SHEARMAN & STERLING LLP

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A QUARTERLY NEWSLETTER FOR CORPORATES AND FINANCIAL INSTITUTIONS

In this issue:

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

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

EU DEVELOPMENTS

Proposed Directive to Improve Gender Balance on Boards

On 14 November 2012, the Commission adopted a proposal for a directive aimed at improving the gender balance of non-executive directors of listed companies by setting an objective of 40% of the under-represented gender on the board. Affected companies with a lower proportion than the objective would be required to make non-executive director appointments through a prescribed selection process whereby priority is given to the candidate of the under-represented sex if that candidate is as equally qualified as a candidate of the other sex in terms of suitability, competence and professional performance, unless on an objective assessment the balance is tilted towards a candidate of the other sex. If the company fails to meet this objective by 2020 (2018 for state-owned companies), it must provide an explanation and may be subject to sanctions imposed by the relevant Member State.

The following companies would be excluded from the proposed directive: SMEs (i.e., companies employing less than 250 persons and having an annual turnover not exceeding €50 million or an annual balance sheet total not exceeding €43 million (or the non Euro equivalent)), non listed companies and, if Member States so provide, listed companies where the members of the under-represented sex represent less than 10% of the workforce.

Rejected applicants would have the right to request details of the selection criteria, the objective comparative assessment of those criteria, and the reasons why a candidate of the other sex was selected instead. If the unsuccessful candidate established facts from which it may be presumed that they were as equally qualified as the successful applicant, the burden of proof would shift to the company to show there had been no breach.

In respect of executive directors, companies will need to set their own target to be met by 2020 (2018 for state-owned companies) regarding the representation of genders and must report annually on progress made. Member States may also provide that even if the 40% objective in respect of non-executive directors is not met, the relevant company can satisfy the objective if instead at least one-third of all (i.e., executive and non-executive) directors are from the under-represented sex.

Member States will have to lay down sanctions for infringements of the "gender balance" rules that the directive will require them to introduce and these will have to be effective, proportionate and dissuasive. The proposed directive states that these can include administrative fines or the appointment of the non-executive director being declared void by a court.

This proposed directive comes after the Commission was forced to abandon an earlier proposal which would have set a mandatory 40% quota of board seats to be allocated to women by 2020 due to resistance from some Member States and concerns of the Legal Service of the Commission as to the legality of such a measure. The Commission's proposal will require approval from the European Council and the European Parliament before it comes into force.

The proposed directive can be viewed at: http://ec.europa.eu/justice/gender-equality/files/womenonboards/directive_quotas_en.pdf.

Adoption of Action Plan on Company Law and Corporate Governance

In response to a non-legislative resolution passed by the European Parliament on 14 June 2012 urging the Commission to publish an action plan following a 2012 consultation on the future of European company law and various earlier studies, the European Commission has adopted an Action Plan outlining future initiatives in modernising EU rules on company law and corporate governance.

The Action Plan is aimed broadly at increasing corporate transparency levels, encouraging and facilitating long-term shareholder engagement, and supporting the growth and competitiveness of European businesses. All of the initiatives will be subject to ex-ante impact assessments and further consultation on specific legislative proposals, likely to take place during the course of 2013 (or, in one case, 2014).

The main initiatives included in the Action Plan are:

- Greater disclosure of board diversity policy and of risk management arrangements (particularly with respect to non-financial risks);
- Improving the visibility of shareholdings in listed companies in Europe;
- Improving the quality of corporate governance reports and in particular the quality of explanations of non-compliance with corporate governance code provisions;
- Disclosure by institutional investors of voting and engagement policies and voting records;
- Improving transparency on remuneration policies and individual remuneration of directors, and granting shareholders the right to vote on remuneration policy and the remuneration report;

- Improving shareholder control over related party transactions;
- Improving the transparency and the conflict of interest frameworks applicable to proxy advisors;
- Close cooperation with competent national authorities and the European Securities and Markets Authority with a view to developing guidance to increase legal certainty as regards the relationship between investor cooperation on corporate governance issues and the rules on acting in concert, and therefore making shareholder cooperation easier;
- Encouraging, and identifying obstacles to, employee share ownership;
- Follow-up on the European Private Company proposal with a view to enhancing cross-border opportunities for SMEs;
- Consultation on the rules regarding cross-border transfers of a registered office;
- Revision of the rules on cross-border mergers and divisions;
- Raising the awareness of the European Company Statute (including employees' involvement) and, possibly, of the European Cooperative Statute;
- Codification of major company law directives, including the recently recast Second Company Law Directive (2012/30/EU) which aims to ensure minimum equivalent protection for both shareholders and creditors of public limited liability companies through the coordination of national provisions relating to their formation and the maintenance, increase or reduction of their capital, into a single instrument; and
- Improving the information available on corporate groups and recognition in European company law of the concept of "group interest" in relation to parent companies and their subsidiaries (an initiative is planned in 2014).

The above initiatives could possibly be modified when specific legislative proposals are prepared for consultation. Furthermore, the Commission is continuing to consider other possible initiatives.

A provisional version of the Action Plan can be viewed at: http://ec.europa.eu/internal_market/company/docs/modern/121212_company-law-corporate-governance-action-plan_en.pdf.

European Securities and Markets Authority ("ESMA") Publishes New Version of its Prospectuses: Questions and Answers

On 20 December 2012, ESMA published version 18 of its Prospectuses: Questions and Answers, which includes changes such as:

- amending question 5 (Share option schemes), clarifying that where in the view of national competent authorities transactions are structured as options, but are in reality an offer of shares, such authorities reserve the right to re-qualify the options as an offer of shares in order to overcome any circumvention of the Prospectus Directive;
- amending question 49 (Use of the term "prospectus"), clarifying that where no prospectus is required under the Prospectus Directive, any advertisement shall include a warning to that effect unless a prospectus which complies with the Prospectus Directive and Prospectus Regulation is produced; and
- various "tidy-ups" such as updating references to reflect the entry into force of the amended Prospectus Directive and the Commission Delegated Regulations 486/2012 and 862/2012, and the deletion of certain questions (such as questions 26(a) and 30(a)) which have been clarified or superseded by new legislation.

The new version of the ESMA Prospectuses: Questions and Answers can be viewed at: http://www.esma.europa.eu/system/files/2012-855.pdf.

GERMAN DEVELOPMENTS

Act Extends German Special Financial Market Stabilization Funds

On 21 November 2012, the German Parliament (*Bundestag*) adopted a bill to extend by two years the SoFFin (Special Financial Market Stabilization Funds - *Sonderfonds Finanzmarktstabilisierung*), a facility for troubled German banks to seek government aid. The SoFFin, a program of the German government, was created in 2008 with the intent of stabilising and restoring confidence in the financial system. As of 31 December 2010, it stopped offering new services but continued managing existing guarantees. In November 2011, the SoFFin was revived for potential new issues if necessary.

According to the new act, the Third Financial Market Stabilization Act (3rd FMSA), which was promulgated on 27 December 2012, banks will be able to seek assistance from Germany's SoFFin fund until the end of 2014. Under current legislation, the fund would have ceased accepting applications at the end of 2012.

The 3rd FMSA is available at: http://dipbt.bundestag.de/dip21/btd/17/115/1711586.pdf.

Update on Short Selling

On 2 November 2012, accompanying the enactment of the European Short Selling Regulation, the German legislator (*Bundestag and Bundesrat*) passed the German Implementation Act for the European Short Selling Regulation. Despite not being an "implementation act" in the technical sense, the act aims at making adjustments to German national law triggered by European harmonisation.

The changes are primarily directed at:

- stipulating the necessary competences of national authorities that will execute functions under the Short Selling Regulation;
- extending rules on penalties that might be imposed by German authorities in case of infringements of requirements under the Short Selling Regulation; and
- revoking German national law deemed outdated due to the enactment of the European Short Selling Regulation, in particular provisions of the WpHG (German Securities Trading Act - *Wertpapierhandelsgesetz*) and the BörsG (German Stock Exchange Act - *Börsengesetz*).

The European Short Selling Regulation has been in force since 25 March 2012 and became "directly" effective in the EU Member States on 1 November 2012. As such, the Regulation became law in each Member State in its own right without the need for domestic implementing measures.

The German Implementation Act for the European Short Selling Regulation is available at: http://dipbt.bundestag.de/dip21/btd/17/108/1710854.pdf.

For additional information, you may refer to our discussion on the European Short Selling Regulation included in the July edition of our newsletter at:

http://www.shearman.com/governance--securities-law-focus-europe-edition-july-2012-07-26-2012/.

German EMIR Implementation Act

On 13 December 2012, the German Parliament adopted the German Implementation Act for the European Infrastructure Regulation ("EMIR") (*EMIR-Ausführungsgesetz*).

Once in force, EMIR will introduce several changes to the over-the-counter ("OTC") derivatives market, in particular by mandating central clearing for standardised contracts and imposing risk mitigation standards for non-centrally cleared contracts. Under EMIR, the clearing requirement will apply to both financial counterparties and non-financial counterparties who exceed specific thresholds and will apply generally to OTC derivative contracts, including interest rate, credit, equity, foreign exchange and commodity derivatives. In addition, EMIR stipulates broad reporting requirements, continuous supervision of central counterparties and enhanced co-operation of supervisory authorities.

The German EMIR Implementation Act provides for transposition of EMIR into German law by, e.g.:

- rules on penalties that might be imposed by German authorities in case of infringements of EMIR requirements; and
- additional provisions to provide for adequate national supervision in accordance with EMIR.

One major point of discussion during the consultation process preceding the adoption of the law was the stipulation of an obligation of a central counterparty to compensate losses of the creditors of an insolvent clearing-member in derivative transactions in insolvency proceedings under German law. Due to the fact that EMIR did not require national implementation law to provide for such a provision, the compensation rule included in the draft act was ultimately taken out in the legislative process of the EMIR Implementation Act.

The German EMIR Implementation Act is available at:

http://dipbt.bundestag.de/dip21/btp/17/17214.pdf#P.26276 and
http://dipbt.bundestag.de/dip21/btd/17/112/1711289.pdf.

German Federal Government Publishes Draft CRD IV Implementation Act

On 15 October 2012, the German Government (*Bundesregierung*) introduced a draft Act to implement CRD IV into German law. The CRD IV package, which aims at improving the risk management of banks and increasing transparency through expanded disclosures, includes a draft EU Directive on the Licensing of Credit Institutions and Supervision of Credit Institutions and Investment Firms and a draft EU Regulation on Prudential Requirements for Credit Institutions and Investment Firms. The Act was originally supposed to go into effect at the same time as the CRD IV package on 1 January 2013.

The Draft CRD IV Implementation Act is available at:

http://dipbt.bundestag.de/dip21/btd/17/109/1710974.pdf.

Reform of Law on Foreign Trade and Payments

In October 2012, the German Government introduced a draft act to reform the German Foreign Trade and Payments Act ("FTPA" - *Außenwirtschaftsgesetz*).

The reform aims at retaining the basic structures of the German Foreign Trade and Payments Law and avoiding substantive changes whilst streamlining the rules and making them easier to apply by market participants.

The draft act provides for certain provisions of the FTPA to be revoked.

Subject to revocation are specific rules relating to the export of dual-use goods that stipulate licensing requirements. Due to the enactment of the EU Dual Use Regulation, which provides for uniform and comprehensive rules on export controls for dual-use goods, specific German rules are no longer deemed required.

However, pursuant to the draft act, the strict provisions on export controls for military equipment will remain unchanged. Furthermore, the relevant rules, and in particular the political principles for the export of weapons of war and other military equipment, will remain unchanged.

Substantive changes are planned regarding provisions on fines and imprisonment for violations of provisions of the FTPA:

- The criminal provisions contained in the FTPA will be redrafted with particular emphasis put on the use of a clear and defined legal wording to avoid uncertainty deriving from the use of vague legal terms.
- Penalties in the form of fines and imprisonment will be linked more strictly to the degree of fault.
- Certain deliberate violations of central provisions of the foreign trade and payments law will no longer be punished as an administrative offence, but as a crime.
- The deliberate unauthorised export of military equipment will remain a criminal offence.
- Violations of arms embargoes, i.e. all forms of exports to embargoed countries or the facilitation of such exports, will be punished as a crime.
- Violations of arms embargoes by way of negligence will remain a criminal offence.

