e., the difference between the trend in annual pay changes and the trend in annualised total shareholder return during the period.

If the alignment is weak or in the case of non-Russell 3000 index companies, ISS will analyse a number of qualitative factors to determine how various pay elements may work to encourage or to undermine long-term value creation and alignment with shareholder interests. These factors include (i) the ratio of performance-to time-based equity awards; (ii) the ratio of performance-based compensation to overall compensation; and (iii) the company's peer group benchmarking practices.

On 20 December 2011, ISS issued a white paper that provides additional guidance on its pay-for-performance methodology. The white paper is available at: http://www.issgovernance.com/sites/default/files/EvaluatingPayForPerformance_20111219.pdf.

Board Responsiveness to High Levels of MSOP Opposition. The Reform Act requires issuers to address, in their CD&A, whether and how their compensation policies and decisions have taken into account the results of the most recent vote on the management say-on-pay ("MSOP") proposal and based on ISS's policy survey, investors expect an explicit response if opposition levels were at more than 30 percent. ISS has updated its related policy item to highlight the types of disclosure that shareholders will examine in determining the sufficiency of management's response.

ISS will vote on a case-by-case basis on the election of compensation committee members (or, in exceptional cases, the full board) and MSOP proposals if the company's previous MSOP proposal received the support of less than 70 percent of the votes cast and will take into account:

- the company's response including (i) engagement efforts with major institutional investors regarding compensation issues; (ii) specific actions taken to address these issues; and (iii) other recent compensation actions taken by the company. ISS emphasises that any specific actions taken should be new rather than a reiteration of existing practices;
- whether the issues raised are recurring or isolated;
- the company's ownership structure; and
- whether the support level was less than 50 percent, in which case the highest degree of responsiveness is required.

Board Responsiveness to Frequency of Advisory Vote on Pay Results. ISS is adopting this new policy item in response to the advisory votes on the preferred frequency of MSOP votes that were held for the first time at shareholder meetings during the 2011 proxy season as required by the Reform Act.

ISS will vote against or withhold from the election of the entire board of directors if the board implements a say-on-pay schedule that is less frequent than the frequency that received the majority of votes cast at the most recent shareholder meeting at which shareholders voted on say-on-pay frequency. It is ISS's view that majority support for a particular frequency should be viewed as a mandate to a board and boards should implement the option preferred by shareholders.

If the board implements a say-on-pay schedule that is less frequent than the frequency that received a plurality, but not a majority, of the votes cast, ISS will evaluate proposals for the election of the entire board on a case-by-case basis, taking into account:

- the board's rationale for selecting a different frequency;
- the company's ownership structure and vote results;
- ISS's analysis of whether there are compensation issues or a history of problematic compensation practices; and
- the previous year's support level on the company's say-on-pay proposal.

Board Accountability – Governance Failures. This policy item provides that ISS will vote against or withhold from the election of either individual directors, committee members or the entire board due to enumerated governance failures. For 2012, ISS is updating this policy item to add an explicit reference to risk oversight, thereby clarifying ISS's existing policy by highlighting the significance of risk oversight within the broader concept of directors' fiduciary responsibilities. ISS's policy update is intended to address material failures in a board's role in overseeing the company's risk management practices.

Proxy Access. This policy item is being updated in response to the SEC's amendment to Rule 14a-8 that took effect in September 2011, providing that companies may not exclude from their proxy materials shareholder proposals for proxy access procedures. While ISS will continue to evaluate proxy access proposals on a case-by-case basis, it has expanded and refined the factors that will be examined in the evaluation and has broadened the policy to also apply to management proposals.

ISS will take into consideration company-specific factors as well as proposal specific factors, including:

- the ownership threshold proposed in the resolution (i.e., percentage and duration);
- the maximum proportion of directors that shareholders may nominate each year; and
- the method of determining which nominations should appear on the ballot if multiple shareholders submit nominations.

The list of enumerated factors is not exhaustive, however, and other factors ISS may consider include the rationale for the proposal.

Disclosure on Political Spending. In response to growing shareholder demand for greater transparency and more disclosure of companies' policies and practices in relating to corporate political spending, ISS is updating this policy item. ISS will now vote for proposals requesting greater disclosure of a company's political contributions and payments to trade association spending policies and activities, while also considering the following:

- the company's current disclosure of policies and oversight mechanisms related to its direct political contributions and payments to trade associations or other groups that may be used for political purposes, including information on the types of organisations supported and the business rationale for supporting these organisations; and
- recent significant controversies, fines, or litigation related to the company's political contributions or political activities.

European Corporate Governance Policy

General. In Europe, the key 2012 updates to ISS's proxy voting guidelines are focused on France and discussed below. Other European policy updates focus on Corporate Governance issues, where ISS clarified that board tenure, i.e., excessive years of service on a board, are taken into consideration when evaluating the independence of a director. In addition, like the change to its US policy item discussed above, ISS made a change to its policy on governance failures to add an explicit reference to risk oversight.

Voting on Equity-Based Compensation (France). The key change to ISS's European Compensation Guidelines on equity-based compensation is the adoption of a France-specific policy with:

- an increased focus on performance criteria in line with local best practice;
- an increase in the allowable capital that can be reserved for equity plans to 10 percent of the share capital; and

- the introduction of a burn rate criterion to measure use of capital.

New Policy relating to Censors (France). In France, certain boards of directors include "censors", which are non-voting advisors to the board that have no legal liability or fiduciary duties towards shareholders. Despite their advisory role, censors often receive the same remuneration as non-executive directors and can have considerable influence on the board. Due to concerns that companies may use censors in order to circumvent conventions of good governance, ISS is now adopting the following policies with respect to censors:

- ISS will generally vote against the (re)election of censors, bylaw amendments to authorise the appointment of censors, or to extend the maximum number of censors to the board;
- ISS will only vote case-by-case if the company provides assurance that the censor will serve on a short-term basis of maximum one year with the intent to retain the candidate before election as director at the next annual general meeting; and
- lastly, in connection with the election of directors, when assessing the number of board seats of a candidate to avoid "overboarding", ISS will now take into account board appointments as censors in French publicly listed companies.

SEC Review of Role of Proxy Advisory Firms

In 2010, the SEC issued a "concept release" on which we reported in our October 2010 Newsletter, soliciting public comment on various aspects of the US proxy voting system, including the role and influence of proxy advisory firms. Recent comments indicate that the SEC will focus on proxy "plumbing" in 2012, starting with a review of the independence and objectivity of proxy advisory firms.

Proxy advisory firms perform a variety of functions, including analysing and making voting recommendations on matters presented for a shareholder vote, assisting with executing votes and performing various other tasks related to the exercise of voting rights and the making of voting decisions and providing research related to corporate governance more generally in order to assist institutional investor clients in formulating and maintaining voting policies and procedures.

At the heart of the issues relating to the role of proxy advisory firms is the argument that proxy advisory firms are controlling or significantly influencing shareholder voting without appropriate oversight and without having an actual economic stake in the issuer. In addition, it is argued that there may be conflicts of interest if proxy advisory firms provide services to both corporations and investors.

Judging from the 2010 concept release, the SEC will likely focus on improving disclosure relating to potential conflicts of interest and enhancing regulatory oversight over proxy advisory firms, generally, and over their issuance of voting recommendations, in particular.

Recent Trends and Patterns in the Enforcement of the Foreign Corrupt Practices Act ("FCPA")

In January, we published our bi-annual "Recent Trends and Patterns in FCPA Enforcement" report, part of our renowned FCPA Digest, which together provide an insightful analysis of recent trends and patterns and an invaluable compendium of all FCPA enforcement actions and private actions.

Although the overall number of new FCPA enforcement actions fell somewhat in 2011 - just 16 corporate cases, compared with 20 in 2010 - US authorities have continued their aggressive and proactive enforcement of the statute and are now being joined by their foreign counterparts. FCPA penalties in 2011 have remained stable and under US$20 million in most cases.

In 2011, US enforcement authorities continued their emphasis on prosecuting individuals, charging 18 individuals and, at the same time, going to trial in several important cases. Interestingly, most of the individuals charged in 2011 were foreign nationals. This presents a twist on the previously noted trends of US enforcement authorities targeting non-US companies. A number of the recent trials have underlined the difficulty of US enforcement authorities in proving foreign bribery beyond a reasonable doubt. Still, judicial opinions have largely supported the US government's expansive interpretation of what constitutes an "instrumentality" of a foreign government, including state-owned entities indirectly controlled by a foreign government.

