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The Impact of Dodd-Frank on Public Companies

The Dodd-Frank Financial Reform Bill: New Reporting and Regulatory Requirements Imposed on Public Companies, New Investor Protection Elements, and New Responsibilities and Powers Given to the SEC

On July 21, 2010, President Obama officially signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which represents the most sweeping regulatory overhaul of the financial markets since the Great Depression. Title IX of the Act, codified as the Investor Protection and Securities Reform Act of 2010, is focused on changes to and reform of the Securities and Exchange Commission ("SEC") to improve investor protections, close regulatory gaps, increase disclosure, and expand the regulation of and limitations on securities products and providers. Along with provisions in other titles in the Act, Title IX contains broad ranging changes impacting public companies. The Act provides the SEC with additional powers and rulemaking authority that will impact the reporting, disclosure and compliance practices of public companies. Set forth below is a summary of significant provisions of the Act that may have consequences for public companies and their officers and directors, as well as related entities.

Compensation Committee Requirements: Independence, Consultants and Disclosure

The Act imposes a number of new requirements relating to the compensation committee of a company's boards of directors, including director independence requirements and rules on the evaluation, retention, and payment of compensation committee consultants and advisors, as well as additional proxy disclosure requirements. SEC is required to issue regulations requiring the national securities exchanges and associations to include each of these new requirements in their listing requirements. The SEC is required to issue such regulations by July 2011.

First, the SEC will issue rules specifying what the national securities exchanges and national securities associations must consider in defining independence of all compensation committee members as a condition for listing on a national securities exchange. Among the relevant factors for determining independence of a compensation committee member will be:

- The source of the member's compensation, including consulting, advisory, or other fees paid by the company; and
- Whether the member is affiliated with the company or any subsidiary or affiliate. (For companies currently complying with the NYSE Listing Requirements, the relationships the compensation committee member or his/her family may have with the listed company are already specified in the standards for determining independence of board members.)

Next, with respect to the retention of a compensation consultant, legal counsel, or other advisor, the Act provides that a compensation committee must have sole discretion to retain compensation consultants, independent legal counsel, or other advisors. The compensation committee is to be directly responsible for the retention, payment, and oversight of such advisors and the company is required to provide funding for reasonable compensation for such advisors. The Act requires the SEC to promulgate rules requiring that compensation committees "tak[e] into consideration" SEC-identified factors that could affect the independence of such an advisor.

The Act specifies that the factors to be considered will include:

- The other services that the advisor's employer provides to the company;
- The amount of fees received from the company by the advisor's employer as a percentage of that employer's total revenue;
- The policies and procedures of the advisor's employer with respect to conflicts of interest;
- Any relationship between the advisor and any member of the committee; and
- Company stock owned by the advisor.

Finally, beginning in July 2011, a company's proxy or similar solicitation must disclose whether the company's compensation committee has retained or obtained the advice of a compensation consultant. If the committee has retained a consultant, the proxy statement must also disclose whether the work of the consultant raised any conflict of interest, the nature of the identified conflict, and how it is being resolved.

The SEC will issue rules by July 2011 requiring national securities exchanges to prohibit listing companies that do not comply with these requirements, but exchanges will be authorized to establish exemptions. The Act excludes certain companies from these requirements, including foreign private issuers, limited partnerships, and controlled companies from the independence requirement. Companies subject to these requirements will be provided a reasonable opportunity to cure defects prior to delisting.

Commentary: The NYSE Listing Requirements or SEC rules do not currently require compensation consultants or any other advisor to the compensation committee to be independent (although the 2009 SEC Proxy Disclosure Regulations required disclosure of certain relationships with compensation consultants), the new rules may be drafted with a clear preference for full independence that committees will have to address. It is recommended that compensation committee charters provide, if they do not already do so, the compensation committee with the sole authority to retain and terminate its consultants and advisors, and to approve consultants' and advisors' fees and other retention terms. In practice, many compensation committees of publicly-traded entities already are authorized to control the selection, retention and compensation of consultants. Many of these practices have been established as part of efforts to improve corporate governance ratings and to satisfy institutional investors. But as the Act now moves beyond simply disclosure toward independence of compensation consultants and other advisors to the compensation committee, additional work will be required in selecting and retaining advisors.

