

GOVERNANCE & SECURITIES LAW FOCUS

Below is a summary of the main developments in US and EU corporate governance and securities law and certain financial markets regulation developments since our last update on 18 April 2018.

The previous quarter’s Governance & Securities Law Focus newsletter is available [here](#). Financial regulation developments are available [here](#).

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EU DEVELOPMENTS

ESMA Proposes Simplifications to Prospectus Format and Content

On 3 April 2018, the European Securities and Markets Authority (**ESMA**) published its final report on its technical advice under the Prospectus Regulation. The technical advice covers the format and content of prospectuses and the EU Growth prospectus, and the scrutiny and approval of prospectuses.

ESMA sets out a number of simplifications to the existing prospectus regime, aimed at reducing the cost and administrative burden on issuers. By way of example, it has amended its technical advice on the format of the prospectus, the base prospectus and final terms by removing the requirements for a mandatory cover note and a stand-alone use of proceeds section in the prospectus. ESMA has also produced a Universal Registration Document, which is a shelf registration document that can be used by issuers to offer securities to the market quickly.

Running alongside these simplifications, ESMA has proposed standard criteria with regards to the scrutiny of prospectuses, while also affording competent authorities a certain level of flexibility, to ensure greater levels of investor protection.

ESMA's technical advice is available here:

- <https://www.esma.europa.eu/regulation/corporate-disclosure/prospectus>

European Commission Launches Consultation on the Shareholder Rights Directive

On 12 April 2018, the European Commission (**EC**) launched a consultation on minimum content requirements with regard to shareholder identification and the exercise of shareholder rights under the Shareholders Rights Directive (**SRD**). The SRD applies to EU companies traded on EU regulated markets.

The consultation paper includes a draft Shareholders Rights Directive II and annex (**SRD II**), which set out standardized formats and minimum content requirements for a wide range of documents, including:

- requests to disclose information on a shareholders' identity;
- notices of general meetings and other corporate notifications;
- confirmations of entitlement to exercise shareholder rights at a general meeting; and
- confirmations of the receipt and counting of votes.

It is hoped that the standardisation of formats and minimum content requirements will improve the efficiency and reliability of information sharing between issuers and shareholders across the EU.

The draft SRD II is available here:

- http://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-1944240_en

European Commission Proposes New Rules to Help Companies Move Across Borders and to Promote the Use of Digital Tools in Company Law

On 25 April, the EC proposed new company law rules to make it easier for companies to merge, divide and move from one EU Member State to another. This proposal follows the landmark judgment in Polbud (C-106/16), in which the European Court of Justice held that it was contrary to the freedom of establishment to require a company to liquidate before transferring its registered office to another Member State.

The new rules would introduce a system of prior consent by the Member State of departure, with specific safeguards put in place against abusive arrangements which aim to circumvent tax rules, undermine workers' rights or harm the protection of creditors or minority shareholder interests. The company can then move while maintaining its legal personality, provided that the conditions laid down in the Member State of destination are satisfied.

The EC also proposed that all Member States should implement digital capabilities to allow company registrations and filings to be done online without the need for applicants to submit in person.

The EC's proposal is available at:

- <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2018%3A241%3AFIN>

European Commission Proposes Legislation to Promote SME Growth Markets

On 24 May 2018, the EC published a proposal for a regulation to amend the Market Abuse Regulation (**MAR**) and the new Prospectus Regulation. We discussed this in the January 2018 edition of this note.

The aim of the proposed regulation is to promote the use of SME Growth Markets by relaxing the regulatory requirements that apply to it, thereby reducing compliance costs and the administrative burden.

The proposed amendments to MAR include the following:

- SME Growth Market issuers must draw up insider lists of those with regular access to inside information, and only produce the list to the competent authority on request;
- SME Growth Market issuers that delay the disclosure of inside information will need to inform the competent authority of the delay, and only provide a reason for the delay on request; and
- SME Growth Market issuers will have two additional days to disclose any information on personal transactions declared to it by persons discharging managerial responsibilities, who will then have three days to notify the issuer.

The proposed amendments to the Prospectus Regulation are to allow SME Growth Market issuers of minimum three years to produce a lighter version of the prospectus when seeking admission to trading on a regulated market.

The EC is seeking feedback on the proposal by July 25, 2018, before passing to the European Parliament and Council for discussion. As currently drafted, the proposed regulation provides that it should apply six months after its entry into force, and this is to allow time for SME Growth Market operators to adapt their rulebooks.

The draft regulation is available here:

- https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-331_en

Publication of the Fifth Money Laundering Directive in the Official Journal

On 19 June 2018, the Fifth Money Laundering Directive (**5MLD**) was published in the Official Journal of the European Union. 5MLD makes a number of changes to the European Anti-Money Laundering and Counter-Terrorist Financing regime set out in the Fourth Money Laundering Directive. The key changes are as follows:

- extends the scope of “obliged entities” to include providers of exchange services between virtual and fiat currencies as well as custodian wallet providers. These entities will need to register in their home Member State;
- harmonises the application of enhanced customer due diligence (**CDD**) for third countries that are determined by the EC to be high risk countries. Member States will be able to apply additional measures, where appropriate;
- reduces the thresholds under which obliged entities are exempt from applying certain CDD measures to prepaid cards. Customers in a remote payment transaction exceeding EUR 50 will need to be identified. In addition, the use of anonymous prepaid cards issued outside the EU will only be permitted where the cards comply with requirements equivalent to EU laws;
- enhances the powers of and cooperation between Financial Intelligence Units (national centres that collect information on suspicious or unusual financial activity), including giving them access to information and the ability to

exchange it without impediments. This will include access to information on all types of virtual currencies, not only those that are serviced by providers of exchange services and custodian wallet providers;

- requires Member States to maintain lists of specific functions that qualify as prominent public functions to assist in the identification of politically exposed persons; and
- enhances access to information on beneficial ownership across the EU and improving transparency in the ownership of companies and trusts.