A similar focus on the prosecution of bribery by foreign companies exists in the UK in connection with the enforcement of the UK Bribery Act that came into effect in July 2011. In this context, the Director of the Serious Fraud Office ("SFO") has indicated that the focus of the SFO from the outset will be on prosecuting non-UK companies with a business presence in the UK to help ensure that UK companies which behave properly are not subject to unfair competition from non-UK companies which do not. In contrast, US authorities, after years of focusing on US companies, have only recently targeted non-US companies as part of an apparent effort to spur non-US enforcement agencies to be more active in this area with respect to their own companies.

Our FCPA Digest provides current and comprehensive information on US foreign bribery proceedings, including criminal prosecutions, DOJ foreign bribery civil actions, SEC actions, DOJ opinion releases, ongoing FCPA investigations, pre-FCPA prosecutions and parallel litigation related to FCPA.

The "Recent Trends and Patterns in FCPA Enforcement" report is available at: http://www.shearman.com/files/Publication/bb1a7bff-ad52-4cf9-88b9-9d99e001dd5f/Presentation/PublicationAttachment/6ec0766a-25aa-41ec-8731-041a672267a6/FCPA-Digest-Trends-and-Patterns-Jan2012.pdf.

The FCPA Digest is available at: http://www.shearman.com/files/Publication/bb1a7bff-ad52-4cf9-88b9-9d99e001dd5f/Presentation/PublicationAttachment/590a9fc7-2617-41fc-9aef-04727f927e07/FCPA-Digest-Jan2012.pdf.

US Securities and NYSE/NASDAQ Regulation: Compliance Manuals for Non-US Companies

We have recently updated our compliance manuals for non-US companies listed on the NYSE and NASDAQ. The manuals summarise the primary reporting obligations and other duties imposed by the Securities Act of 1933, the Exchange Act, the Sarbanes-Oxley Act of 2002 and other US securities laws upon a non-US company as an SEC registrant and upon its officers, directors and certain of its shareholders. They also summarise the reporting obligations and other duties that are imposed as a result of the listing of a non-US company on the NYSE or NASDAQ. In addition, we provide guidance on recommended best practice for compliance with the various US securities and NYSE or NASDAQ regulations, and links to relevant regulatory compliance tools.

Whether listed in the US or not, the manuals provide an informative overview of SEC and US stock exchange regulations in the increasingly convergent global disclosure and governance environment.

If you wish to receive a copy of the relevant manual, you may contact your usual Shearman & Sterling representative or any of the persons listed at the end of this publication.

Noteworthy US Securities Law Litigation

US Federal Court stresses importance of oral safe harbour warnings before conference calls and other oral presentations: In re Coinstar Securities Litigation. A federal court in Washington State recently issued a noteworthy decision in a securities class action case, which reinforces the importance of including oral safe harbour warnings with forward-looking projections. Although it is often tedious to include oral safe harbour warnings during oral presentations, this case reinforces the importance of adhering to best practices if the company hopes to benefit from the "meaningful cautionary statement" test under the safe harbour provision of the Private Securities Litigation Reform Act ("PSLRA") in US securities litigation.

In *Coinstar*, the plaintiff alleged that the defendants violated Section 10(b) of the Exchange Act by making false and misleading statements about their revenue guidance during an earnings call and a follow-on oral presentation to investors. The court analysed the transcripts from the earnings call and the investor presentation and reached different results based on the oral warnings provided by the company's executives.

The court first reviewed the transcript from the earnings call and ruled that the projections provided by the defendants were protected by the PSLRA's "meaningful cautionary statement" test under the safe harbour. The court found the company's executives adequately advised investors at the beginning of the call that actual results may differ materially from expectations and referred investors to the company's latest Form 10-K and 10-Q filings for a full list of risk factors. Based on these facts, the court dismissed this aspect of the plaintiff's securities fraud case.

The court next reviewed the transcript from an investor presentation and ruled that the same projections were not protected by the PSLRA safe harbour because the company's executives did not provide an oral warning to investors and did not refer investors to the risk factors in recent SEC filings. The court refused to take judicial notice of a slide in the investor PowerPoint presentation that included cautionary language because the slide was not included in the complaint and the plaintiff contested its authenticity. Based on these facts, the court ruled that this aspect of the plaintiff's securities fraud case could proceed to discovery. There are two other tests under the PSLRA safe harbour for forward-looking statements: (i) the statement is protected if it is immaterial; or (ii) the statement is protected if the plaintiff is unable to prove that the statement was made with actual knowledge that it was false.

Whether the result would have been different if the warning slide in the investor presentation had been included in the complaint and its authenticity had not been questioned is a matter of conjecture. Accordingly, it is best to have a consistent practice of providing the oral safe harbour warning before all oral presentations, whether by conference call or in person, that contain projections and forward-looking statements.

Dismissal of securities fraud claims for lack of economic loss if stock price recovers after corrective disclosure: ***In re China North East Petroleum***. In October 2011, a federal court in New York dismissed a putative securities fraud class action because the court found that the plaintiff had not adequately alleged a cognisable economic loss. In order to state a claim for securities fraud under Section 10(b) of the Exchange Act, a plaintiff must plead and later prove, among other things, the elements of economic loss and loss causation (i.e., a causal connection between the material misrepresentation and the loss). In this case, the plaintiff asserted that it had adequately pleaded these elements because the defendant's stock price declined after the truth regarding the defendant's alleged fraud was revealed to the market. The defendant responded that the plaintiff had not adequately alleged an economic loss because the stock price fully recovered after the alleged corrective disclosure and the plaintiff could have sold its shares above its average purchase price. The court agreed with the defendant and held that a plaintiff that foregoes a chance to sell its shares at a profit following a corrective disclosure cannot ascribe a later loss to devaluation caused by the disclosure. Accordingly, the court dismissed the securities fraud class action against the defendant.

This case provides defendants with an important argument for challenging securities fraud claims where the price of a defendant's stock rebounds after a corrective disclosure.

Recent SEC/DOJ Enforcement Matters

New York federal judge rejects consent judgment for lack of admission of factual allegations: Citigroup. In November 2011, a federal judge in New York rejected a proposed US$285 million consent judgment between the SEC and Citigroup related to the sale of mortgage-backed securities. In his opinion, the federal judge noted that private parties can settle disputes without agreeing on the underlying facts or presenting those facts to a court. In contrast, when the parties ask the court to approve a settlement and aid in its enforcement, the parties must provide the court with sufficient factual context so that the court can determine whether the settlement is fair, reasonable, adequate, and in the public interest. The court noted that in the Citigroup settlement, like most SEC settlements, the defendant entered into the agreement without admitting or denying the underlying allegations. This practice, the court ruled, deprives the court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact. Accordingly, the court refused to approve the proposed consent judgment and directed the parties to be ready for trial by July 2012. The SEC has appealed the court's decision to the US Court of Appeals for the Second Circuit.

This case is significant because SEC settlements often include language indicating that the defendant does not admit or deny the allegations. If future agreements must include admissions by a defendant in order to obtain court approval, it will likely be more difficult for the SEC to settle cases, partly because the defendants will be concerned that such admissions will be used against them in related private litigation.

SEC issues cease-and-desist order for Regulation FD violation: Fifth Third Bancorp. In November 2011, the SEC issued a cease-and-desist order against Fifth Third Bancorp, a diversified financial services company with headquarters in Cincinnati, Ohio, for violating Regulation FD when it issued a redemption notice to holders of trust preferred securities without also disclosing the redemption to the public. The day after the redemption notice was issued, Fifth Third noticed an unusually heavy volume of trading in the trust preferred securities and realised that investors with knowledge of the redemption may have been selling to purchasers who did not know about it. Later that day, Fifth Third filed a Form 8-K that publicly disclosed the redemption. The trust preferred securities opened trading that day at US$26.66 per share and closed at US$25.20 per share – two cents above the redemption amount of US$25.18 per share.

The order requires Fifth Third to, among other things, cease and desist from committing any future violations of Regulation FD, which prohibits the selective disclosure of material nonpublic information to securities market professionals and holders of the company's securities who reasonably can be expected to trade on the information. The SEC did not impose a civil penalty on Fifth Third based, in part, on the company's prompt and voluntary remedial measures, including its adoption of additional policies and procedures relating to the redemption of securities, its cooperation with the SEC's investigation, and its decision to compensate investors who were harmed by the timing of its disclosure.

This case highlights the importance of ensuring that the public is notified about material events related to an issuer's securities at the same time that the holders of the securities receive the information.

DOJ and SEC enter into deferred prosecution agreements in FCPA enforcement actions: Magyar Telekom Plc. and Deutsche Telekom AG. In December 2011, Magyar Telekom Plc., a Hungarian telecommunications company, and Deutsche Telekom AG, a German telecommunications company and majority owner of Magyar Telekom, entered into a two-year deferred prosecution agreement and agreed to pay a combined US$63.9 million criminal penalty to resolve alleged violations of the FCPA. The DOJ alleged that Magyar Telekom entered into a secret agreement with senior government officials in Macedonia to delay or preclude the issuance of a license to a competitor. In order to secure the benefits of the secret agreement, Magyar Telekom executives paid approximately US$6 million to a third-party intermediary with the intent that the intermediary would forward the money to the government officials. The DOJ further alleged that Magyar Telekom used intermediaries to pay bribes to government officials in Montenegro in return for their support of Magyar Telekom's acquisition of a state-owned telecommunications company on terms favourable to Magyar Telekom.