Compensation Proxy Disclosures

Public companies will, as a result of the Act, be required to include significantly more information in proxy statements and other disclosures regarding the compensation paid to their executives. The SEC will issue rules requiring public companies:

- To include in their compensation disclosures information showing the relationship between executive compensation actually paid to the executives and the company's financial performance (this disclosure may include a graphic representation, and should take into account change in stock value, dividends, and other distributions).

- To disclose:
 - The median of the annual total compensation of all employees other than the chief executive officer;
 - The annual total compensation of the chief executive officer; and
 - The ratio of the median annual compensation to the total compensation of the chief executive officer.
- Whether any employee or director (or designee) is permitted to purchase financial instruments designed to hedge or offset decreases in value of the company's stock that was granted to the employee or director as compensation or that is held directly or indirectly by the employee or director.

Commentary: The Act does not specifically permit the SEC to exclude companies from these requirements, even though they likely will be particularly burdensome for small companies. There is no deadline for the SEC to issue rules, and detailed guidance from the SEC will be necessary in order to implement these requirements. While companies are familiar with calculating total compensation for the named executive officers for proxy disclosures, this is not a calculation normally done for all employees. Companies with employees moving between different countries' payroll systems with different exchange rates and some union negotiated benefits may present new challenges in calculating total compensation and defining the median compensation of all employees. These compensation-related proxy disclosure requirements, particularly the median employee compensation and pay versus performance disclosures, impose risks for companies simply because of their complexity and the resulting risk of error.

Clawback Requirements

Public companies now will have an obligation in most instances to recover, or "claw back" some portion of incentive-based compensation from senior executives in the event of a financial restatement. The SEC will issue rules requiring the exchanges to demand public companies, as a condition to listing on a national securities exchange, to develop and implement policies:

- For disclosure of the company's policy on incentive-based compensation based on financial information required to be reported under applicable securities laws; and
- For recovery from current or former executive officers of incentive-based compensation in the event the company is required to prepare an accounting restatement due to material non-compliance with any financial reporting requirements under the securities laws.

The Act specifies that the "clawback" requirement of the SEC rules will apply to incentive-based compensation received during the three-year period preceding the date on which the company is required to prepare the restatement and which is in excess of the amount that would have been paid to the executive using the restated financial components. The clawback requirement extends to current or former executive officers and, while that term is not defined in the Act, it likely will be broader than just the CEO and CFO. No deadline is specified for development of these clawback rules.

Commentary: The “clawback” provision applicable to compensation of current and former executive officers in the event of a restatement is broader in some respects than the clawback provisions under Section 304 of Sarbanes-Oxley and likely will have significant impact on public companies and their officers. While the provision in this Act does not address clawing back any proceeds from stock sales as does Section 304 of Sarbanes-Oxley, it requires the return of compensation received during a period of three years prior to a restatement rather than the one year provision in Sarbanes-Oxley. Moreover, the Act requires that a company’s clawback policy apply to executive officers without defining the term; Sarbanes-Oxley Section 304 applies only to the CEO and CFO of an issuer. Finally, the clawback will be applicable in any restatement as a result of material noncompliance with the financial reporting requirements without the limitation in Sarbanes-Oxley to only restatements caused by “misconduct.”

Shareholder Say on Pay and Say on Change of Control Pay

The ability of shareholders to influence or be heard on the compensation of senior executives, and the impact on companies resulting from that ability, became a hot topic of financial reform. Congress sided with shareholders and in the Act imposes two non-binding “say on pay” shareholder voting requirements on public companies: first, a vote on approval of compensation for named executive officers; and second, a vote on approval of “golden parachute” pay in connection with a merger or similar transaction.