The draft act on the reform of Foreign Trade and Payments Law will have to go through the legislative process before its enactment and may be subject to further changes before its final adoption by German Parliament.

The draft Act on the reform of the Foreign Trade and Payments Law is available at:

http://www.bundestag.de/bundestag/ausschuesse17/a09/anhoerungen/18_Oeffentliche_Anhoerung/Gesetzentwurf/1711127.pdf.

Update on German Implementing Act for AIFMD

On 12 December 2012, the German Government adopted a draft act to implement the EU Directive on Alternative Investment Fund Managers (EU Directive 2011/61) ("AIFMD") into German law. The adoption by the German Government of the draft act is the next step to create uniform regulations for Alternative Investment Funds. The draft act was originally published by the German Ministry of Finance in July 2012.

The draft act establishes a combined set of rules for investment funds in the form of a Capital Investment Act, which will comprise the future German legal framework for all investment funds.

The draft German Implementing Act for AIFMD is available at:

http://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetzentwuerfe_Arbeitsfassungen/2012-12-12-aifml-Gesetzentwurf.pdf?__blob=publicationFile&v=2.

For additional information on the draft act, you may refer to our report on the draft bill included in the October edition of our newsletter at:

http://www.shearman.com/governance--securities-law-focus-europe-edition-october-2011-10-14-2011/.

Update of Requirements for Risk Management for Banks and Financial Services Institutions (MaRisk)

On 15 December 2012, BaFin, the German financial services regulator, published the 4th revised version of its circular on Minimum Requirements for Risk Management for banks and financial services institutions ("MaRisk"). As in the first three versions (2005, 2007 and 2009), BaFin prepared the revised version of the MaRisk in conjunction with the German central bank (*Deutsche Bundesbank*) and in close co-operation with the financial industry.

Introduced pursuant to section 25a of the German Banking Act (*Kreditwesengesetz – KWG*), MaRisk sets forth BaFin's positions on the interpretation of specific provisions affecting risk management and provides a principles-based framework to give institutions discretion for individual implementation solutions.

The recent update primarily focuses on aspects of (i) the capital planning process, (ii) the risk controlling function, (iii) the compliance function and (iv) the internal netting system for liquidity costs, benefits and risks.

The revised MaRisk is available at:

http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Rundschreiben/rs_1210_marisk_ba.html?nn=2819248.

BaFin Asks 36 Banks to Provide "Living Wills"

In December 2012, BaFin confirmed it has selected up to 36 banking institutions that it says will need to provide so-called "living wills", or recovery and resolution plans for an orderly winding-down should circumstances require it. All 36 banks deemed relevant to the country's financial system must provide living wills by the end of 2013, but some could be required to provide information sooner. BaFin will not disclose the list of these banks to the public.

In addition, the German Government announced it plans to introduce an act on restructuring and recovery measures of German financial institutions, which will require large banks that are deemed to be market-systemically relevant for the German financial market to come up with recovery and restructuring plans.

To provide institutions with initial guidelines on the development of recovery plans, BaFin published a draft circular on Minimum Requirements for Restructuring Planning ("MaSan") for consultation purposes.

BaFin's recent initiatives in the field of restructuring planning for financial institutions should be viewed in the context of the current international developments in restructuring planning.

The BaFin circular on draft MaSan is available at:

http://www.bafin.de/SharedDocs/Downloads/DE/Konsultation/2012/dl_kon_1212_EntwurfMaSan_ba.pdf;jsessionid=463C97A6D572823457DE5DF8D52B3F9B.1_cid226?__blob=publicationFile&v=4.

ITALIAN DEVELOPMENTS

Changes in the Regulation of Placement of Financial Instruments to Employees

Italian legislative decree No. 184 of 11 October 2012 (the "Legislative Decree") has amended the previous regime on Italian placement of financial instruments to employees by introducing certain changes to Article 30 of the Legislative Decree No. 58 dated 24 February 1998 (the "Italian Securities Act").

The previous regime provided that any offering of financial instruments by companies with a registered office in an EU Member State other than Italy to employees of their Italian subsidiaries (or affiliates) was considered as "door-to-door selling". Accordingly, certain activities constituting "investment services" or "supplementary services to investment services", such as the promotion and placement of financial instruments in a place different than the registered seat or the premises of the issuer could be provided only by registered financial intermediaries or banks. In compliance with such provisions, the presence of an officer (a so-called "promotore finanziario") of an authorised bank was necessary during any presentation, as well as for the placement, of the offering to the employees taking place outside the premises of the issuer (i.e., any presentation taking place in the premises of Italian subsidiaries of a European issuer).

The new regime introduced by the Legislative Decree, which entered into force in mid-November 2012, expressly provides that an offer of financial instruments addressed to the members of the board of directors or of the supervisory board, to employees and to short-term employees of the issuer, its controlling company or its subsidiaries, if made in their respective offices or branches, is not considered as door-to-door selling. As a consequence for such offers the (onerous) intervention of the financial intermediaries and of their financial promoters will no longer be necessary.

Offers to employees were already exempted in Italy from the obligations to publish a prospectus pursuant to Article 100 of the Italian Securities Act and Article 34-ter, letter m) of CONSOB's Regulation on Issuers. The issuers will now also be able to carry out any such offer without the presence or intervention of the financial intermediary, likely by simply delivering all relevant information and documents to the employees and by having them execute the subscription form (although no specific guidance has yet been issued by CONSOB).

UK DEVELOPMENTS

ICSA Stewardship Consultation Launched

Following expressions of concern by company chairmen during dialogues organised by the Investor Stewardship Working Party in 2012 regarding shortcomings in investor engagement, and the subsequent publication of a report on improving the quality of investor stewardship by the Working Party, the Institute of Chartered Secretaries and Administrators ("ICSA") was asked by the Working Party to produce a good practice guide regarding shareholder engagement and to identify ways for companies and investors to seek and provide feedback on meetings. On 12 October 2012, ICSA published a consultation paper which covers:

- whether the discussions between a company and its investors should have a greater emphasis on building and encouraging a long-term relationship with the company;
- what improvements can be made to the process of holding investor engagement meetings; and
- whether companies and institutional investors should seek feedback on the quality of their meetings, and how that might be most effectively done.

The consultation closed on 30 November 2012 and the ICSA steering group intends to issue guidance in March 2013.

The consultation paper can be viewed at: http://www.icsaglobal.com/assets/files/pdfs/Policy2/01-Improving-Engagement-Practices-between-Companies-and-Institutional-Investors-Consultation-Oct-2012.pdf.

The ABI Issues New Remuneration Principles, a Report on Board Effectiveness and a Report on Comply or Explain

On 26 November 2012, the Association of British Insurers ("ABI") published a new version of its remuneration principles which provide guidance on executive remuneration.

The main substantive change is a recommendation that companies only use one annual bonus incentive and one long term incentive so as to promote a simple remuneration structure. Also, the guidance on performance measures for long term incentives has been updated to include operational measures, which should usually relate to business volume or growth, but must be carefully drafted to minimise undue risk.

Also appended to the new remuneration principles are the ABI's views on the Department for Business Innovation & Skills' ("BIS") proposed remuneration reporting requirements.

The new version of the ABI Remuneration Principles can be viewed at: http://www.ivis.co.uk/ExecutiveRemuneration.aspx.

After conducting a review of annual reports, a survey of company secretaries, and one-on-one interviews with chairmen, all of FTSE 350 companies, the ABI published a report on Board Effectiveness on 12 December 2012.

The report made the following findings:

- the role of the chairman revolves around creating the right board dynamic, managing the board's relationship with the executives, helping to set the board agenda, being an ambassador for the company and being fully engaged in the business;
- although the number of women being appointed to boards is increasing, the lack of women executives remains a key concern for shareholders, and the majority of disclosures on board diversity are at best, boiler-plate, or worse, absent;
- the voluntary approach to improving gender diversity has led to improvements, and the advantages of adopting a legislative approach are doubtful;
- disclosure on succession planning continues to be minimal and boiler-plate, and a majority of the companies surveyed identified succession planning as an area for improvement; and
- companies are concerned about the lack of experience, credibility and independence of available board evaluators, and company secretaries cite independence of the evaluator as the least important consideration, with more weight placed on experience and gravitas, and the following recommendations:
- chairmen should outline in their annual report their role in creating an effective board and how the board has been set up to respond to the business structure and any challenges which the company faces;
- companies should make clear, company-specific and forward-looking disclosure on the steps taken to promote diversity in their boardroom, the board appointment process, the barriers to appointing women and the proportion of women on the board, senior management and the whole company;
- companies should provide meaningful disclosure on their succession plans and should ensure they are actively engaged in succession planning for board members and senior management; and
- companies should disclose the performance evaluation process for board evaluations and any significant recommendations; board evaluations should be carried out by an independent party (and any past business relationship should be explained).

The ABI's Report on Board Effectiveness can be viewed at: http://www.ivis.co.uk/pdf/abi%20report%20on%20Board%20effectiveness%202012%20-%20final.pdf.

The ABI also published a report on 13 December 2012 reviewing explanations provided by the 128 companies from the FTSE All Share Index that departed from the UK Corporate Governance Code during the 2011/12 reporting season. The ABI has developed six key criteria to assist companies in framing informative and useful explanations of any non-compliance with Code principles and provisions. The six criteria are:

- the context in which companies make governance decisions, including historical developments and business specific reasons should be provided;
- explanations should provide a convincing and understandable rationale for the governance decision;

- any mitigating action taken to address risk arising from the non-compliance should be explained;
- disclosures should indicate whether the non-compliance is time limited;
- deviations from Code provisions as well as from the main principles should be explained and specified; and
- companies should explain how any alternative arrangements are consistent with Code principles and contribute to the objective of good governance.

The report concluded that many of the disclosures failed to meet investors' needs, with only 27% of companies providing a convincing and understandable rationale for non-compliance and 20% of companies providing any description of mitigating action to address additional risk through non-compliance.

The ABI was encouraged by a trend of more chairmen providing an introductory corporate governance statement and recommended all chairmen follow suit. In addition, the report recommended that investors adopt a more active approach to overseeing and scrutinising the explanations provided by companies. The report accepted that smaller companies face a larger burden complying with corporate governance standards, but such companies should improve the quality of their explanations, particularly since they will often have good reasons for non-compliance given the nascent nature of their business.

The ABI's Report on Comply or Explain can be viewed at: http://www.abi.org.uk/content/contentfilemanager.aspx?contentid=65367.

Revised NAPF Corporate Governance Policy and Voting Guidelines

On 4 December 2012, the National Association of Pension Funds ("NAPF") published a revised version of its Corporate Governance Policy and Voting Guidelines, making the following changes:

- a recommendation that shareholders use their powers to ensure that high standards of governance (including in relation to the re-election of directors, approval of annual reports and accounts and the appointment of auditors) are maintained;
- a recommendation that directors' service contracts should be available online for shareholder inspection;
- guidance that any statement on succession should include the company's policy on diversity, which should set out targets for gender diversity and progress towards achieving them;
- a recommendation that the board's diversity policy should include its policy on professional, international and gender diversity as well as any measurable targets for implementing the policy and progress towards achieving them;
- an endorsement of the audit requirements under the Corporate Governance Code and a recommendation that shareholders be informed of the company's intention to tender the audit contract;
- a preference for simpler remuneration plans, particularly for executive directors;
- in relation to executive director remuneration, base pay increases should be capped at inflation and in line with other employees, bonuses should be linked to profits, share awards should be reduced where lower performance targets are set and recipients should be required to hold a greater number of shares for longer periods;
- a recommendation that where there is significant dissent in relation to a shareholder vote, the directors should explore the reasons behind such dissent and address these issues as appropriate; and

- given the potential future changes in corporate governance over the next 12 months, the NAPF encourages greater dialogue between companies and shareholders.

The revised NAPF Corporate Governance Policy and Voting Guidelines can be viewed at: http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0277_Corporate_governance_policy_and_voting_guidelines_an_NAPF_document.ashx.

