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

EU DEVELOPMENTS

Commission Consultation on Central Securities Depositories (“CSD”) and on Harmonisation of Securities Settlement

On 13 January 2011 the Commission launched a consultation on a common regulatory framework for CSDs and the harmonisation of certain aspects of securities settlement in the EU.

CSDs are considered systematically important post-trading infrastructure which perform services that allow for registration, safe-keeping, settlement and processing of securities transactions in the financial markets. The consultation covered common definitions of CSD services, harmonisation of rules on authorisation and on ongoing supervision of CSDs, prudential standards for CSDs, rules on access to CSDs and interoperability between CSDs.

Further, measures regarding the well-functioning of securities settlement are addressed. The Commission intends to improve settlement discipline, i.e., adherence to the intended settlement date, and harmonise the settlement periods within the European Union.

The consultation closed on 1 March 2011. A legislative proposal is expected in June 2011. The Commission is consulting separately on harmonising the legal framework for holding and disposing securities and the exercise of rights attached to securities, the so-called Securities Directive. A legislative proposal of the Securities Directive is expected in May 2011.

Commission Proposal to Interconnect Companies’ Registers within the EU

On 24 February 2011 the Commission proposed to amend Directive 2009/101/EC intending to facilitate cross-border access to official business information by setting up an electronic network of companies’ registers and by setting a minimum standard for up-to-date information that must be made available to third parties by electronic means in every EU member state. In addition, amendments to Directive 89/666/EEC are proposed to ensure that the register of a company provides up-to-date information on the status of the company to the registers of its foreign branches across Europe. Further, the Commission intends to improve the cooperation between companies’ registers in cross-border mergers by amending Directive 2005/56/EC. The proposal has been passed to the EU member states and the European parliament for consideration.


Commission Consultation on Corporate Governance Framework

On 5 April 2011 the Commission published a green paper on the improvement of the corporate governance framework for European companies. The paper addresses, for example, the effective functioning and composition of board of directors by enhancing gender diversity and diversity in professional backgrounds, skills and nationalities of board members and also discusses risk management and directors’ remuneration. The green paper also addresses the enhancement of shareholder involvement in corporate governance issues by encouraging shareholders to take interest in sustainable returns and long-term performance, covering, among others, proxy advisors, the protection of minority shareholders, shareholder identification and employee share ownership. Moreover, the green paper focuses on improving the monitoring and enforcement of existing national corporate governance codes, in particular the quality of information provided by companies and the oversight by monitoring bodies.


GERMAN DEVELOPMENTS

Act to Strengthen Investor Protection and to Improve the Functioning of the Capital Markets

On 11 February 2011 the German Bundestag adopted the Act on Strengthening Investor Protection and Improving the Functioning of the Capital Markets. The Act brings about amendments to the Securities Trading Act, the Securities Acquisition and Takeover Act, the Investment Act, the Financial Markets Stabilisation Acceleration Act and the Restructuring Fund Act. The Act, approved by the German Bundesrat on 18 March 2011, predominantly became effective the day following its announcement in the German federal gazette on 7 April 2011.

The Act contains rules that are aimed to ensure that certain employees of investment service companies in advisory, sales or compliance functions have adequate qualification and reliability and going forward, these employees will have to be registered with the BaFin.

There will be a minimum holding period of 24 months for new investments in open-end real estate funds as of 2013, with the exemption of redemptions of up to EUR30,000 per investor per six months. Redemptions exceeding EUR30,000 per six months will be subject to a twelve months’ prior notice period even after the expiration of the two year holding period. The Act further limits the maximum borrowings of an open-end real estate fund to 30% of the market value of the real estate held by the fund as of 2015. Redemptions will only be possible at fixed dates. The period for the regular valuation of the open-end real estate fund is reduced to the period between two possible redemption dates, but no less than three months.

Following public discussions triggered by the Continental/Schaeffler and the Hochtief/ACS takeovers, the Act also introduces rules to impede the so-called “creeping in” of investors. Investors will be obliged to disclose holdings in financial or other instruments which enable the respective owner to acquire existing voting shares of an issuer domiciled in Germany, provided that the holding reaches, exceeds or
falls below a relevant threshold (5, 10, 15, 20, 35, 50 and 70%). The holder must immediately notify the issuer and the BaFin. All voting shares, financial and other instruments held by an investor are to be aggregated in determining whether a relevant threshold is met.

Lastly, the Act stipulates that private investors must be informed of all the material features of a financial instrument by means of a standardised key information paper provided to them prior to completion of the investment advice.

**Draft Bill to Amend the Law Governing Financial Investment Advisors and Investments**

On 6 April 2011 the German Government passed the draft bill to strengthen investor protection in the grey capital market. Products traded in the grey capital market will qualify as financial instruments under the Banking Act and the Securities Trading Act and therefore require adherence to the advisory and documentation standards of the regulated market.

Further, the rules for public offerings of grey market products are tightened. Sales prospectuses need to comply with more stringent requirements; investors need to be given a key information paper and issuers will be subject to additional financial reporting standards.

Intermediaries and advisors of grey market products will have to prove competence and the existence of professional liability insurance. A legal ordinance will set forth these requirements along with the new standard of conduct. The intermediaries and advisors will continue to be supervised by the trading supervisory authorities of the German federal states.

**ITALIAN DEVELOPMENTS**

During the last week of March, the Italian Government approved two law decrees that may result in postponements of 2011 annual general meetings and, in the longer run, increase the role of the Italian Government as shareholder in strategic companies.

**Italian Companies Allowed Postponing 2011 Annual General Meetings**

On 23 March 2011 the Italian Government approved a law decree allowing annual general meetings to be postponed up to 29 June 2011 and announced the possible adoption of anti-takeover measures.

The decree authorises listed companies having Italy as their home member state to hold their annual general meeting within 180 days from the end of their financial year (as opposed to 120 days), even if their by-laws do not provide so. The decree also allows companies having Italy as their home member state, whose annual meeting has already been called, to postpone the meeting, provided that: (i) the call notice is published at least 30 days (or 40 days, if a new board of directors or board of statutory auditors is to be elected at the meeting) prior to the meeting; and (ii) the record date (which in Italy is set at seven trading days before the meeting) has not yet occurred. If an annual meeting at which the board of directors or the board of statutory auditors (Collegio Sindacale) are to be elected is postponed, slates that have already been submitted will continue to be valid and additional slates may be submitted within 25 days prior to the new meeting date.

In this context, an official press release issued by the Italian Government stated that, during the cabinet meeting held to approve the law decree, “the Ministry of Economy discussed […] other possible legal measures that could, inter alia, be introduced in the form of amendments to the law decree, subject to prior consultations with the EU as required”. Based on press reports not denied by the Government, such “legal measures” could include: (i) the introduction of a lower thresholds for mandatory takeover bids (currently set at 30% of the voting shares of Italian issuers); (ii) the provision that even the acquisition of interests lower than 30% in an Italian issuer could trigger the requirement to launch a takeover bid on all the outstanding shares of the issuer, to the extent that such acquisition entails a “change of control” of the issuer (CONSOB, the Italian securities regulator, would assess whether a “change of control” occurs); and/or (iii) the requirement for the prior authorisation for takeovers of (or acquisitions of “significant” interests in) companies operating in “strategic” sectors.
As a matter of procedure, the law decree must be converted into law by the Parliament within 60 days after its publication, otherwise it will lapse. The 60-day period is due to expire on 25 May 2011. During the conversion process, amendments and additions to the law decree may be submitted and approved. Unless otherwise indicated by the conversion law, such amendments will enter into force together with, and as of the date when, the conversion law itself enters into force, and are not retroactive.

According to its preamble, the law decree was adopted to “ensure that annual general meetings take place orderly...in light of the first-time application” in Italy of the law provisions implementing the Shareholder Rights Directive.

State Investments in Strategic Companies

On 31 March 2011 the Italian Government approved a law decree allowing State-controlled Cassa Depositi e Prestiti S.p.A. (“CDP”) to acquire equity interests in companies of “significant national interest” that are strategic in terms of “business sector, employment levels, turnaround volumes or impacts over the economic and business system of the country”. The law decree entered into force on the date of its approval.