5MLD will come into force on 20 July 2018. Member States are required to transpose 5MLD into their national laws within 18 months of that date, which is 10 January 2020.

The directive is available here:

- <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018L0843&from=EN>

EU Agrees Countering Money Laundering by Criminal Law Directive

On 7 June 2018, the Council of the European Union and the European Parliament announced their agreement on new EU criminal sanctions for money laundering. The proposed Countering Money Laundering by Criminal Law Directive will complement the Fifth Money Laundering Directive, which was adopted in May 2018.

The new Directive establishes minimum rules on the definition of criminal offences and sanctions in the area of money laundering. Member states will be required to implement national laws providing for money laundering offences by individuals to be punishable by a maximum term of imprisonment of at least four years. National laws will continue to provide for additional measures, such as fines, temporary or permanent exclusion from public tender procedures, grants and concessions and national laws will also provide for national courts to take into account any aggravating factors for sentencing.

In addition, the new Directive establishes corporate liability for money laundering in certain circumstances and provides for corporates to face various sanctions, such as exclusion from entitlement to public benefits or aid, temporary or permanent exclusion from public tender procedures, grants and concessions, temporary or permanent disqualification from the practice of commercial activities, placing under judicial supervision, judicial winding-up and temporary or permanent closure of the establishments used for committing the offence.

The new Directive also includes rules for establishing jurisdiction and for cross-border cooperation between member states.

The U.K., Ireland and Denmark will not adopt the new Countering Money Laundering by Criminal Law Directive. In the U.K., this follows the approach in relation to EU criminal sanctions for market manipulation where the U.K. has implemented its own national regime instead.

The new Directive must now be formally adopted by the Council and Parliament. It will enter into force 20 days after it has been published in the Official Journal of the European Union and member states will have up to 24 months to transpose the new provisions into national law.

Parliament's press release is available here:

- <http://www.europarl.europa.eu/news/en/press-room/20180605IPR05049/eu-wide-penalties-for-money-laundering-deal-with-council>

Council's press release is available here:

- <http://www.consilium.europa.eu/en/press/press-releases/2018/06/07/eu-agrees-new-rules-to-make-sure-money-laundering-criminals-are-punished/pdf>

UK DEVELOPMENTS

BEIS Statement on Women on Boards

The Government commissioned the Hampton-Alexander review to look into ensuring women at the top of business are recognised, promoted and rewarded. The Hampton-Alexander Review target is for 33% of board positions of FTSE 350 companies to be held by women by the end of 2020. On 27 June 2018, the BEIS and Government Equalities Office published a press release on FTSE 350 companies' progress in meeting this target. The press release encourages companies to speed-up their progress in order to achieve this target.

The 2018 Hampton-Alexander Review will be published on 13 November 2018. We discussed the 2017 Hampton-Alexander Review and its supplementary report in the January 2018 edition of this newsletter.

The press release can be accessed here:

- <https://www.gov.uk/government/news/ftse-350-urged-to-step-up-to-meet-2020-women-on-boards-targets>

House of Lords Select Committee on Bribery Act 2010 Call for Evidence

On 21 June 2018, the House of Lords Select Committee on the Bribery Act 2010 called for evidence for its scrutiny of the Bribery Act. The House of Lords appointed the Committee in May 2018 to consider whether the Bribery Act has achieved various aims, including a reduction in corrupt conduct and a higher conviction rate. The Committee will also examine the effectiveness of the Bribery Act, its impact on SMEs and the effect of the introduction of Deferred Prosecution Agreements.

Evidence must be submitted by 31 July 2018.

The details of the Committee are available here:

- <https://www.parliament.uk/business/committees/committees-a-z/lords-select/bribery-act-2010/role/>

Consultation on Wates Corporate Governance Principles for Large Private Companies

On 29 August 2017, the Government published a response to the green paper on corporate governance reform that it had issued in November 2016. Within the proposals in the response, the Government proposed to invite the FRC to develop a set of corporate governance principles for large private companies. We published a client memorandum on the Government's response in September 2017 and it is available via the link below.

The Companies (Miscellaneous Reporting) Regulations 2018, published on 11 June 2018 and discussed more generally below, set out reporting obligations which require a company to state the corporate governance code it applies, how the company applies that code and if the company departed from that code, how and why the company departed from it. This new reporting requirement applies to all companies that have either (i) more than 2,000 employees, or (ii) a turnover of more than £200 million, and a balance sheet of more than £2 billion. The regulations will come into force on 1 January 2019, if approved in their current form.

On 13 June 2018, the FRC issued a draft of the Wates Corporate Governance Principles for Large Private Companies for public consultation. The FRC has drafted the principles to help companies comply with the Companies (Miscellaneous Reporting) Regulations 2018. Companies will be able to adopt voluntarily the Wates Corporate Governance Principles when making a disclosure in accordance with the regulations about the company's application of a corporate governance code.

The FRC is seeking comments on the principles by 7 September 2018.

The principles can be accessed here:

- <https://www.frc.org.uk/getattachment/48653f86-92c3-4cd6-8465-da4b7cac0034/;:aspx>

Our client memorandum on the Government's response in August 2017 can be accessed here:

- <https://www.shearman.com/perspectives/2017/09/uk-corporate-governance-reform>

Draft Companies (Miscellaneous Reporting) Regulations 2018 Published

On 11 June 2018, the Draft Companies (Miscellaneous Reporting) Regulations 2018 were published. The intention behind the regulations is to build confidence in the way that large private and quoted companies are run. The regulations introduce certain reporting requirements which are intended to support these aims.

A company's strategic report must include a statement from the directors describing how they are fulfilling their duty under s.172 of the Companies Act 2006 to promote the success of the company. The directors' report must describe the actions taken to increase engagement with suppliers, customers and others in a business relationship with the company. These requirements will apply to companies meeting two out of three of the following specifications:

- turnover of more than £36 million;
- balance sheet total of more than £18 million; and
- more than 250 employees.