Under the terms of the deferred prosecution agreement with Magyar Telekom, the company agreed to pay a US$59.6 million penalty for its illegal activities, implement an enhanced compliance programme, and submit annual reports regarding its efforts to remediate past problems. Under the terms of the deferred prosecution agreement with Deutsche Telekom, the company agreed to pay a US$4.36 million penalty in connection with its books and records violation and to enhance its FCPA compliance programme. In addition, Magyar Telekom, three of its former executives, and Deutsche Telekom agreed to pay US$31.2 million in disgorgement and prejudgment interest in order to settle civil FCPA charges brought by the SEC.

This case is significant because the civil and criminal penalties of approximately US$95 million are one of the ten largest ever levied against a corporate defendant for FCPA violations. The case shows that the DOJ and SEC continue to aggressively enforce FCPA violations outside of the United States.

EU DEVELOPMENTS

EU Short Selling Regulation

The European Commission and European Parliament have agreed the text of the EU Regulation on short selling and sovereign credit default swaps ("CDS"). The Regulation, which applies to financial instruments admitted to trading in the EU and sovereign debt issued by the EU or any member state or by the European Investment Bank, with certain exceptions for market-makers, requires or creates:

- confidential disclosure to national regulators of short positions in shares which exceed or fall below 0.2 percent of the issued share capital of the company concerned and/or any 0.1 percent increment above 0.2 percent;
- public disclosure of short positions in shares which exceed or fall below 0.5 percent of the issued share

capital of the issuer concerned and/or any 0.1 percent increment above 0.5 percent;

- disclosure of short positions on sovereign debt, including naked CDS, above thresholds still to be determined by the European Commission. Thresholds may be varied for each member state;
- a restriction on naked short sales in shares and sovereign debt unless the trader has possession of, the right to, or reasonably expects that it will have the right to, the underlying share or sovereign debt instrument. The restriction on naked short sales can be lifted by national regulators for up to six months at a time, on a renewable basis, if the liquidity in the market falls below a threshold determined by the European Commission;
- a ban on naked CDS that reference a sovereign debt obligation without having the purpose of hedging against the risk of default on the reference sovereign debt obligation or the risk of a decline in the value of the sovereign debt, where the person entering into the CDS holds the debt or is subject to a liability which has a value that is correlated to the value of the sovereign debt. The restriction on such naked CDS can be lifted by national regulators in situations where the sovereign debt market is not functioning properly and the restriction may have a negative impact on the market;
- mandatory buy-ins by central counterparties for shares that are not delivered within four days of the date settlement;
- new powers for national regulators, including requiring private or public disclosure of short positions or the imposition of restrictions or conditions on short selling or sovereign debt instruments, if there is a threat to financial stability or a financial instrument significantly falls in price in one day; and
- new powers for the European Securities and Markets Authority ("ESMA") to impose its own restrictions or conditions on short selling or require private or public disclosure in relation to short sales, but not sovereign debt instruments, and to facilitate and coordinate national regulators, including providing opinions as to the appropriateness of national regulators' proposed restrictions or requirements in relation to short sales.

The Regulation will apply from 1 November 2012.

MiFID II Legislative Proposal

On 20 October 2011, the European Commission published its legislative proposal to amend the Markets in Financial Instruments Directive ("MiFID"). The proposal is divided into two parts, a revised Directive and a new Regulation, both of which are currently expected to come into force in 2013.

The revised Directive ("MiFID II") will be an amendment and restatement of MiFID, and will cover a number of areas, including:

- *Changes in Market Structure*: MiFID II extends the reach of MiFID to capture additional trading activities and systems, with a key change being the introduction of a new category of trading facility, the organised trading facility ("OTF"). An OTF will be a trading facility that does not fall within one of the following existing categories of (i) Regulated Market ("RM"); (ii) Multilateral Trading Facility ("MTF"); or (iii) Systematic Internaliser.
- *Transparency Regime*: the current transparency requirements are extended to cover additional instruments, such as bonds, structured finance products, derivatives and emissions allowances, as well as different trading venues, such as OTFs. Their application will, however, be calibrated to each type of asset class and type of trading.
- *Powers of National Authorities*: national regulators will be given powers to permanently ban products in coordination with ESMA. In addition, ESMA will be able to temporarily ban products.

The new Regulation ("MiFIR") will cover a number of areas, including:

- *Disclosure Obligations*: obligation to disclose trade data to the public. Pre-trade transparency applies to shares, depository receipts, exchange-traded funds, certificates and similar financial instruments.
- *Transaction Reporting*: requirement to report transactions to the home state regulator.
- *Organised Trading*: requirement to trade derivatives on organised venues.
- *Clearing and Trading*: access to clearing and trading.

- *Product Intervention and Position Management*: this includes the provisions on ESMA's powers to ban sales or practices under certain conditions.
- *Emission Allowances*: trading in emission allowances is brought within the scope of regulation.

Both MiFID II and MiFIR include proposals for a harmonised approach across Europe with respect to the treatment of third-country firms wishing to provide financial services covered by the legislation:

- the EU must deem third countries as being equivalent before providing access for firms from such countries;
- ESMA will maintain a central list of the relevant countries;
- third-country firms will have to establish branches in order to provide services to retail clients; they may, however, continue to provide services without establishing a branch to eligible counterparties provided they are supervised in their own countries and are registered with ESMA; and
- existing third-country firms will have four years to comply with the new requirements set out in MiFIR from its effective date.

As a result of the proposed legislation, financial institutions and users of financial services will need to prepare to negotiate a wider regulatory perimeter, which captures previously unregulated or more weakly regulated business areas. Pre-trade and post-trade transparency will apply to a broader scope of instruments. Firms will also need to be aware of the wider interventionist powers of the EU and national regulators, which are under contemplation.

Our related client publication is available at: http://www.shearman.com/a-changing-landscape-the-mifid-ii-legislative-proposal-10-20-2011/.

ESMA Consultation on MiFID

ESMA has published consultation papers on draft ESMA guidelines on MiFID suitability requirements and on MiFID compliance function requirements.

Suitability. The purpose of the draft guidelines is to facilitate the implementation of the suitability requirements, which focus mainly on the need for firms to have in place appropriate policies and procedures to know their clients when recommending suitable investment choices.

The aim is to assist investment firms to implement these requirements, and improve investor protection. It is important to note that the draft guidelines, and by extension the consultation, does not address every aspect of the MiFID suitability requirements.

The consultation paper is available at:

http://www.esma.europa.eu/content/Consultation-paper-guidelines-certain-aspects-MiFID-suitability-requirements.

Compliance Function. ESMA has created these draft guidelines because the financial crisis highlighted the need for clearer information on compliance, and because it is concerned that compliance risk can take second place to other risk areas within an investment firm, leading to the deficient implementation of appropriate compliance processes.

- The draft guidelines clarify the compliance function investment firms are required by MiFID to implement as part of their policies and procedures and reinforce the importance of the compliance function.
- The draft guidelines focus on the responsibilities of the compliance function for monitoring, reporting and advising, and the organisational requirements of the compliance function for the standards of effectiveness, permanence and independence.

The consultation paper is available at:

http://www.esma.europa.eu/content/Consultation-paper-guidelines-certain-aspects-MiFID-compliance-function-requirements.

Both consultations close on 24 February 2012. ESMA expects to publish the final report and final guidelines for each during the second quarter of 2012.

Review of Market Abuse Directive

On 20 October 2011, the European Commission published legislative proposals to revise the Market Abuse Directive ("MAD"). The European Commission proposes to replace MAD with a market abuse regulation ("MAR") and to create a new directive introducing mandatory criminal sanctions for market abuse ("CSMAD").

