January 9, 2017

2016 U.S. Legal and Regulatory Developments

The following is our summary of significant U.S. legal and regulatory developments during 2016 of interest to Canadian companies and their advisors.

Recent Developments (Fourth Quarter 2016)

1. SEC Releases New Compliance and Disclosure Interpretations for Foreign Private Issuers

On December 8, 2016, the Securities and Exchange Commission (the "SEC") released several new Compliance and Disclosure Interpretations ("C&DIs") clarifying when a foreign issuer possesses too close a nexus with the United States to be classified as a Foreign Private Issuer (an "FPI"). Under Rule 405 of the Securities Act of 1933 (the "Securities Act") and Rule 3b-4(c) of the Securities Exchange Act of 1934 (the "Exchange Act"), an issuer will be ineligible for FPI status if more than 50% of its outstanding voting securities are directly or indirectly held of record by residents of the United States and if the issuer fails the second prong of the FPI test.[1] The SEC's recent C&DIs clarify that issuers with multiple classes of voting stock carrying different voting rights may, for the purposes of calculating compliance with this threshold, examine either (i) the combined voting power of its share classes or (ii) the number of voting securities, in each case held of record by U.S. residents.

The C&DIs also address the elements of the second prong of the FPI test. Eligibility for FPI status may depend upon the residency and citizenship of the issuer's executive officers and directors. The C&DIs clarify that the evaluation of the citizenship and residency of officers and directors necessitates four independent inquiries, examining each of the citizenship and the residency of each group (officers and directors) separately. The SEC clarified that for the purposes of this determination, a U.S. permanent resident or Green Card holder is presumptively a U.S. resident. The C&DIs also clarify that when determining the location of an issuer's assets for the purposes of evaluating FPI status, an issuer may use the geographical segment information adopted in the preparation of the issuer's financial statements or any other consistently-applied, reasonable methodology. Last, the SEC clarified that when evaluating the location where an issuer's business is "administered principally" for the purposes of determining FPI eligibility, no single factor is determinative. Instead, an issuer must examine, on a consolidated basis, the

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1 An issuer will fail the second prong of the FPI test if any of the following conditions apply: (i) the majority of the executive officers or directors of the issuer are United States citizens or residents; (ii) more than 50% of the assets of the issuer are located in the United States; or (iii) the business of the issuer is administered principally in the United States.

location from which officers, partners or managers of the issuer primarily direct, control and coordinate the issuer's activities. Annual or special meetings of shareholders, or occasional board meetings, held in the United States are alone insufficient to render an issuer's business "administered principally" in the United States.

The C&DIs also provide additional guidance on (i) determining the status of Qualified Institutional Buyers under Rule 144A under the Securities Act, (ii) the registration statements of FPIs guaranteeing the securities of, or issuing securities guaranteed by, non-FPI subsidiaries, and (iii) the filing requirements of non-reporting FPIs succeeding to the reporting obligations of reporting issuers under Exchange Act Rule 12g-3.

For the full text of the SEC's December C&DIs, please see:
https://www.sec.gov/divisions/corpfin/cfnew/cfnew1216.shtml.

2. U.S. Supreme Court Reaffirms *Dirks*, Confirms that a Gift of Information to a Trading Relative or Friend Satisfies Personal Benefit Requirement for Insider Trading

On December 6, 2016, the U.S. Supreme Court issued its first opinion addressing the scope of insider trading liability in nearly twenty years. In a much anticipated decision, in *Salman v. United States* the Court addressed whether insider trading liability can arise where a tipper makes a "gift" of confidential information to a trading friend or relative but receives no financial or other tangible benefit in return. Relying on the 1983 seminal insider trading case *Dirks v. SEC*, the Supreme Court answered that question in the affirmative.