- At least once every three years, a company’s annual meeting proxy statement must provide shareholders with a separate non-binding vote to approve the compensation of named executive officers (*i.e.*, “say on pay” voting). In addition, at least once every six years, a company must provide its shareholders with a separate vote on whether this say on pay vote should occur more frequently (either annually or every other year). Although it is not entirely clear, this vote too is apparently non-binding. These provisions take effect 6 months after the date of enactment and, as a result, will be in place for the early 2011 proxy season. In that first year, companies will be required to provide shareholders with both a vote on the named executive officers’ pay and on how frequently this vote must occur.
- Also beginning in six months, in any proxy or consent solicitation relating to a meeting at which shareholders are asked to approve an acquisition, merger, consolidation, or proposed sale of substantially all of a company’s assets, a company is required to make new disclosures and conduct a new vote as follows:
 - The person making the solicitation must disclose all agreements and understandings with the named executive officers of the company (or the acquiring company, as applicable) for any compensation relating to the transaction (*i.e.*, “golden parachute” pay);
 - Aggregate total golden parachute pay and the conditions under which it will be paid must also be disclosed; and
 - Shareholders must be provided with a separate non-binding vote to approve the agreements and understandings providing golden parachute pay, unless those agreements and understandings have already been subjected to a non-binding shareholder vote (*i.e.*, a say on pay vote as above).

Institutional investment managers subject to Section 13(f) of the Securities Exchange Act of 1934 (the "Exchange Act") will be required to disclose how they vote in each of these votes. The SEC is authorized to exempt companies from these voting requirements, and is to consider whether they would disproportionately burden small companies. The Act states that these shareholder votes are not to be construed to either change or add any fiduciary duties for either affected companies or their boards of directors.

Commentary: While the say on pay provisions are "non-binding", they clearly put further pressure on companies that choose not to follow shareholder wishes and to make additional disclosures that might impact a corporate transaction. Boards will need to engage in discussions with and communicate clearly with shareholders so that they can avoid a negative advisory vote. The compensation committee in particular will need to provide information to shareholders sufficient to explain the rationale for the compensation paid to an executive.

The implementation of procedures to comply with the say-on-pay and executive compensation disclosure requirements may give affected companies an opportunity and incentive to revisit their existing executive compensation structures and associated governance practices. Revisiting executive compensation arrangements with an eye toward the increased shareholder scrutiny may provide opportunities to renegotiate. Any renegotiation which involves amounts which might constitute deferred compensation should be done considering the increased regulation of such arrangements by the Internal Revenue Service and the limited opportunity during 2010 to make corrections of documentation missteps that may not exist in future years.

Proxy Access and Corporate Governance

The Act gives the SEC rulemaking authority to require that proxy solicitations by an issuer include board nominees submitted by shareholders in any proxy materials. The SEC is authorized to establish rules regarding the inclusion of shareholder nominees including procedures to be followed by issuers and any terms and conditions of shareholder use of this process.

The Act specifies that issuers are required to disclose in annual proxy statements the reasons why the issuer chose either to have the same person serve as both chairman of the board and CEO or to have different individuals fill those roles. Although the SEC has already promulgated Rule 407(h) of Regulation S-K requiring such disclosure, the Act directs the SEC to issue rules and to exempt from those rules such issuers for which the disclosure would be a disproportionate burden.

Commentary: In passing the Act, Congress resolved the debate over whether the SEC had the power to adopt proxy access rules that had been previously proposed. In the SEC's proposals last year, to be eligible to include nominees in the company's proxy materials a shareholder would have to own a minimum amount of the company's voting securities (one percent if the company has a market capitalization of \$700 million or more, three percent if the company has a market capitalization of between \$75 million and \$700 million, and five percent if the company has a market capitalization of less than \$75 million). The SEC is likely to enact rules consistent with those previously proposed.

Miscellaneous Disclosure Provisions

This Title also imposes disclosure requirements on certain public companies concerning:

- Certain conflict minerals [columbite-tantalite (coltan), cassiterite, gold, wolframite, or their derivatives] from the Democratic Republic of the Congo or an adjoining country that are used in the public company's manufacturing process.
- Coal and other mine safety information, including reporting shutdowns and patterns of violations.
- Payments by "resource extraction issuers" involved in the commercial development of oil, natural gas, or minerals, including exploration, extraction, processing, export, and other significant actions as determined by the SEC.