MAR includes proposals on:

- expanding the definition of "inside information" and adding a new category of inside information, which is information not generally available but which would be relevant to a reasonable investor;
- requiring issuers who delay public disclosure of inside information so as not to prejudice legitimate interests (an exemption currently allowed under MAD) to inform national regulators of their decision to delay disclosure;
- extending the obligation on market operators to adopt structural provisions aimed at preventing and detecting market manipulation to operators of MTFs and OTFs, a new category of trading venue created under the MiFID II proposals discussed above;
- extending the market abuse regime to any financial instruments admitted to trading on an MTF or OTF as well as to any related financial instruments traded over-the-counter which can have an effect on an underlying market covered by MAR. Only instruments which are exclusively traded over-the-counter and which are not related derivative financial instruments to those otherwise covered by MAR would be outside the scope of MAR. MAD currently prohibits market abuse in financial instruments admitted to trading on a regulated market;
- introducing an obligation on persons engaging in transactions in EU emissions allowances to publicly disclose inside information. The duty would be imposed on market participants whose physical activities could have an impact on greenhouse gas emissions and thus the market price for emission allowances. The MiFID II proposals discussed above expand the scope of financial instruments that are included under the market abuse regime to trades in EU emissions allowances;
    - our client publication that provides further details on this topic is available at: http://www.shearman.com/proposed-regulation-of-eu-emissions-allowances-as-financial-instruments-11-08-2011/;
- expanding the scope of the powers of national regulators to allow regulators to:
    - requisition existing telephone data records where there is a reasonable suspicion that the records may be relevant to proving insider dealing;
    - suspend trading of a relevant financial instrument;
    - impose a temporary ban on any member of an investment firm's organisational body; and
    - impose the criminal sanctions proposed under CSMAD; and
- introducing a minimum level of civil sanctions to be imposed by national regulators.

CSMAD would require member states to establish criminal sanctions for individuals for intentional insider dealing and market manipulation, including attempts to commit those offences and inciting or aiding and abetting. CSMAD also proposes that legal persons may be held liable for any of the offences if the offence is committed for its benefit by a person who holds a "leading position" at the firm or where the lack of supervision or control of such persons has made the commission of the offence possible.

Both MAR and CSMAD will now pass through the European legislative process and are currently due to come into effect two years after their final adoption.

Our related client publication is available at: http://www.shearman.com/twice-as-mad-legislative-proposals-to-amend-the-european-regulation-of-market-abuse-12-21-2011/.

EU Reforms to the Derivatives Market Delayed

The reforms to the over-the-counter derivative markets have been delayed after the European Parliament, the Council of Ministers and the European Commission failed to agree on a final text for the proposed European Markets Infrastructure Regulation ("EMIR").

It has been suggested that there was a failure to reach agreement on whether to give ESMA power to authorise clearing houses and a disagreement over Europe's ability to provide unrestricted access to the European markets to market participants from non-EU countries who are in the clearing business.

Proposals to Amend EU Regulation on Credit Rating Agencies

On 15 November 2011, the European Commission published legislative proposals to amend the EU Regulation on Credit Rating Agencies (the "CRA Regulation"). The proposals include:

- introducing a system of rotation of credit rating agencies ("CRAs") under which:
  - the period during which any one CRA may continuously provide credit ratings on the same issuer or its debt instruments where the issuer pays for ratings is limited to (a) three years for providing credit ratings, and (b) one year where the CRA rates more than ten consecutive rated debt instruments of the issuer. There would be no requirement to change CRA within the first 12 months in either event;
  - the outgoing CRA would not be able to provide ratings for that same issuer for a period of four years after ceasing to provide such ratings;
  - the outgoing CRA would have to transfer relevant information on an issuer or instruments to the incoming CRA; and
  - CRAs issuing sovereign ratings would be exempt;
- requiring an issuer, originator or sponsor of structured finance instruments established in the EU to publicly disclose information on the underlying assets and structure of a securitisation, including cash flows and supporting collateral;
- requiring issuers to engage two CRAs to rate its structured finance instruments, if the issuer pays for the rating;
- extending the scope of the Regulation to rating outlooks and credit watches;
- imposing civil liability on a CRA for damage caused, either intentionally or through gross negligence, to an investor as a result of an infringement of the Regulation which has an impact on the rating outcome;
- requiring sovereign ratings to be reviewed at least every six months, instead of annually as currently required;
- proposing the establishment of a European Ratings Index (EURIX) to allow investors to compare all ratings of an issuer and to provide average ratings;
- requiring any modifications to CRA methodologies to be subject to consultation with issuers, investors and other interested parties and to be subject to verification by ESMA; and
- placing restrictions on holdings in CRAs that would provide that shareholders or members may not hold 5 percent or more of the capital or voting rights of more than one CRA unless the CRAs belong to the same group.

The legislative proposals are now being considered by the European Parliament and the European Council. The European Parliament has indicated that it will consider the proposals during its early July 2012 plenary session.

The legislative proposals are available at: http://ec.europa.eu/internal_market/securities/docs/agencies/COM_2011_747_en.pdf.

Draft Regulatory Technical Standards under CRA Regulation

On 20 December 2011, ESMA published four draft regulatory technical standards under the CRA Regulation that specify the details on:

- the information CRAs must provide to ESMA on registration and certification;
- the content and format of periodic ratings data which CRAs may be requested to report to ESMA;
- the information, structure and format of a CRA's historical performance data to be disclosed publicly through ESMA's central repository; and
- the compliance of credit rating methodologies with the CRA Regulation.

The draft standards have been submitted to the European Commission for endorsement. Once endorsed, the standards will be directly applicable in all member states.

ESMA Extends Period for Use of Non-EU Credit Ratings

ESMA has extended the period during which credit ratings issued in third countries can be used in the EU to

30 April 2012 to allow more time for the convergence process and the endorsement process of third countries.

Under the CRA Regulation, credit institutions and investment firms, amongst others, may only use credit ratings for regulatory purposes if they are issued by CRAs established and registered in the EU unless one of two exceptions apply:

- credit ratings issued by a CRA established outside the EU which relate to an entity established or a financial instrument issued outside the EU may be used for regulatory purposes within the EU if the third-country CRA seeks certification that they are regulated in an equivalent manner to CRAs registered in the EU; and
- where a CRA not established or registered in the EU is in the same group of companies as a CRA which is, the latter CRA can endorse credit ratings made in whole or in part by the former if the third country CRA fulfils certain requirements.

ESMA's Technical Advice on Detailed Rules under the AIFMD

On 16 November 2011, ESMA published its final advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive ("AIFMD"). The advice contains proposals intended to provide detail and clarification on a wide range of the AIFMD's provisions, relating to issues such as depositary liability, delegation, capital requirements, transparency, leverage, supervision and third-country provisions.

The European Commission will adopt the implementing measures in July 2012, relying to a large extent on ESMA's advice, either in the form of regulations or directives. Member states are required to implement the AIFMD by 22 July 2013, as well as the implementing legislation. Fund managers subject to the AIFMD will have until July 2014 to comply with the directive and the implementing measures.

The AIFMD is principally concerned with the regulation of EU fund managers, but its scope means that it also has significant implications for non-EU managers.

The full text of ESMA's Final Advice is available at: http://www.esma.europa.eu/content/Final-report-ESMAs-technical-advice-European-Commission-possible-implementing-measures-Alter.

Our related client publication is available at: http://www.shearman.com/european-regulation-of-fund-managers--esmas-final-level--2-advice-published-12-12-2011/.

EU Legislative Proposals on Venture Capital

On 7 December 2011, the European Commission issued legislative proposals for a new "European Venture Capital Fund" label, which includes new measures to allow venture capitalists to market their funds across the EU and grow while using a single set of rules. The proposals are aimed at making it easier for venture capitalists to raise funds for start-ups by standardising their legal status across the EU.

The proposals are a result of the realisation that the AIFMD would impose obligations on venture capitalists which would be too onerous and thus hinder their ability to raise funds.

In order to use the new label, funds will have to prove that a high percentage of investments (70 percent of the capital received from investors) are spent in supporting young and innovative companies. The European Commission hopes that by introducing a single rulebook, venture capital funds will have the potential to attract more capital commitments and become bigger, thus allowing more capital for individual companies, which in turn will give them the ability to specialise in particular sectors such as information technology, biotech or life-science.

The proposal on venture capital now passes to the European Parliament and the European Council for negotiation and adoption under the EU co-decision procedure.

The legislative proposals are available at: http://ec.europa.eu/internal_market/investment/venture_capital_en.htm.

EU Legislative Proposal on Social Entrepreneurship Funds

On 7 December 2011, the European Commission published a legislative proposal which sets out a new "European Social Entrepreneurship Fund" label. This proposal is aimed at allowing investors to easily identify funds that focus on investing in European social businesses.

The proposed approach is relatively simple: once the uniform requirements defined in the proposal are met, the managers of social entrepreneurship funds will be able to use the new label and market their funds across the whole of Europe. In order to use the label, funds will have to prove that a high percentage of investments (70 percent of the capital received from investors) are spent in supporting social businesses. Uniform rules on disclosure will ensure that investors get clear and effective information on these investments.

The key elements of the proposal are:

- a recognised EU brand for social entrepreneurship funds;
- improved investor information;
- better performance measures;
- the break down of barriers to fundraising across Europe; and
- an initial limit of the availability of the fund to professional investors, and once it is established, opening it to retail investors.