A separate decree of the Ministry of Economy and Finance (“MEF”) will set forth the criteria that companies need to meet for CDP to invest in their capital. The law decree also allows CDP to acquire these interests either directly, or through investment vehicles or funds set up autonomously or together with other entities, whether State-controlled or not.

The current by-laws of CDP allow the company to merely hold interests transferred to it by the MEF. An amendment of the by-laws of CDP seems therefore required before it can actually purchase interests in other entities.

CDP, which is 70%-controlled by the MEF, currently holds interests in, inter alia, ENI S.p.A. (26.4%) and Terna S.p.A. (29.9%).

UK DEVELOPMENTS

Draft Takeover Rule Changes Published

On 21 March 2011 the UK Takeover Panel published its long awaited draft changes to the Takeover Code rules which are proposed to implement the changes that were announced by the Panel in October 2010. A copy of our client publication on the Panel’s October 2010 announcement is available at http://www.shearman.com/files/Publication/aeec964a-ae34-4983-b60b-d23075d4e60b/Presentation/PublicationAttachment/7df76ce3-c372-44a8-a946-7e09fa6de7c3/EC-102610-Update-on-the-UK-Takeover-Panel.pdf.

While the key rule changes remain the same as the ones announced last year, the Panel has introduced some important clarificatory modifications, particularly in relation to the provisions that will require offerors to be identified and to clarify their intentions within a short period of time and those that will ban target companies from agreeing to inducement fees and other deal protection mechanisms.

The Panel is inviting comments on the draft rule changes by 27 May 2011, following which it intends to publish a further response statement setting out the final version of the rule changes. The Panel has said that it will publish guidance as to the likely timing of the publication of this further statement and the implementation date for the rule changes. The implementation date will be at least one month after the date of publication of the final rule changes.

Aims of the Rule Changes

The rule changes have the following aims:

- Shortening the “virtual bid” period during which target companies can find themselves under virtual siege by a rumoured or potential offeror which has not yet announced a firm intention to make an offer;

- Strengthening the position of target companies, particularly with respect to the now common demands by “recommended” offerors for extensive US-style deal protection measures (such as inducement fees (currently limited by the Code to 1% of the value of the target company based on the
offeror’s bid price and soon to be outlawed all together) and no-shop or matching rights provisions);

- Increasing transparency and quality of disclosure in offer documentation (e.g., in relation to advisor fees and offeror financial information even in the case of cash offers); and

- Providing greater recognition in the bid process of the interests of the employees of target companies.

The Panel also takes the opportunity to make certain miscellaneous amendments to the Code, including adding a new rule requiring an offeror who (unusually) has been permitted to include a financing pre-condition in its offer, to notify the Panel promptly on becoming aware that the financing pre-condition may not be met.

**Shortening the "Virtual Bid" Period**

In relation to the requirement for potential offerors to be named in any “potential offer” announcement, the Panel provides clarification that all potential offerors will have to be named at the start of the offer period; subsequent additional potential offerors will only need to be named where there is an accurate rumour about the offeror or where, prior to a rule 2.5 announcement by another offeror of a firm intention to make an offer, the target company wishes to refer to a new potential offeror in any announcement.

The now mandatory “Put Up or Shut Up” deadline requiring that within 28 days following the first announcement identifying a potential offeror, the offeror must either announce a firm (and effectively binding) intention to make an offer or announce that it will not make an offer (in which case, under the Code, it will be precluded from making an offer for the next six months), will apply separately in relation to each potential offeror. The target company’s right to ask the Panel to grant an extension to this 28-day deadline will, however, enable it to request that all competing offers have the same timetable.

Once a rule 2.5 announcement has been made of a firm intention to make an offer, any other potential offerors already subject to the 28-day deadline will be released from it, but the Panel will have the right to require any continuing uncertainty as to such potential offerors’ intentions to be clarified at a later stage in the offer period. The 28-day deadline will also apply to other potential offerors (including those who have not had to be named) announced by the target company following a “firm offer” announcement, but by reference to a date to be fixed by the Panel later on in the offer period.

**Prohibition on Deal Protections**

With respect to the new prohibition on any deal protection mechanisms being agreed by the target company and the offeror, there will be the following exemptions:

- Situations where the target company commences a formal sale process;

- De minimis inducement fee (only) arrangements with one (only) “white knight” (i.e., a competing offeror who announces a firm intention to bid which has the target’s recommendation after a firm bid has been announced by a non-recommended offeror); and

- Targets in serious financial distress.

A copy of the Panel’s consultation paper which includes the draft rule changes is available at:


**Early Implementation of Certain Aspects of Prospectus Directive Amendments**

On 17 March 2011 the UK Government published its consultation paper on early implementation of two aspects of amendments to the Prospectus Directive. The amendments were approved in June 2010 and member states are required to implement the changes by 1 July 2012, but have discretion to transpose the amendments before that date. The UK Government intends to implement the following two changes by the summer 2011:

- The threshold for an offer of securities for which a prospectus is required will be raised from EUR2.5 million to EUR5 million; and

- The minimum number of investors for which a prospectus is required will increase from 100 to 150 investors per member state.

Early implementation of these amendments poses the risk that during the transitional period certain offers of
securities may be exempt from the requirement to publish an approved prospectus in some member states, such as the UK, but not in others. Issuers will therefore need to take care when undertaking cross-border offers.

The deadline for responses to the consultation is 9 June 2011. A copy of the paper is available at: http://www.hm-treasury.gov.uk/consult_amend_prospectus_directive.htm.

OFT Underwriting Report Published

On 27 January 2011 the Office of Fair Trading (“OFT”) published its market study report on equity underwriting fees. The OFT is responsible for reviewing the UK market and identifying features that prevent, restrict or distort competition in the supply of goods and services.

The market study, which began in August 2010, concentrated on share issues (other than initial public offerings) used by FTSE 350 companies to raise capital in the UK.

The OFT concluded that there has been a significant increase in fees paid to investment banks since the onset of the financial crisis in 2007 and that there are reasonable grounds for suspecting that competition for equity underwriting services is prevented, restricted or distorted. However, the OFT declined to make a market investigation reference to the Competition Commission, on the basis that the level of underwriting fees would be best addressed by companies and institutional shareholders.

In particular, the report found that:

* Companies are generally not focused on negotiating cost-effective outcomes with investment banks for the cost of equity underwriting services, instead prioritising speed, confidentiality and a successful “take-up”;

* Certain companies also lack regular experience of raising equity capital and do not consider a range of options when appointing equity underwriters, such that they often find it difficult to hold investment banks to account on costs; and

* While institutional shareholders have expressed concerns about prices, they have yet to put sufficient pressure on companies to reduce the fees paid.

To improve competition between investment banks in their pitches for appointments as equity underwriters, the report concluded that companies should (a) request a breakdown of the underwriter’s proposed fees (so as to put pressure on the fees incurred for each element); (b) hold competitive tenders; (c) increase the number of banks that they work with so as to increase the number of potential providers; and (d) address any lack of experience by seeking advice where necessary.

In turn, the report recommended that institutional shareholders (a) apply greater pressure on the companies they own shares in to reduce underwriting fees; (b) where possible, commit to sub-underwriting issues before they are announced, reducing the risk borne and therefore fees charged by, the underwriters; and (c) indicate that they are willing to accept lower sub-underwriting fees.

Whilst investment banks have avoided the threat of a full inquiry by the Competition Commission, the report clearly concludes that companies and institutional shareholders can be more pro-active to achieve more cost effective outcomes, principally by applying greater pressure on underwriting fees and discounts.


Board Effectiveness Guidance Published by the FRC

On 3 March 2011 the UK’s independent accounting and corporate governance regulator, the Financial Reporting Council (the “FRC”), published guidance that replaces the so-called Higgs Guidance for non-executive directors (including the chairman). This guidance, now entitled Guidance on Board Effectiveness, is designed to assist boards in applying relevant principles of the new UK Corporate Governance Code, particularly those contained in section A of the Code (focusing on the board’s, and in particular the chairman’s, leadership responsibilities) and in section B (focusing on the
effectiveness of the board with respect to its composition and performance).