In *Dirks*, the Court articulated the so-called personal benefit test. In particular, the Court held that trading on inside information is unlawful only if there has been a breach of a duty of trust and confidence, and that the test for determining whether such a breach has occurred is whether the insider personally benefits from the disclosure. The precise contours of the personal benefit requirement have been subject to debate and uncertainty following the Second Circuit's landmark decision in 2014 in *United States v. Newman*. The Court in *Salman* unanimously reaffirmed *Dirks*' personal benefit requirement for insider trading liability and held that, under *Dirks*, a gift of confidential information to a friend or relative may satisfy that requirement. The Court also rejected the Second Circuit's holding in *Newman* to the extent that it required a more substantial showing in the context of a gift to a friend or relative.

The Court did not, however, resolve the uncertainty around the personal benefit requirement. Instead, the Court narrowly limited its holding to tipping a friend or relative and expressly declined to address more broadly the scope of the personal benefit requirement outside of that specific context. That approach may be the result of the Court's recognition of a potentially significant distinction between a disclosure to a friend or relative, on the one hand, and to a market professional, such as a research analyst, on the other. Although the Court did not reach that issue, the Court did not adopt the government's argument that a gift of confidential information "to anyone, not just a 'trading relative or friend'" would be sufficient to satisfy *Dirks*.

For a more detailed summary of the Court's decision in *Dirks*, please see the Paul, Weiss memorandum available at: https://www.paulweiss.com/media/3837915/7dec16salman.pdf.

3. SEC Proposes Mandatory Universal Proxies in Contested Elections and Voting Procedure Enhancements

On October 26, 2016, the SEC proposed requiring the use of universal proxy cards by both companies and dissidents in contested director elections that are subject to the SEC's proxy rules (which are not applicable to Canadian FPIs). While both the Company and the dissident would still be able to use their own versions of proxy cards, those cards would be required to include the names of all director candidates up for election regardless of who nominated them. They would also be subject to various content and format requirements.

Under a universal proxy regime, shareholders voting by proxy, which is how most shareholders vote, would be able to pick and choose from among all candidates, instead of having to vote for one slate or the other as is the current prevalent practice. While the SEC took pains to explain that the proposed rules are meant only to facilitate shareholder suffrage by equalizing the voting options available to shareholders voting by proxy with those available to shareholders voting in person at a shareholder meeting, the adoption of these rules would give a significant boost to dissidents in any proxy contest. The SEC's proposal is a long sought-after victory for activist hedge funds and, if adopted, would further tilt the playing field in their favor.

Institutional investors have typically been hesitant to vote for a full dissident slate, and the universal proxy would make it much easier for them to choose a subset of those candidates. This feature of universal proxy cards – coupled with the generally greater willingness of proxy advisory firms and institutional investors to support a minority changeover of directors (as opposed to a full slate that would result in a change in control at a company) – strongly favors activists. In addition, a universal proxy card could decrease solicitation costs for dissidents because their ability to reach shareholders with a competing slate would, as a practical matter, be buoyed by the company's solicitation efforts. The SEC's proposed rules attempt to safeguard against this potential free-rider problem by specifying that a universal proxy card would only be available to dissidents that solicit at least a majority of the voting power of shares eligible to vote in director elections. While this would ensure that a dissident will continue to bear a significant portion of the cost of its solicitation, unless the final rule changes, the dissident would be able to solicit a subset of shareholders but nevertheless reach all shareholders with its candidates.

For the full text of the SEC's proposed rule, see: https://www.sec.gov/rules/proposed/2016/34-79164.pdf.

For a more detailed summary of the SEC's proposed rules, please see the Paul, Weiss memorandum available at: https://www.paulweiss.com/media/3795607/31oct16_sec.pdf.

4. Treasury Issues Final Debt/Equity Tax Regulations, Tempers Controversial Approach Taken in Proposed Regulations

On October 13, 2016, the U.S. Department of the Treasury released the highly-anticipated final and temporary regulations under Section 385 of the Internal Revenue Code. The April 4, 2016 proposed regulations had drawn widespread criticism from practitioners and others as being fraught with a slew of unresolved technical issues and overbroad in their attempt to address certain (ostensibly inversion-related) earnings-stripping transactions. The final and temporary regulations retain much of the structure and approach of the proposed regulations in terms of recharacterizing certain intercompany debt obligations as equity and requiring more extensive documentation of certain of these obligations, but they cut back significantly the scope of the proposed regulations, ease compliance burdens and expand the availability of exceptions to the rules.