A company's directors' report must describe the actions taken to increase engagement with employees. This requirement applies to all companies with more than 250 U.K. employees.

A company is also required to report pay ratio information comparing the remuneration of the CEO with the remuneration of the company's U.K. employees. Specifically, the company must report the ratio of the CEO's remuneration to the median, 25th and 75th quartile pay remuneration in the director's remuneration report. A company must also give an illustration of the effect of future share price increases on executive pay outcomes. These requirements apply to U.K. incorporated quoted companies that are quoted on a recognised stock exchange (this does not include AIM companies).

A company must make a statement in the director's report stating the corporate governance code it applies, how it applies that code and if the company departed from that code, how and why the company departed from it. This requirement applies to all companies that have either:

- more than 2,000 employees; or
- a turnover of more than £200 million, and a balance sheet of more than £2 billion.

If approved in their current form, the regulations will come into force on 1 January 2019.

The regulations can be accessed here:

- http://www.legislation.gov.uk/ukdsi/2018/9780111170298/pdfs/ukdsi_9780111170298_en.pdf

Primary Market Bulletin No.19 Published by the FCA on Changes to the UKLA Knowledge Base

On 11 June 2018, the FCA published its 19th Primary Market Bulletin to consult on changes to the UKLA Knowledge Base. The bulletin covers a proposed update to the FCA's current technical note on periodic information and inside information.

According to the proposed update, issuers preparing financial reports should assess on a continuous basis whether information they hold is inside information as set out in Article 7 of MAR. Issuers should assume that information regarding financial results could be inside information. Issuers should exercise judgement and conduct ongoing assessments in good faith, including when assessing if immediate disclosure will prejudice the issuer's legitimate interests.

Comments on the proposed update are due by 23 July 2018.

The bulletin can be accessed here:

- <https://www.fca.org.uk/publication/newsletters/primary-market-bulletin-19.pdf>

FCA Policy Statement on Premium Listing Category for Sovereign Controlled Companies

On 8 June 2018, the FCA published a policy statement on the creation of a new premium listing category available to sovereign controlled companies which will be effected by an amendment to the listing rules. The FCA intends for this new category to maintain the standards of the current premium listing categories while allowing enough flexibility to enable a sovereign controlled company to fulfil the requirements.

There are three key modifications to the requirements for companies in this new category:

- Firstly, companies in this category will not need to receive prior shareholder approval for related party transactions where that transaction is with the sovereign shareholder because this would be disproportionately onerous for these companies.
- Secondly, the company does not have to enter into a controlling shareholder agreement with the issuer as this can be impractical for sovereign owners; investors are able to understand the relationship between the company and the sovereign owner using a wider pool of available information.
- Thirdly, as an alternative to equity shares being listed directly, depository receipts over equity shares in a sovereign controlled company will be eligible for listing. For this alternative to be available, the rights attached to the underlying equity must be capable of being exercised by the depository receipt holders and the depository receipt agreements must ensure this legally.

All other features of the premium listing regime apply as usual. These amendments to the listing rules took effect on 1 July 2018.

A client memorandum on this development can be accessed here:

- <https://www.shearman.com/perspectives/2018/06/new-premium-listing-option-in-london-for-sovereign-controlled-companies>

The policy statement can be accessed here:

- <https://www.fca.org.uk/publication/policy/ps18-11.pdf>

CLLS and Law Society Company Law Committees' Joint Working Parties Publish Updated MAR Q&A

On 22 May 2018, CLLS and Law Society Company Law Committees' Joint Working Parties published an updated MAR Q&A. The Q&A have been updated to explain how Article 19 MAR applies to issuers that have only debt financial instruments admitted to trading on an EU trading venue.

As detailed in the updated Q&A, Article 19 applies to persons discharging managerial responsibilities of debt issuers and the persons closely associated with them if the debt instruments are admitted to trading on an EU trading venue. Article 19 does not apply if the debt instruments are not themselves admitted to trading on an EU venue, unless they are linked financial instruments in relation to the traded debt.

The updated Q&A can be accessed here:

- <http://www.citysolicitors.org.uk/attachments/category/114/CLLS%20and%20Law%20Society%20MAR%20QA%20-%20updated%2022%20May%202018.pdf>

LSE Consultation on Changes to AIM Rules for Nominated Advisers

On 26 April 2018, the LSE published proposed changes to the AIM Rules for nominated advisers for consultation. The LSE has stated that it will continue to review its supervisory powers in order to promote consistency in standards across the market.

The proposed changes include:

- Amending the eligibility criteria for nomads, e.g. the nomad must have appropriate financial and non-financial resources.
- Increasing the notification obligations of nomads, e.g. notification must be made if the nomad is being investigated by a regulatory body for its conduct.
- A new rule under which the LSE may take action with regard to the nomad's performance, e.g. placing restrictions on the services the nomad may provide.

Comments on the proposals were due by 25 May 2018.

The proposed rule changes can be accessed here:

- <http://www.londonstockexchange.com/companies-and-advisors/aim/advisers/aim-notice/aim-rules-for-nominated-advisers-consultation-mark-up-april2018.pdf>

Updated QCA Corporate Governance Code

On 25 April 2018, the QCA published a revised Corporate Governance Code. The QCA corporate governance code is tailored to small and mid-size companies and takes an outcome orientated approach to compliance.

The revisions to the code are varied and include: merging the principles and necessary disclosure sections, expanding the section on effective application of the code, inserting a new description of board composition and the removal of the section on board effectiveness which is now in a separate document. The revised code has increased relevance as the LSE has recently announced that all AIM companies will have to apply a recognised corporate governance code from September 2018 and for many such companies the QCA code is a common choice.

The revised QCA code can be purchased here:

- <http://www.theqca.com/shop/guides/143861/corporate-governance-code-2018-downloadable-pdf.html>

FCA's Dear CEO Letter on Irredeemable Preference Shares

On 19 April 2018, the FCA published a Dear CEO letter on irredeemable preference shares and other similar capital instruments. The FCA's intention is to ensure that investors have access to the information necessary to assess the risk and rewards attaching to these types of share. Aviva plc recently announced it had an ability to cancel certain shares issued through a reduction of capital, affecting the market price of those shares and similar shares listed by other companies.