FRC Report on Implementation of the UK Corporate Governance Code

The FRC published on 19 December 2012 a report on the implementation of, and compliance with, the UK Corporate Governance and Stewardship Codes over the past 12 months. The report made the following findings:

- more than 50% of FTSE 350 companies complied fully with the Corporate Governance Code, but the quality of explanations for deviation from the Code was variable;
- the FRC recommends that companies should consider how to encourage more female executive positions on boards;
- the FRC is expecting there to be high rates of compliance with the requirement of external evaluation of boards every three years;
- 96% of FTSE 350 companies complied with the requirements regarding the annual re-election of all directors;
- there was an improvement in the overall quality of reporting of principal risks and uncertainties, but reporting by audit committees on their activities remained uninformative; and
- the number of signatories to the Stewardship Code has increased to nearly 260, including most of the largest investors in UK equities (the most notable exceptions being sovereign wealth funds).

The FRC will consult in 2013 on possible changes relating to directors' remuneration (after revised legislation on reporting and voting on remuneration has been finalised), guidance on going concern, risk and internal control, and narrative reporting.

The FRC Report can be viewed at: http://www.frc.org.uk/getattachment/47293b70-bd65-485c-bbcd-d9a63688b87d/Developments-in-Corporate-Governance-in-2012.aspx.

Consultation on Further Changes to the Listing Rules

On 5 October 2012, the Financial Services Authority ("FSA") published its quarterly consultation paper, which includes a number of proposed amendments to the Listing Rules, including requiring a premium listed company to appoint a sponsor when it is required to submit a supplementary prospectus or supplementary listing particulars.

The FSA also proposes the removal of certain Listing Rule requirements (which are not strictly necessary under relevant EU legislation) which apply to depositaries which issue global depositary receipts, such as the requirement for a depositary to be a suitably authorised and regulated financial institution acceptable to the FSA (the FSA considers that investors are sufficiently protected by disclosure instead) and the requirement that a depositary which issues global depositary receipts should hold rights and monies relating to the shares on trust (or under equivalent arrangements) for the benefit of the global depositary receipt holders. The FSA proposes replacing the latter with a requirement that the depositary would instead need to have arrangements in place to safeguard certificate holders' rights and to disclose these arrangements in the prospectus.

The consultation closed on 5 December 2012.

The consultation paper can be viewed at: http://www.fsa.gov.uk/static/pubs/cp/cp12-27.pdf (Chapter 10).

Publication of Issue 5 of Inside AIM

Issue 5 (October 2012) of the Inside Aim newsletter, published on 24 October 2012 by the AIM Regulation Team at the London Stock Exchange, focuses particularly on nominated advisers and their consideration of directors. Guidance (neither definitive nor binding) is provided on the education of directors on their AIM Rules obligations, due diligence on AIM directors, contact between AIM companies and their nominated advisers, directors' participation in a fundraising exercise, the application of the close period rules for accounts, and the cancellation of the admission of securities to trading on AIM. The newsletter also provides an update on investigations and cases of censure.

Issue 5 of Inside AIM can be viewed at: http://www.londonstockexchange.com/companies-and-advisors/aim/advisers/inside-aim-newsletter/inside-aim-issue-5.pdf.

UK Listing Authority ("UKLA") Knowledge Base

The UKLA, in its Primary Market Bulletin published on 7 December 2012, announced the launch of the UKLA Knowledge Base, which is intended to be the single repository of technical guidance in relation to the UKLA Listing Rules, Prospectus Rules and Disclosure and Transparency Rules. The Knowledge Base consists of previous UKLA guidance notes on technical and procedural issues, revised and updated to take into account subsequent developments. Unlike the previous UKLA guidance notes, the revised notes published in the Knowledge Base will constitute formal FSA guidance.

The guidance notes included in the UKLA Knowledge Base, subject to the abovementioned updating, been published largely in the form in which the UKLA held a consultation exercise earlier in the year, save that the proposed note on block listings has been withdrawn to allow the UKLA to consider the issues raised from feedback, and the proposed note on prospectus disclosure of credit ratings was also withdrawn as the issue is being considered further by the European Securities and Markets Authority.

The Primary Market Bulletin can be viewed at: http://www.fsa.gov.uk/static/pubs/ukla/ukla-bulletin-no4.pdf.

The UKLA Knowledge Base can be viewed at: http://www.fsa.gov.uk/doing/ukla/knowledge-base.

FSA Consultation on Amendments to the Listing Rules and Disclosure and Transparency Rules

On 18 December 2012, the FSA published consultation paper 12/37. This sets out the changes that will need to be made to the Listing Rules and the Disclosure and Transparency Rules in order to implement the Financial Services Bill 2012-2013 (which involves inter alia the creation of the Financial Conduct Authority ("FCA") which will be responsible for the conduct of business regulation and the FSA's existing market regulation functions).

The FCA will adopt the existing FSA Handbook; however, this will need to be amended to align with the objectives and functions of the FCA. The consultation paper therefore proposes, amongst others, the following changes:

- the FCA to have the ability to restrict or limit a sponsor's approval (initial or otherwise) where the sponsor does not have the necessary expertise or experience, or its systems and controls are unsuitable, although this power will not be exercised on a transaction by transaction basis;
- the FCA to have the power to suspend the approval of a sponsor where the FCA considers it desirable to do so to advance one or more of its operational objectives (this power is likely to be invoked where the FCA has already made its concerns clear but the sponsor ignores them);
- the FCA to have the power to impose a range of disciplinary sanctions (including fines and public censure) on sponsors;

- sponsors to be able to request that their approval be suspended (they can currently only request that it be cancelled);
- the insertion of provisions in the Disclosure and Transparency Rules regulating regulatory information providers (to be known as "primary information providers"); these will largely replicate the existing Criteria for Regulated Information Services published by the FSA, updated to reflect electronic methods currently used to deal with regulatory information; and
- the existing policies in the Decision Procedure and Penalties Manual that relate to financial penalties and suspensions will apply to the FCA's new disciplinary powers.

Responses to the consultation should be submitted by 1 February 2013.

FSA consultation paper 12/37 can be viewed at: http://www.fsa.gov.uk/static/pubs/cp/cp12-37.pdf.

Panel Statement on Review of Takeover Code Amendments

On 26 November 2012, the Code Committee of the Takeover Panel published a Panel Statement containing a review of the September 2011 amendments to the Takeover Code in the 12 month period to 18 September 2012. The Code Committee believes that the amendments have operated satisfactorily, and there has not been any significant reduction in bid activity, and therefore they do not intend to propose any immediate changes.

In particular, the Code Committee found that:

- the number of offer periods that commenced following rumour, speculation or an untoward movement in share price was significantly reduced, while the number of offer periods that commenced with a firm offer announcement increased, which suggested greater protection for offeree companies against protracted virtual bid periods;
- there was no significant reduction in bid activity, which suggested potential bidders were not deterred by the loss of anonymity. Furthermore, the disclosure of potential bidders appears to have encouraged the maintenance of secrecy around possible offers;
- the 28 day "put up or shut up" period has allowed target companies to control uncertainty and disruption following a possible offer announcement;
- a significant number of formal sale processes indicate that the mechanism (with the exemptions available in respect of it from the naming of potential bidders and the prohibition on inducement fee arrangements) is a valuable addition to the options available to target companies, but it is too early to make a full assessment;
- the prohibition on deal protection measures has reduced the tactical advantages available to a bidder over a target company; however, there have been cases of parties using terms in agreements (e.g. co-operation agreements and irrevocable undertakings) that exceed those considered permissible under the new rules. The statement says that the Panel Executive will take appropriate remedial and disciplinary action if there are further breaches of this rule;
- the requirement to disclose offer-related fees and expenses has improved transparency and has not given rise to major issues;
- the requirement to disclose financial information has worked well, although dispensation has been granted regarding market flex provisions within financing documents to reduce the risk of any potential finance syndicatee becoming aware of the flex limits (and negotiating its participation accordingly) before the offer document is published;
- while there has been an improvement in the quality and detail of disclosures of intentions regarding the target company's employees, in many cases disclosure has been general and non-specific. Any statement of intention

should be as detailed as possible, and the Panel will treat it as a serious breach if it is established that a bidder had formulated an intention to take specific action in relation to the target but only made a general, non-specific disclosure about its intention; and

- an increase in the publication of employee representatives' opinions demonstrated improved communications and increased the effectiveness of employee representatives in providing their opinion, whilst not placing a disproportionate burden on target companies.

The Panel Statement can be viewed at: http://www.thetakeoverpanel.org.uk/wp-content/uploads/2012/01/2012-8.pdf.

Government Response to Kay Review

BIS published on 22 November 2012 a response to the Kay Review on equity capital markets. In our October 2012 Newsletter, we summarised the key recommendations made in the Final Report of the Kay Review.

The BIS response rejected blanket regulation of the structure of directors' remuneration, stating that the structure of remuneration should be determined by individual companies in consultation with shareholders.

Otherwise, there was broad acceptance of the Kay Review, including the ten principles for equity markets (except for a rephrasing of the "fiduciary standards" duty that participants and the equity investment chain should observe with their clients), the directions for market participants, the good practice statements for directors and for asset managers and holders, the interpretation of directors' duties in the context of takeovers, and the removal of mandatory quarterly reporting obligations.

Furthermore, the response confirmed the Government's view that the establishment of an investors' forum as a mechanism for collective engagement by investors in UK companies would be unlikely to trigger a mandatory bid under the Takeover Code and noted that directors should consult major long-term investors over major board appointments, and should seek to disengage from the process of managing short-term earnings expectations and announcements.

In addition, in light of concerns that certain investment intermediaries interpret their fiduciary duties to require the maximisation of short-term financial profits, the Law Commission has been asked to review the legal obligations arising from fiduciary duties in the context of trustees and other investment intermediaries.

The Government does not intend to propose new regulations (beyond those proposals already announced), and instead aims to promote a change in culture. In view of this, it has solicited the views of business groups, industry associations and regulators as to the good practice statements. A progress report on the response to the Kay Review will be published in 2014.

The Government response can be viewed at: http://www.bis.gov.uk/assets/biscore/business-law/docs/e/12-1188-equity-markets-support-growth-response-to-kay-review.

On 12 December 2012, the Business, Innovation and Skills Select Committee of the House of Commons announced a call for evidence regarding the recommendations set out in the Kay Review as well as the Government's proposed implementation plan. The consultation closes on 18 January 2012.

The call for evidence can be viewed at: http://www.parliament.uk/business/committees/committees-a-z/commons-select/business-innovation-and-skills/inquiries/parliament-2010/the-kay-review/.

Updated British Private Equity & Venture Capital Association Guide to Responsible Investment

On 6 December 2012, the British Private Equity & Venture Capital Association published a new version of its Guide to Responsible Investment. Whereas the previous version focused on environmental, social and governance issues in the pre-investment stage, this new version addresses the ownership phase and the exit phase as well.

The new version also provides additional guidance in relation to due diligence.

The updated Guide to Responsible Investment can be viewed at: http://admin.bvca.co.uk/library/documents/BVCA_Responsible_Investment_Guide_2012.pdf.

Guidelines Monitoring Group Report on Conformity with Walker Guidelines

On 14 December 2012, the Guidelines Monitoring Group published its fifth annual report on conformity of private equity and portfolio company reporting with the Guidelines for Disclosure and Transparency in Private Equity. The report found that although there were at least basic levels of compliance, overall, compliance was lower than previous years, and non-compliance often went unexplained.

In addition, the report indicates that the Guidelines would be reviewed to ensure they reflect financial reporting developments.

The report can be viewed at:

http://walker-gmg.co.uk/sites/10051/files/gmg_guidelines-dec12.pdf.

FRC: Consultation on Disclosure Requirements Framework

The Financial Reporting Council ("FRC") published on 15 October 2012 a discussion paper addressed to regulators, standard setters, preparers of financial reports, end users and auditors, and aimed at tackling a perceived trend of financial reporting becoming more about compliance than communication of information for users.

The discussion paper seeks to establish a road map for a disclosure framework for financial reporting aimed at improving the quality of disclosure and its value to users, and in particular, at reducing clutter in financial reports by avoiding duplication in disclosures and using tests of materiality more rigorously.

The road map proposed by the discussion paper sets out principles grouped broadly around what information users need, where disclosures should be located, when disclosures should be provided and how disclosures should be communicated.

Comments must be submitted by 31 January 2013.

