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Q2 2014 U.S. Legal and Regulatory Developments

The following is a summary of significant U.S. legal and regulatory developments during the second quarter of 2014 of interest to Canadian companies and their advisors.

1. SEC Issues Guidance on Proxy Advisory and Voting Services

On July 2, 2014, the U.S. Securities and Exchange Commission (the "SEC") Divisions of Investment Management and Corporation Finance issued long-awaited guidance related to investment advisors' proxy voting responsibilities and use of proxy advisory firms and enhanced conflicts disclosure by proxy advisory firms. Staff Legal Bulletin No. 20 relies heavily on existing SEC rules and guidance in these areas and reflects four key themes:

- Investment advisers have an ongoing responsibility to ensure that their proxy votes are cast in accordance with their voting policies and procedures and in their clients' best interests;
- Investment advisers have flexibility to design voting arrangements with their clients and may delegate their proxy voting responsibilities to proxy advisory firms, subject to certain conditions;
- Conflicts disclosure by proxy advisory firms providing services other than voting recommendations must be enhanced; and
- Proxy advisory firms are reminded that they operate outside the application of most of the SEC's proxy rules only if they meet the conditions set forth in one of two specific exemptions.

For a more detailed discussion of the themes addressed in the Staff Legal Bulletin, see the Paul, Weiss memorandum at: http://www.paulweiss.com/media/2544397/2jul14alert.pdf.

Staff Legal Bulletin No. 20 consists of 13 questions and answers and can be found at: http://www.sec.gov/interps/legal/cfslb20.htm.

2. U.S. Supreme Court Declines to Overrule or Modify *Basic*, but Allows Rebuttal of "Price Impact" in Opposing Class Certification

On June 24, 2014, in *Halliburton Co.* v. *Erica P. John Fund, Inc.*, the U.S. Supreme Court declined either to eliminate the fraud-on-the-market presumption established by *Basic Inc.* v. *Levinson* or to modify *Basic* to require a plaintiff to prove that a defendant's misrepresentation affected the stock price (a

showing known as "price impact") in order to invoke the presumption. The fraud-on-the-market presumption is a prime enabler of class action securities litigation in the United States. One of the elements of a private right of action under Section 10(b) of the U.S. Securities Exchange Act of 1934 (the "Exchange Act") is that the plaintiff relied on the alleged misrepresentation in deciding whether to purchase or sell a security. The fraud-on-the-market theory posits that if a company's security trades in an efficient market, a materially misleading statement by the company affects the security's prices and thereby affects any person buying or selling the security. Class members can plead reliance without regard to individual awareness of the statement.

The Court clarified that *Basic* does afford a defendant the opportunity to defeat the presumption at the class certification stage by introducing evidence that the misstatement did not affect the stock price. Defendants will now have an opportunity to present economic defenses before being faced with the settlement pressures that they would face after a class has been certified. It remains to be seen, however, what lower courts will require to disprove price impact.

For a more detailed analysis of the Court's decision in *Halliburton*, see the Paul, Weiss memorandum at: http://www.paulweiss.com/media/2536967/24june14alert.pdf.

3. SEC Issues Guidance on Verification of "Accredited Investors" under Regulation D

On July 3, 2014, the SEC released six new Compliance and Disclosure Interpretations ("C&DIs") relating to the verification of prospective investors as accredited investors for purposes of Rule 506(c) of Regulation D under the U.S. Securities Act of 1933. Rule 506(c) permits the use of general solicitation and advertising where sales are made only to accredited investors and the issuer takes reasonable steps to verify the accredited investor status of the purchasers.

Two of the C&DIs serve to clarify certain criteria for "accredited investor" status:

- If a prospective investor's income is reported in a foreign currency, an issuer can rely on either the exchange rate in effect on the last day of the year for which the income was reported, or on the average exchange rate for that year; and

- If a prospective investor owns property or an account jointly with a person other than the prospective investor's spouse, the value of that property or account can only be counted for net worth purposes to the extent of the prospective investor's percentage of ownership in the joint property or account.

The remaining C&DIs further explain certain of the methods of verifying accredited investor status established by the SEC. The explanations generally emphasize that the verification processes set out in Rule 506(c) are to be narrowly construed but also reiterate that the enumerated verification processes are

non-exclusive and that an issuer can still satisfy its obligation to verify accredited investor status by other means using a "principles based approach."

The C&DIs can be found at: http://www.sec.gov/divisions/corpfin/cfnew.shtml.

4. 2014 Conflict Minerals Filing Review

June 2, 2014 was the first filing deadline for SEC registrants to comply with the SEC's conflict minerals rule, which implemented Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 1502 added Section 13(p) to the Exchange Act and required the SEC to promulgate rules requiring companies that (1) file reports with the SEC under the Exchange Act ("issuers") and (2) use conflict minerals necessary to the functionality or production of a product manufactured by the issuer, to disclose annually whether any of those conflict minerals originated in the Democratic Republic of the Congo or an adjoining country (the "Covered Countries"). If an issuer's conflict minerals originated in the Covered Countries, Section 13(p) requires the issuer to submit a report to the SEC that includes a description of the measures it took to exercise due diligence on the conflict minerals' source and chain of custody, including an independent private sector audit of the report (a "Conflict Minerals Report"). Roughly 1,300 companies submitted conflict minerals filings to the SEC, almost 1,000 of which included a Conflict Minerals Report.

5. The Public Company Accounting Oversight Board Adopts New Auditing Standard for Related Party Transactions

On June 10, 2014, the Public Company Accounting Oversight Board (the "Board") adopted a new auditing standard and amendments to other auditing standards to strengthen auditor performance requirements in three critical areas of the audit: related party transactions, significant unusual transactions, and a company's financial relationships and transactions with its executive officers.

Auditing Standard No. 18, Related Parties, requires specific audit procedures for the auditor's evaluation of a company's identification of, accounting for, and disclosure of transactions and relationships between a company and its related parties. The amendments to other auditing standards include specific audit procedures designed to improve identification and evaluation of significant unusual transactions and specific audit procedures requiring the auditor to obtain an understanding of the company's financial relationships and transactions with executive officers during the risk assessment process.

The new standard and other amendments will be effective, subject to SEC approval and determination of potential application to emerging growth companies, for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of interim financial information within these fiscal years.

For more information on the Board's new auditing standard and amendments, see the release at: http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2014_002_Related_Parties.pdf.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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