The letter suggests that companies should consider whether any intention to cancel or retire a class of shares constitutes inside information under MAR. The letter also suggests that certain information should be available to shareholders and potential shareholders. This information includes: the terms and conditions of the instrument, details of changes to terms and conditions after issue, the articles of association of the issuer and a Q&A to present information to investors in a clear manner.

The letter can be accessed here:

- <https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-irredeemable-preference-shares.pdf>

US DEVELOPMENTS

SEC and NYSE/Nasdaq Developments

SEC Publishes New Guidance on Non-GAAP Financial Measures

On 4 April 2018, the staff of the Division of Corporation Finance of the U.S. Securities and Exchange Commission (**SEC**) updated its compliance and disclosure interpretations (**C&DIs**) regarding disclosure of non-GAAP financial measures in the context of business combination transactions. The new C&DI expands on prior guidance that financial measures included in forecasts provided to a financial advisor and used in connection with a business combination transaction are not considered non-GAAP financial measures if two conditions are met:

- The financial measures are included in forecasts provided to the financial advisor for the purpose of rendering an opinion that is materially related to the business combination transaction;
- The forecasts are being disclosed in order to comply with Item 1015 of Regulation M-A or requirements under state or foreign law, including case law, regarding disclosure of the financial advisor's analyses or substantive work;
- The new C&DI states that a registrant can rely on this guidance if the same forecasts provided to its financial advisor are provided to its board of director or board committee; and
- In another new C&DI, the staff provided its view that when a registrant provides material forecasts to bidders in a business combination transaction and the disclosure of such forecasts is required to comply with the anti-fraud and other liability provisions of the federal securities laws, the financial measures included in such forecasts would be excluded from the definition of non-GAAP financial measures and therefore not subject to Item 10(e) of Regulation S-K and Regulation G.

The SEC's C&DI's are available at:

- <https://www.sec.gov/divisions/corpfin/guidance/nongapinterp.htm>

Center for Audit Quality Publishes Roadmap of Non-GAAP Financial Measures for Audit Committees

On 16 March 2018, the Center for Audit Quality (**CAQ**) published *Non-GAAP Measures: A Roadmap for Audit Committees (Roadmap)* to serve as a guide to audit committees on advancing their oversight and involvement with non-GAAP financial measures. The Roadmap presents themes that emerged at a series of 2017 roundtable discussions held by the CAQ and attended by a variety of stakeholders, including audit committee members, management, investors, securities lawyers and public company auditors. The Roadmap suggests that audit committees should:

- **Put themselves in the investors' shoes** when evaluating if the presented non-GAAP measures and related disclosures align with the company's overall strategy and performance;
- **Engage with investors directly or through investor relations** to ensure that the presented non-GAAP measures aid investors' understanding of the company's performance;
- **Ask management whether it has an internal policy** that provides guidelines for determining how non-GAAP measures are generated, calculated and presented, including the rationale for the measures and adjustments that it presents and excludes. If there is no policy, encourage management to create one;
- **Discuss with management how the company makes changes to non-GAAP measures it presents**, and the rationale for why it would or would not make changes;
- **Seek the perspective of counsel** on non-GAAP measures;

- **Ask the company to compare or to benchmark** its non-GAAP measures to those of its peers;
- **Find out what disclosure controls and procedures are in place** as they relate to the information that is presented and disclosed; and
- **Ask the external auditors what their responsibilities are for non-GAAP measures**, including whether the measures are consistent with the auditors' understanding and knowledge of the company's performance.

In addition, the Roadmap identified the following as some of the leading and recommended practices that companies have instituted to support their presentation of appropriate non-GAAP financial measures:

- **Disclosure controls:** Companies should strive to establish robust disclosure controls specific to non-GAAP financial measures as this will help mitigate risks and support sound decision-making about the reporting of non-GAAP measures. The disclosure controls should be documented and should facilitate their testing;
- **Non-GAAP policies:** Management should have policies and guidelines in place to guide the preparation and presentation of non-GAAP financial measures with a view to promoting consistency in how the measures are presented and calculated; and
- **Audit committee disclosure:** Companies may benefit from their audit committee making disclosure regarding the existence of non-GAAP policies (even if the policies themselves are not disclosed) as this could serve as helpful evidence for investors that the company has adequate policies to ensure the non-GAAP financial measures are used consistently, transparently and comparably.

The Roadmap is available at:

- <https://www.thecaq.org/non-gaap-measures-roadmap-audit-committees>

SEC Considering Allowing All Companies to Use 'Testing the Waters'

The JumpStart Our Business Startups Act of 2012, commonly known as the JOBS Act, sought to make it easier for smaller companies to access the public capital markets by relaxing restrictions on pre-IPO communications and allowing "emerging growth companies" (companies with less than \$1 billion in annual turnover) to pursue limited private discussions with institutional or accredited investors to gauge their interests in a potential IPO, known as "testing the waters." The provision was intended to allow companies to gain a better sense of whether to pursue an offering without violating pre-IPO communications restrictions.

The SEC has announced it is considering giving all companies access to "testing the waters" benefits. Bill Hinman, SEC Division of Corporation Finance, stated that there is no specific timeline to put such plans into effect for all companies but that the agency does not expect implementation to take an "inordinate time."

SEC Launches Probe Into Whether Issuers May Have Improperly Rounded Up Their Earnings

On 22 June 2018, the *Wall Street Journal*, relying on a source familiar with the matter, reported that the SEC has launched a probe into whether certain issuers may have improperly rounded up their earnings per share to the next highest cent in quarterly reports. The article stated that the investigation was incited by the release of an academic research paper which found the number "4" appeared at an abnormally low rate in the first decimal place of companies' earnings per share, expressed in cents. Companies whose earnings per share come out to 5 or higher in the first decimal place should round up to the next higher cent (e.g., 55.5 cents would be rounded up to 56 cents), while if the first decimal place is a 4 or lower, it should be rounded down to the next lower full cent (e.g., 55.4 cents would be rounded down to 55 cents).