The discussion paper can be viewed at: http://www.frc.org.uk/getattachment/4e747c33-cc31-469b-9173-a07a3d8f0076/Thinking-about-disclosures-in-a-broader-context-A-road-map-for-a-disclosure-framework.aspx.

BIS Consultation on Draft Regulations on Reporting

BIS published on 18 October 2012 a consultation (including draft regulations) on proposed changes to reporting requirements. The proposed changes include:

- requiring directors to produce a strategic report instead of the business review within the directors' report (the original proposal to replace the directors' report with an annual directors' statement has been dropped). The content of the strategic report will broadly match that of a business review save that, for quoted companies only, the strategic report:

  - must include a description of the company's business model and strategy;
  - must state the gender split for its directors, managers and employees;
  - must include consideration of human rights issues, alongside social and community issues; but
  - is not specifically required to disclose persons with whom the company has essential contractual or other arrangements;

- the strategic report replacing the summary financial statements as a document that can be sent as a standalone document for shareholders who do not wish to receive the full annual report and accounts; and
- a reduction in the scope of the required content of disclosures in the directors' report, currently prescribed by secondary legislation (such as information about principal activities, asset values, charitable donations, and policy and practice of payment to creditors).

BIS is not proceeding with its original proposal to require all directors sign the strategic report or to increase the level of audit or assurance on the strategic report, nor will the original proposal to remove the requirement for companies who employ more than 250 people to report how they involve employees in terms of information, consultation and share schemes be implemented.

The consultation closed on 15 November 2012. The draft regulations will, if approved, come into effect for accounting periods ending on or after 1 October 2013.

The consultation document can be viewed at: http://www.bis.gov.uk/assets/biscore/business-law/docs/f/12-979-future-of-narrative-reporting-new-structure.pdf.

BIS Consultation on Implementation of Nuttall Review Relating to Share Buybacks

On 30 October 2012, BIS published a consultation document on the implementation of the Nuttall Review's recommendations. With a view to encouraging ownership of shares by employees, the consultation proposes deregulatory changes to the UK statutory share buyback regime which should remove disincentives to an increase in direct employee ownership by making it easier for companies to repurchase employees' shares when they leave the company.

The consultation proposes the following amendments:

- allowing a contract for an off-market buyback of shares to be authorised by an ordinary resolution, rather than a special resolution, and so bringing the consent requirements for an off-market purchase in line with those for a market purchase (note: the consultation document talks about this amendment in the context of private companies, but it appears to apply to all companies in the draft regulations);
- introducing an exception to the requirement that repurchased shares be paid for in full at the time of the purchase. This exception would apply where shares are purchased for the purpose of, or pursuant to, an employees' share scheme and so would give companies the flexibility to make instalment payments (views are sought on whether a maximum period should be set); and
- allowing unlisted shares that are purchased by a private limited company to be held in treasury.

The consultation is also seeking views on whether the restrictions on the source of funds for a buyback of shares are overly restrictive in the context of a buyback of shares for the purposes of an employees' share scheme.

In addition, BIS has published draft statutory instruments implementing the proposed changes.

The consultation closed on 16 November 2012 and a response document will be published in Spring 2013.

The consultation document can be viewed at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32716/12-1162-employee-ownership-share-buy-backs-consultation.pdf.

The draft statutory instruments can be viewed at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32719/12-1248-companies-act-2006-amendment-part-18-regulations-draft.pdf.

Deferred Prosecution Agreements in the UK

Following a consultation period, on 23 October 2012 the UK Ministry of Justice ("MoJ") announced that legislation would be introduced to allow Deferred Prosecution Agreements ("DPAs") in the UK for economic crimes committed by commercial organisations. Similar to the practice in the US, the UK version of a DPA (as contemplated by the MoJ) will be an agreement between a prosecutor and a commercial organisation under which the prosecutor will bring, but not immediately proceed with, criminal charges against the organisation. Certain agreed terms and conditions will be imposed on a company as a requirement of a DPA, which are likely to include financial penalties, reparation to victims, confiscation of the profits of wrongdoing, and measures to prevent future offending. Although the MoJ recognises that the parties will need a level of certainty and confidentiality to be able to negotiate the details of a DPA, the public interest in ensuring that the DPAs are part of a robust prosecutorial approach requires that the final DPA will be made public in open court to ensure openness and transparency.

The MoJ has noted that even if the proposed legislation is passed, DPAs will have to be applied in a clear and practical manner and supported by guidance to ensure that all parties have a thorough understanding of how they operate. Thus, the Director of Public Prosecutions and the Director of the SFO will be required to develop and publish a "DPA Code of Practice for Prosecutors", setting out the factors to which prosecutors ought to have regard when considering whether to enter into a DPA; the Sentencing Council will need to produce sentencing guidelines on offences likely to be encompassed by DPAs, providing transparency and certainty for the parties and the court; and Criminal Procedure Rules will have to be developed to enable the DPA process to operate effectively and efficiently.

Bribery Act Update

In March 2011, the UK Ministry of Justice ("MoJ") issued comprehensive guidance on the Bribery Act 2010, mostly in relation to the new corporate offence (section 7 of the Bribery Act) and its adequate procedures defence. The SFO and the Crown Prosecution Service also issued joint enforcement guidance addressing the policies they would follow in evaluating issues such as facilitation payments (which are violations of the UK's general prohibition on corrupt payments). The SFO also published on its website some of its own guidance on its approach to certain issues arising under the Bribery Act.

However, in September 2012 the SFO removed from its website its previous guidance, replacing it with statements referring to the Code for Crown Prosecutors, the Joint Prosecution Guidance of the Director of the SFO and the Director of Public Prosecutions, and the Joint Guidance on Corporate Prosecutions. The SFO also withdrew its guidance in respect of corporate self-reporting, which had suggested that the SFO might settle through a civil remedy, as opposed to criminal prosecution, if a company self-reported bribery and corruption issues. Subsequently, on

6 December 2012, David Green QC (the new Director of the SFO) published an open letter on facilitation payments, re-emphasising that such payments are illegal under English law, regardless of their size or frequency.

These developments show a definite shift in approach by the SFO. The SFO appears to have made a conscious effort to step away from its previous stance, particularly with regard to self-reporting. Notably, Mr. Green has emphasised in his recent appearance before a House of Commons Justice Committee that the SFO is a "crime-fighting agency" as an investigator and prosecutor of serious fraud, bribery and corruption, not an adviser to corporates. If actions follow rhetoric, this may presage an increase in prosecutions under the Bribery Act in the near future.

US DEVELOPMENTS

SEC Developments

In this section, we are covering developments relating to the implementation of provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Reform Act") and the Jumpstart Our Business Startups Act ("JOBS Act") through rulemaking by the US Securities and Exchange Commission ("SEC") as well as other SEC developments.

New SEC Reporting Requirements for Specified Business Activities Relating to Iran

The recently enacted Iran Threat Reduction and Syria Human Rights Act of 2012 (the "Threat Reduction Act") imposes on SEC-registered companies specific additional disclosure requirements concerning certain business activities relating to Iran and other targets of US economic sanctions programs.

Under these new disclosure requirements, which are reflected in a new Section 13(r) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), an SEC registrant must disclose the following business activities in its annual Form 20-F if such activities are conducted by the issuer or its affiliates during the period covered by the Form 20-F:

- Business activities relating to Iran's energy sector and development of weapons of mass destruction as proscribed under the United States Iran Sanctions Act (as amended);
- Certain transactions by financial institutions with the Government of Iran or persons or entities designated on the US Government's Specially Designated Nationals and Blocked Persons List (the "SDN List") as global terrorists or weapons of mass destruction proliferators as proscribed under the United States Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (as amended) ("CISADA");
- Business activities relating to the suppression of human rights in Iran as proscribed under CISADA; and
- Transactions or dealings with: (i) the Government of Iran; or (ii) persons or entities designated on the SDN List as global terrorists or weapons of mass destruction proliferators.

Under the new requirements, the business activities described above must be disclosed if the SEC registrant or any of its affiliates "knowingly" conduct (or conducted during the period covered by the report) such activities. Under US law generally, a person or entity "knowingly" engages in an activity if the person or entity knows (i.e., had actual knowledge), or should have known, that they are engaged in such activity. This suggests that an SEC registrant has an affirmative obligation to review its (including its affiliates') business activities to determine whether such activities are reportable under the new requirements.

For each business activity disclosed in the annual Form 20-F, the SEC registrant must disclose: (i) the nature and extent of the activity; (ii) gross revenues and net profits, if any, attributable to the activity; and (iii) whether the issuer intends to continue the activity.

The requirement to disclose gross revenues and net profits, "if any", suggests that there is no materiality threshold for reporting business activities that fall within one of the four categories described above.

The issuer must also file a concurrent public notice with the SEC that such activity has been disclosed by the issuer in the Form 20-F. The concurrent public notice will trigger a mandatory investigation by the US Government to be completed within 180 days into whether the reported activity is sanctionable under US economic sanctions programs, including extraterritorial sanctions programs administered by the US Secretary of State and US Secretary of the Treasury.

Under the new reporting requirements, an issuer is required to report business activities of its "affiliates". The term "affiliate" is defined in Rule 12b-2 under the Exchange Act. Rule 12b-2 states that "[a]n 'affiliate' of, or a person 'affiliated' with, a specified person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified". Accordingly, SEC registrants will need to determine which of their subsidiaries, joint ventures and other related entities fall within the Rule 12b-2 definition and analyse the business activities of such affiliates to determine whether they engage in activities that are reportable under the new disclosure requirements.

Furthermore, any "transaction or dealing" by any of an SEC registrant's affiliates with a person or entity designated on the SDN List as a global terrorist or weapons of mass destruction proliferator, regardless of whether such activity is sanctionable as to the SEC registrant itself under US economic sanctions programs, is now subject to disclosure under Section 13(r) of the Exchange Act.

Compliance with Section 13(r) of the Exchange Act is subject to the certifications made by the Chief Executive Officer and Chief Financial Officer in annual reports on Form 20-F pursuant to Sections 302 and 906 of the United States Sarbanes-Oxley Act of 2002.

Our related client publications are available at:

- http://www.shearman.com/section-219-of-iran-threat-reduction-and-syria-human-rights-act-of-2012--additional-reporting-requirements-for-us-domestic-and-foreign-issuers-registered-with-sec-11-08-2012/,
- http://www.shearman.com/sec-publishes-cdis-for-iran-sanctions-disclosures-required-under-exchange-act-section-13r-12-06-2012/ and
- http://www.shearman.com/the-iran-threat-reduction-and-syria-human-rights-act-of-2012--how-are-you-planning-to-comply-with-section-219s-new-reporting-requirements-12-17-2012/.

Our 7 January 2013 client publication "Sanctions Round-Up: Fourth Quarter 2012" provides a summary of recent developments in US and EU sanctions programmes and is available at: http://www.shearman.com/Sanctions-Round-Up-Fourth-Quarter-2012-01-07-2013/.

SEC Staff Allege Netflix Facebook Post May Have Violated Regulation FD

In December 2012, Netflix, Inc. announced that it had received a notice from the Staff of the SEC indicating its intent to recommend enforcement action for an alleged violation of Regulation FD.

Regulation FD requires all US reporting companies to make a public announcement or filing with the SEC of any material nonpublic information they disclose on a non-confidential basis to certain persons outside the company, including securities market professionals and large money managers as well as investors, where it is reasonably foreseeable that the investor would trade on the basis of the information.

The alleged violation involves a Facebook posting by Netflix's CEO in which he disclosed that Netflix's members had enjoyed over one billion hours of content in June. Netflix did not disseminate this information by issuing a press release or filing a Form 8-K.

Netflix's CEO has over 200,000 followers on Facebook, and the statement was picked up by bloggers and in the media. Netflix contends that the Facebook post was "very public" and that in any case the information was not "material" to investors.

This is the first high-profile test of whether social media constitutes adequate distribution of material information for the purposes of the selective disclosure rules.

Although non-US companies are exempted from Regulation FD, the SEC expects such issuers to conduct themselves in accordance with the basic principles underlying Regulation FD and has stated that it may extend the same or similar obligations to such issuers in the future.