The proposals now pass to the European Parliament and the European Council for negotiation and adoption under the EU co-decision procedure.

The legislative proposals are available at: http://ec.europa.eu/internal_market/investment/social_investment_funds_en.htm.

EC Proposals for Reform of the Audit Market

The European Commission published a set of proposals on 30 November 2011 to amend the EU Statutory Audit Directive and to issue a new regulation containing important new requirements for the statutory audit of "public-interest entities" ("PIEs"), which include EU incorporated issuers with transferable securities listed on an EU regulated market. These proposals could have a significant effect on the audit market and audit firms and their clients within the EU.

The amendments to the existing Statutory Audit Directive are largely concerned with:

- improving competition amongst audit firms by:
  - providing for a system of "passporting" for audit firms that are approved in one member state but wish to provide statutory audits in other member states;
  - removing the current requirements for a majority of voting rights in an audit firm to be held by licensed accountant practitioners, statutory auditors or audit firms. However, a majority of the members of the administrative or management body of the audit firm must still be audit firms or statutory auditors; and
  - prohibiting audited entities and third parties from agreeing on a contractual restriction on which auditor or audit firm may be appointed by the entity;
- improving the quality of audits within the EU by:
  - requiring audits to be carried out in accordance with international auditing standards; and
  - establishing new rules governing the public oversight of auditors by appropriately empowered and resourced competent authorities that must co-operate with each other, particularly in the areas of auditor training and qualification or approval; and
- relaxing the audit requirements for small and medium-sized undertakings by providing for a proportionate application of auditing standards to:
  - medium-sized undertakings; and
  - any small undertakings that, following the European Commission's earlier proposed removal of the requirement for small undertakings to have to have their financial statements audited, might still be required by national law to have a statutory audit.

The proposed new regulation on the statutory audit of PIEs contains several significant new requirements with respect to both the businesses of statutory auditors and the engagement of auditors by PIEs.

As far as PIEs are concerned, the major proposals include:

- the mandatory rotation of auditors:
  - after six years, or nine years where there are joint auditors, with the possibility of an extension of this period to eight years or twelve years, respectively "on an exceptional basis" (not defined in the draft regulation)

where the relevant competent authority allows this; and

- with a minimum "cooling-off" period of four years before an auditor can then be re-appointed by the PIE;

- a mandatory tendering process for the appointment of statutory auditors (except where an existing appointment is being renewed as permitted by the regulation) which will require at least one of the audit firms invited to tender to be a firm that has not received more than 15 percent of its total audit fees from large PIEs in the appointing company's member state in the previous calendar year; and

- requirements that audit committees must be composed of non-executive members of the company's administrative or supervisory body, a majority of whom must be independent, and have at least one member with competence in auditing and another member with competence in accounting and/or auditing. By way of comparison, the existing Statutory Audit Directive only requires the committee to have at least one independent member and one member, who may be the same person, with competence in accounting and/or auditing. The UK Corporate Governance Code requires FTSE 350 companies to have an audit committee comprised of at least three independent non-executive directors with at least one member having "recent and relevant financial experience".

As far as audit firms are concerned, the major proposals include:

- restrictions on the provision of non-audit services as follows:
  - prohibitions on the provision of "non-audit services" to an audit client if the provision of such services will or may give rise to conflict of interest issues. The competent authority or, in some cases, the audit committee has, however, the limited ability to allow the provision of the "non-audit service", e.g., the provision of due diligence services and of comfort letters; and
  - prohibitions for "large audit firms" (as defined) on the provision of any non-audit services to PIEs, on belonging to a network that provides non-audit services within the EU and strict limits on the ownership rights or voting interest of audit firms in non-audit service firms (and vice versa); and

- detailed requirements with respect to the performance of the statutory audit and the production of a public audit report and a separate report to the audit committee.

The draft amending directive and new regulation will have to be considered by the European Parliament and the Council of Ministers. There is no currently scheduled or expected date by which these proposals will become effective.

A copy of the European Commission's proposed amending directive is available at: http://ec.europa.eu/internal_market/auditing/docs/reform/COM_2011_778_en.pdf.

A copy of the European Commission's proposed new regulation is available at:

http://ec.europa.eu/internal_market/auditing/docs/reform/COM_2011_779_en.pdf.

EC Proposal to Amend Accounting Directives

On 25 October 2011, the European Commission published a new draft directive that will repeal and replace the Fourth Company Law Directive and the Seventh Company Law Directive, together referred to as the Accounting Directives.

The draft directive will outline the form and content of annual and consolidated financial statements. The European Commission hopes to reduce the administrative burden on smaller companies by simplifying the preparation of financial statements for small companies and to improve comparability of financial statements prepared by medium-sized and large companies.

The proposed directive imposes the following key changes:

- harmonise and increase of the size criteria for small, medium-sized and large companies;

- reduce the disclosure requirements for small companies;

- omit the requirement for a statutory audit for small companies;

- exempting small groups from preparing consolidated financial statements; and
- introducing country-by-country reporting for payments made by extractive industries, such as oil, gas and mining, or loggers of primary forests to governments.

Provided the proposal is adopted by the European Parliament and the Council of Ministers, the final version of the new Directive is expected to be implemented by member states into national law by 1 July 2014 at the latest.

The draft directive amending the Accounting Directives is available at: http://ec.europa.eu/internal_market/accounting/docs/sme_accounting/review_directives/20111025-legislative-proposal_en.pdf.

ESMA Consultation on Materiality

On 10 November 2011, ESMA published a consultation paper requesting comments on the understanding of interested parties of various aspects of the concept of materiality in the preparation of financial statements and reporting under International Financial Reporting Standards ("IFRS"). The consultation has been prompted by the apparent differing views among issuers, auditors, investors and even accounting enforcers of the practical application of this concept. Depending on the feedback that ESMA receives, it may consider the need for further regulation in this area. Comments are due by 29 February 2012.

The paper seeks views on a wide range of general and more specific questions, including:

- how materiality is applied in accounts prepared using IFRS;
- whether guidance on the application of the concept of materiality should be published; and
- whether an accounting policy disclosing the materiality judgements exercised by those preparing the financial statements should be included in financial statements.

The consultation paper is available at: http://www.esma.europa.eu/content/Consultation-paper-Considerations-materiality-financial-reporting.

Prospectus Directive: ESMA Final Technical Advice

On 4 October 2011, ESMA delivered its final technical advice to the European Commission on certain delegated acts referred to it by the European Commission in connection with the implementation of amendments to the Prospectus Directive introduced by the amending directive 2010/73/EU. The advice includes ESMA's final position after having considered responses to the consultation paper issued by it in June 2011, on which we reported in our July 2011 Newsletter.

The final advice differs from that set out in the draft advice that ESMA issued in June 2011 in the following ways:

- ESMA no longer prescribes how individual disclosures must be set out in the prospectus summary, provided the disclosure is made within the appropriate table comprised within the required five tables which must make up the summary;
- ESMA has proposed that the length of the summary must not exceed 7 percent of the length of the prospectus or 15 pages, if shorter;
- for the purposes of the "proportionate disclosure" regime that will allow reduced disclosure in prospectuses for rights issues, ESMA has amended its definition of "near identical rights" in relation to issuers that have replaced statutory pre-emption rights with separate pre-emption rights. Issuers with near identical rights will benefit from the proportionate disclosure regime. Open offers without a compensatory element will remain excluded from the "proportionate disclosure" regime; and
- while rejecting calls for further deletions from the mandatory content of the share registration part of the prospectus, ESMA will allow the omission of the Operating and Financial Review where the management report is included. This aims to limit the costs of producing a prospectus for small- and medium-sized enterprises and small cap companies.

The final report is available at: http://www.esma.europa.eu/content/Final-report-ESMAs-technical-advice-possible-delegated-acts-concerning-Prospectus-Directive-.

On 13 December 2011, ESMA published a further consultation paper on its technical advice to the

European Commission on remaining delegated acts under the amended Prospectus Directive. These include the basis on which an issuer may give its consent to the use of its initial prospectus by intermediaries conducting a "retail cascade" offer of the issuer's securities as well as four specific requirements of the Prospectus Regulation. These comprise:

- disclosure in relation to:
  - taxes withheld at source on income receipts from the issuer's securities; and
  - disclosure in relation to indices to which the issuer's securities are linked that are composed by the issuer; and
- the requirements for:
  - a report for profit forecasts and profit estimates; and
  - audited financial information covering the latest three financial years of the issuer.

ESMA aims to provide its technical advice in these areas by 29 February 2012. A copy of its consultation paper is available at: http://www.esma.europa.eu/content/ESMA%E2%80%99s-technical-advice-possible-delegated-acts-concerning-Prospectus-Directive-amended-Dire.

