January 9, 2015

2014 U.S. Legal and Regulatory Developments

The following is our annual summary of significant U.S. legal and regulatory developments during 2014 of interest to Canadian companies and their advisors.

Q4 Developments

SEC Proposes Rule Changes to Exchange Act Registration Requirements Pursuant to the JOBS Act

On December 17, 2014, the U.S. Securities and Exchange Commission (the "SEC") proposed rule changes under the Jumpstart Our Business Startups Act (the "JOBS Act"). The proposed amendments would revise rules adopted under Section 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), to reflect the new, higher thresholds for SEC registration, termination of SEC registration and suspension of SEC reporting that were set forth in the JOBS Act. Specifically, the proposed rules would reflect the fact that the JOBS Act revised the threshold at which an issuer that is not a bank or bank holding company is required to register a class of equity securities to situations where the issuer has more than U.S.$10 million of total assets and the securities are "held of record" by either 2,000 persons, or 500 persons who are not accredited investors. The proposed rules also would apply the thresholds specified for banks and bank holding companies to savings and loan holding companies. In addition, the proposed amendments would revise the definition of "held of record" in Exchange Act Rule 12g5-1, in accordance with the JOBS Act, to exclude certain securities held by persons who received them pursuant to employee compensation plans and establish a non-exclusive safe harbor for determining whether securities are "held of record" for purposes of registration under Section 12(g) of the Exchange Act.

For the SEC's proposed rules, see: http://www.sec.gov/rules/proposed/2014/33-9693.pdf.

Second Circuit Rules for Defendants in Landmark Insider Trading Case

On December 10, 2014, the U.S. Court of Appeals for the Second Circuit issued a long-anticipated ruling dismissing with prejudice indictments against two insider trading defendants in *United States* v. *Newman*. Two aspects of the decision are particularly important. First, the Court ruled that the government must prove that a remote tippee knows of the personal benefit received by a tipper in exchange for disclosing nonpublic information. Second, the Court held that the government must prove that the personal benefit is "of some consequence," and determined that the benefits alleged by the

government in *United States* v. *Newman* were not sufficient to support a conviction. The ruling likely will have major ramifications for the future prosecutions of insider trading cases in the Second Circuit. Paul, Weiss was counsel for Anthony Chiasson, one of the defendants, in the appeal and was lead counsel at the Second Circuit argument.

For a more detailed discussion of *United States* v. *Newman*, see the Paul, Weiss memorandum at: http://www.paulweiss.com/media/2733575/11dec14alert.pdf.

Delaware Court of Chancery holds that a 17.3% Stockholder/CEO may be a Controlling Stockholder

In *In re Zhongpin Inc. S'holders Litig.*, the Delaware Court of Chancery denied motions to dismiss breach of fiduciary duty claims against an alleged controlling stockholder and members of the company's board of directors, holding that the plaintiffs had raised reasonable inferences that (i) although the stockholder held only 17.3% of the company's outstanding common stock, as CEO and Chairman of the Board, he possessed "both latent and active control" over the company, and (ii) the sales process was not entirely fair. The decision is noteworthy because courts have been reluctant to apply the label of controlling stockholder to, and impose new or additional fiduciary duties on, minority stockholders. The decision is of further interest because the Court focused on the latent control of the stockholder rather than the exercise of active control that recent Court of Chancery decisions have required a stockholder to exercise in order to be deemed a controlling stockholder.

For a more detailed discussion of *In re Zhongpin Inc. Shareholders Litigation*, see the Paul, Weiss memorandum at: http://www.paulweiss.com/media/2734358/11dec14_alert.pdf.

Delaware Court of Chancery Refuses to Enforce Merger-Related Obligations Against Non-Consenting Stockholder

On November 26, 2014, in *Cigna Health and Life Insurance Company* v. *Audax Health Solutions, Inc.*, the Delaware Court of Chancery held that (i) a broad release of claims found only in a letter of transmittal that a stockholder was required to execute to receive merger consideration was unenforceable for lack of consideration, and (ii) a post-closing indemnification obligation requiring direct payment from a non-consenting stockholder that was indefinite in duration, and potentially required repayment of the stockholder's entire pro rata portion of the merger consideration, was unenforceable because it violated Section 251 of the Delaware General Corporation Law, which requires a merger agreement to quantify the merger consideration stockholders are to receive.