This serves as a reminder that a company's disclosure controls and procedures should not be limited to the documents that the company files with the SEC, such as its reports on Form 20-F and 6-K, but should encompass other disclosures attributable to the company and its senior management, including press releases, websites, blogs and postings on social media networks, such as Facebook or Twitter. Given the potential enforcement action against Netflix, until the SEC provides further guidance on the use of social media to disseminate information to the securities markets, companies should use extreme caution disclosing material information through social media and should keep in mind that website postings or the use of social media networks alone may not constitute adequate distribution of material information.

SEC Conflict Minerals Rules – Frequently Asked Questions

The first reporting period for the SEC's new conflict minerals rules began on 1 January 2013. Under the new rules, SEC reporting companies that manufacture products that contain tantalum, tin, tungsten or gold face new reporting requirements. Those companies will be seeking information from private companies in their supply chains. Required by the Reform Act, the conflict minerals rules require disclosure of products that contain conflict minerals originating in the Democratic Republic of the Congo and adjoining countries. SEC reporting companies have been working to put in place controls and procedures to comply with the conflict minerals rules and to ensure that minerals contained in their products are conflict-free.

Our client publication dated 19 December 2012 seeks to provide guidance, as well as to suggest some best practices for compliance. The primary focus in this series of frequently asked questions is on how to get started, including:

- analyzing whether the conflict minerals rules apply to your company,
- what is required by the "reasonable country of origin inquiry", and
- practical considerations for implementing a compliance framework.

Our related client publication is available at http://www.shearman.com/all-that-glitters-may-be-a-reportable-conflict-mineral-12-19-2012/.

Updated Financial Reporting Manual

On 18 January 2013, the SEC's Division of Corporation Finance updated its Financial Reporting Manual. The changes and clarifications in this update relate to significance testing for related businesses, auditor responsibility for cumulative period from inception amounts, PCAOB requirements for auditors of non-issuer financial statements and other changes.

The SEC's Division of Corporation Finance previously updated its Financial Reporting Manual on 4 October 2012. The changes in that update were:

- a note indicating the JOBS Act is not covered by the manual;
- clarification of proxy statement requirements for the disposal of a business;
- clarification of auditor association with amounts from inception in development stage companies;
- clarification of the application of PCAOB auditor requirements pursuant to a reverse merger; and
- clarification of reporting requirements in a reverse acquisition with a domestic registrant that is not a shell company.

The comprehensive updated Financial Reporting Manual is available at: http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml.

SEC Approves NYSE and Nasdaq Listing Standard Changes Governing Compensation Committee Independence and Advisors

On 16 January 2013, the SEC approved new listing standards implementing the SEC's final rules on compensation committee independence and advisors pursuant to Rule 952 of the Reform Act. The listing standards were adopted substantially as proposed with a few amendments including:

- Nasdaq modified the effective dates for its amended listing standards to align with the effective dates of the NYSE rules. The rules relating to compensation advisors will be effective on 1 July 2013, rather than immediately upon SEC approval. The rules relating to the compensation committee independence standards will be effective on the earlier of (i) a company's first annual meeting after 15 January 2014 or (ii) 31 October 2014.
- Both the NYSE and Nasdaq rules expressly provide that a compensation committee is not required to conduct an independence assessment of an advisor whose role is limited to (i) consulting on any broad-based plan that does not discriminate in scope, terms or operation, in favor of executive officers or directors, and that is available generally to all salaried employees or (ii) providing information that either is not customized or that is customized based on parameters that are not developed by the adviser, and about which the adviser does not provide advice.
- Nasdaq clarified that companies are only required to consider the six specified factors when evaluating advisor independence. The NYSE rules provide that compensation committees must consider all factors relevant to an advisor's independence including the six factors.
- The Nasdaq proposed rules provide that the independence factors need only be considered with respect to "*independent*" legal counsel. The final rules eliminate the word "*independent*" so that that the only exclusion from the independence assessment are in-house counsel. In addition, Nasdaq clarified that the independence factors must be considered when selecting, *or receiving advice from*, a compensation advisor (emphasis added) clarifying that the analysis cannot be circumvented by simply not "*selecting*" an advisor.

A summary of the proposed listing standards can found in our client publication available at: http://www.shearman.com/the-nyse-and-nasdaq-issue-proposed-rules-to-implement-the-sec-compensation-committee-independence-and-advisor-rules-10-04-2012/.

Trends to Monitor for the 2013 Proxy Season and Beyond

ISS Publishes 2013 US Corporate Governance Policy Updates

On 16 November 2012, Institutional Shareholder Services Inc. ("ISS") released its US policy updates for the 2013 proxy season (the "2013 US Policies"), having received comments to its draft policies released 16 October 2012. The most significant 2013 US Policies contain updates on the following matters:

- hedging and pledging of company stock;
- board responsiveness to majority-supported shareholder proposals;
- overboarded directors;
- executive pay-for-performance evaluations;
- say on golden parachute proposals; and
- environmental, social and governance non-financial performance compensation-related proposals.

The 2013 US Policies will generally be effective for shareholder meetings of publicly-traded companies in the US held on or after 1 February 2013.

Hedging and Pledging of Company Stock. Under current ISS Policies (the "2012 US Policies"), ISS may, in extraordinary circumstances, recommend that shareholders vote either "against" or "withhold" from individual directors or the entire board due to material failures of governance, stewardship, risk oversight or fiduciary responsibilities at the company. The 2013 US Policies make explicit that the hedging of company stock or significant pledging of company stock by directors and executives will be considered failures of risk oversight.

Board Responsiveness to Majority-Supported Shareholder Proposals. Under the 2012 US Policies, ISS recommends that shareholders vote either "against" or "withhold" from the entire board of directors, other than new nominees who are considered case by case, if the board failed to act on a shareholder proposal that either (i) received the support of a majority of shares outstanding in the previous year, or (ii) received the support of a majority of shares cast in the last year and one of the two previous years. The 2013 US Policies will give directors less time to respond to shareholder proposals by providing that ISS will issue a negative vote recommendation if the board fails to act on a shareholder proposal that received the support of a majority of the shares cast in the previous year. This change in policy is being implemented on a transitional basis, however, and will only become effective beginning with shareholder proposals appearing on companies' ballots in 2013. In addition, the 2013 US Policies give ISS the flexibility, effective in the 2013 proxy season, to recommend against individual directors or committee members, rather than against the entire board.

Overboarded Directors. Under the 2012 US Policies, ISS recommends that shareholders vote either "against" or "withhold" from individual directors who (i) sit on more than six public company boards, or (ii) are CEOs of public companies who sit on the boards of more than two public companies besides their own (the negative vote recommendation is only with respect to outside boards). Under the 2012 US Policies, ISS does not count service by a director on the board of a parent as well as the board of its publicly-traded subsidiary (where ownership is 20% or higher) as serving on two separate boards. The 2013 US Policies change this approach and provide that service by a parent director on any non-controlled (i.e., where ownership is less than 50%) subsidiary board that is publicly-traded will be counted as service on two separate boards.

Executive Pay for Performance Evaluations: Advisory Votes on Executive Compensation. ISS's general pay for performance alignment evaluation methodology generally remains the same, with the following key changes:

- A company's self-selected benchmarking peer group will be used as an input to ISS's peer group methodology, but ISS will otherwise continue to select peer groups based on company size and market capitalization.
- A comparison of realizable pay to the grant date pay disclosed in the summary compensation table will potentially be incorporated into ISS's evaluation of pay for performance alignment for large cap companies.

Peer Groups. The 2013 US Policies set forth a new methodology for identifying peer groups that focuses on identifying companies that are reasonably similar in terms of industry profile, size and market capitalization, while granting greater deference to a company's self-selected peers.

- Under the 2012 US Policies, a company's peer group was generally comprised of 14-24 companies in the company's Standard & Poor's Global Industry Classification Standard ("GICS") industry group. ISS noted that this methodology did not always reflect multiple business lines in which companies operate, with the result that a company's competitors were sometimes omitted from its ISS peer group. The revised methodology under the 2013 US Policies is intended to minimize such omissions.
- The methodology set forth in the 2013 US Policies incorporates information from both the company's self-selected benchmarking peer group (as disclosed in its proxy statement) and the company's GICS industry group. ISS will prioritize companies that fall in one (or more) of the following categories:
  - Companies included in the subject company's disclosed peer group.
  - Companies naming the subject company in their own peer group.
  - Companies with "numerous" connections to the subject company's disclosed peers or companies that name the subject company as a peer.
- ISS also noted that it will give lower priority to a company's self-selected peer if it is the only peer company in its 6- and 8-digit GICS code. On 4 December 2012, ISS issued FAQs detailing how the new peer groups would be constructed. These can be found at http://www.issgovernance.com/policy/USPeerGroupFAQ.
- Companies were given the opportunity to notify ISS of changes to their compensation peer groups for 2012 by 21 December 2012. ISS will likely default to using the 2011 benchmarking peer group that was disclosed in the company's 2012 proxy for companies that do not submit revisions. Companies that do not use a peer group to set executive pay also had the opportunity to submit a list of peers for ISS's consideration.

Comparison of Realizable Pay to Grant Date Pay. Under the 2013 US Policies, ISS may consider an additional factor in its pay-for-performance analysis that compares "realizable pay" to grant date pay for large capitalization companies in the S&P 500.

- "Realizable pay" is intended to reflect how executive pay has been affected by performance. Under the 2013 US Policies, realizable pay consists of the sum of cash paid, equity and long-term cash awards granted and other compensation provided during the three-year performance period. These amounts are valued based on actual amounts for awards that are earned, vested or exercised and target values for on-going awards. Equity awards will be revalued using the stock price at the end of the performance period.

Say on Golden Parachute Proposals. The 2013 US Policies update ISS's current policy concerning say on golden parachute proposals to provide for the following key modifications:

- ISS will analyze existing change in control arrangements maintained with named executive officers, rather than focusing only on new or extended arrangements;
- While recent amendments that incorporate problematic pay practices[1] will carry greater weight in the analysis, ISS will place further scrutiny on existing change in control agreements that contain more than one problematic pay practice; and
- ISS will focus on excise tax gross ups that are triggered and payable (as opposed to a provision providing for a gross up).

Environmental, Social and Governance Compensation Related Proposals. Under the 2012 US Policies, ISS generally recommends against shareholder proposals to link, or report on linking, executive compensation to environmental or social non-financial performance measures. The 2013 US Policies amend this approach by requiring a case by case analysis of these proposals based on certain factors (which have not changed from the 2012 US Policies, except that the "significant and persistent controversies or violations" factor has been modified to reference "significant and/or persistent controversies or violations").

Other Updates in the 2013 US Policies. The 2013 US Policies contain a number of other clarifications and updates, including:

- recommending a vote against an individual director, instead of the full board, if proxy disclosure is insufficient to determine whether such director attended at least 75% of board and committee meetings;
- revising director categorizations to provide that any director named in the summary compensation table, including any current interim officer, is an inside director, while expanding the exclusion for directors named in the table because they were former interim officers (in the past the exclusion was limited to former interim CEOs);
- establishing overarching principles for evaluating social and environmental proposals for all markets, with emphasis on how the proposal may enhance or protect shareholder value in either the short or long term; and
- in connection with proposals requesting information on a company's lobbying activities, which are considered on a case by case basis by ISS, revising the policy to clarify the scope (all types of lobbying activities) and focus (lobbying policies and procedures as well as lobbying activities) to be considered in developing a recommendation.

Our related client publication is available at: http://www.shearman.com/iss-publishes-2013-us-corporate-governance-policy-updates-11-26-2012/.

[1] Problematic pay practices include: (i) single or modified single trigger cash severance; (ii) single trigger acceleration of unvested equity awards; (iii) excessive cash severance (greater than three times base salary and bonus); (iv) excise tax gross ups triggered and payable (as opposed to a provision to provide excise tax gross ups); (v) excessive golden parachute payments (on an absolute basis or as a percentage of transaction equity value); (vi) recent amendments that incorporate any problematic features (such as (i) through (v)) or recent actions (such as extraordinary equity grants) that may make packages so attractive as to influence merger agreements that may not be in the best interests of shareholders; or (vii) the company's assertion that a proposed transaction is conditioned on shareholder approval of the golden parachute advisory vote.