EC Proposals for Amendments to the Transparency Directive

The European Commission began a review of the Transparency Directive in 2009, and on 25 October 2011, it published its proposal to amend the Transparency Directive in a new draft directive (the "Amendment Directive"). The current proposals are the outcome of the review along with extensive consultation of major stakeholders including securities regulators, market participants (issuers, intermediaries and investors) and consumers, and the findings of an external study. The proposal is part of a package of measures to encourage "responsible business" and address several policy objectives, such as the improvement of financial stability by increasing transparency of economic interests in companies and the focus on long-term results, and also making the obligations on smaller and medium-sized enterprises more proportionate.

Removal of the Requirement for the Publication of Quarterly Reports or Interim Management Statements

In an attempt to reduce the administrative burden associated with listing on regulated markets, the proposal removes the requirement for listed companies to publish quarterly reports or interim management statements, as such information is not considered necessary for investor protection. This proposal was originally aimed at helping smaller issuers, but the European Commission decided to remove the requirement completely as opposed to introducing different rules for different types of issuer. The European Commission does, however, highlight that it is still open to companies to publish such reports or statements should investors call for it.

Notification of Interests Regime

The proposal makes it mandatory to aggregate holdings of voting rights with holdings of financial instruments when calculating the thresholds for notification of major holdings. This was not the case under the Transparency Directive which allowed for inconsistencies throughout the EU as member states adopted different approaches in this field.

The proposal also makes changes to the notification of interests provisions and broadens the scope of the rules to require greater disclosure of economic interests and to provide for greater uniformity across member states. The definition of financial instruments relating to shares that are subject to notification is widened to include cash-settled derivatives as well as any future similar financial instruments. This will align the EU rules with the UK's Disclosure and Transparency Rules which already require notification of financial instruments which create a long economic interest in an issuer's shares. It will be open to member states to set lower notification thresholds than those provided in the Amendment Directive, but they will not be permitted to impose more onerous disclosure requirements.

Sanctions

In an attempt to improve the implementation of the provisions of the Amendment Directive, the sanctioning powers of competent authorities will be enhanced, and the Amendment Directive defines certain minimum powers they should have. In addition, the European Commission suggests that sanctions be published and competent authorities in the member states have the power to suspend the exercise of voting rights where the relevant holder has breached the notification rules on major holdings.

Storage of Regulated Information

In order to facilitate cross border access to regulated information, the Amendment Directive confers power on the European Commission to:

- set out minimum standards for dissemination of regulated information;
- arrange access to regulated information at an EU level; and
- develop a central storage mechanism of regulated information.

Other Proposals

Other proposals include:

- a requirement for issuers that are active in the extractive or logging of primary forest industries to prepare annual reports on payments made to governments. This proposal is also addressed in the draft directive which will repeal and replace the Fourth Company Law Directive and the Seventh Company Law Directive, which govern company accounting;
- clarification of the default home member state for issuers that have not chosen their home member state, but are required to do so under the Transparency Directive;
- the removal of the requirement for an issuer proposing to amend its instrument of incorporation or statutes to notify the draft amendment to the competent authority and the regulated market; and
- the abolition of the requirement for disclosure of new loans.

Next Steps

Next steps will involve consideration of the draft amendments by the European Parliament and the Council of Ministers, and the final text of the Amendment Directive will have to be agreed by both parties before it can become effective. Once the Amendment Directive has become effective, it is expected that implementation across member states will be required in 2014.

The Amendment Directive is available at: http://ec.europa.eu/internal_market/securities/docs/transparency/modifying-proposal/20111025-provisional-proposal_en.pdf.

UK DEVELOPMENTS

FRC Announces Changes to Strengthen Boardroom Diversity

On 11 October 2011, the Financial Reporting Council ("FRC") announced that the UK Corporate Governance Code will be amended to require companies to report annually on their boardroom diversity policy, including gender diversity. Companies will also have to report on any objectives the board has set for implementing the policy and the progress it has made in achieving such objectives. The diversity of the board, including gender, will also be a factor when evaluating board effectiveness.

While the changes will apply to financial years on or after 1 October 2012, the FRC encourages all companies to voluntarily comply with these changes with immediate effect.

NAPF Corporate Governance Policy and Voting Guidelines

On 25 November 2011, the National Association of Pension Funds ("NAPF") published the 2011 version of its influential corporate governance policy and voting guidelines (the "Guidelines"). The small number of minor changes in policy outlined below are intended to apply for annual general meetings in 2012.

UK Corporate Governance Principles. A new principle has been added which highlights NAPF's support for the Stewardship Code which sets out important principles for the role of investors in monitoring and improving standards of corporate governance in the UK and encourages pension funds and asset managers to publicly state their support for it.

Gender Diversity. NAPF has updated its guidance to reflect the importance of gender diversity. NAPF highlights the fact that investors now expect boards to set out an explicit policy for achieving a greater degree of gender diversity in the boardroom and to track implementation of that policy.

Board Effectiveness. NAPF expects companies to fully state the skills and experience that a director brings to his/her role, including details of current appointments which might compromise his/her ability to contribute fully to the work of the board. NAPF hopes this will allow shareholders to make a more informed decision on the re-election of the board.

The Guidelines may be found at: http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0201_Corporate_Governance_Policy_Voting_Guidelines_Nov_2011_COMPLETE.ashx.

High Pay Commission Final Report on Executive Pay

On 22 November 2011, the High Pay Commission ("HPC'), which is a non-governmental enquiry, published its final report on top pay in the private sector, concentrating mainly on the pay of executives in listed companies and other publicly quoted companies. The report includes 12 recommendations for reforms to corporate governance and disclosure requirements which are in line with the discussion paper recently published by the Department for Business, Innovation and Skills ("BIS").

The HPC advises that their recommendations be implemented through amendments to the UK Corporate Governance Code, or otherwise through voluntary adoption by companies and shareholders, with legislative enforcement only if necessary.

The HPC's recommendations are as follows:

- radical simplification of executive pay, to comprise basic salary and "one additional performance-related element where absolutely necessary";
- disclosure of the top ten pay packages earned by executives below board level;
- presentation of directors' remuneration reports in a standard format, including a single total remuneration figure for each executive, disclosing also the method of calculation;
- full disclosure of all voting decisions in respect of listed company shares made by institutional investors and fund managers, including on resolutions relating to directors' remuneration;
- inclusion of employee representatives on remuneration committees. The HPC adds that there are concerns that this will alter the UK's unitary board system, but it considers the unitary board system ineffective at holding executive directors to account in the long-term interests of the company over issues of pay;
- publication of annual statements setting out the distribution of a company's income over three years, disclosing the year-on-year percentage changes to items including total expenditure on executive pay and benefits, staff costs, dividends, reinvestment and tax. The HPC proposes that further research be undertaken to consider the extent to which the distribution statement could be subject to a shareholder vote;
- reform of the shareholder vote on executive pay, i.e., the annual advisory vote on the directors' remuneration report, presumably alongside a reform of the directors' remuneration report requirements;
  - the HPC suggests this vote be non-binding and forward-looking in respect of pay over the next three years. At present, the report must set out details of actual directors' remuneration in the last financial year, although the report must also contain some forward looking information, e.g., about directors' remuneration policy and long-term incentive awards that have not yet vested);
- improvement of companies' internal succession planning and talent development. The HPC considers that outside executive recruitment escalates pay;
- open advertisement of vacancies for non-executive directors, and adoption of other measures to encourage greater diversity amongst non-executives;
- reduction of conflicts of interest involving remuneration consultants, initially by requiring disclosure of all services provided to the company by firms of remuneration consultants who advise the remuneration committee;
- publication by listed companies of "fair pay reports" setting out the ratio of highest to median pay within the company and changes in this ratio over three years; and

- establishment of a permanent national body to monitor, comment and report on high pay. Part of this body's remit would be to ensure that company legislation delivers transparency, accountability and fairness in pay at the top of British companies.

The HPC report can be found at: http://highpaycommission.co.uk/wp-content/uploads/2011/11/HPC_final_report_WEB.pdf.

Preliminary Report of Sharman Inquiry

In March 2011, the FRC appointed Lord Sharman to lead an inquiry to identify lessons for companies and auditors addressing going concern and liquidity risks. The aim of the inquiry is to address concerns about the quality of information that companies provide about their financial health. The Panel conducting the inquiry published a report summarising responses to their call for evidence published in May 2011, together with their recommendations.