This Guidance is specifically not intended to be prescriptive but rather to stimulate boards’ thinking on how they can carry out their role most effectively.


FRC Discussion Paper on Enhancing Corporate Reporting and Audit

On 7 January 2011 the FRC published a discussion paper raising a number of proposals regarding financial and narrative reporting by companies and containing seven key recommendations for companies to achieve high standards of relevant, reliable, fair and balanced reporting. The paper also contains proposals on improved audit reports, greater involvement of investors in the auditor appointment process and on the FRC’s responsibilities for on-going monitoring of developments in corporate reporting.

Specific proposals call for greater transparency regarding business activities and their associated risks and fuller reporting on the activities of companies’ audit committees. In this context, the UK Financial Reporting Review Panel recently warned about companies’ inadequate reporting of the principal risks and uncertainties facing their business.

The paper also addresses the question of the best form of publication of companies’ annual reports in light of the ever increasing length of such reports over the last couple of years - a recent study has shown that the length of annual reports and accounts for listed companies has increased by 41% compared to 2005.

The paper strongly encourages a more searchable web-based form of publication (such as the use of XBRL, already mandated by the SEC and in use for HMRC and certain Companies House filings) and recommends to no longer obliging companies to publish their reports in paper form.

Apart from the proposals contained in its paper, the FRC acknowledges the need to avoid unnecessary additional regulation of companies’ reporting activities. It also points out that some legislative changes to the current reporting regime may be required to allow for the implementation of its proposals as well as the development of narrative reporting standards by the Accounting Standards Board.


Government Proposal to Reduce Certain Audit and Narrative Reporting Obligations

In its jointly published Plan for Growth that forms part of the UK Budget for 2011, HM Treasury and the Department for Business Innovation and Skills (“BIS”) announced a number of proposals designed to stimulate growth in the UK economy. In the area of corporate governance and business regulation, these proposals were specifically designed to reduce the regulatory burden on certain companies.

First, it is proposed that the audit obligations of subsidiaries and small-to-medium sized enterprises be reduced. As indicated earlier in an announcement made on 4 March 2011 by BIS, this will entail the following:

- With effect from 2012, amendments will be made to the small company audit and account rules contained in the Companies Act 2006 to bring them in line with the less demanding underlying small company audit exemption rules in the Fourth and Seventh EU Company Law Directives;

- With effect from 2012, additional legislation will be introduced to enable subsidiaries to take advantage of EU rules that provide an audit exemption where a subsidiary’s debts are guaranteed by its parent company; and

- The UK Government aims to press the EU to agree to
  - A simplification of the audit and accounting rules so as to exempt most medium-sized companies from a mandatory audit; and
  - An exemption for the smallest companies (e.g., those with less than ten employees) from the current minimum reporting
requirements of the Fourth EU Company Law Directive.

Second, with regards to “quoted companies”, the Government proposes to simplify the narrative reporting framework by removing certain duplicative reporting requirements and by improving non-regulatory guidance.


PIRC Publishes Revised UK Shareholder Voting Guidelines

On 24 March 2011 the Pensions Investment Research Consultants (“PIRC”), one of the UK’s most prominent investor protection organisations, published the 15th edition of its UK shareholder voting guidelines. These guidelines represent PIRC’s views of current best corporate practice with respect to companies listed on UK markets and form the basis on which it issues voting recommendations.

Directors

The new guidelines generally support full compliance with the new UK Corporate Governance Code and related guidance with respect to the roles, responsibilities and shareholder expectations of the chairman, the senior independent director and the executive and non-executive directors. This includes, at least from 2012 onwards, the annual re-election of the entire board.

Directors’ Re-Election and Remuneration

As with the re-election of directors who have raised concerns in the discharge of their roles on other companies’ boards, inadequate performance on other companies’ remuneration committees will be considered by PIRC when a member of the remuneration committee comes up for re-election. The new guidelines also state that restraints in remuneration should be real and should not be compensated for by subsequent excessive awards or increases in other parts of a director’s remuneration. In addition, bonuses should be clawed back where a subsequent restatement of financial or performance measures shows that they were not properly earned.

Audit and Reporting

The guidelines call for greater transparency and more detail in the audit committee’s reports and it is PIRC’s view that such reports should be specifically commented on in the auditor’s report. In addition, companies should comment on their rationale for any executive sitting on their risk management committee. PIRC also considers it inappropriate to support the election of any audit firm that seeks to change the scope of the statutory audit.

Shareholder Relations

The guidelines make clear that PIRC will not be satisfied only with statements in annual reports that non-executive directors remain available to meet with shareholders throughout the year, but will expect to see evidence of meetings that have taken place during the year. PIRC also supports the idea of a shareholder advisory vote on the directors’ business review report.

A copy the PIRC UK shareholder voting guidelines can be purchased at http://www.pirc.co.uk/publications.

The Lord Davies “Women on Boards” Report

On 24 February 2011 Lord Davies published his Government-commissioned report on increasing the presence of women on the board of directors of listed companies. Rejecting the introduction of statutory quotas, he has made a number of practical recommendations designed to encourage greater female representation on boards, including:

- FTSE 100 companies should aim for a minimum of 25% female board representation by 2015;
- FTSE 350 companies should set their own targets, to be announced by September 2011, for female board representation by 2013 and 2015;
- Quoted companies should disclose the proportion of women on their boards and in senior executive positions in the company; and
- The FRC should amend the UK Corporate Governance Code to require the disclosure of a company’s policy on boardroom diversity.

The FRC has announced that it will be consulting on these recommendations. A copy of Lord Davies’ report is available at...
First Conviction under UK Corporate Manslaughter and Corporate Homicide Act 2007

On 15 February 2011 Cotswold Geotechnical (Holdings) Ltd ("Cotswold") was found guilty of corporate manslaughter following the death of one of its employees in September 2008. It is the first time a company has been charged with or convicted of this offence under the Corporate Manslaughter and Corporate Homicide Act 2007 (the "Act"), which took effect two years ago, on 6 April 2008.

Alex Wright, who was employed by Cotswold as a junior geologist, died whilst taking soil samples from a 3.5 metre deep trial pit on a building site, which had been excavated as part of a site survey. Mr Wright had climbed in to investigate soil conditions when the sides of the pit collapsed, crushing him. Industry guidance prohibits entry into pits more than 1.2 metres deep.

The Act was introduced to make it easier for the authorities to successfully prosecute large organisations for deaths caused by failings in corporate management. The Act replaces the previous common law charge of involuntary manslaughter by gross negligence as applied to organisations, which required evidence that a "directing mind" was personally guilty of manslaughter. Insufficient evidence of such an individual had hindered the prosecution of companies, particularly those with complex management structures.

Under the Act, an organisation will be found guilty of corporate manslaughter if (a) its conduct caused the employee’s death and amounted to a gross breach of a relevant duty of care owed to the employee; and (b) a substantial element of the breach was in the way its senior management managed or organised its activities.

The jury found that Cotswold’s system of digging trial pits was unnecessarily dangerous. The company ignored well-recognised industry guidance that prohibited entry into excavations more than 1.2 metres deep, typically requiring junior employees to enter into unsupported trial pits from 2 to 3.5 metres deep. At the time of his death, Cotswold had also left the employee unsupervised on the site.

The sentence for corporate manslaughter is an unlimited fine, to be determined by a judge, together with a possible publicity or remedial order. Cotswold was fined £385,000, which was intended to have a punitive effect and to act as a deterrent. A charge of gross negligence manslaughter and a health and safety offence had also been brought against a director of Cotswold but it was ruled that he was too unwell to stand trial.

At the time of the offence, Cotswold only had eight employees and the fine was made payable over ten years due to the company’s size and financial state. As larger corporations are expected to suffer greater fines, the case demonstrates the importance for all companies to adhere to health and safety guidance and for all individuals to take responsibility.