Although the SEC's investigation into the matter has not been officially confirmed, the Journal reports that the SEC has sent inquiries to at least ten companies requesting information about such adjustments that could have inflated reported earnings.

The Wall Street Journal article is available at:

- <https://www.wsj.com/articles/sec-probes-whether-companies-rounded-up-earnings-1529699702>

SIFMA Issues Recommendations to Help More Companies Go and Stay Public

On 27 April 2018, the Securities Industry and Financial Markets Association (**SIFMA**) along with other organisations, notably the U.S. Chamber of Commerce and Nasdaq, published a report entitled *Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public (SIFMA Report)*.

The SIFMA Report sets forth several recommendations, including the following:

- Enhancement of several provisions of the JOBS Act

The JOBS Act entered into force six years ago and has demonstrated that laws and regulations dealing with capital raising can be relaxed without compromising investor protections. The SIFMA Report recommends amending several provisions of the JOBS Act, notably:

- Extend certain JOBS Act “on-ramp” provisions from five years to ten years following an IPO in favour of issuers that continue to meet the definition of an EGC. These benefits include streamlined financial disclosure, allowance for confidential reviews of registration statements by the SEC and simplified executive compensation disclosure or exemption from certain executive compensation requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act.
- Allow all issuers, not only EGCs, to use “testing the waters” by amending Section 5(d) of the Securities Act of 1933 (**Securities Act**). See “*SEC Considering Allowing All Companies to Use ‘Testing the Waters’*” above.
- Extend the five-year exemption from the requirement in Section 404(b) of the Sarbanes-Oxley Act of 2002 to report on the adequacy of internal control over financial reporting to ten years for EGCs that have less than \$50 million in annual revenue and less than \$700 million in public float.
- Encourage more research of emerging EGCs and other small public companies

In response to the lack of research coverage with regard to a majority of listed companies, which may reduce interest from investors and impact the liquidity for such companies’ stock, the SIFMA Report recommends:

- Amend the Rule 139 research safe harbour to provide that continuing coverage by research analysts of any issuer (including those that do not qualify for Form S-3 or F-3) would not constitute an offer or sale of a security of such issuer before, during or after an offering by such issuer.
- Allow investment banking and research analysts to jointly attend “pitch” meetings in order to have an open and direct dialogue with EGCs. Currently, Section 105(b) of the JOBS Act prohibits analysts from engaging in efforts to solicit investment banking business.
- Improvement to certain corporate governance, disclosure and other regulatory requirements

Companies often view the significant compliance costs of being a public company as a disincentive to going and staying public. In order to address this, the SIFMA Report recommends the following:

- Institute reasonable and effective SEC oversight of proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis which have growing influence over public companies and have become the standard setters for corporate governance.
- Reform shareholder proposal rules under Rule 14a-8 under the Securities Exchange Act of 1934 (**Exchange Act**) by increasing the “resubmission thresholds” that determine when a proponent is permitted to resubmit a proposal that has previously garnered low support. Currently, the level of support that a proposal must receive before resubmission is:
 - if voted on once in the past five years, 3% of shareholders the last time it was voted on;
 - if voted on twice in the past five years, 6% of shareholders the last time it was voted on; or
 - if voted on three or more times in the past five years, 10% of shareholders the last time it was voted on.

The SIFMA Report recommends raising these thresholds to 6%, 15% and 30%, respectively.

- Simplify quarterly reporting requirements and grant EGCs the option to issue a press release that includes quarterly earnings results in lieu of a full Form 10-Q.
- Recommendations related to financial reporting

The SEC guidance, the SIFMA Report, recommends the following:

- Modernize the Public Company Accounting Oversight Board (**PCAOB**) inspection process related to internal control over financial reporting (**ICFR**), by updating SEC guidance issued in 2007. The recommendation is intended to ensure that the existing SEC guidance, which aimed to allow companies to prioritize and focus on “what matters most” in assessing ICFR, works as intended.
- It also suggests that the PCAOB should consider forming an ICFR task force that could address issues that arise for companies as a result of the PCAOB inspection process and its consequences for audit firms and auditors.
- Lastly, the SIFMA Report recommends pre- and post-implementation reviews to improve audit standards setting, prevent harmful impacts and address unintended consequences that occur in the process of implementing PCAOB auditing standards.

The SIFMA Report is available at:

- https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/IPO-Report_EXPANDING-THE-ON-RAMP.pdf

SEC May Consider Amending Rules on Oil and Gas Reserve Reporting

On 21 June 2018, during the oversight hearing held by the House Financial Services Committee, SEC Chairman Jay Clayton stated that the agency was considering amendments to the SEC oil and gas reserves reporting rules, notably given the increasing significance of the shale formations in U.S. energy supply.

Under current SEC rules, companies may generally only report estimates of oil and gas quantities as “proved undeveloped reserves” for up to five years without being developed, unless the specific circumstances justify a longer time. The SEC has provided guidance that no particular type of project per se justifies a longer time period, and any extension beyond five years should be the exception, and not the rule. A relaxation of this five-year rule could potentially allow companies to include reserves as proved undeveloped reserves that take more than five years to develop, such as shale projects.

Answering a question from Representative Frank Lucas highlighting both changes in domestic energy production and the fact that “the five-year rule might not reflect the realities of the new American energy landscape,” Chairman Jay Clayton stated: “I’m concerned in this space that the way our rules require disclosure is inconsistent with the way investors value these companies. So they are looking for additional disclosures, and we should make sure that our rules line up with what investors think is the material information.”