The Panel recommends that the FRC should:

- establish some protocols with BIS and other regulatory authorities to set out the scope of its functions when significant companies fail;
- harmonise the common purpose of the going concern assessment and disclosure process within the UK Corporate Governance Code and related guidance, in particular whether the requirement to report if the company is a going concern is too definitive;
- amend their 2009 guidance for directors on going concern reporting so that the going concern assessment extends beyond short-term liquidity risks to cover solvency risks that could threaten a company's survival over the business cycle or cause significant damage to the community and environment, bearing in mind the directors' responsibility under the Companies Act 2006; and
- incorporate going concern reporting into the company's discussion on strategy and principal risks as well as the audit committee's report.

The Panel further recommends that the Auditing Practices Board amend UK auditing standards to require a statement in the auditor's report that the auditor is satisfied it has nothing to add to the directors' disclosure about the robustness of the going concern assessment process and its outcome.

The Panel asked for comments by 31 December 2011 and intends to publish a final version of its recommendations in February 2012.

The report is available at: http://www.frc.org.uk/images/uploaded/documents/The%20Sharman%20Report%20-%20final%20031111.pdf.

Consultation on Future Role of the FRC

On 18 October 2011, BIS and FRC published a consultation paper requesting comments as to the future role of the FRC.

The paper seeks views on:

- narrowing the scope of the FRC's regulatory activities to concentrate only on publicly-traded and the largest private companies, and narrowing the scope of the FRC's accountancy disciplinary arrangements to deal with the quality of work and conduct of accountants in preparing and auditing reports for capital markets, thus allowing professional bodies to deal with other cases of potential misconduct;
- allowing the FRC to establish a Recognised Supervisory Body to impose sanctions on an audit firm and/or individual auditors if they prepare poor quality work, and to prepare its own rules for disciplinary actions in relation to accountants, without needing the agreement of accountancy professional bodies; and
- setting up two board committees to replace the FRC's seven operating bodies. One body will concentrate on codes and standards and the other on conduct.

The consultation paper requested responses by 10 January 2012 and changes are expected in April 2012.

The consultation paper is available at: http://www.frc.org.uk/images/uploaded/documents/FRC%20reforms%20condoc.pdf.

BVCA Guide to Responsible Investment

On 17 October 2011, the BVCA published an updated version of its guide to responsible investment for private equity and venture capital firms. The guidance is broadly the same as that published in June 2010, apart from a few minor changes and the inclusion of a new supplement. The supplement intends to address in more detail the evaluation of environmental, social and governance issues at the pre-investment stage.

The BCVA recommends that during the pre-investment stage, firms establish a responsible investment policy, with separate environment, social and governance (ESG) sections; and draw up a 3-step process of top-level screening, business profiling and due diligence to evaluate ESG issues. The BVCA notes that over time it intends to add guidelines for the remaining periods of the private equity investment cycle (i.e., immediately post-investment, post-investment and exit).

The guidance is available at: http://admin.bvca.co.uk/library/documents/FINAL-_Guide_to_RI_v2.pdf.

UK Market Abuse Sunset Clauses Extended

The UK market abuse regime has long had provisions (so-called "super-equivalent" provisions) that exceed the requirements of the EU market abuse regime, a practice also known as "gold plating". In December 2010, the UK government announced that it would end the practice of "gold-plating" future EU Directives. The super-equivalent provisions under the UK market abuse regime are subject to sunset clauses, which were due to expire on 31 December 2011. On 8 December 2011, the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2011 (SI 2011/2928) were published. The regulations came into force on 31 December 2011 and extend the sunset clauses until 31 December 2014 to reflect the existing policy of aligning any changes with the outcome of the MAD review discussed above.

FSA publishes Financial Crime Guide

Following a consultation last year, the Financial Services Authority ("FSA") has recently published a financial crime guide which now forms part of the FSA Handbook. The FSA is currently the main regulator for firms operating in the financial sector in the UK. Firms regulated by the FSA are required to have in place effective systems and controls to monitor and manage legal risks, which includes the mitigation of legal risks relating to financial crime. The FSA's financial crime guide outlines steps that regulated firms can take to reduce their financial crime risk, and provides practice indications for firms on anti-bribery systems and controls. The FSA guidance will be used by the FSA in assessing and enforcing any systems and controls breaches by regulated firms.

The guide is available at: http://fsahandbook.info/FSA/html/handbook/FC/link/PDF.

British Bankers' Association Guidance on the Bribery Act

In December 2011, the British Bankers' Association ("BBA") published a detailed guide for financial institutions on steps that the banking sector can take to comply with the Bribery Act 2010. The BBA has also indicated that in 2012 it will undertake separate work in relation to wider bribery and corruption risks.

Of particular note are the "red flags" sections of the BBA guidance. These set out a number of red flags which may indicate corruption, and suggest the appropriate response where a red flag is identified. In the context of undertaking due diligence on an associated person, the BBA notes that "[w]here a red flag is identified it should be documented and there should be a clear audit trail detailing any further investigation undertaken, how any issues have been resolved and the decision of whether to proceed." Examples of red flags in this area set out by the BBA include: "the associated person insists on operating in anonymity"; "there are persons involved in the transaction who have no substantive commercial role"; and "the associated person does not reside or have a significant business presence in the country where the customer or project is located". Examples of red flags given in the context of the sixth principle (monitoring and review) in the Ministry of Justice guidance on the Bribery Act are: "excessive or disproportionate gifts and hospitality, offered, received and declined"; "relocation of third party/supplier/contractor/agents to countries with higher bribery risk"; and "large/frequent fourth-quarter adjustments to contractual payments by associated persons".

The Bribery Act's treatment of gifts, corporate hospitality and promotional expenditure are issues of concern to many companies and the BBA guidance deals specifically with these topics. For example, its guidance states, "The best protection for banks, to ensure they do not infringe the Bribery Act, is to have in place clear written policies detailing the principles for giving and or receiving gifts, entertainment and hospitality."

The guide is available at: http://www.bba.org.uk/media/article/bribery-act-2010-guidance-on-compliance.

DEVELOPMENTS SPECIFIC TO FINANCIAL INSTITUTIONS

US Developments

The Final 'Living Wills' Requirements for Large Financial Institutions

A major step in the prevention of future financial bailouts has been taken by Federal bank supervisors with the adoption of final joint regulations requiring a resolution plan (or "living will") for the largest financial institutions active in the United States. Preparation of these plans will constitute a major undertaking for the institutions with consequences that will evolve over time. The Federal Deposit Insurance Corporation (the "FDIC") and the Board of Governors of the Federal Reserve System (the "Federal Reserve") approved final resolution-plan regulations for the largest financial groups operating in the US on 13 September and 17 October 2011, respectively. The FDIC also approved a final interim regulation requiring plans of FDIC-insured institutions with US$50 billion or more in total assets. The joint rule approved by the FDIC and the Federal Reserve implements the resolution-plan requirements of Section 165(d) of the Reform Act. This rule (the "DFA Rule") requires the largest US bank holding companies and non-US headquartered institutions that conduct US banking operations, and any financial companies designated as systemically important by the new US systemic risk council (the Financial Stability Oversight Council ("FSOC")), to prepare and periodically revise a plan that would facilitate its resolution in the event of material financial distress or failure. The DFA Rule sets out an extensive list of minimum information requirements for a satisfactory resolution plan. The rule approved by the FDIC is an interim final rule (the "IDI Rule") requiring a US insured depository institution ("IDI") with US$50 billion or more in total assets (a "Covered IDI") to submit periodic contingency plans to the FDIC for resolution in the event of the institution's failure. The IDI Rule became effective on 1 January 2012, but, as an interim rule, it remains subject to public comment and further modification. Although the IDI Rule was originally proposed in May 2010, the FDIC delayed its issuance in anticipation of the resolution-plan requirement of the Reform Act. In delaying the issuance of the IDI Rule, the FDIC sought to make it complementary with the DFA Rule, to avoid imposing burdens on the covered institutions.

The DFA and IDI Rules form core elements of the regulatory reforms designed in the Reform Act to identify and mitigate systemic risks and to contribute to the end of so-called "too big to fail" status. The requirements are intended both to assist the FDIC in conducting advanced resolution planning for covered institutions facing financial distress and also "to facilitate improved efficiencies and risk management practices amongst systemically important financial institutions as they produce and evaluate these plans". However, the two Rules, while complementary, have some fundamental differences. The DFA Rule requires a plan for a rapid and orderly resolution – liquidation or orderly restructuring – under the Bankruptcy Code and other insolvency statutes applicable to particular types of regulated entities (such as securities broker-dealers), while the IDI Rule requires a plan for resolution under the Federal Deposit Insurance Act ("FDIA") with the FDIC acting as receiver. Although the Bankruptcy Code and FDIA share some similarities, the differences between the two statutes are significant. The DFA Rule and IDI Rule also have fundamentally different purposes. The DFA Rule focuses on minimising systemic risk in the resolution of a failed institution in order to protect the stability of the US financial system while maximising recovery for creditors. Thus, the driving concept is that steps should be taken to prevent the discontinuance of critical operations of a systemically significant institution, or mitigate its fallout, through a restructuring, and the DFA Rule plan is intended to outline those steps, including any impediments to taking them and efforts needed to avoid them. The IDI Rule, on the other hand, focuses on ensuring that depositors receive prompt access to insured deposits upon the failure of a Covered IDI, minimising costs to the FDIC and creditors, and maximising recovery value for creditors. The note provides the background of the new regulations, the requirements that the regulations impose, tips for compliance, and possible difficulties to be faced as the process unfolds.