A copy of the Act is available at http://www.legislation.gov.uk/ukpga/2007/19/

Proposed Listing Rule Changes

On 6 January 2011 the FSA published its proposed changes to the Listing Rules, which govern listed companies’ continuing obligations together with the sponsors’ regime. The proposed changes are clarificatory only and do not amend the substance of the rules.

The key amendments published in the quarterly consultation paper are:

- **Open offers.** Clarification that certain requirements concerning the settlement of compensation to non-accepting shareholders and announcements of offer and rump placing results, which apply to rights issues, apply equally to open offers made with a compensatory element. Furthermore, a new rule is proposed providing that the open offer subscription period should be a minimum of ten business days (this reflects the limit already prescribed by the LSE admission and disclosure standards).

- **Major shareholder disclosures in accounts.** Clarification that the statement required in annual
reports, disclosing the notifications received from major shareholders as required by DTR 5, requires only those notifications received by the end of the period under review and any changes made between the end of that period and a date not more than one month before the AGM.

- **Omission of information from circulars.** New guidance to issuers and their advisers specifying the grounds on which information may be omitted from circulars (the grounds replicate those already provided in respect of the preliminary statement of annual results, dividends and half-yearly reports) and the introduction of a new rule specifying how requests for such omissions may be made.

- **Independence of the Board.** Clarification that a board of directors with an equal number of independent and non-independent members does not satisfy the independence requirement.

- **Rights issue subscription period.** Clarification that the ten business day period for a rights issue begins on the first day on which the rights issue is open for acceptance.


**Bribery Act Update**

The UK Government has now confirmed that the Bribery Act 2010 (the “Act”) will come into force on 1 July 2011. The delay in implementation of the Act has received widespread criticism, although some commentators have also expressed concern about the Act’s stringent standards and uncertain breadth. One of the offences under the Act is a corporate offence of failure to prevent bribery. The offence is committed where a person associated with a relevant commercial organisation pays a bribe with the intention of obtaining or retaining business or a business advantage for that organisation. This is a strict liability offence, but commercial organisations will have a defence if they have in place adequate procedures to prevent bribery.

Under the Act, the Secretary of State is required to publish guidance on the adequate procedures defence. After repeated delays to address the concerns of the business community, the Ministry of Justice has now published its final guidance. The Ministry of Justice guidance identifies six principles of bribery prevention. These are (1) proportionate procedures; (2) top-level commitment; (3) risk assessment; (4) due diligence; (5) communication (including training); and (6) monitoring and review. The Government has also provided 11 case studies which do not form part of the guidance but will undoubtedly prove useful in determining how the six principles should be applied in certain situations.

The guidance contains a section on Government policy in relation to the corporate offence under the Act. This sets out the Government’s view on specific elements of the offence. For example, the guidance states that it is not the Government’s intention “for the Act to prohibit reasonable and proportionate hospitality and promotional or other similar business expenditure intended for these purposes”. On the jurisdictional scope of the corporate offence, commercial organisations incorporated outside the UK are subject to the Act if they carry on a business or part of a business in the UK. The guidance indicates, however, that the Government does not expect “the mere fact that a company’s securities have been admitted to the UK Listing Authority’s Official List and therefore admitted to trading on the London Stock Exchange, in itself, to qualify that company as carrying on a business or part of a business in the UK and therefore falling within the definition of a ‘relevant commercial organisation’ for the purposes of [the corporate offence]. Likewise, having a UK subsidiary will not, in itself, mean that a parent company is carrying on a business in the UK, since a subsidiary may act independently of its parent or other group companies.”

The Serious Fraud Office and the Director of Public Prosecutions, who have joint responsibility for prosecutions under the Act, have also published joint guidance on the use of prosecutorial discretion for the purposes of the Act. Certain industry bodies (such as the British Bankers’ Association) are expected to publish best practice codes and sector specific guidance in the near future.


The joint prosecution guidance is available at http://www.sfo.gov.uk/press-room/latest-press-

US DEVELOPMENTS

SEC Developments

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

SEC Issues Final Rules on Say-on-Pay Provisions

The Reform Act requires (1) a non-binding shareholder vote on executive compensation at least once every three years; (2) a non-binding shareholder vote on the frequency of the say-on-pay vote; (3) disclosure of “golden parachute” arrangements in connection with specified change in control transactions; and (4) a non-binding shareholder vote on golden parachute arrangements in connection with these change in control transactions. The say-on-pay voting provisions of the Reform Act do not apply to foreign private issuers.

In October 2010 the SEC issued proposed rules implementing these provisions, which we reported on in our January 2011 Newsletter. On 25 January 2011 the SEC issued the final rules. The final rules are largely consistent with the proposed rules.

- Say-on-Pay Vote. The say-on-pay vote covers the compensation of the issuer’s named executive officers as disclosed in the annual proxy statement. The final rules do not specify the format or wording for the say-on-pay vote; however, the resolution must clearly indicate that the say-on-pay vote is to approve the compensation of executives as disclosed pursuant to Item 402 of Regulation S-K. The final rules do provide an example of a compliant resolution. In addition, issuers must (1) disclose that they are holding a separate shareholder vote on executive compensation; (2) briefly explain the general effect of the vote; and (3) disclose the current frequency of the vote and when the next frequency vote will be held. The rules clarify that the say on pay vote is required at least once every three “calendar” years.

- Say-on-Pay Frequency Vote. The final rules also do not specify the format or wording for the frequency vote, but do require issuers to (1) state that they are holding a separate shareholder advisory vote on the frequency of the say-on-pay vote; (2) briefly explain the general effect of the vote; and (3) disclose the current frequency of the vote and when the next frequency vote will be held. If an issuer’s board of directors includes a recommendation on the frequency of the vote, the proxy statement must clearly state that shareholders are voting to approve the actual frequency and not the board of directors’ recommendation.

- Additional Say-on-Pay Matters.
  - Say-on-pay and frequency votes are only required at annual or special meetings at which directors are to be elected.
  - Issuers are required to address in their subsequent proxy statement whether and, if so, how their compensation policies and decisions have taken into account the results of the most recent say-on-pay vote.
  - Issuers may vote uninstructed proxies in accordance with management’s recommendation on the frequency vote only if the proxy (1) included a recommendation for the frequency vote; (2) permitted abstentions on the proxy card; and (3) included language as to how uninstructed shares will be voted.
  - Issuers must disclose their decision as to how frequently they will conduct their say-on-pay votes on an amendment to the Form 8-K disclosing the results of the frequency vote. The amendment must be filed within 150 calendar days following the meeting, but in no event later than 60 calendar days prior to
the deadline for submitting shareholder proposals for the next annual meeting.

- Say-on-pay and frequency votes are executive compensation matters and brokers therefore may not vote uninstructed shares on these matters.
- TARP entities and foreign private issuers are exempted from the say-on-pay and frequency votes.

**Disclosure of Golden Parachutes.** New Item 402(t) of Regulation S-K specifies a tabular format for the golden parachute disclosure. The final rules expand the list of SEC forms for which disclosure is required to include those filed in connection with proxy and consent solicitations, going private transactions, third-party tender offers and similar transactions, as well as registration statements on Forms S-4 and F-4. If the target is a foreign private issuer, disclosure under Item 402(t) is generally not required. However, if the target is a US domestic issuer, disclosure is required even if the acquiror is a foreign private issuer. The disclosure is required for all initial filings made on or after 25 April 2011.

- Vote on Golden Parachutes. The golden parachute vote is only applicable for proxy and consent solicitations and not the additional transactions described above. Moreover, the vote is only required when the actual transaction is up for approval, as opposed to other proposals made in connection with the transaction (e.g., an increase in the number of shares or a reverse stock split). The vote is required for all initial filings made on and after 25 April 2011. Compensation arrangements are not subject to the golden parachute vote if they were subject to a prior general say-on-pay vote. In order to take advantage of this exemption, an issuer must have voluntarily included disclosure regarding the change in control arrangements in its annual meeting proxy statement in accordance with Item 402(t). In the event that compensation arrangements that were not subject to a prior say-on-pay vote were in place at the time of a transaction, issuers would need to segregate the required disclosure into two tables meeting the requirements of Item 402(t) showing the total amounts payable under all arrangements and just those amounts payable under new arrangements subject to the current vote. The final rules clarify that changes in compensation previously approved to reflect price movement in the issuer’s common stock or that result in a reduction in the value of the total compensation will not trigger a new advisory vote. Subsequent changes in compensation due to the addition of a new named executive officer, additional equity grants and salary increases must be subject to the golden parachute vote.