For the full text of the U.S. Department of the Treasury's final and temporary regulations, see: https://www.gpo.gov/fdsys/pkg/FR-2016-10-21/pdf/2016-25105.pdf.

For a more detailed summary of the final and temporary regulations, please see the Paul, Weiss memorandum available at: https://www.paulweiss.com/media/3790237/28oct16_tax.pdf.

Previously Reported 2016 Developments (First through Third Quarters)

5. Recent DOJ and SEC Actions Underscore Regulators' Pronouncements that "Vigorous Enforcement" of FCPA Violations Remains a "High Priority"

As the end of their fiscal years approached on September 30, the Department of Justice and SEC announced a number of resolutions, underscoring their pronouncements that "vigorous enforcement" of violations of the Foreign Corrupt Practices Act remains a "high priority" for both agencies. These resolutions, which we summarize in the memorandum accessible at the link below, provide more significant detail about the underlying FCPA violations than did previous resolutions, in keeping with the DOJ's stated "effort to promote both transparency and accountability" through their publication and the SEC's desire to build a "robust disclosure regime." Along similar lines, a new SEC regulation went into effect on September 26, 2016, Rule 13q-1, which is designed to promote transparency in the resource extraction industry.

Two of the DOJ's resolutions at first blush appear to bolster the department's efforts to use the FCPA Pilot Program to "increase the incentive for companies to self-report," by declining to prosecute certain FCPA violations. However, given that the companies involved were publicly identified, required to pay disgorgement, and their FCPA violations described in significant detail, it remains to be seen whether the FCPA Pilot Program will in fact provide incentives to companies to self-report that otherwise would not.

Public companies continue to struggle with the business climate in much of Asia, as evidenced by recent SEC enforcement activity focused on the region. That recent enforcement activity also reflects a continued focus on the provision of intangible benefits as "things of value" and on financial institutions. Moreover, SEC Chair Mary Jo White spoke recently of the increasing importance of international cooperation to the SEC's ability to carry out its mission: "All securities regulators, around the world, share the overarching obligation to protect investors . . . . Fulfilling this all-important function is not possible if we stop our work at country borders or fail in our efforts to achieve robust international cooperation."

For a more detailed summary of these recent developments, including recent FCPA enforcement actions, please see the Paul, Weiss memorandum available at:
https://www.paulweiss.com/media/3758362/13oct16fcpa.pdf.

6. SEC Crackdown on Use of Non-GAAP Financial Measures

On September 8, 2016, as part of a general sweep aimed at non-GAAP financial measures being conducted by the SEC Division of Enforcement, the SEC announced charges against former executives of a publicly traded company for allegedly overstating its financial performance by intentionally manipulating calculations of its adjusted funds from operations, a non-GAAP measure.

The charges are part of a broader effort by the SEC directed to the presentation of non-GAAP measures and the investing public's ability to understand and rely on such measures in connection with a company's financial statements. Following the cue of a March 2016 speech by SEC Chair Mary Jo White which warned that the SEC would be narrowing in on the use of non-GAAP measures, in May 2016 the SEC's Division of Corporation Finance updated its C&DIs relating to the use of non-GAAP measures. The update presented further interpretation of the prohibitions found in Regulation G and Item 10(e) of Regulation S-K, violations of which are now more likely to attract the scrutiny of the SEC. The updated interpretation suggests that the SEC will be especially vigilant with regards to failing to present a GAAP measure with equal or greater prominence to that of its non-GAAP comparable.