Virtual Currency Regulatory Developments

In recent months, several virtual currency regulatory developments have taken place in the United States:

- SEC Corporation Finance Director provides analysis in assessing whether digital assets constitute securities
 - On 14 June 2018, the Director of the SEC’s Division of Corporation Finance, William Hinman, discussed the analysis applied by the SEC Staff in assessing whether a digital asset constitutes a security. The assessment of the status of a given asset as a security will rely on two sets of non-exhaustive factors. Hinman stated that the primary issue is “*whether a third party . . . drives the expectation of a return,*” and then, whether the digital asset functions “*more like a consumer item and less like a security.*”
 - The list of factors to consider in assessing whether a digital asset is offered as an investment contract and is thus a security includes:
 - Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?
 - Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?
 - Are purchasers “investing,” that is seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?
 - The list of contractual or technical ways to structure digital assets so that they function more like a consumer item and less like a security includes:
 - Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
 - Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
 - Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
 - The SEC will continue to focus on the economic substance of transactions in determining if the securities laws should apply. In particular, the SEC states that the securities laws generally will apply where transactions involve raising capital from investors to fund a venture.
 - Finally, Hinman further confirmed that current offers and sales of ether and bitcoin are not securities transactions.

- Federal court upholds that virtual currencies are commodities
 - On 6 March 2018, the United States District Court for the Eastern District of New York confirmed that virtual currencies are commodities within the anti-fraud jurisdiction of the Commodity Futures Trading Commission (the **CFTC**). The order, which came in the form of a preliminary injunction, follows the CFTC’s 18 January 2018 civil enforcement action against Patrick K. McDonnell and his company CabbageTech, doing business as Coin Drop Markets (**CDM**), alleging that McDonnell had induced customers to send money and virtual currencies to CDM in exchange for virtual currency trading advice and purchasing on customers’ behalf. The CFTC also alleged that McDonnell and CDM misappropriated investors’ funds.
 - The Court considered whether virtual currencies are commodities under the Commodity Exchange Act (**CEA**) and whether the CFTC has jurisdiction over commodity fraud that is not tied to the sale of derivatives products. The court held that virtual currencies “fall well-within the common definition of ‘commodity,’” and thus the CFTC maintains the jurisdictional authority to stop spot trade virtual currency fraud under the CEA. Further, the order clarified that the CFTC may exercise jurisdiction over spot transactions in virtual currencies when there is potential fraud, even if the fraud is not in conjunction with derivatives based on virtual currencies.
- Virtual commodity self-regulatory organization proposed
 - On 13 March 2018, Gemini, a virtual currency exchange, released a proposal to create the first self-regulatory organization for U.S. virtual commodity exchanges. The so-called Virtual Commodity Association (**VCA**), as envisioned, would be a non-profit, independent regulatory organization that would operate to foster responsible virtual commodity markets by requiring members to implement specified sound practices and supervising members’ implementation of such practices. The VCA would also encourage greater co-operation with relevant regulators in an effort to assist with the maturation of the virtual commodity industry.
 - The proposal noted that the VCA would not operate any markets, be a trade association or provide regulatory programs for security tokens or security token platforms. Initially, the VCA would be open to trading facilities that offer users the ability to transact in the virtual commodity spot markets, but may offer membership to additional categories of market participants in the future.

William Hinman’s speech is available at:

- <https://www.sec.gov/news/speech/speech-hinman-061418>

Our related client publication is available at:

- <https://www.shearman.com/perspectives/2018/04/regulators-clarify-virtual-currency-regulation-murky>

Noteworthy US Securities Litigation

Federal Court Dismisses Securities Fraud Class Action Because Individual Defendants’ Retention of Zero-Cost Stock and Vested Options Undermined Inference of Scienter

On 11 June 2018, a federal district court judge in New York dismissed with prejudice a putative securities fraud class action against veterinary pharmaceutical company Aratana Therapeutics Inc. (**Aratana**) and two of its officers. The plaintiffs had alleged that the defendants violated Sections 10(b) and 20(a) of the Exchange Act by making misstatements about the timeline for bringing Entyce, an appetite stimulant drug for dogs, to market, and thus caused the plaintiffs to suffer losses when Aratana later disclosed that it had not yet found a manufacturer approved by the Food & Drug Administration (**FDA**) and Aratana’s stock price declined. The court disagreeing found that the plaintiffs

had failed to allege that Aratana's statements about its FDA approvals or timeline were false or made with intent to mislead investors, and dismissed the plaintiffs' amended complaint with prejudice.

The court first considered the plaintiffs' allegation that Aratana repeatedly misrepresented that it was on the cusp of achieving, or had achieved, the FDA approvals necessary for commercialization of Entyce on Aratana's stated timelines. The plaintiffs had contended that the statements were misleading because Aratana had not yet secured an FDA-approved third-party manufacturer, so any approvals were "a mere placeholder that required further amendments and approvals." The court disagreed and found that most of Aratana's statements constituted mere puffery, statements of opinion or forward-looking statements that were not actionable. Similarly, the court held that Aratana's disclosures about FDA approval and the timeline for Entyce's commercial release could not be the basis of a lawsuit, either as opinions (such as "we believe") or as forward-looking statements accompanied by cautionary disclosures (such as warnings that Aratana was dependent on third-party manufacturers and the selection of such manufacturers was subject to FDA approval).