**SEC Proposes Rules Requiring Listing Standards for Compensation Committees and Compensation Consultants**

In our July 2010 Newsletter we reported on Section 952 of the Reform Act addressing the independence of compensation committees and their compensation advisors. On 30 March 2011 the SEC proposed rules to implement the provisions of Section 952 by adding Section 10C to the Securities Exchange Act of 1934 (the “Exchange Act”). New Section 10C requires the SEC to adopt rules directing the national securities exchanges to prohibit the listing of any equity security of an issuer that is not in compliance with Section 10C’s compensation committee and compensation adviser requirements. The proposed rules are largely consistent with the statutory requirements of the Reform Act.

Any foreign private issuer is exempt from the compensation committee independence requirements if it discloses in its annual report the reasons that it does not have an independent compensation committee.

- **Independence of Compensation Committee Members.** Under the SEC’s proposed rules, exchanges would be required to adopt listing
standards requiring each member of an issuer’s compensation committee to be a member of the board of directors and to be independent. In developing the definition of independence, the exchanges would be required to consider the following factors:

- The sources of compensation of the director, including any consulting or advisory fees he or she receives from the issuer; and
- Whether a member of the board of directors of an issuer is affiliated with the issuer, its subsidiaries or affiliates.

**Authority and Funding of the Compensation Committee.** The proposed rules would require the exchanges to adopt listing standards providing that the compensation committee of a listed company has sole discretion to obtain the advice of compensation advisers and is directly responsible for the appointment, payment and oversight of compensation advisers. An issuer must provide its compensation committee with appropriate funding for payment of reasonable compensation to compensation advisers.

**Compensation Adviser Selection.** The proposed rules would also require the exchanges to adopt listing standards providing that a compensation committee may select a compensation consultant, legal counsel or other adviser only after considering the following independence factors:

- Whether the compensation consulting company employing the compensation adviser is providing any other services to the issuer;
- How much the compensation consulting company who employs the compensation adviser has received in fees from the issuer, as a percentage of that person’s total revenue;
- What policies and procedures have been adopted by the compensation consulting company employing the compensation adviser to prevent conflicts of interest;
- Whether the compensation adviser has any business or personal relationship with a member of the compensation committee; and
- The compensation adviser’s ownership of stock of the issuer.

**Compensation Consultant Conflicts of Interest Disclosure.** The proposed rules would modify existing rules to require disclosure about whether the compensation committee has obtained the advice of a compensation consultant, whether the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.


**SEC Proposes Changes to Net Worth Standard for Determining Accredited Investor Status**

On 25 January 2011 the SEC proposed amendments to its rules to conform the definition of “accredited investor” to the requirements of the Reform Act. Section 413(a) of the Reform Act, which became effective on its enactment, requires the definition of “accredited investor” to exclude the value of a person’s primary residence for purposes of determining whether the person qualifies as an “accredited investor” on the basis of having a net worth in excess of US$1 million, but does not prescribe a method for calculating the value of the primary residence, nor does it address specifically the treatment of mortgage or other indebtedness secured by the residence.

According to the SEC’s proposed amendments, the value of the primary residence is determined by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property. As a result, an investor’s net worth would be reduced by the amount of the value that represents the investor’s net equity in the primary residence. Any indebtedness in excess of the fair market value of the property will be
considered a liability and deducted from the net worth calculation.

Under Section 413(b), the new net worth standard must remain in effect until 21 July 2014, fours years after enactment of the Reform Act. In 2014 and thereafter, the SEC is required to review the definition of “accredited investor” in its entirety every four years and engage in further rulemaking to the extent appropriate. The SEC comment period on the proposed rules closed on 11 March 2011.


Our related client publication is available at http://www.shearman.com/files/Publication/ce04a825-4b59-4896-ab4-33e5fb5e164a/Presentation/PublicationAttachment/fad80759-7f7a-4a8c-9f07-a7f3a0425ef8/FIA-021011-Private-Placement-Update.pdf.

SEC Proposes Changes to Eligibility Requirements for Use of Forms S-3 and F-3

On 9 February 2011 the SEC issued proposed rules to replace rule and form requirements for securities offerings and issuer disclosure rules under the Securities Act of 1933 and the Exchange Act that rely on, or make special accommodations for, security ratings with alternative requirements. This rulemaking was required pursuant to Section 939A of the Reform Act.

In particular, the SEC is proposing to amend the eligibility requirements for the use of short-form registration statements on Forms S-3 and F-3 for offerings of non-convertible debt and preferred stock for cash.

- Forms S-3 and F-3 permit eligible issuers to incorporate by reference information from the issuer’s reports filed under the Exchange Act to satisfy many of the offering disclosure requirements of the Securities Act.

- Issuers that are eligible to use Forms S-3 and F-3 may also register securities in a shelf registration under Rule 415 of the Securities Act, which enables them, once the shelf registration statement is effective, to conduct offers on a delayed or continuous basis without further action required by the SEC.

To be eligible to use Forms S-3 or F-3, an issuer must meet the form’s eligibility requirements as to registrants and at least one of the form’s transaction requirements. One such transaction requirement currently permits registrants to register primary offerings of non-convertible securities if they are rated investment grade by at least one nationally recognised statistical rating organisation. The proposed rules would replace this transaction requirement with a minimum registered debt issuance threshold that uses the same method and threshold than one of the prongs’ of the definition of well-known seasoned issuer.

Under the new standard, the use of Forms S-3 and F-3 would be available to register primary offerings of non-convertible securities if the issuer has issued, as of a date within 60 days prior to the filing of the registration statement, for cash at least US$1 billion in non-convertible securities in offerings registered under the Securities Act, other than common equity, over the prior three years. The SEC considers this standard appropriate because in its view it generally corresponds with a wide following of the issuer in the marketplace and information about the issuer being readily available. The SEC acknowledges that its proposal would cause some issuers that have relied or could rely on the investment-grade criteria to lose eligibility for the use of Forms S-3 and F-3 and is requesting comments on whether other or additional requirements may be appropriate to retain eligibility for these issuers. Conversely, the proposed rules would result in certain high-yield issuers becoming eligible to use short-form registration for the first time. The SEC is also requesting comments on whether special consideration should be given for foreign private issuers under Form F-3.

The proposed rules make related amendments to safe harbours for certain communications during the offering process, registration statements on Forms S-4 and F-4 for securities issued in connection with business combinations and exchange offers and Schedule 14A of the Exchange Act.

Independent Consultant Report on SEC Organization and Operations

On 10 March 2011 the Boston Consulting Group (“BCG”) presented US Congress with a report examining the organisation and operations of the SEC, as required by Section 967 of the Reform Act. The consultants focused their attention on four broad areas:

- Organisation structure;
- Personnel and resources;
- Technology and resources; and
- The SEC’s relationship with self-regulatory organisations (SROs).

While recognizing that the SEC has recently undertaken several initiatives to increase its efficiency and effectiveness, one of BCG’s key conclusions is that there is significant opportunity for the SEC to further optimise its available resources through implementing initiatives recommended in the report, such as:

- Reprioritising regulatory activities;
- Reshaping the organisation;
- Investing in enabling infrastructure; and
- Enhancing the SEC’s role as both overseer and co-regulator of SROs, in particular enhance its oversight of the Financial Industry Regulatory Authority, FINRA.

As a second step, BCG recommends that US Congress reflect on whether such optimisation adequately meets its expectations for the agency’s efficiency and effectiveness and if not, makes a choice to either increase the SEC’s funding to better fulfil its current role or to change the SEC’s role to fit available funding.