The SEC has until April 2011 to issue regulations detailing these new disclosure requirements.

Commentary: These disclosures relate to current political "hot buttons." But, the minerals involved may span numerous industries outside of the obvious oil, gas, and coal companies - reaching electronics and component manufacturers, for example. Public companies will need to examine the product mix and process carefully to determine whether these provisions are implicated and whether additional disclosure is required.

Exemption from Internal Controls Reporting for Small Issuers

The requirement for evaluation and reporting of internal controls under Section 404(b) of Sarbanes-Oxley has long been viewed as an onerous burden for small issuers and, as a result, the application of that provision to companies who are not "accelerated filers," i.e., companies with a market capitalization of less than \$75 million had been delayed by the SEC. The Act goes further by providing an exemption from Section 404(b) compliance for an additional three years for those small issuers. During the three year exemption period, the Government Accountability Office ("GAO") will conduct a study on that small issuer exemption from Sarbanes-Oxley Section 404(b) to determine whether those issuers have more restatements than companies that comply with Section 404(b), whether there are increased costs of capital or reduced investor confidence for those small issuers, and what the costs and benefits are of that exemption. Additionally, the SEC is required to conduct a study and report by April 2011 on means to reduce the burden of Sarbanes-Oxley compliance for companies who market capitalization is between \$75 million and \$250 million.

Commentary: Small issuers, again, are given a reprieve from the internal controls and reporting requirements under Section 404(b) of Sarbanes-Oxley. While many of the other provisions of the Act will significantly increase the compliance costs to all public companies, this provision results in a delay of certain costs for the smallest public companies. Moreover, with the additional study directed toward finding means to reduce the compliance burden to issuers with a market capitalization up to \$250 million, the SEC may elect to implement a different compliance program altogether for many public companies.

Voting by Brokers

The Act adds a requirement that national securities exchanges must prohibit their member firms from voting proxies for which they have not received shareholder instructions on votes involving the election of a member of the board of directors, executive compensation, or other significant matters as determined by the SEC. The rules of the national securities exchanges must provide that a broker-dealer member firm have instructions from the beneficial owner of the security to vote in accordance with specific instructions of the beneficial owner.

Commentary: The New York Stock Exchange has already prohibited broker voting in the election of directors. However, the NYSE prohibition and the expected rules of the other exchanges likely will make it more difficult for companies to obtain quorums at annual meetings and achieve the votes needed for significant matters. Companies should work with broker-dealers and the exchanges to educate shareholders about the need to cast votes or to provide instructions to broker-dealers so that important corporate decisions are not delayed.

Regulation D Changes: “Bad Actor” Disqualification and Accredited Investor Standard

The SEC is directed to issue rules to disqualify certain “bad actors” from using Regulation D to offer and sell securities. By July 2011, the SEC should have rules in place to disqualify anyone who has been convicted of a felony or misdemeanor involving the purchase or sale of a security or any false filing with the SEC. In addition, the SEC’s rules will disqualify from using Regulation D, for a period of ten years, anyone who has been the subject of a final order based on fraudulent, deceptive or manipulative conduct entered by a state securities commission, banking commission, insurance commission or similar agency.

The Act also instructs the SEC to adjust the net worth standard for an accredited investor to require that the individual net worth of any natural person, or joint net worth with the spouse of that person, is, at the time of purchase, greater than \$1 million, exclusive of the value of the person’s primary residence. The current requirement has the same net worth figure but allows an investor to count the value of his or her primary residence. The change to the individual net worth standard is effective immediately and may not be altered by the SEC until 2014. Thereafter, the SEC is required, no less frequently than once every four years, to undertake a comprehensive review of the accredited investor definition to determine whether modifications to such definition are appropriate. After that review, the SEC is authorized to make changes to the accredited investor definition, but only with respect to natural person investors.