PCAOB Developments

SEC Approves PCAOB Proposed Auditor Communications Standard

On 17 December 2012, the SEC approved the Public Company Accounting Oversight Board's ("PCAOB") Auditing Standard No. 16, Communications with Audit Committees ("AS 16"), and related and transitional amendments to PCAOB standards. AS 16 will supersede PCAOB interim auditing standard AU section 380, Communication with Audit Committees, and interim auditing standard AU section 310, Appointment of the Independent Auditor.

AS 16 retains or enhances existing audit committee communication requirements, incorporates SEC auditor communication requirements set forth in Rule 2-07 of Regulation S-X, provides a definition of the term "audit committee" for issuers and non-issuers, and adds new communication requirements that are generally linked to performance requirements set forth in other PCAOB auditing standards. For a summary of AS 16, please refer to our October 2012 Governance & Securities Law Focus newsletter.

The SEC release approving the adoption of AS 16 is available at: http://www.sec.gov/rules/pcaob/2012/34-68453.pdf.

On 20 December 2012, the PCAOB stated that the new rules are effective for public company audits of fiscal periods beginning on or after 15 December 2012. Additionally, the SEC determined that the standard and related amendments will apply to audits of "emerging growth companies" under the JOBS Act.

The PCAOB press release announcing the approval of AS 16 is available at: http://pcaobus.org/News/Releases/Pages/12202012_AS16.aspx.

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

In January 2013, 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 pattern and an invaluable compendium of all FCPA enforcement actions and private actions.

In our July 2012 Trends & Patterns, we noted that the year had been "a fairly slow time" in terms of enforcement actions. The second half of 2012 hasn't changed that story — since July, the US government has brought only five additional enforcement actions — Pfizer/Wyeth, Tyco International, Oracle, Allianz and Eli Lilly. This may be explained by the various pending motions in cases against individuals, and, as we noted earlier, the US Department of Justice, in particular, has been busily clearing away some previous cases with pleas, dismissals, and sentencings.

The most significant act of the last half of 2012 was the release of the long-awaited US guidance on the FCPA, "A Resource Guide to the US Foreign Corrupt Practices Act", much of which confirms our reading of the tea-leaves of previous enforcement action, including some of the more disturbing positions that we have identified in our previous Trends & Patterns.

In this edition of Trends & Patterns, we summarize recent statistics, analyze legal developments, and provide insight into the latest legislative and regulatory trends in anti-bribery enforcement in the US and the UK.

Our January 2013 "Recent Trends and Patterns in FCPA Enforcement" report is available at http://www.shearman.com/shearman--sterlings-recent-trends-and-patterns-in-the-enforcement-of-the-foreign-corrupt-practices-act-fcpa--fcpa-digest-2013-01-02-2013/.

Noteworthy US Securities Law Litigation

US federal courts rule that Argentina breached pari passu clause in refusing to honour bonds not tendered in exchange offer: NML Capital v. Argentina

In November and December 2012, federal courts in New York issued a series of important decisions regarding the restructuring of Argentina's sovereign debt and Argentina's refusal to honour bonds whose holders have declined its exchange offers.

As background, the plaintiffs are holders of sovereign bonds issued by Argentina pursuant to a Fiscal Agency Agreement prior to Argentina's 2001 default ("FAA Bonds"). In 2005 and 2010, Argentina made exchange offers to holders of the FAA Bonds, pursuant to which bondholders who tendered FAA Bonds received new bonds ("Exchange Bonds"). The plaintiffs did not tender their FAA Bonds in the exchange offers and Argentina has made it clear that it does not intend to make any further payments on the plaintiffs' unexchanged FAA Bonds.

The plaintiffs filed suit in federal district court in New York and alleged that Argentina's conduct in making full payment on the Exchange Bonds while making no payments on the FAA Bonds constituted a breach of the FAA's pari passu clause. This clause states, in part, that Argentina's payment obligation "shall at all times rank at least equally with all its other present and future unsecured and unsubordinated external indebtedness". The district court agreed that Argentina had breached the pari passu clause and issued an injunction requiring, among other things, that whenever Argentina made a payment under the terms of the Exchange Bonds, it had to concurrently or in advance make a ratable payment to the plaintiffs.

On appeal, the federal appeals court agreed with the district court and ruled that the pari passu clause prohibits Argentina, as bond issuer, from formally subordinating the FAA Bonds by issuing superior debt, and prohibits Argentina, as bond payor, from paying on other bonds without paying on the FAA Bonds. The appeals court, however, remanded the case to the district court to provide additional clarity with regard to, among other things, the ratable payment mechanism contained in the district court's injunction.

On remand, the district court ruled, among other things, that the plaintiffs are to be paid 100 percent — all principal and interest — currently due on the FAA Bonds. Additionally, and significantly, the district court ruled that The Bank of New York, the paying agent on the Exchange Bonds, is subject to the court's orders, meaning that funds paid by Argentina to the The Bank of New York for payment to the holders of Exchange Bonds are potentially available for payment instead to the plaintiffs. By specifically including The Bank of New York within the ambit of its orders, the court effectively forced Argentina to pay the plaintiff bondholders in full or default on the Exchange Bonds, since any payment by Argentina to The Bank of New York for payment on the Exchange Bonds would have to be withheld or rejected by The Bank of New York absent full payment on the plaintiffs' bonds. Soon after this ruling, the federal appeals court issued a stay of the district court's decision and set an expedited briefing schedule, which calls for the parties to fully brief the appeal by 1 February 2013 and for the court to hear oral argument on 27 February 2013.

For more information, you may refer to our Argentina sovereign debt webpage at: http://www.shearman.com/argentine-sovereign-debt/.

New York state appellate court overturns lower court, dismisses claims brought by plaintiffs against a foreign corporation on jurisdictional grounds under Morrison: Viking Global Equities, LP v. Porsche Automobil Holding SE

In December 2012, a New York State appellate court reversed a lower court's decision to deny a motion to dismiss filed by Porsche Automobil Holding SE based on forum non conveniens. This decision marks the latest chapter in a long-running effort by a group of hedge funds to pursue claims against Porsche in the US based on alleged misstatements that Porsche made regarding its intent to obtain control of Volkswagen AG.

In the first phase of this case, which we summarized in our April 2012 update, a federal court in New York, relying on the US Supreme Court's landmark decision in *Morrison v. National Australia Bank*, dismissed a federal securities fraud lawsuit against Porsche on the grounds that the securities transactions at issue in that case were foreign transactions that were not entitled to the protection of Section 10(b) of the Securities Exchange Act of 1934.

Some of the plaintiffs that lost in federal court initiated a separate action in New York state court, in which they alleged claims of common law fraud and unjust enrichment. Porsche moved to dismiss the state court complaint based on forum non conveniens, but the state court denied the motion.

On appeal, the New York appellate court unanimously reversed the lower court's decision and dismissed the complaint on the ground of forum non conveniens. The appellate court ruled that the only connections to New York were some phone calls and emails between the plaintiffs in New York and a representative of the defendant in Germany. The court found that these connections failed to create a substantial nexus with New York, particularly because the defendants and most of the plaintiffs were not New York residents, the relevant stock was traded only on foreign exchanges, many of the witnesses and documents were located in Germany, and Germany provides an adequate alternative forum. Based on these facts, the court ruled that Porsche had met its heavy burden to establish that New York was an inconvenient forum.

This decision demonstrates that plaintiffs will face considerable hurdles in their effort to try to circumvent Morrison by pursuing common law fraud claims against foreign corporations in state court.

Recent SEC/DOJ Enforcement Matters

UBS LIBOR Investigation

In December 2012, UBS AG and UBS Securities Japan Co. Ltd. entered into agreements with the Department of Justice, the Commodities Futures Trading Commission, the UK Financial Services Authority, and the Swiss Financial Market Authority to resolve multi-year investigations into UBS's alleged manipulation of the London Interbank Offered Rate (LIBOR). In the agreements, UBS acknowledged that certain of its employees had worked with co-workers and employees at other banks to manipulate LIBOR in order to enhance the profits they earned from trading derivatives linked to LIBOR.

A particularly noteworthy aspect of the agreements is that UBS Japan agreed to plead guilty to felony wire fraud and UBS AG agreed to enter into a non-prosecution agreement with the Justice Department. In addition, the Justice Department filed a criminal complaint against two former senior UBS traders for their role in allegedly manipulating LIBOR.

In addition, UBS agreed to pay more than $1.5 billion in penalties and disgorgement -- $700 million in the CFTC action, $500 million in the DOJ action, $259.2 million in the UK FSA action, and $64.3 million in the Swiss FINMA action. UBS also agreed to take certain remedial actions, including implementing firewalls to prevent improper communications between traders and rate submitters, enhancing auditing and monitoring procedures, and making regular reports to the regulators regarding its compliance efforts.

Numerous regulators around the world are currently investigating the alleged manipulation of LIBOR, TIBOR, and EURIBOR rates. UBS is the second financial institution to enter into settlement agreements with the regulators (Barclays was the first in June 2012) and UBS Japan is the first entity to plead guilty to a criminal offense related to LIBOR manipulation.

ASIAN DEVELOPMENTS

New Rules on Hong Kong IPO Sponsors

On 12 December 2012, the Securities and Futures Commission ("SFC") published the conclusions of its "Consultation Paper on the regulation of sponsors". Other than the proposal to have a limit on the number of sponsors appointed for each IPO and the requirement for all sponsors to be independent of the listing applicant, the SFC has decided to proceed with most of its proposals.

The new rules on sponsor responsibilities, to be included in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct"), will apply to listing applications submitted on or after 1 October 2013. The proposed clarification of sponsor liability under the Companies Ordinance, as discussed below, will be subject to a separate legislative process and timetable.

Statutory Reform – Prospectus Liability under the Companies Ordinance

One of the most controversial proposals of the SFC is to remove any ambiguity in the case law by clearly identifying sponsors as being liable, along with directors and others who authorize the issue of a prospectus, under section 40 (civil liability for misstatements in prospectus) and section 40A (criminal liability for misstatements in prospectus) of the Companies Ordinance. Any person who commits an offence under section 40A is liable to a fine of HK$700,000 and imprisonment for three years.

In deciding to proceed with its proposal, the SFC acknowledges that the current standard of liability under section 40A may be too onerous. The SFC therefore proposes that criminal liability should only apply if the prosecution can prove that:

- the person knew that, or was reckless as to whether, a statement in the prospectus was untrue; and
- the untrue statement was materially adverse from an investor's perspective.

The SFC also proposes that only sponsor firms, and not individuals, will be subject to the civil and criminal liability under the Companies Ordinance. However, as stated in the Consultation Conclusions, there could be situations where individuals would be held liable under general criminal law, e.g., "aiding and abetting" under the Criminal Procedure Ordinance.

Publication of Application Proof on HKEx's website

With effect from 1 October 2013, the first draft of the listing document submitted to the Hong Kong Stock Exchange ("Application Proof") will be required to be posted on the website of Hong Kong Exchanges and Clearing Limited ("HKEx"). The Hong Kong Stock Exchange will also increase its practice of rejecting poor quality draft documents and will consider imposing a "cooling-off" period during which the submission of a revised draft will not be allowed.

In response to market concerns that applicants already listed on an overseas stock exchange might face practical difficulties given that any public disclosure in Hong Kong might trigger a corresponding disclosure obligation overseas, the SFC stated in the Consultation Conclusions that it may consider confidential filings for overseas listed companies.

Streamlined Regulatory Commenting Process

Some market participants have commented that disclosures in listing documents are sometimes driven by the rounds of regulators' comments rather than their relevance or materiality, and the paternalistic approach of the regulatory commenting process has been a contributing factor of sub-standard listing documents. While stressing the regulators are not responsible for the adequacy or accuracy of disclosures, the SFC stated that it will work with the Hong Kong Stock Exchange on measures to streamline and shorten the regulatory commenting process.

Sponsors' Role - Minimum Appointment Period and Fees

The SFC has also adopted some of the proposals by market participants to enhance the role and authority of sponsors, e.g.:

- a sponsor will be required to be formally appointed for a minimum period of two months before submission of the listing application. Where there is more than one sponsor, each of them will be required to comply with the minimum appointment period; and
- sponsor fees will be required to be specified in terms of engagement and should be based solely on a sponsor's role. Any "no deal, no fee" arrangement should be avoided.