Our related client publication is available at: http://www.shearman.com/preparing-for-the-big-whatifs-of-corporate-life-10-21-2011/.

EU Developments

ESMA Final Report on Guidelines for Highly Automated Trading

On 22 December 2011, ESMA published its final report on guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities. The report contains feedback to the July 2011 consultation by ESMA.

The guidelines cover:

- the operation of an electronic trading system by a regulated market or a multilateral trading facility;
- the use of an electronic trading system, including a trading algorithm, by an investment firm for dealing on own account or for the execution of orders on behalf of clients; and
- the provision of direct market access or sponsored access by an investment firm as part of the service of the execution of orders on behalf of clients.

The guidelines will also have implications for firms not authorised as market operators or investment firms under MiFID. These include firms that sell electronic trading systems to market operators or investment firms, or act as the outsourced providers of such systems, or provide connectivity services to investment firms when accessing trading platforms.

The guidelines will also affect firms exempt from MiFID that trade on own account and access trading platforms directly as members, participants or users, or through direct market access or sponsored access.

The guidelines will become effective one month after the publication by national competent authorities of the guidelines and recommendations on their official website. Unless there is a notification to the contrary, the guidelines will be in force from 1 May 2012. However, this date has not been finalised, and is subject to change.

The final report is available at: http://www.esma.europa.eu/content/Final-report-Guidelines-systems-and-controls-automated-trading-environment-trading-platforms.

UK Developments

FSA Policy Statement on Implementation of CRD III

The FSA has published its policy statement and final rules on the implementation of CRD III. CRD III is a directive forming part of a sequence of major amendments to the Capital Requirements Directives (2006/48/EC and 2006/49/EC). CRD III made significant changes to the remuneration structures and capital requirements of credit institutions and investment firms, requiring extensive amendments to FSA's remuneration code. Most of the rules, particularly the remuneration requirements, were implemented by 1 January 2011.

The policy statement covers the following issues:

- certain aspects of the CRD III trading book requirements;
- CRD III requirements relating to securitisation in the non-trading book;
- guidelines published by the Committee of European Banking Supervisors, which has now been superseded by the European Banking Authority, in December 2010 on Article 122a of Directive 2006/48/EC. Article 122a imposes due diligence requirements on credit institutions that have credit exposure to securitisations, including a "risk retention" requirement for the securitisation sponsor, the so-called "skin in the game" provisions;
- Pillar 3 disclosure requirements; and
- prudent valuation.

The rules and guidance in this policy statement came into force on 31 December 2011, and the changes to firms' reporting took effect for reporting periods ending on or after that date.

The policy statement is available at: http://www.fsa.gov.uk/pubs/policy/ps11_12.pdf.

HM Treasury Launches Consultation to Improve Bank Bonus Transparency

The UK's HM Treasury published a consultation paper on proposed regulations to require the disclosure of remuneration by the eight highest-paid non-board executives with responsibility for managing risk at the largest banks operating within the UK. The disclosures will not include executives on the main board of a UK bank, as details of those remuneration arrangements must already be disclosed under the FSA's Remuneration Code, the Disclosure and Listing Rules and the Companies Act 2006. Under Project Merlin, the four major UK banks made a commitment in 2011 to publish the pay of the five highest paid non-board executives.

It is intended that the improved transparency for senior executives who manage risk will help provide shareholders with more tools to hold senior management to account.

Responses to the consultation are due by 14 February 2012.

The consultation paper is available at: http://www.hm-treasury.gov.uk/consult_merlin_remuneration_disclosure.htm.

UK Government Responds to the Vickers Report

On 19 December 2011, the UK government published its formal response to the report of the Independent Commission on Banking (the "ICB"), chaired by Sir John Vickers and published on 12 September 2011 (the "Vickers Report"). The UK government indicates it will implement most of the ICB's recommendations including ring-fencing UK banks' retail banking operations, higher capital requirements for UK retail banks, preferential status for insured deposits in a bank insolvency and measures to increase competition in the UK banking sector.

One of the most controversial of the ICB's proposals is to require UK retail banks to ring-fence their retail business. The UK government accepts this proposal but minor differences with the ICB are evident. For example, the UK government proposes to open the *de minimis* exception for further review despite this exception having been rejected by the ICB as well as stating that the limits on intra-group exposures to the ring-fenced bank recommended by the ICB would be reviewed.

The UK government also broadly accepts the ICB's recommendations relating to loss absorbency. However, an important concession has been made to UK-based globally systemically important banks. The ICB proposed that such banks would need to have primary loss absorbing capital equal to at least 17 percent across their global operations. However, the UK government has stated that as long as such a bank can show that any non-UK operations do not pose a risk to UK financial stability, the requirement will not apply to its non-UK operations. Such a bank could evidence this through producing a robust, credible plan for the resolution of foreign operations separately from the resolution of UK operations.

The UK government states it will publish a white paper in spring 2012 setting out how it will implement the ICB's recommendations. Following a three-month consultation, the UK government will introduce primary legislation into Parliament and aims to ensure that all the necessary legislation is enacted by May 2015. Banks will be expected to comply with the new legislation relating to ring-fencing as soon as practically possible thereafter. Non-structural changes relating to loss absorbency will be implemented in stages and are currently expected to be fully completed by the beginning of 2019.

Financial Regulation Reform: FPC Toolkit Discussion

The UK government is proposing to reform the financial services supervisory framework having published a white paper and draft bill in June 2011, on which we reported in our July 2011 Newsletter. The reforms envisage the establishment of three new regulatory institutions, including the Financial Policy Committee (the "FPC"). The FPC will monitor the stability of the UK financial system and use its powers to deal with any risks arising. The FPC will be a new committee within the Bank of England. An interim FPC was established in February 2011. The UK government has since asked the interim FPC to consider the macro-prudential toolkit that the committee will need to meet its statutory obligations. On 20 December 2011, the interim FPC published a discussion paper on the instruments that it considers should be included in its macro-prudential toolkit. The tools include:

- balance sheet tools such as countercyclical capital buffers, sectoral capital requirements, maximum leverage ratios and restrictions on distributions;
- tools that influence terms and conditions on new lending including loan to value and loan to income restrictions and margin requirements for secured financing and derivatives transactions; and

- market structure tools such as mandating the use of central counterparties, mandating trading on an organised trading venue and enhanced disclosure on exposure to specific risks.

Comments on the discussion paper are requested by 10 February 2012. The FPC will then assess different tools and report to HM Treasury on its recommendations for the permanent FPC toolkit.

The discussion paper is available at: http://www.bankofengland.co.uk/publications/other/financialstability/discussionpaper111220.pdf.

International Developments

The Financial Stability Board ("FSB") has agreed the policy measures for global systemically important financial institutions ("G-SIFIs"), following requests from G20 leaders for the establishment of a policy framework to address the systemic and moral hazard risks associated with systemically important financial institutions ("SIFI"").

The policy measures comprise:

- a new international standard setting out the responsibilities, instruments and powers that all national resolution regimes should have to enable authorities to resolve failing financial firms in an orderly manner and without exposing the taxpayer to the risk of loss;
- requirements for resolvability assessments and for recovery and resolution planning for G-SIFIs, and for the development of institution-specific cross-border cooperation agreements so that home and host authorities of G-SIFIs are better prepared for dealing with crises and have clarity on how to cooperate in a crisis;
- requirements for banks determined to be globally systemically important to have additional loss absorption capacity tailored to the impact of their default, rising from 1 percent to 2.5 percent of risk-weighted assets (with an empty bucket of 3.5 percent to discourage further systemicness), to be met with common equity; and
- more intensive and effective supervision of all SIFIs, including through stronger supervisory mandates, resources and powers, and higher supervisory expectations for risk management functions, data aggregation capabilities, risk governance and internal controls.

An initial group of 29 G-SIFI's that will need to meet the resolution planning requirements by the end of 2012 has been identified. A further set of firms, to which the additional loss absorbency measures will apply, will be identified in November 2014. The loss absorbency requirements will be phased in, starting in January 2016, with full implementation by January 2019.

The FSB documents are available at: http://www.financialstabilityboard.org/list/fsb_publications/tid_72/index.htm

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

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