The court then considered whether the plaintiffs had adequately alleged that the defendants had made any misstatements with scienter (fraudulent intent). To do so, the plaintiffs would have to show that the defendants either had "motive and opportunity" to make false or misleading statements or engaged in "conscious misbehaviour or recklessness" when making the challenged statements. The court first addressed the plaintiffs' contention that the individual defendants enriched themselves through suspicious sales of Aratana stock. The defendants had countered that the individual defendants' acquisition of additional stock and stock options during the same period that they sold shares should be taken into account in comparing the volume of an insider's sales to his or her overall share holdings; the plaintiffs argued that stock and options acquired at no cost should be disregarded in determining whether the individual defendants' trading activity gave rise to an inference of scienter. Noting that the Second Circuit Court of Appeals (which covers Connecticut, New York and Vermont) had not yet definitively determined what types of shares should be included in such an analysis, the court found that "there is wisdom" in the approach taken in *In re eSpeed, Inc. Securities Litigation*, in which Judge Scheindlin adopted the Ninth Circuit's nuanced approach of distinguishing between exercisable vested stock options and unvested stock options that could not be sold immediately. Under that approach, the decisive question in assessing whether an insider's stock sales suggest scienter is how many shares the insider sold during the period compared to the total number he or she could have sold. Accordingly, the court counted both zero-cost shares of common stock and vested options, but not unvested options, in calculating the individual defendants' total share holdings. Under that methodology, one individual defendant had only a "minuscule overall reduction" in holdings during the class period, while the other had a significant increase in holdings. Emphasizing that this lack of evidence of suspicious sales by the individual defendants undermined the inference that they had sought to capitalize on any artificial inflation of Aratana's stock price, the court held that the plaintiffs' allegations of insider stock sales did not establish motive.

The court also rejected the plaintiffs' contention that the company and the other defendants had a motive to lie about Entyce's approvals to avoid early penalty payments on an outstanding loan, and pointed out that courts in the Second Circuit have consistently held that a desire to reduce a company's debt burden or keep a stock price high is insufficient to establish an inference of scienter. Finally, noting that the plaintiffs' complaint failed to identify any internal documents or confidential witness statements suggesting that the defendants knowingly deceived shareholders, the court concluded that the plaintiffs had not adequately alleged conscious misbehaviour or recklessness.

It is not uncommon for plaintiffs to point to insiders' sales of stock as evidence of their fraudulent intent. The court's holding here—that zero-cost stock and vested options should be counted in a defendant's overall shareholdings for purposes of analysing whether a complaint adequately alleges fraudulent intent—will potentially be useful to future defendants in trying to fend off such allegations.

Supreme Court Rules That Successive Class Actions Are Not Tolled Under *American Pipe*

On 11 June 2018, the U.S. Supreme Court, resolving a split between different courts of appeals, held in *China Agritech, Inc. v. Resh* that the tolling rule first stated in the landmark case of *American Pipe & Construction Co. v. Utah* cannot salvage otherwise untimely successive class claims. Upon denial of class certification, the court held, a putative class member may intervene as an individual plaintiff or commence an individual suit, but may not commence a new class action beyond the time allowed by the applicable statute of limitations.

In *American Pipe*, the Court had held that the timely filing of a class action tolls (suspends) the applicable limitations period for all persons encompassed by the class complaint. The issue presented in *China Agritech* was whether *American Pipe* tolling can salvage a new class claim filed after the expiration of the limitations period that would ordinarily apply. The Sixth Circuit (which covers Kentucky, Michigan, Ohio and Tennessee) and the Ninth Circuit (which covers Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada and Washington) ruled that *American Pipe* tolling applied to successive class action lawsuits, while certain other circuits, including the First, Second, Fifth, and Eleventh, held that *American Pipe* tolling did not apply.

The plaintiff, a China Agritech shareholder, sued the company in June 2014, after the district court had denied class certification in two prior putative class actions (brought by different plaintiffs in 2011 and 2012, respectively) and a year and a half after the limitations period had expired. The district court, dismissing the class action as untimely, held that the previous two class actions did not toll the time to initiate class claims. The Ninth Circuit reversed, holding that the reasoning of *American Pipe* extended not only to individual claims, but to successive class claims.

The Supreme Court reversed and remanded the Ninth Circuit's decision. It held that a putative class member may not commence a new class action beyond the time allowed by the statute of limitations. The Court emphasized that *American Pipe* addressed only putative class members that wished to sue individually after class certification was denied. The Court noted that both the Federal Rules of Civil Procedure and the Private Securities Litigation Reform Act favour the early resolution of class issues, and remarked that early assertion of competing class representative claims allows district courts to select the best lead plaintiff or deny certification at the outset of the case, as appropriate. In that vein, the Court held that the "efficiency and economy of litigation" that supported tolling of individual claims in *American Pipe* militate against the tolling of class claims.

The Court emphasized that plaintiffs must demonstrate diligence in pursuit of their claims to benefit from equitable tolling, and said that a purported class representative who commences suit after the class period expires "can hardly qualify as diligent in asserting claims and pursuing relief." The Court noted that holding otherwise "would allow the statute of limitations to be extended time and again; as each class is denied certification, a new named plaintiff could file a class complaint that resuscitates the litigation."

The Court further noted that its holding did not "run afoul of the Rules Enabling Act by causing a plaintiff's attempted recourse to Rule 23 to abridge or modify a substantive right" because "[p]laintiffs have no substantive right to bring their claims outside the statute of limitations." The Court also rejected the argument that declining to toll the limitation period for successive class suits will lead to the multiplication of protective class-action filings, noting that this had not occurred in the Second and Fifth Circuits, where the Courts of Appeals had already declined to read *American Pipe* as permitting successive class actions outside of the limitations period. The Court concluded that "allowing no tolling for out-of-time class actions [] will propel putative class representatives to file suit well within the limitation period and seek certification promptly," thereby increasing the "efficiency and economy of litigation," a principal goal of *American Pipe* and Rule 23 (the class certification rule of the Federal Rules of Civil Procedure).

In light of this decision and others limiting the scope of *American Pipe* tolling, plaintiffs may press for class certification earlier in cases. This decision might also cause class counsel to include more individual plaintiffs in class action filings, just in case one or more prove inadequate and a class is not certified for that reason.

US Withdraws From Iran Nuclear Deal

On 8 May 2018, President Trump announced the withdrawal of the United States from the nuclear agreement with Iran—the Joint Comprehensive Plan of Action (**JCPOA**)—and initiated plans to re-impose sanctions on Iran that had been suspended under the terms of the 2015 agreement.