Commentary: Small issuers and others who use Regulation D as a means to raise capital should ensure that none of their officers or directors have been the subject of an action that would disqualify the individual, and thereby the company, from using Regulation D as an exemption from SEC registration. Similarly, companies that use Regulation D must review their investor questionnaires and other materials to comply with the new net worth requirement and clearly state that a primary residence cannot be included in the calculation.

Whistleblower Incentives and Protections

Whistleblowers are given expanded incentives and protections under the Act. Previously, the SEC had the ability to provide bounties to informants who provided information regarding insider trading violations under certain circumstances. The new provisions are significantly broader. The SEC is directed to pay whistleblowers an award in any judicial or administrative action in which the sanctions, including penalties, disgorgement and interest, exceed \$1 million.

- The amount of a whistleblower award is directed to be between ten and 30 percent of the total sanction collected in any action but the SEC is given discretion to determine the amount of an award using specified criteria.
- Auditors are specifically excluded from claiming a whistleblower award as are employees of regulatory agencies, self-regulatory organizations, and law enforcement agencies. However, even employees who may have been involved in the underlying conduct are eligible for an award unless they are criminally convicted for their misconduct.
- The award will be paid through an Investor Protection Fund established by the SEC for the payment of the whistleblower awards as well as for funding the activities of the SEC's inspector general.
- The Investor Protection Fund will be funded, up to a maximum of \$300 million, through the deposit of all disgorgement and penalty amounts that are not otherwise distributed to investor victims in any SEC action. However, if the amounts in the Investor Protection Fund are not sufficient to satisfy a whistleblower award, the unfunded portion of the award shall be deducted from the amount collected in the specific action on which the award is based.

Whistleblowers are protected from retaliation by their employers and the Act establishes a cause of action by whistleblowers who are subjected to harassment, demotion, threats or other misconduct from their employers. Whistleblowers are entitled to receive reinstatement, two times their back pay, and all litigation expenses if they prevail in any action under this section.

The SEC must pass final regulations for the whistleblower provisions by April 2011. The SEC also must establish an office to administer and enforce the whistleblower provisions and report annually to Congress on the whistleblower programs.

Commentary: The sizeable bounty available to employees who may become whistleblowers will have significant implications for public companies. While some employees are motivated by loyalty to report problems internally, they and others will have an option to go directly to the SEC and provide little or no information, before or after, to the company. Companies should provide frequent training to employees on the internal reporting of potential violations, including identifying the avenues and reasons for internal reporting. Moreover, companies may want to consider incentives which, although not likely to be as large as any available through the SEC's program, allow employees to profit in addition to helping the company and remaining loyal to their employer.

Further, in light of the whistleblower protections, companies should provide anti-retaliation training, in particular to management employees. It will be important as well for companies to provide protections internally and protect employees who are whistleblowers – whether they report to the company directly or to the government.

Improvements to the Regulation of Credit Rating Agencies

In setting the stage for regulations to be imposed on credit rating agencies, Congress commented on the importance of credit ratings and notes that the inaccurate ratings on structured financial products contributed to the mismanagement of risks which, among other things, led to the financial crisis. The Act requires each nationally recognized statistical rating organization ("NRSRO") to establish and follow an internal control structure over the

process for determining credit ratings. Additionally, each NRSRO must establish and enforce procedures to ensure the prevention of conflicts of interest.

For public companies, the two most significant rating agency changes in the Act are:

- SEC Rule 436(g), which previously provided an exemption to credit ratings prepared by NRSROs from being considered as part of a registration statement, has been eliminated. As a result, NRSROs are considered to be a participant in a registration statement if rating information is included in any registration statement. NRSROs must consent to the inclusion of rating information in any issuer registration statement and may be subject to liability to purchasers under Section 11 of the Securities Act.
- NRSROs are subject to private rights of actions and can be liable for statements in the same manner and to the same extent as an accounting firm or securities analyst would be. The Act provides that the statements of an NRSRO are not deemed forward-looking statements under the securities laws.