Moving forward, companies should expect heightened scrutiny from the SEC surrounding the disclosure of any non-GAAP measures. Companies should review the updated C&DI as well as Regulation G and Item 10(e) of Regulation S-K, and ensure that the use of non-GAAP measures in disclosures is both justifiable and does not have the potential to confuse or mislead readers. When non-GAAP measures are used, companies should be sure to disclose the comparable GAAP financial measure in an equally or more prominent fashion.

For a more detailed summary of the C&DIs, please see the Paul, Weiss memorandum available at: https://www.paulweiss.com/media/3571705/3june16_sec_updates.pdf.

7. SEC Approves Requirement to Disclose Third-Party Director Compensation for Nasdaq Companies

On July 1, 2016, the SEC approved a new Nasdaq rule to require a listed company to disclose the material terms of any third-party compensation or payments made to any nominee for director, or sitting director, in connection with his or her candidacy or service on the company's board of directors. The New York Stock Exchange has not yet proposed a similar rule for its listed companies, so only Nasdaq-listed companies are subject to this requirement for the time being. FPIs may elect to follow home country practices instead of complying with the rule, *provided* that the issuer discloses on its website or in its annual report that it has elected not to comply with the rule.

Nasdaq's new Rule 5250(b)(3) requires listed companies to disclose the material terms of all agreements and arrangements between any director or nominee for director and any third party relating to compensation or other payment in connection with such person's candidacy or service as a director. This disclosure must be made on an annual basis until the earlier of the resignation of the director or one year after the termination of the compensation arrangement, either on the company's website or in the definitive proxy or information statement for the shareholders' meeting at which directors are to be elected (or in the Form 10-K or 20-F, if the company does not file proxy or information statements). If a company makes the disclosure on its website, the disclosure must be available no later than the date of filing of the definitive proxy or information statements in connection with the applicable shareholder meeting (or the Form 10-K or Form 20-F, if the company does not file proxy or information statements) and must be continuously accessible.

For the full text of the final rule see:
http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2016/SR-NASDAQ-2016-013_Amendment_2.pdf.

For a more detailed discussion of the new rule, see the Paul, Weiss memorandum available at:
https://www.paulweiss.com/media/3635184/13jul16securities.pdf.

8. SEC Adopts Disclosure Rules for Resource Extraction Issuers

On June 27, 2016, the SEC adopted final rules requiring resource extraction issuers to disclose payments made to the U.S. federal government or foreign governments for the commercial development of oil, natural gas or minerals. The rules are mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act and are intended to advance U.S. policy interests by promoting greater transparency regarding payments related to resource extraction, combatting global corruption and empowering citizens of resource-rich countries to hold their governments accountable for the wealth generated by those resources.

Under the final rules, resource extraction issuers are required to disclose payments that are:

- made to further the commercial development of oil, natural gas or minerals;
- not *de minimis*; and
- one of the types of payments specified in the rules.

The rules define "not *de minimis*" as any payment, whether a single payment or a series of related payments, that equals or exceeds U.S. $100,000 during the same fiscal year.

The types of payments related to commercial development activities that are required to be disclosed include taxes, royalties, fees (including license fees), production entitlements, bonuses, dividends and payments for infrastructure improvements. This list of payment types is generally consistent with the requirements of Canada's Extractive Sector Transparency Measures Act ("ESTMA"), the EU Accounting and Transparency Directives, and the Extractive Industries Transparency Initiative.

The rules require a resource extraction issuer to provide the following information about payments made to further the commercial development of oil, natural gas or minerals:

- the type and total amount of such payments made for each project of the resource extraction issuer relating to the commercial development of oil, natural gas or minerals;
- the type and total amount of such payments for all projects made to each government;
- the total amounts of the payments by category;
- the currency used to make the payments;
- the fiscal year in which the payments were made;
- the business segment of the resource extraction issuer that made the payments;
- the government that received the payments, and the country in which the government is located;
- the project of the resource extraction issuer to which the payments relate;
- the particular resource that is the subject of commercial development; and
- the subnational geographic location of the project.