For a more detailed discussion of *Cigna Health and Life Insurance Company* v. *Audax Health Solutions*, see the Paul, Weiss memorandum at: http://www.paulweiss.com/media/2722747/2dec14maalert.pdf.

SEC Rulemaking on Executive Compensation Delayed Until October 2015

In late November, the SEC indicated in its Regulatory Flexibility Agenda ("Reg Flex Agenda") that it will not take action with respect to pay-for-performance rules, compensation clawback requirements, hedging rules and CEO pay ratio rules until October 2015. Specifically, the new Reg Flex Agenda has indicated that the pay ratio rules will not be adopted until October 2015 and the compensation clawback requirements, pay-for-performance rules and hedging rules will not be proposed until October 2015. Companies that qualify as foreign private issuers will not be subject to the new rules. While the SEC previously targeted the end of 2014 for rulemaking, this delay means companies affected by the rules will not be subject to disclosure requirements regarding the difference between executive compensation and employee compensation until late 2015, at the earliest.

The SEC's latest Reg Flex Agenda can be found at:

http://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235

SEC Announces "Historic" Year in Its Annual Whistleblower Report

On November 17, 2014, the SEC's Office of the Whistleblower's 2014 Annual Report revealed that 2014 was historic in both the overall dollar amount and the number of whistleblower awards. On September 22, the SEC announced an award of more than U.S.$30 million. The award was the largest made by the SEC's whistleblower program to date and the fourth award to a whistleblower living in a foreign country. A record number of nine whistleblower awards were made in 2014 alone, more than in all previous years combined. 2014 also saw a record number of 3,620 whistleblower tips, compared to 3,238 in 2013.

The SEC's annual report can be found at: http://www.sec.gov/about/offices/owb/annual-report-2014.pdf.

Q1, Q2 AND Q3 DEVELOPMENTS

Delaware Court of Chancery Upholds Forum Selection Bylaw Designating Exclusive Forum Adopted Concurrently with Merger Agreement

On September 8, 2014, the Delaware Court of Chancery held that the board of directors of First Citizens BancShares, a Delaware corporation, did not breach their fiduciary duty by designating North Carolina as the exclusive forum for intra-corporate disputes in a forum selection bylaw on the same day as it entered into a merger agreement to acquire First Citizens Bancorporation, an entity allegedly controlled by the

same stockholders that control the acquiring corporation.

In holding that the forum selection bylaw was valid and did not breach the directors' fiduciary duties, the court ruled the following:

- Nothing in *Boilermakers Local 153 Retirement Fund* v. *Chevron Corporation* prohibits a Delaware corporation from designating an exclusive forum other than Delaware in its bylaws;
- Because the forum selection bylaw did not regulate whether a stockholder could file a suit, but where, it was not invalid; and
- The fact that a controlling stockholder favored the bylaw, and the minority stockholders could not repeal it, did not make it invalid.

For more information on the court's ruling, see the Paul, Weiss memorandum at: http://www.paulweiss.com/media/2639475/9sept14alert.pdf.

Second Circuit Decision in Parkcentral v. Porsche Extends Morrison Test by Limiting Applicability of Section 10(b) Based on "Foreignness" of Claims

In its 2010 decision in *Morrison* v. *National Australia Bank*, the United States Supreme Court addressed the question of whether Section 10(b) of the Exchange Act applies to a securities transaction involving foreign investors, foreign issuers and/or securities traded on foreign exchanges. The Morrison decision curtailed the extraterritorial application of the U.S. federal securities laws by holding that Section 10(b) applies only to (a) transactions in securities listed on domestic exchanges or (b) domestic transactions in other securities.

In its August 15, 2014 *Parkcentral Global Hub Ltd.* v. *Porsche Automobil Holdings SE* decision, the Second Circuit added a layer of restrictions on the application of Section 10(b) of the Exchange Act to claims based in substantial part on extraterritorial conduct. In *Parkcentral*, the Second Circuit ruled that while a domestic securities transaction (or transaction in a domestically listed security) is necessary under Morrison for Section 10(b) to apply, such a transaction is not sufficient to support the application of Section 10(b), and claims may still be considered "predominantly foreign," and thus considered extraterritorial and immune to Section 10(b) liability. The Second Circuit declined to lay out guidelines for determining whether a claim is "predominantly foreign," leaving that question for development in future cases.

For a summary of prior interpretations of Morrison, see the Paul, Weiss memorandum at: http://www.paulweiss.com/media/103257/5Mar12Memo.pdf.