President Trump ordered the Secretary of State and the Secretary of the Treasury to prepare immediately for “the re-imposition of all of the U.S. sanctions lifted or waived in connection with the JCPOA,” making clear that the snap-back of sanctions will be comprehensive and not, as some commentators had predicted, in piecemeal or partial fashion.

On 27 June 2018, the Treasury Department’s Office of Foreign Assets Control (**OFAC**) announced key steps in that withdrawal. It revoked two general licenses issued pursuant to the JCPOA: General License H, which permitted foreign subsidiaries of U.S. companies to engage in certain business activities with Iran, and General License I, which permitted U.S. persons to enter into contingent contracts for activities permitted under the JCPOA. It also implemented wind-down periods for activities involving Iran that were commenced pursuant to JCPOA sanctions relief.

Our related client publication is available at:

- <https://www.shearman.com/perspectives/2018/05/us-withdrawal-from-jcpoa>
- <https://www.shearman.com/perspectives/2018/06/non-us-companies-face-challenges-as-us-sanctions-on-iran-return>

SEC Issues \$35 Million Fine for Alleged Failure to Disclose Data Breach

On 24 April 2018, the SEC instituted a settled administrative proceeding against Altaba Inc., f/d/b/a Yahoo! Inc. (**Yahoo!**) for allegedly failing to disclose a significant data breach that affected its user accounts, in violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act and Section 13(a) of the Exchange Act. The SEC imposed a \$35 million penalty on Yahoo!, which neither admitted nor denied the SEC’s findings.

Yahoo! provides more than a billion users worldwide with Internet search services, emails, and digital content. According to the SEC, in late 2014, Yahoo! learned of a breach in its user database that resulted in the theft of hundreds of millions of its users’ personal data, including usernames, telephone numbers, dates of birth and passwords. Although the company’s senior management was notified of the breach, Yahoo!’s auditors and outside counsel were not, and Yahoo!’s internal disclosure controls did not mandate that the breach be assessed to determine whether or how it should be disclosed. Accordingly, this data breach was never disclosed in various reports that the company filed with the SEC from 2014 through 2016—including in its Form 10-Q and 10-K filings in 2015. Instead, Yahoo!’s reports disclosed only that security breaches were a potential risk factor. Similarly, during talks with Verizon Communications, Inc. (**Verizon**) regarding the sale of Yahoo!’s operating business, Yahoo! did not disclose the 2014 data breach when addressing past instances in which users’ data were exposed. When Yahoo! publicly disclosed the breach in a press release attached to its September 2016 Form 8-K, its stock price dropped by 3%—a market capitalization loss of nearly \$1.3 billion. The company was also forced to reduce the price Verizon paid for its business by \$350 million.

The SEC contended that Yahoo! violated Sections 17(a)(2) and (a)(3) of the Securities Act and Section 13(a) of the Exchange Act by failing to disclose the 2014 data breach in reports filed with the SEC, and by failing to maintain controls that ensured the breach would be evaluated for inclusion among Yahoo!’s disclosures. As a result, the SEC required Yahoo! to pay a \$35 million civil monetary penalty. Yahoo! agreed not to contest any of the findings in the

SEC's order and undertook to aid and co-operate in the SEC's ongoing investigation. The SEC noted that it took Yahoo!'s cooperation into account in declining to seek a penalty in excess of \$35 million.

This proceeding is the first instance in which a company has settled Securities Act fraud charges with the SEC for failing to disclose a data breach.

Court of Appeals Splits With Five Circuit Courts in Holding That Negligence, Not Intent, Is Required for Section 14(e) Claims Under Exchange Act

On 20 April 2018, the Ninth Circuit Court of Appeals, splitting from five other circuit courts in *Varjabedian v. Emulex Corp.*, held that claims under Section 14(e) of the Exchange Act require only a showing of negligence rather than intent to defraud. The Second, Third, Fifth, Sixth and Eleventh Circuits have held that claims alleging misstatements or omissions in connection with a tender offer under Section 14(e) of the Exchange Act require a showing of scienter (intent to defraud).

The Ninth Circuit's decision stems from the 2015 acquisition of Emulex by Avago Technologies Wireless Manufacturing pursuant to an all-cash tender offer. After the closing, investors filed a class action alleging that Emulex had failed to disclose in its recommendation statement on Schedule 14D-9 one of six financial analyses performed by Emulex's financial advisor, Goldman Sachs, in delivering its fairness opinion to the Emulex board. The omitted analysis found that the 26.4 percent merger premium was fair, but fell below the average for comparable transactions in the semiconductor industry. Five other circuits that have considered similar questions have held that claims under Section 14(e) require a finding of scienter. These courts have held that claims under Section 14(e) require a pleading of scienter because of its "shared text" with Rule 10b-5, which has a well-established scienter requirement.

In splitting from other circuit courts, the Ninth Circuit noted that Section 14(e) prohibits either (1) making untrue statements or omissions of material fact or (2) engaging in fraudulent or deceptive acts. By focusing on the use of the word "or," the court found that Section 14(e) provides for two different offenses: one for making material misstatements and another for fraudulent conduct. Thus the Ninth Circuit found that a showing of scienter is not required to bring a claim under Section 14(e), and hence that a showing of negligence would be sufficient to bring a claim under Section 14(e) on the basis of misstatements or omissions of material fact. The Ninth Circuit did not determine whether the omitted fact in this case was "material," but directed the lower court to consider that question.

The Ninth Circuit's ruling marks the first instance where a negligence standard has been applied to an allegation of a material misstatement in connection with a tender offer. In the event that Emulex is not reversed by an en banc panel of the Ninth Circuit, the Supreme Court may ultimately resolve the circuit split.

- The Ninth Circuit's application of a negligence standard to disclosures in connection with tender offers under Section 14(e) is consistent with well-established jurisprudence applying a negligence standard to false or misleading statements made in connection with solicitation material (i.e., proxy statements) under Section 14(a). Until the issue is resolved, there may be a higher volume of Section 14(e) challenges to tender offers in federal court in the Ninth Circuit.

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