Significantly, issuers will be able to meet the requirements of the final rules by providing disclosure that complies with the resource extraction payment disclosure requirements of a foreign jurisdiction or the U.S. Extractive Industries Transparency Initiative ("USEITI"), if those requirements are deemed equivalent by the SEC. In conjunction with the adoption of the final rules, the SEC issued an order recognizing Canada's ESTMA, the EU Accounting and Transparency Directives and the USEITI in their current forms as being substantially similar disclosure regimes for purposes of alternative reporting, subject to certain conditions. In addition, issuers filing an alternative report prepared pursuant to a recognized foreign reporting regime are permitted to follow the reporting deadline applicable under that regime.

For the full text of the final rules see: https://www.sec.gov/rules/final/2016/34-78167.pdf.

For a more detailed summary of the proposed rules, see the Paul, Weiss memorandum available at: https://www.paulweiss.com/media/3621505/8jul16re.pdf.

9. SEC Proposes Rules to Modernize Property Disclosure for Mining Registrants

On June 16, 2016, the SEC announced proposed rules to modernize the property disclosure requirements for mining registrants, with the objective of aligning standards with current industry and global regulatory practices. If adopted, the rules would rescind the SEC's Industry Guide 7 and Item 102 of Regulation S-K, the SEC's existing rules regarding mining disclosure, and create new Regulation S-K subpart 1300. The proposed rules would apply to both domestic registrants and FPIs. However, Canadian registrants that file reports pursuant to the Canada-U.S. Multijurisdictional Disclosure System could continue to prepare mining disclosure in accordance with Canadian disclosure requirements.

The SEC's proposed rules represent a significant update to its disclosure rules for properties owned or operated by mining companies and introduce a number of new disclosure obligations. Among other things, the proposed rules:

- apply where a registrant's mining operations are material to its business or financial condition, with such operations being presumed material if a registrant's mining assets constitute 10% or more of its total assets;
- define "mining operations" to include all related activities from exploration through extraction to first point of material external sale;
- provide that individual properties must be identified as either "exploration," "development" or "production" stage on a property-by-property basis, as well as applying such designations to the registrant as a whole;
- require a registrant to disclose mineral resources and material exploration results in addition to its mineral reserves;
- adopt the Committee for Mineral Reserves International Reporting Standards ("CRIRSCO") based classification of mineral resources and require a registrant to classify its mineral resources into inferred, indicated and measured mineral resources, in order of increasing confidence based on the level of underlying geological evidence;

- revise the definition of mineral reserves to align it generally with the definition under the CRIRSCO-based standards; based on the definitions of "mineral reserves," "probable mineral reserves," "proven mineral reserves," and "modifying factors";
- require disclosure of mineral resources and mineral reserves to be based on either a preliminary feasibility study or a final feasibility study which, in either case, must include a life of mine plan that is technically and economically feasible;
- require that every disclosure of mineral resources, mineral reserves and material exploration results be based on documentation prepared by a "qualified person," defined as a person who is both (1) a mineral industry professional with at least five years of relevant experience and (2) a member or licensee of a recognized professional organization;
- require a registrant to file a technical report summary prepared by a qualified person for each material property, setting forth scientific and technical information and conclusions reached concerning material mineral exploration results, initial assessments used to support disclosure of mineral resources, and preliminary or final feasibility studies used to support disclosure of mineral reserves; and
- require royalty companies and similar companies to provide all applicable mining disclosure if the mining activities that generate the royalties or other payments are material to such company's operations as a whole.

For the full text of the proposed rules see: https://www.sec.gov/rules/proposed/2016/33-10098.pdf.

For a more detailed summary of the proposed rules, see the Paul, Weiss memorandum available at: https://www.paulweiss.com/media/3606589/29june16cdn.pdf.

10. SEC Increases Thresholds for Exchange Act Registration

On May 3, 2016, the SEC adopted final rules, substantially as proposed in December 2014, under the Jumpstart Our Business Startups Act (the "JOBS Act") and the Fixing America's Surface Transportation Act that reflect new, higher thresholds for registration under the Exchange Act. The SEC has amended Rule 12g-1 under the Exchange Act to exempt an issuer from the requirement to register a class of equity securities and comply with reporting obligations under the Exchange Act if the class of equity securities is held of record by fewer than 2,000 persons or by fewer than 500 persons who are not "accredited investors."