For more information on the extension of the Morrison test, see the Paul, Weiss memorandum at: http://www.paulweiss.com/media/2593946/03sept14_alert.pdf.

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, as amended. 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, including the exchange rate used when a prospective investor's income is reported in a foreign currency and how property not owned with a spouse is counted towards net worth. 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.

SEC Issues Guidance on Proxy Advisory and Voting Services

On July 2, 2014, the SEC Divisions of Investment Management and Corporation Finance issued long-awaited guidance related to investment advisors' proxy voting responsibilities and the 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.

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 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.

Washington D.C. Court Finds Conflict Minerals Rule Violates First Amendment

On April 14, 2014, the U.S. Court of Appeals for the District of Columbia Circuit issued a summary judgment ruling in *National Association of Manufacturers* v. *SEC*, a case that challenged Rule 13p-1 (the "Rule") requiring disclosure of the use of conflict minerals in manufactured products. The Court found that the provision in the Rule that compels companies to report to the SEC and to state on their websites that any of their products have "not been found to be 'DRC conflict free'" violates the First Amendment of the U.S. Constitution.

On April 29, 2014, the SEC's Division of Corporation Finance issued guidance on the effect of the Court's decision, stating that, subject to further action that may be taken either by the SEC or a court, the SEC expects companies to file any reports required under Rule 13p-1 on or before the due date of June 2, 2014. Companies that do not need to file a Conflict Minerals Report should disclose their reasonable country of origin inquiry and companies that are required to file a Conflict Minerals Report should include a description of the due diligence undertaken. No company will be required to describe its products as "DRC conflict free," "having not been found to be 'DRC conflict free'" or "DRC conflict undeterminable," although companies can voluntarily elect to describe their products as "DRC conflict free," as permitted by the Rule.

In keeping with the guidance contained in the statement, on May 2, 2014, the SEC issued an order staying the effective date for compliance with the portions of the Rule and Form SD that would require statements by issuers that the Court held would violate the First Amendment. In its order, the SEC denied the plaintiff's motion for a stay of the entire rule.

For a more detailed discussion of the SEC's guidance following the Court's decision on conflict minerals, see the Paul, Weiss memorandum at: http://www.paulweiss.com/media/2475522/2may14alert.pdf.

Delaware Supreme Court Affirms Roadmap to Avoid Entire Fairness in a Going-Private Transaction

In its March 14, 2014 *Kahn* v. *M&F Worldwide Corp.* decision, the Delaware Supreme Court provided a clear path for controlling stockholders of Delaware corporations to structure going-private transactions to avoid the entire fairness standard of review. The requirements to avoid entire fairness, and revert to the business judgment standard of review, are as follows: (i) the controller must condition the transaction from the outset on the approval of both a special committee and a majority of the minority stockholders; (ii) the special committee must be independent, empowered to freely select its own advisors and to say no definitively and meet its duty of care in negotiating a fair price; and (iii) the vote of the minority must be informed and uncoerced. It is critical that the conditions related to approval by the special committee and a majority of the minority stockholders be established by the controller at the outset of its efforts to take the corporation private.

This decision is important because it provides controllers who engage in a fair process a more predictable path to take controlled companies private. While the going-private process must still be carefully managed and the decision will not prevent lawsuits challenging such transactions, it is now possible to end the litigations at an earlier stage.

For a more detailed discussion of the decision in *Kahn* v. *M&F Worldwide Corp.*, see the Paul, Weiss memorandum at: http://www.paulweiss.com/media/2414608/14mar14del.pdf.

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For a discussion of certain other developments during 2014 not highlighted above, please see:

Q1 memorandum: http://www.paulweiss.com/media/2498630/12may14alert.pdf
- Mandatory Exchange Trading Requirements for Swaps Begin February 18, 2014
- SEC Announces 2014 Examination Priorities
- FTC Announces New Hart-Scott-Rodino and Clayton Act Section 8 Thresholds

Q2 memorandum: http://www.paulweiss.com/media/2559083/18july14alert.pdf
- 2014 Conflict Minerals Filing Review
- The Public Company Accounting Oversight Board Adopts New Auditing Standard for Related Party Transactions

Q3 memorandum: http://www.paulweiss.com/media/2679718/14oct14alert.pdf
- Form SD Post-filing Survey Examines High Cost of Conflict Mineral Disclosure

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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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