SEC issues updated Compliance and Disclosure Interpretations

On 4 March 2011 the SEC issued updated CD&Is on a variety of topics relating to the Securities Act and its rules and forms, including guidance on compliance with Regulation FD in the context of a Rule 144A/Regulation S offering; Rule 144; free writing prospectuses; director disclosure; and compensation disclosure and analyses.


Developments on Beneficial Ownership Reporting Requirements

In our October 2010 Newsletter we reported that the Reform Act amended Section 13 of the Exchange Act by authorising the SEC to shorten the 10-day period for filing an initial beneficial ownership report and added provisions relating to security-based swaps.

With respect to the first item, on 25 February 2011 MarketWatch reported that Michele Anderson, chief of the SEC’s Office of Mergers & Acquisitions, is planning to recommend to the SEC to shorten the 10-day period in which shareholders, including activist hedge fund managers, must currently disclose the acquisition of more than 5% of the equity securities of a public company by filing a beneficial ownership report. The full article is available at http://www.marketwatch.com/story/sec-eyes-faster-disclosure-for-activist-funds-2011-02-25.

With respect to the treatment of security-based swaps, on 17 March 2011 the SEC issued proposed rules that will re-adopt without change the SEC’s existing beneficial ownership rules with the aim to preserve the existing application of these rules to persons who purchase or sell security-based swaps. The rulemaking will remove any ambiguity that security-based swaps will remain within the scope of the beneficial ownership reporting rules to the same extent as they are now following the effective date of new Section 13(o) of the Exchange Act, which was added by Section 766 of the Reform Act. It is the SEC’s view that absent rulemaking under new Section 13(o), Section 766 of the Reform Act may be interpreted to render the beneficial ownership determinations made under Rule 13d-3 inapplicable to a person who purchases or sells a security-based swap.

Section 13(o) provides in its relevant parts that “…a person shall be deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap, only to the extent that the Commission, by rule, determines after consultation with the prudential regulators and the Secretary of the treasury, that….”.
In the proposed rules, the SEC clarifies that investors must continue to make their determination of whether a security-based swap confers “beneficial ownership” based on the existing standards set forth in Rule 13d-3 on a case-by-case basis. The proposed re-adoption will also not change any existing administrative or judicial application or interpretation of the beneficial ownership rules.

- Under the SEC’s existing rules, holders of security-based swaps may be subject to beneficial ownership reporting in cases where a security-based swap:
  - Confers sole or shared voting and/or investment power (or a person otherwise acquires such power based on the purchase or sale of a security-based swap);
  - Grants a right to acquire an equity security; or
  - Is used with the purpose or effect of divesting or preventing the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements.

In the proposing release, the SEC also points out that its staff is engaged in a separate project to develop proposals to modernise reporting under Exchange Act Sections 13(d) and 13(g).


### SEC Review of Private Placement Rules

On 6 April 2011, in a letter sent by the SEC to Rep. Darrell Issa, Chairman Mary Shapiro notified the lawmaker of the SEC staff’s review of the impact of the SEC’s regulations on capital formation for small businesses, including its private placement rules. The letter was in response to a 22 March 2011 letter from the lawmaker inquiring about the SEC’s plan to address a lag in the US IPO market. According to Ms. Shapiro, the SEC review focuses on issues such as:

- The restrictions on communications in initial public offerings;
- The prohibition on “general solicitation” in private offerings in light of current technologies and capital-raising trends;
- The number of shareholders that trigger the obligation for SEC registration and public reporting (currently 500 or more “holders of record”) and whether the current threshold should be increased. The SEC is also reviewing the current method of calculating the number of “record holders” and is looking at questions surrounding the use of special purpose vehicles that hold securities of a private company for groups of investors; and
- Regulatory questions posed by new capital raising strategies, such as “crowdfunding”, where investors pool money, typically comprised of very small individual contributions, to fund a developing business.

Ms. Shapiro also confirmed that the staff is currently monitoring the secondary trading activity on a variety of online trading platforms, many of which are facilitating the trading of securities of private companies.


Already on 1 March 2011 Reuters reported that Ms. Shapiro told the Reuters Future Face of Finance Summit that the agency has been reviewing its rules on private placements and the secondary market for privately placed securities. While the issue has recently gained prominence as Wall Street banks offer their clients stakes in Internet companies before they go public, according to Mary Shapiro the SEC has been interested in the question of pre-IPO trading for some time to ensure that it is appropriate.

The full article is available at http://www.reuters.com/article/2011/03/01/us-finance-summit-sec-offerings-idUSTRE7204HF20110301.

### SEC Updates its Financial Reporting Manual

On 1 April 2011 the SEC’s Division of Corporation Finance updated its Financial Reporting Manual for issues relating to, among others, combined periodic reporting, income averaging, changes in accountants, and foreign private issuer financial statements. The manual was last updated in December 2010. A copy of the updated Financial Reporting Manual is available at
Stock Exchanges File Proposal to Address Extraordinary Market Volatility

On 5 April 2011, the SEC announced that national securities exchanges and FINRA filed a proposal to establish a new “limit up-limit down” mechanism to address extraordinary market volatility in US equity markets. Under the proposed plan, which would operate as a one-year pilot, trades in listed equity securities would be prevented from occurring outside a specified price band, which would be set at a percentage level above and below the average price of the security over the immediately preceding five-minute period. These “limit up-limit down” requirements would be coupled with trading pauses to accommodate more fundamental price moves.

The SEC will seek comment on the proposed plan, which is subject to Commission approval following a 21-day public comment period. If approved, the new mechanism would replace the existing single stock circuit breakers.


Recent Trends and Patterns in the Enforcement of the Foreign Corrupt Practices Act

In January 2011, we published our bi-annual FCPA Digest, which provides an insightful analysis of recent trends and patterns and an invaluable compendium of all FCPA enforcement actions and private actions. 2010 saw a resurgence in corporate cases against large corporations, with over US$1.7 billion in total penalties. With very few exceptions, most of these cases have involved non-US companies as the DOJ’s focus in the short-term seems to be very much on putting pressure on non-US companies to comply with global anti-corruption agreements, particularly when those companies’ home countries are less than aggressive in enforcing their own corruption laws.

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


Noteworthy US Securities Law Litigation

US Supreme Court declines to adopt bright-line standard for pleading materiality in securities fraud cases: Matrixx Initiatives, Inc. v. Siracusano. In March 2011 the United States Supreme Court issued a significant ruling regarding the standard for pleading materiality and scienter in securities fraud cases. In Matrixx, the plaintiffs alleged that the defendant (a publicly listed pharmaceutical company) made public statements that were materially misleading because it failed to disclose reports of a possible link between its leading product, a cold remedy, and a loss of smell. The defendant urged the Court to adopt a bright-line rule providing that, in order to plead materiality, a plaintiff must identify a sufficient number of adverse event reports such that there was a “statistically significant” risk that the company’s product was, in fact, causing the negative side effect.

The Supreme Court rejected the defendant’s bright-line rule and held that such a rule would artificially exclude information that would otherwise be considered significant to the trading decision of a reasonable investor. Relying on precedent from earlier securities fraud cases, the Court stated that the materiality requirement is satisfied when there is a “substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” The Court emphasised that this is a fact-specific inquiry that requires consideration of the source, content, and context of the information.

Applying this standard to the facts of the case, the Court ruled that the plaintiffs had adequately pleaded materiality. The Court explained that, at the same time
that the defendant informed the market that its revenues were going to rise 80 percent, it had allegedly received information from physicians, customer reports, and product liability lawsuits that plausibly indicated a causal link between its product and the loss of the sense of smell. Based on these allegations, the Court ruled the plaintiffs’ allegations were material because it was “substantially likely that a reasonable investor would have viewed this information as having significantly altered the total mix of information made available”.

The Court also ruled that the plaintiffs had adequately pleaded the element of scienter (i.e., a mental state evidencing intent to deceive, manipulate or defraud). Applying the standard for scienter articulated in earlier securities fraud cases, the Court held that the plaintiffs’ allegations gave rise “to a ‘cogent and compelling’ inference that the defendant elected not to disclose the reports of adverse events not because it believed they were meaningless but because it understood their likely effect on the market.”