In addition, the SEC revised the definition of "held of record" in Rule 12g5-1 under the Exchange Act to exclude certain securities received pursuant to employee compensation plans in transactions exempt from, or not subject to, the registration requirements of Section 5 of the Securities Act.

For the full text of the final rules see: http://www.sec.gov/rules/final/2016/33-10075.pdf.

For a more detailed summary of the final rules, see the Paul, Weiss memorandum available at: https://www.paulweiss.com/media/3526468/9may16sec.pdf.

11. Delaware Court of Chancery Rejects Another Disclosure-Only Settlement

On January 22, 2016, in *In re Trulia, Inc. Stockholders Litigation*, the Delaware Court of Chancery again rejected a settlement in the M&A context that released a broad range of claims in exchange only for supplemental disclosure in a proxy circular. The Court commented that practitioners should expect approval of such disclosure-only settlements only if the plaintiff obtains supplemental disclosures that are "plainly material" (that is, not a "close call" with respect to materiality) and if the release is narrowly tailored to encompass only disclosure and fiduciary duty claims concerning the sale process, rather than a broad release of any and all claims, including unknown claims.

The Court highlighted the problematic features of deal litigation that prompted its decision. The Court explained that its willingness in the past to approve disclosure settlements of marginal value resulted in a litigation landscape where virtually every transaction involving the acquisition of a public corporation became subject to hastily filed class action lawsuits alleging disclosure violations, but that far too often such litigation served no useful purpose for stockholders. Instead, it served only to generate attorneys' fees for certain plaintiffs' attorneys and as a means for defendants to obtain through settlement an extremely broad release of all claims against them in exchange for immaterial disclosures.

For a more detailed discussion of *In re Trulia, Inc. Stockholders Litigation*, see the Paul, Weiss memorandum available at: https://www.paulweiss.com/media/3325930/26jan16ma.pdf.

12. U.S. House of Representatives Passes Bill that Proposes Changes to the Definition of "Accredited Investor"

On February 1, 2016, the U.S. House of Representatives passed a bill that proposes changes to the definition of "accredited investor" under U.S. federal securities laws. Known as "The Fair Investment Opportunities for Professional Experts Act," the bill directs the SEC to broaden its definition of "accredited investor" for natural persons found in Section 2(a)(15) of the Securities Act. Firstly, the bill would codify the net worth and income tests largely in their current forms under Section 501(a)(5) and (6) of Regulation D. Secondly, the bill proposes adding two additional classes of persons to the definition of "accredited investor," regardless of the level of that person's income.

The additional classes of "accredited investors" would include:

1) **Licensed brokers or advisors.** Natural persons currently licensed or registered as a broker or investment adviser by the SEC, the Financial Industry Regulatory Authority ("FINRA"), or an equivalent self-regulatory organization (as defined in section 3(a)(26) of the

Exchange Act) ("SRO"), or the securities division of a state or the equivalent state division responsible for licensing or registration of individuals in connection with securities activities; and

2) **Persons with certain professional knowledge.** Natural persons the SEC determines, by regulation, to have demonstrable education or job experience to qualify such person as having professional knowledge of a subject related to a particular investment, and whose education or job experience is verified by FINRA or an equivalent SRO.

The first additional class is straightforward, but the potential breadth of the second additional class is not determinable at this point in time. However, it is clear that adding these new classes of "accredited investors" would expose a currently untapped source of capital for private placements.

For the full text of the bill, see: https://www.gpo.gov/fdsys/pkg/BILLS-114hr2187eh/pdf/BILLS-114hr2187eh.pdf.

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For a discussion of certain other developments not highlighted above, please see our memoranda available at: http://www.paulweiss.com/practices/region/canada.aspx.

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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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