The Revised Code of Conduct

The SFC has consolidated all existing rules and new obligations and standards governing sponsor conduct in a new paragraph 17 of the Code of Conduct. A key theme of the new rules, as reflected in some of the provisions summarized below, is early completion of comprehensive due diligence:

Work required before submission of listing application. Under the revised Code of Conduct, a sponsor is required to complete all reasonable due diligence on the listing applicant before submitting a listing application, except in relation to matters that by their nature can only be dealt with at a later stage. In addition, before submitting a listing application, a sponsor should come to a reasonable opinion that:

- the information in the Application Proof is substantially complete;
- the applicant has complied with all relevant listing qualifications under the Listing Rules (except to the extent that waivers from compliance have been applied for);
- the applicant has established procedures, systems and controls to ensure compliance with the Listing Rules and other relevant regulatory requirements; and
- the directors individually and collectively have the necessary experience, qualifications and competence.

Standards and responsibility of due diligence. The revised Code of Conduct codifies due diligence obligations and sets out typical due diligence steps and interview practices to be followed. In particular, it provides that a sponsor cannot abrogate its due diligence responsibility. Where a sponsor engages a third party (e.g., lawyer or consultant) to assist in the due diligence exercise, the third party's work, in itself, would not be sufficient evidence that the sponsor has discharged its obligation.

In relation to expert reports to be included in a listing document, the revised Code of Conduct introduces a "negative" test: a sponsor (i) should have no reasonable ground to believe; and (ii) should not believe that the information in the expert reports is untrue, misleading or contains any material omissions. A sponsor should carry out due diligence on expert reports covering the following aspects:

- the expert's qualification, experience and competence;
- the expert's scope of work;
- the bases and assumptions underlying the report; and
- the expert's opinion together with the rest of the information in the report.

Provision of information to regulators. A sponsor should reasonably satisfy itself that all information provided to the regulators is accurate and complete in all material respects and not misleading in any material respect. Where a sponsor becomes aware of any change in information provided or any material information which concerns non-compliance with the Listing Rules or other regulations, it should report the matter to the Hong Kong Stock Exchange in a timely manner.

Where a sponsor ceases to act for a listing applicant, the sponsor should inform the Hong Kong Stock Exchange in a timely manner of the reasons for ceasing to act.

Resources, systems and controls. A sponsor should maintain sufficient resources and effective systems and controls to ensure that it is able to meet its obligations. In respect of each assignment, a sponsor should ensure that it has sufficient staff with appropriate levels of knowledge, skills and experience to devote to the assignment. The management of a sponsor must be ultimately responsible for supervision of the sponsor work and there must be clear and effective reporting lines so that decisions on critical matters are made not by the transaction team but by the management.

Record keeping. A complete set of sponsor's records should be retained in Hong Kong for at least seven years after completion or termination of a listing assignment. A sponsor should keep a record of all sponsor work and maintain adequate records to demonstrate that it has complied with the Code of Conduct.

Impact of the Reform

As shown in the *Hontex* case where the SFC imposed a HK$42 million fine and revoked the license of Mega Capital for failure to discharge its sponsor's obligations, the SFC will not hesitate to take action against sponsors and exercise its disciplinary power to the full extent. With the revised Code of Conduct and the potential civil and criminal liability, the SFC will be vested with further powers. It is therefore important for sponsors to get prepared for the new regime.

The new rules will have significant impact on the ways IPOs are conducted in Hong Kong. Sponsors will be concerned about potential criminal liability and will look for additional safeguards and comforts during the listing exercise to ensure that they will not be tainted with any allegation of "recklessness". The tightened regulations under the revised Code of Conduct will front load many tasks and sponsors and all professional parties involved will be working on a much longer and intensive pre-A1 timetable. To offset the increased workload under the new regime, it is important that the SFC and the Hong Kong Stock Exchange streamline the regulatory commenting process, as promised in the Consultation Conclusions. We look forward to the announcement of the new measures and hope that the streamlined procedure will mean not only fewer rounds of regulators' comments, but also a change in the overall vetting approach.

The Consultation Paper and the Consultation Conclusions are available at:

http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=12CP1

http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=12CP1

DEVELOPMENTS SPECIFIC TO FINANCIAL INSTITUTIONS

EU Developments

EMIR: European Commission Adopts Technical Standards

On 19 December 2012, the European Commission adopted nine regulatory and implementing technical standards to complement the obligations set out in the European Market Infrastructure Regulation ("EMIR"), which came into force on 16 August 2012. The technical standards were developed by the European Supervisory Authorities and were endorsed by the European Commission without modification. One technical standard on colleges for central counterparties ("CCPs") was not endorsed due to concerns on the legality of the provisions. The standard will be redrafted by ESMA and adopted at a later stage, although this will not affect the timing of the clearing obligation or the timing of the authorisation of CCPs under EMIR.

The adopted technical standards will come into force on the twentieth day following publication in the EU's Official Journal and will be directly applicable on Member States from that date. The adoption of these technical standards finalises requirements for the mandatory clearing and reporting of transactions, in accordance with the EU's G20 commitment made in Pittsburgh in September 2009.

The technical standards are available at:

Regulatory technical standards on capital requirements for central counterparties

Regulatory technical standards on requirements for central counterparties

Regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, risk mitigation techniques for OTC derivatives contracts not cleared by a CCP

Regulatory technical standards on the minimum details of the data to be reported to trade repositories

Regulatory technical standards specifying the details of the application for registration as a trade repository

Regulatory technical standards specifying the data to be published and made available by trade repositories and operational standards for aggregating, comparing and accessing the data

Implementing technical standards on requirements for central counterparties

Implementing technical standards on the minimum details of the data to be reported to trade repositories

Implementing technical standards specifying the details of the application for registration as a trade repository

EMIR: Consultation on the Assessment of Interoperability Arrangements for CCPs

ESMA has published a consultation paper on guidelines regarding the assessment of interoperability arrangements for CCPs. The guidelines clarify obligations for national regulators on how to assess existing or new interoperability arrangements between CCPs. In particular, the guidance focuses on the following issues relating to interoperability arrangements: legal risk; ensuring fair and open access; identification, monitoring and management of risks; ring-fencing of collateral deposits; and co-operation between national regulators. The consultation closes on 31 January 2013.

The consultation is available at:

http://www.esma.europa.eu/consultation/Consultation-Guidelines-establishing-consistent-efficient-and-effective-assessments-int

EMIR: European Commission Requests Technical Advice on the Equivalence of Third Country Frameworks

The European Commission has requested ESMA's technical advice on the equivalence between the legal and supervisory frameworks of certain third countries under EMIR. Under EMIR, a CCP or trade repository established in a third country must be recognised by ESMA. One of the recognition conditions is that the Commission has adopted an implementing act determining that the legal and supervisory regime in the third country ensures that the CCP or trade repository complies with the requirements equivalent to those in EMIR. Additionally, the Commission may also adopt implementing acts declaring that the legal, supervisory and enforcement arrangements of a third country are equivalent to the clearing and reporting requirements laid down in EMIR in order to avoid duplicative or conflicting rules. The request for technical advice from ESMA is with a view to the preparation of the implementing acts and concerns the following third countries: the United States, Canada, Hong Kong, Japan, Switzerland, Australia, Dubai, India and Singapore.

ESMA is required to deliver its technical advice under a phased timetable: Phase I – 15 March 2013 and Phase 2 – within three months after the entry into force of regulatory and implementing technical standards but at the latest, 15 June 2013.

The Commission's request is available at:

http://www.esma.europa.eu/system/files/formal_request_for_technical_advice_on_equivalence.pdf

EMIR: Frequently Asked Questions

The European Commission has published frequently asked questions (FAQs) on EMIR. The FAQs relate to the timing of implementation, the scope of the requirements and the position of third country CCPs and trade repositories, and are designed to provide clarity on these areas from the perspective of the Commission's services, although the FAQs note that only the EU Court of Justice can provide an authoritative interpretation of Union legislation.

The FAQs are available at:

http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/doc_121114_emirfaqs_en.pdf

Reform of the EU Banking Structure

In October 2012, the high-level expert group on reforming the structure of the EU banking sector, chaired by Erkki Liikanen, presented its final report (Liikanen Report) to the European Commission. The report recommended actions in the following areas:

- mandatory separation of proprietary trading and other high-risk trading activities;
- possible additional separation of activities conditional on the recovery and resolution plan;
- possible amendments to the use of bail-in instruments as a resolution tool;
- review of capital requirements on trading assets and real estate related loans; and
- strengthening of the governance and control of banks.

Following the publication of the Liikanen Report, the European Commission launched a consultation on the recommendations of the high-level expert group. Comments were due by 13 November 2012.

The Liikanen Report and the Commission's consultation website are, respectively, available at:

http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf

http://ec.europa.eu/internal_market/consultations/2012/hleg-banking_en.htm

AIFM Directive: European Commission Adopts Delegated Regulation on AIFMs

On 19 December 2012 the European Commission adopted a delegated regulation to supplement the AIFM Directive. The delegated regulation concerns conditions and procedure for the determination and authorisation of alternative investment fund managers ("AIFMs"), general operating conditions for AIFMs, conditions for delegation, depositaries, reporting requirements and leverage calculation, transparency and supervision.

The delegated regulation is subject to a three-month scrutiny period by the European Parliament and the Council and will enter into force the day following publication in the Official Journal.

The delegated regulation is available at: http://ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf

AIFM Directive: Consultations on Guidelines on Key Concepts of the AIFM Directive and on Draft Technical Standards on Types of AIFMs

ESMA has launched a consultation on guidelines on key concepts of the AIFM Directive. The purpose of the draft guidelines is to clarify the rules applicable to hedge funds, private equity and real estate funds and whether certain entities fall within the ambit of the AIFM Directive. The guidelines set out criteria for what is considered to be: (i) a collective investment undertaking; (ii) capital raising; (iii) defined investment policy; and (iv) the necessary number of investors.

ESMA has also launched a consultation on draft regulatory technical standards on types of AIFMs. The technical standards distinguish between managers of AIFs whose investors have the right to redeem their shares at least annually and investors who have less frequent redemption rights, amongst other things.

Both the guidelines and the technical standards are due to be finalised in the first half of 2013. Consultations on the guidelines and the technical standards close on 1 February 2013.

The consultation on the guidelines and the technical standards are, respectively, available at:

http://www.esma.europa.eu/consultation/Consultation-Guidelines-key-concepts-AIFMD

http://www.esma.europa.eu/consultation/Consultation-Draft-regulatory-technical-standards-types-AIFMs

Credit Rating Agencies: Consultation on Guidelines and Recommendations on the Scope of the CRA Regulation

ESMA has published a consultation paper on guidelines and recommendations on the scope of particular aspects of the Credit Ratings Agencies (CRA) Regulation. The draft guidelines address the obligation to register credit rating activities and exemptions from registration, private ratings, establishment of branches outside the EU by registered CRAs, specific disclosure best practices and enforcement of the scope of CRA Regulation. The consultation closes on 20 February 2013 and an open hearing on the consultation will take place in Paris on 22 January 2013.

The consultation is available at:

http://www.esma.europa.eu/system/files/2012-841.pdf

Credit Rating Agencies: Update

As part of the ongoing reform on CRAs, on 16 January 2013 the European Parliament announced that it had approved the proposals for further amendments to the EU rules on CRAs amending Regulation 1060/2009 on CRAs. The agreement needs to be formally approved by the Council.

Short Selling: European Commission Requests Technical Advice on the Short Selling Regulation

The European Commission has requested ESMA's technical advice on the evaluation of the Short Selling Regulation. In particular, the Commission has asked ESMA to consider the observable effects of the Short Selling Regulation, if any, in order to answer the following questions, taking into account both the provisions relating to short selling as well as those relating to credit default swaps:

- whether and to what extent the beneficial effects of short selling for volatility and price formation during normal times have been affected by reporting and publication requirements or restrictions on uncovered short selling;
- to what extent any temporary restrictions imposed by competent authorities on short selling have had any positive effects in terms of reducing price falls, or any negative effects on volatility and price formation;
- to what extent the thresholds set for notification to competent authorities are appropriate for competent authorities' supervisory purposes and the thresholds for public disclosure are appropriate for the market's needs;
- whether the thresholds set to identify a significant drop in the price of financial instruments are appropriate for all instruments, and whether (and if so how) thresholds should be set for significant price falls in UCITS and commodity derivatives; and
- whether and to what extent the ban on naked sovereign credit default swaps has had any effects in terms of market prices and of volatility of sovereign debt markets or investment by affecting the scope for hedging.