This case is important because it resolves a split between the federal courts of appeal in the United States. Before this ruling, certain courts of appeal had held that a company’s financial statements would not be materially misleading until the company had information that its product caused a statistically significant number of adverse events. Following this ruling, it is clear that, while “statistical significance” remains a factor in determining materiality, it is not the only factor. Courts must also consider the source, content, and context of the information.

**US Court of Appeals adopts plaintiff-friendly materiality standard and addresses “trend disclosure” requirements: Litwin v. The Blackstone Group, L.P.** In March 2011 the US Court of Appeals for the Second Circuit issued an important ruling regarding the materiality standard in securities fraud cases and addressed the requirement for “trend disclosure” under Item 303 of Regulation S-K.

Reversing a district court’s decision granting Blackstone’s motion to dismiss, the Court ruled that investors had plausibly alleged that material information was omitted from, or misstated in, Blackstone’s registration statement for its initial public offering (“IPO”) in violation of Sections 11 and 12(a)(2) of the Securities Act. In its complaint, the plaintiffs alleged that, at the time of the IPO, Blackstone knew of problems in two of its portfolio companies and real estate fund investments, but failed to disclose in its registration statement that it reasonably expected these problems to materially impact its future revenues.

In its motion to dismiss, and on appeal, Blackstone argued that, with regard to the two portfolio companies, the information the plaintiffs alleged was omitted was not material because it was already publicly known. The Court rejected this argument, stating that the plaintiffs adequately alleged that, pursuant to Item 303(a) of SEC Regulation S-K, Blackstone was required to disclose the manner in which Blackstone reasonably expected known trends, events, or uncertainties to materially impact its future revenues.

Blackstone also argued that the losses in the portfolio companies were not material because they were offset by gains in other portfolio companies, but the Court disagreed. The Court held that Blackstone is not permitted, in assessing materiality, to aggregate negative and positive results in order to avoid disclosure of a particular material event. The Court also found that, even though the impact on Blackstone’s revenue fell below the “presumptive 5% threshold of materiality,” certain qualitative factors made the plaintiffs’ materiality allegations plausible. In particular, the Court focused on the fact that the omission impacted Blackstone’s flagship business segment and concluded that, even though the effect on future revenue was quantitatively small, the omission was material because a reasonable investor would want to know about an adverse impact on an important segment of Blackstone’s business.

Finally, Blackstone argued that, with regard to its real estate investments, the plaintiffs failed to identify any specific real estate investments that might have been at risk as a result of the known downturn in the real estate market. The Court, again disagreeing, held that the plaintiffs had alleged a plausible link between the alleged negative trend in the residential real estate market and Blackstone’s real estate investments.

This case is important for a number of reasons. First, it is the first decision of the Second Circuit in 10 years finding that a plaintiff stated a claim, and survived a
motion to dismiss, for an alleged failure to identify a “trend” required to be disclosed under Item 303. Second, the Court set out a plaintiff-friendly standard of materiality, permitting a claim to be based on publicly available information, emphasising that the issuer must not only disclose the fact of a trend, but the manner in which a particular trend might impact the issuer. This case may encourage more investors to try to rely on alleged violations of Item 303(a) in securities litigation and may lead to a renewed focus on “trend disclosure” by issuers. Third, the Court’s focus on the importance of the alleged misleading statements to a corporate segment, rather than the public entity itself, may increase the pressure on issuers to disclose additional information about their business segments, portfolio companies or subsidiaries.

Foreign issuer exposure to US securities fraud actions curbed further: Elliott Assocs v. Porsche Automobil Holding SE. Lower federal courts in the US continue to explore the boundaries of the US Supreme Court’s landmark decision in Morrison v. National Australia Bank. In Morrison, the Court adopted the so-called “transactional test” and limited the applicability of the US securities laws to fraud that is “in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.” After the Morrison decision, several lower federal courts have ruled that the “transactional test” bars securities fraud claims brought by both foreign and US investors, as long as the investors purchased the securities on a foreign exchange.

In Elliott Assocs. v. Porsche Automobil Holding SE, the plaintiffs argued that Porsche, a German company and two of its senior executives, who were based in Germany, violated Section 10(b) of the Exchange Act by misrepresenting Porsche’s intentions to take over Volkswagen AG, a German public company listed on German exchanges only. The plaintiffs, who were hedge funds, had entered into security-swap agreements in New York and Texas referencing Volkswagen stock. The plaintiffs asserted that, even after Morrison, Section 10(b) applied to the security-based swap agreements because the swap transactions occurred in the United States (i.e., New York and Texas).

The Court rejected the plaintiffs’ argument, stating that, even though the swap agreements were signed in the United States, the transactions were the functional equivalent of selling short the underlying Volkswagen shares on a German exchange. Because the economic reality of the swaps was that they were foreign – and not domestic – transactions, the Court held that, under Morrison, the swap transactions were not entitled to the protection of Section 10(b).

This case is important because it further limits foreign issuers’ exposure to private securities fraud lawsuits in the US.

Recent SEC/DOJ Enforcement Matters

**Trial of Insider Trading Case against Founder of Galleon Group begins.** In March 2011 the insider trading trial against Raj Rajaratnam, the founder of the hedge fund Galleon Group LLC, began in federal court in New York. In a fourteen-count indictment, federal prosecutors in Manhattan have alleged that Mr. Rajaratnam knowingly purchased and sold securities based on material, non-public information and conspired with others to commit securities fraud. If convicted, Mr. Rajaratnam could face twenty years in prison and forfeiture of more than US$45 million.

The case has drawn widespread publicity in the US, in part because some of the witnesses and alleged co-conspirators formerly worked in high-ranking positions at large US corporations, including IBM, McKinsey & Co., Intel, AMD and others. The trial is scheduled to last approximately ten weeks.

**International Business Machines Corporation.** In March 2011 the SEC charged International Business Machine Corporation (“IBM”) with violating the books and records, and internal control provisions of the FCPA. The SEC alleged that from 1998 to 2003, employees of an IBM subsidiary and an IBM joint venture paid cash bribes and provided improper gifts and payments of travel and entertainment expenses to various government officials in South Korea in order to secure the sale of IBM products. The SEC also alleged that from 2004 to 2009, employees of two wholly-owned IBM subsidiaries provided overseas trips,
entertainment, and improper gifts to Chinese government officials.

Without admitting or denying the SEC’s allegations, IBM consented to the entry of final judgment that permanently enjoins the company from violating the books and records, and internal controls provisions of the FCPA. IBM also agreed to pay disgorgement of US$5,300,000, US$2,700,000 in prejudgment interest, and a US$2,000,000 civil penalty.

This case is noteworthy because it demonstrates that companies can run afoul of the FCPA even if they have well developed policies and procedures regarding compliance with the FCPA. The SEC found that, despite these policies, IBM lacked sufficient internal controls and oversight to ensure that the policies and procedures were followed.

DEVELOPMENTS SPECIFIC TO FINANCIAL INSTITUTIONS

EU Developments

AIFM Directive Adopted

The Alternative Investment Fund Managers Directive (the “AIFM Directive”) was adopted by the European Parliament on 11 November 2010. It had been expected that the AIFM Directive would be published in the EU Official Journal by the end of March 2011, which publication would bring the Directive into force and start the timeframes for national implementation. However, the European Commission has since published a letter it sent to ESMA stating that there will be a delay to the publication of the AIFM Directive and that it is not likely to come into force before June 2011.


German Developments

Draft Restructuring Fund Ordinance

The German Government published a draft Restructuring Fund Ordinance to specify the provisions of the Restructuring Fund Act, the legal framework for the German banking levy. The provisions set forth the calculation method for the annual contributions to the restructuring fund, which will be based on a financial institution’s business volume and will also take into account the financial institution’s outstanding futures transactions. Annual contributions range from a minimum of 5% to a maximum of 15% of the institution’s annual profits. The calculation of the annual contributions must be certified by an auditor and reported to the Federal Financial Markets Stabilization Authority. The draft ordinance is subject to approval by the German Bundestag and Bundesrat.