The Commission is required to report to the European Parliament and the Council on the short selling regulation by 30 June 2013. The deadline set to ESMA to deliver the technical advice is 31 May 2013.

The formal request to ESMA is available at:
http://www.esma.europa.eu/system/files/esma_ssr_review_mandate_20121012.pdf

Short Selling: Updated Questions and Answers

ESMA has published updates to questions and answers on the implementation of the Short Selling Regulation. Additional questions and answers relate to the duration adjustment issue for calculating net short positions in sovereign debt and to the calculation and reporting for the specific situation of group and fund management activities. The questions and answers are intended to promote common supervisory approaches and practices amongst the EU's national securities markets regulators on the requirements of the Short Selling Regulation, which came into force on 1 November 2012, and to provide clarity on the requirements of the new regime to market participants and investors.

The updated questions and answers are available at:

http://www.esma.europa.eu/system/files/2012-666.pdf

Recovery and Resolution Planning: Update

The European Commission has launched a consultation on a recovery and resolution framework for financial institutions other than banks. The consultation paper focuses on ascertaining how and when the failure of a financial institution other than a bank can threaten financial stability, with particular regard to financial market infrastructures, and what arrangements are needed to prevent their failure from compromising financial stability. Comments were due by 29 December 2012.

The consultation paper can be viewed at:

http://ec.europa.eu/internal_market/consultations/2012/nonbanks/consultation-document_en.pdf

In addition, the Financial Stability Board launched a consultation on guidance on recovery and resolution planning. In particular, the guidance relates to recovery triggers and stress scenarios, developing resolution strategies and operational resolution plans and identification of critical functions and critical shared services. The guidance is aimed at regulators, supervisors and resolution authorities. Comments were due by 7 December 2012.

The guidance can be viewed at:

http://www.financialstabilityboard.org/publications/r_121102.pdf

UK Developments

Financial Services Bill: Update

The Financial Services Bill received royal assent on 19 December 2012 and has now become an Act of Parliament, known as the Financial Services Act. The Financial Services Act establishes the new financial regulatory framework comprising the Bank of England, the Financial Policy Committee, the Prudential Regulation Authority and the Financial Conduct Authority. The Financial Services Act is due to come into force on 1 April 2013.

The press release from HM Treasury is available at:

http://www.hm-treasury.gov.uk/press_126_12.htm

Prudential Regulation Authority (PRA): Update

The Bank of England and the FSA have published a consultation paper on the designation of investment firms for prudential supervision by the PRA. Under the draft of the Financial Services and Markets Act 2000 (PRA-Regulated Activities) Order 2001 (Order), the PRA will have the power to designate certain investment firms for prudential supervision by the PRA. The consultation paper aims to provide greater clarity on which firms will be regulated by the PRA and to consult on a draft policy statement, which sets out proposed factors to which the PRA will have regard when deciding whether to designate an investment firm, the rationale for these factors and the procedural arrangements for making these decisions. Comments were due by 4 January 2013.

The consultation is available at:

http://www.bankofengland.co.uk/publications/Documents/other/pra/boeprapolicy1210.pdf

Additionally, the Bank of England and the FSA have published a consultation paper on the proposed policies and procedures that the PRA will be required to publish under the Financial Services and Markets Act 2000 (FSMA). The consultation addresses regulatory decision-making, financial penalties, suspensions and restrictions, settlement, statutory notice decisions and interviews at the request of overseas regulators. Comments are due by 28 February 2013.

The consultation is available at:

http://www.fsa.gov.uk/library/policy/cp/2012/12-39.shtml

The Bank of England and the FSA have also published a consultation paper on a draft policy statement regarding the power of direction over qualifying parent undertakings by the PRA. The power of direction relates to new sections of the FSMA added by the Financial Services Act 2012, which grant the PRA specific powers in relation to qualifying parent undertakings. The consultation paper aims to set out the context of these new powers and to consult on a draft Statement of Policy on the use of the power of direction. Comments are due by 1 March 2013.

The consultation paper can be viewed at:

http://www.bankofengland.co.uk/publications/Documents/other/pra/21dec12.pdf

Financial Conduct Authority (FCA): Update

The FSA has published a paper on how the FCA will approach its regulatory objectives, how it intends to achieve a fair deal in financial services for consumers and the FCA's progress to meeting these objectives. Comments on the paper were due by 14 December 2012. The paper is available at:

http://www.fsa.gov.uk/about/what/reg_reform/fca

The FSA has also published two consultation papers on the new FCA Handbook, CP12/34 on FCA Handbook updates relating to supervision and threshold conditions and statement on the FCA's new power of direction over qualified parent undertakings and CP12/37 on implementing market powers, decision making procedures and penalties policies under the Financial Services Bill. Both consultation papers form part of a series of papers setting out proposed changes to the regulatory requirements needed to create the new rulebooks and policies for the FCA and the PRA.

The changes are intended to be in place when the new regulators acquire their legal powers in 2013. Transitional arrangements are anticipated in relation to certain areas and details will be made available in the months prior to the new regulators acquiring their powers. The FSA intends to publish a designated version of the existing Handbook before the new regulators acquire their powers to indicate how the Handbook provisions are being transitioned to the PRA and the FCA. Comments on CP12/37 are due by 1 February 2013.

CP12/34 and CP12/37 can be viewed, respectively, at:

http://www.fsa.gov.uk/static/pubs/cp/cp12-34.pdf

http://www.fsa.gov.uk/static/pubs/cp/cp12-37.pdf

Bank of England: Supervision of Financial Market Infrastructures

Pursuant to the Financial Services Act, responsibility for the supervision of CCPs and securities settlement systems will transfer from the FSA to the Bank of England, effective 1 April 2013. In preparation for the transfer, the Bank of England published a document on 18 December 2012, which sets out its intended approach to the supervision of financial market infrastructures. The document addresses the supervisory priorities for the Bank of England, how supervisors will engage with institutions in practice, policy making, enforcement, fees, accountability, transparency and complaints.

The paper can be viewed at:

http://www.bankofengland.co.uk/publications/Documents/news/2012/nr161.pdf

Benchmarks: Update

Following the UK Government's decision to accept the recommendations of the Wheatley Report on the LIBOR process, the UK Government tabled amendments to the Financial Services Bill (now the Financial Services Act) to:

- amend section 22 and Schedule 2 of the Financial Services and Markets Act 2000 (FSMA), which sets out the nature of the activities which can be regulated, to allow the specification of benchmark-related activities as regulated activities under FSMA;
- The repeal of section 397 of FSMA – which provides for criminal offences related to the making of misleading statements and practices – and the creation of three criminal offences in relation to misleading statements and

impressions: one offence, relating to benchmarks, will be new; the other two offences largely replicate the effect of section 397; and

- An amendment to the powers of the FCA to create a specific power to allow it to make rules requiring authorised persons to contribute to a specified benchmark (e.g. LIBOR). Such rules may refer to the Codes issued in relation to the administration of the benchmark.

The Government's press release is available at:

http://www.hm-treasury.gov.uk/press_94_12.htm

The Government then launched a public consultation on secondary legislation to implement the Wheatley Review on 28 November 2012. The consultation relates to two pieces of secondary legislation: the Order to be made under section 22 of FSMA, as amended by the Financial Services Bill, to amend the Financial Services and Markets Act 2000 (Regulate Activities) Order 2001 and the Order to be made under the new provisions of the Financial Services Bill which create new criminal offences. The Government anticipates that the secondary legislation will be laid in draft before Parliament as early as possible in 2013. Comments on the consultation paper were due by 24 December 2012.

The consultation paper can be viewed at:

http://www.hm-treasury.gov.uk/d/implementing_wheatley_review281112.pdf

On 5 December 2012, the FSA published a consultation paper (CP12/36) on the regulation and supervision of benchmarks. The consultation sets out the FSA's approach to regulating benchmarks, which will involve rules and guidance set out in the Market Conduct section of the FSA Handbook and requiring that individuals in management roles must be FCA-approved persons under the controlled persons regime. Comments should be submitted by 16 January 2013.

The consultation paper also includes a discussion paper on how best to broaden participation in the LIBOR benchmark to prompt discussion, due to the importance of preserving the continuity of the LIBOR benchmark and recognition that a larger range of submitters to LIBOR would enhance its integrity. Comments on the discussion paper are due by 13 February 2013.

CP12/36 can be viewed at:

http://www.fsa.gov.uk/static/pubs/cp/cp12-36.pdf

EMIR: Update

David Lawton, Director of Markets at the FSA, has given a speech in which he sets out key points on EMIR, the challenges raised by EMIR and practical advice for firms. Mr Lawton also provided his "current best guess" on the timetable for implementation:

- Entry into force of level 2: late Q1 2013;
- First clearing obligations: Q4 2013;
- Reporting requirement: July 2013 for credit and interest rate derivatives, January 2014 for all other classes. 90 days for backloading;
- Collateralisation of non-cleared trades: consultation likely H1 2013.

The text of the speech can be viewed at:

http://www.fsa.gov.uk/library/communication/speeches/2012/1122-dl.shtml

AIFM Directive: Update

On 14 November 2012, the FSA published CP12/32 on the rules and guidance to transpose the requirements of the AIFM Directive into UK law, in advance of the requirement on Member States to implement rules transposing the AIFMD by 22 July 2013. The consultation paper is the first consultation of two on the transposition of the AIFMD and addresses the following issues:

- the prudential regime for all types of investment fund managers, AIFMs and the regime for depositaries including capital requirements, risk of professional negligence, the liquid assets requirement and reporting matters, as well as changes affecting UCITS management companies;
- the regime for depositaries, including the eligibility of firms to be an AIF depositary, the capital requirements, and the requirement to act independently; and
- the Level 1 Directive requirements on AIFMs, including organisational matters, duties in relation to management of funds, and transparency obligations towards investors and the FCA.

Comments are due by 1 February 2013.

The FSA intends to publish the second consultation paper in February 2013, together with a Policy Statement.

CP12/32 can be viewed at:

http://www.fsa.gov.uk/static/pubs/cp/cp12-32.pdf

On 11 January 2013 HM Treasury published its first consultation on the transposition of the AIFMD covering:

- requirements for sub-threshold fund managers,
- marketing and
- private equity.

Comments are due by 27 February 2013. The consultation paper is available at:

http://www.hm-treasury.gov.uk/d/consult_transposition_of_the_alternative_investment_fund_managers_directive_110113.pdf.

Short Selling: Update

In October 2012, the Financial Services and Markets Act 2000 (Short Selling) Regulations 2012 were published. The regulations implement Regulation EU No. 236/2012 on short selling and certain aspects of credit default swaps (Short Selling Regulation), including providing the FSA with certain supervisory, investigatory and enforcement powers. The regulations also repeal provisions of the Financial Services and Markets Act 2000 (FSMA) which are inconsistent with the Short Selling Regulations or are no longer required and revoke rules made by the FSA under repealed sections of FSMA. The regulations entered into force on 1 November 2012.

The regulations can be viewed at:

http://www.legislation.gov.uk/uksi/2012/2554/pdfs/uksi_20122554_en.pdf

On 1 November 2012, the FSA published a policy statement (PS12/19) setting out the final amendments to the FSA Handbook to implement the Short Selling Regulation. The amendments to the FSA Handbook are based largely on the changes proposed by the FSA in its consultation paper CP12/21. However, a further amendment has been made to FINMAR 2.5 (Measures to prohibit, restrict or limit transactions in short selling) to prescribe the circumstances in which the FSA will make an in-year adjustment to the applicable exchange rate for calculating significant falls in price for the purposes of article 23(1)(b) of Commission Delegated Regulation (EU) 918/2012. FINMAR 2.5.6G confirms that the applicable exchange rate will only be adjusted during a 12 month period where the Sterling-Euro spot rate set by the Bank of England fluctuates by more than 10% for 20 consecutive business days. The amendments to the FSA Handbook came into effect on 1 November 2012.

PS12/19 is available at:

http://www.fsa.gov.uk/static/pubs/policy/ps12-19.pdf

Contact Us

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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