Draft Amendment of Derivatives Ordinance

The ordinance covers risk management and risk measurement for the use of derivatives in collective investment schemes (“UCITS”). The BaFin published a draft ordinance to further implement Directive 2010/43/EU with regard to the organisational requirements, conflicts of interest, rules of conduct of business, risk management and the content of agreements between the depositary bank and the management company administrating the collective investment scheme. The draft ordinance is further intended to implement the CESR Guidelines on risk measurement and the requirements concerning the risk management process of collective investment schemes.

Draft Bill to Implement the Omnibus I Directive

The draft bill implements the Omnibus I Directive into German law. The Directive creates a European System of Financial Supervision, comprising European Supervisory Authorities (ESA) covering the banking, the securities and the insurance and occupational pensions sectors, the European Systemic Risk Council as well as a joint committee. The draft bill adopts rules for the cooperation of BaFin with the ESA and the transfer of information and contains specifications with respect to certain notification and information obligations of BaFin. The draft bill further implements
rules with regard to disputes and cases of insufficient cooperation among national supervisory authorities.

**UK Developments**

**HM Treasury Consultation on Financial Regulation Reform**

On 17 February 2011 the UK Government published further details on its proposals to reform the national financial regulatory structure. The Government proposes to address the absence of a financial stability watchdog through the establishment of the Financial Policy Committee within the Bank of England, with responsibility for ‘macro prudential’ regulation, to supervise the stability and resilience of the financial system as a whole. It also proposes to reassign the FSA’s current functions between two new regulatory entities:

- The Prudential Regulation Authority: a subsidiary of the Bank of England carrying out ‘micro-prudential’, firm-specific regulation of regulatory capital and related matters; and
- The Financial Conduct Authority: effectively, the successor to most current FSA functions, responsible for conduct of business regulation across the entire spectrum of the financial services sector (formerly proposed as the ‘Consumer Protection and Markets Authority’).

In addition, the Bank of England will supervise systematically important market infrastructure relating to payment systems, settlement systems and recognised clearing houses.

The consultation paper is available at [http://www.hm-treasury.gov.uk/consult_finreg_strong.htm](http://www.hm-treasury.gov.uk/consult_finreg_strong.htm).


**Change to FSA Code of Market Conduct following Spector Decision**

In our January 2011 Newsletter we reported that the FSA had consulted on amending the Code of Market Conduct following the European Court of Justice’s decision in Spector Photo Group NV, Chris Van Raemdonck v Commissie voor het Bank, Financie-en-Assurantiewezen (Case C-45/08). In the Spector case, the ECJ found that the fact that a person who holds inside information trades in financial instruments to which that information relates implies that the person has ‘used that information’. This presumption is, however, without prejudice to the person’s rights of defence and right to rebut that presumption. The FSA considers that the wording in the Code of Market Conduct suggests that it would need evidence of a person’s intention to prove insider dealing and that this is not necessary due to the Spector decision. The necessary amendments to the Code of Market Conduct were brought into effect on 6 March 2011.

**Reform of Her Majesty’s Courts Service and the Tribunals Service**

On 1 April 2011 the Ministry of Justice (“MoJ”) confirmed that Her Majesty’s Courts Service and the Tribunals Service have merged to form a new, single organisation called HM Courts and Tribunals Service (“HCMTS”). The new HCMTS is responsible for all administration in courts and tribunals, including the Upper Tribunal (Tax and Chancery Chamber) from which decisions of the FSA are appealed. We reported on the related MoJ consultation in our January 2011 Newsletter.

**ICB Publishes Interim Report**

On 11 April 2011 the Independent Commission on Banking (“ICB”) published its Interim Report: Consultation on Reform Options. The Interim Report sets out the ICB’s provisional views on possible reform options. Reform options being considered by the ICB are:

- Requiring systematically important banks to hold at least a 10% baseline ratio of equity to risk-weighted assets (3% above that required for banks by the new Basel III rules). The ICB believes that this should become the international standard which, in the UK, would apply to large UK retail banking
operations. Wholesale and investment banking businesses of UK banks would not need to exceed the international standard provided that those firms have credible resolution plans.

- Ring-fencing UK retail banking activities within separately capitalised subsidiaries (as opposed to a full separation under which retail banking and wholesale and investment banking could not be conducted within the same corporate group). It is proposed that the retail separation would be based on activities as opposed to the existing way in which most banks are organised, which prevents certain customers from receiving services from certain types of entities. Any global bank seeking to conduct retail banking activities in the UK would be subject to the rules, not only UK headquartered firms. Importantly, the ICB proposes to allow banks to transfer capital between their UK retail and other banking activities. However, a parent company would not be able to transfer capital out of the retail entity if that transfer would result in the retail entity no longer meeting the minimum regulatory capital requirements.

- Improving competition in banking by (a) improving methods for consumers to switch bank accounts at a reasonable cost; and (b) giving the proposed Financial Conduct Authority a primary duty to promote effective competition. See the discussion above for more detail on the proposed reform to the UK financial regulatory framework.

The closing date for responses is 4 July 2011. The ICB is due to publish its final report in September 2011. A copy of the consultation is available at: http://bankingcommission.independent.gov.uk/bankingcommission/.

US Developments

Financial Institutions Update

On 30 March 2011 seven US Federal financial agencies (the “Agencies”) announced joint proposed rules (the “Joint Proposal”) implementing the provisions of Section 956 of the Reform Act, which (1) prohibits incentive-based compensation at a covered financial institution that encourages inappropriate risk by providing excessive compensation or that could lead to a material loss, and (2) requires sufficient disclosure for regulators to evaluate incentive compensation structures. The Agencies are seeking public comments on the Joint Proposal and the final version of the Joint Proposal will become effective six months after its publication in the Federal Register. After the Joint Proposal becomes final, each Agency will codify its own version of the rules. Agency rules will vary to accommodate differences between regulated entities, as well as varying statutory and regulatory requirements.

The Joint Proposal applies to financial institutions with total consolidated assets of US$1 billion or more. It also includes US branches of foreign institutions if total US assets are US$1 billion or more. It contains heightened standards for institutions with US$50 billion or more in total consolidated assets.

The Joint Proposal contains the following provisions:

- Excessive Compensation. The Joint Proposal would prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangement that encourages any covered person to expose the institution to inappropriate risks by providing that person excessive compensation. Encouragement of Inappropriate Risks. The Joint Proposal would prohibit incentive-based compensation arrangements that incentivise behaviour that could lead to a material financial loss; specifically for executive officers, non-executive individuals whose activities may expose covered institutions to a material financial loss (such as traders with large position limits) and groups of individuals with the same incentive-compensation arrangements who could collectively expose the institution to a material financial loss (such as loan officers).

- Deferral Requirement. At larger covered financial institutions (institutions with US$50 billion or more in total consolidated assets), “executive officers” will be required to defer at least 50% of their incentive-based compensation over a period of at least three years. The board of directors, or appropriate committee, will also be required to individually approve the incentive-based compensation arrangements for certain individuals at larger covered financial institutions.
• **Anti-Evasion.** The Joint Proposal includes an anti-evasion provision that prohibits covered financial institutions from evading the proposed rules by effecting measures counter to the Joint Proposal indirectly or through another person.

• **Reporting Requirements.** The Joint Proposal implements the reporting requirements under the Reform Act. The report would need to be filed with the institution’s appropriate Federal regulator on an annual basis. The format of the annual report will be specified by the governing Federal regulator, but under the Joint Proposal, it must contain the following information:
  - A clear narrative description of the components of the incentive arrangements and the classes of covered persons to which they apply;
  - A succinct description of the policies and procedures governing the incentive arrangements;
  - For covered institutions with assets over US$50 billion, a succinct description of any specific incentive compensation policies and procedures for executive officers and other individuals that have the ability to expose the institution to possible substantial losses;
  - Any material changes from the previous report; and
  - The specific reasons the institution believes the structure of its incentive-based compensation does not provide incentives to engage in behaviour that is likely to cause material financial loss.


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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