Two studies mandated by the Act may also change dramatically the operation of the credit rating process:

- The SEC is required to study the credit rating process for structured finance products and consider the establishment of a system to assign NRSROs to determine the credit ratings of structured finance products. By July 2012, the SEC must make its report and, thereafter, establish a system for the assignment of NRSROs to determine initial credit ratings of structured finance products in a manner that prevents rating shopping. The Act provides that, unless the SEC determines a better alternative system, the SEC should implement a Credit Rating Agency Board, a new self-regulatory organization, to assign credit rating agencies to issuers.
- GAO is directed to conduct a study, and report by January 2012, on alternative means for compensating NRSROs that would create incentives for more accurate credit ratings. The GAO is also tasked with conducting a study on the possible creation of an independent professional organization for rating analysts, and reporting on its study within one year after the SEC publishes its standards on rating analyst qualifications discussed below.

The SEC will be establishing an Office of Credit Ratings to administer rules regarding the NRSROs and conducting annual examinations of each NRSRO. The inspection reports produced by that office will be publicly available. The SEC is empowered to establish rules relating to, among other things, (1) internal controls and attestations; (2) the prevention of sales and marketing by NRSROs from influencing ratings; (3) disclosures that are comparable between and among the NRSROs; (4) procedures and methodologies applied by the NRSROs; (5) forms to provide information on the assumptions and data used to produce a rating, the volatility of the rating, as well as the historical performance of the rating and probability of default; and (6) the standards of training, experience and competence required for credit rating analysts. In the next 90 days, the SEC is required to revise Regulation FD and eliminate the current exemption as to credit rating agencies so that Regulation FD applies to NRSROs.

The Act expands the SEC's authority to include regulation of and action against persons associated with an NRSRO. The SEC is also given new authority to take action against, including to censure, suspend or bar a person from association with, an NRSRO based upon misconduct or upon a failure to supervise someone who has engaged in a violation. The SEC may suspend or revoke the registration of an NRSRO if the SEC finds that the NRSRO does not have the ability to produce consistently credit ratings with integrity. Finally, the Act requires studies to be performed regarding NRSROs including standardizing credit rating terminology between agencies and between asset classes, credit rating agency independence, and conflicts of interests.

Commentary: Without the protections from the SEC regarding the use of ratings in the registration statement, without the exemptions from the safe-harbor for forward looking statements, and with increased exposure to private litigation, the market has seen in the first week some impact in the credit rating process. NRSROs notified the SEC that they would not consent to the use of ratings in registration statements in certain issuances such as those of asset-backed securities. The SEC has permitted issuers to omit the ratings from a registration statement for the next six months. It is likely that the changes of the Act applicable to NRSROs will result in a different approach by those agencies in future ratings at additional cost to public companies.

Improvements to the Asset-Backed Securitization Process

By April 2011, the SEC and banking agencies must jointly prescribe regulations to require any issuer of an asset-backed security (also called a "securitizer") to retain an economic interest in a portion of the credit risk for any asset sold to a third party. The regulations will require that a securitizer maintain not less than five percent of the credit risk for any asset that is not a qualified residential mortgage while requiring something less than five percent retention of the credit risk for securitizers selling asset-backed products involving qualified residential mortgages meeting certain underwriting standards.

The banking agencies and the SEC, by joint rulemaking, will specify items such as the duration and form of the risk retention required; the allocation of risk retention obligations between securitizers and originators; differentiations applicable to certain asset classes; and any appropriate exemptions from the risk retention requirements. The Act also specifies that the SEC will establish rules and regulations for registration statements and filings by issuers of asset-backed securities as well as for disclosures of information regarding the assets backing each class or tranche of a security.

Commentary: By requiring issuers, underwriters or others who are deemed securitizers to retain a portion of credit risk and keep some "skin in the game," Congress hopes to prevent those parties from taking unnecessary risks or packaging products they are not willing to retain. Attorneys and commentators are split on whether this will negatively impact the market for asset-backed securities. Investors may be encouraged to purchase more asset-backed securities if they know the seller is also invested in the outcome. But, on the other hand, issuers and underwriters may be able to engage in fewer deals because their investment assets are tied up in the retained portion of the security.

Accounting Firm and Public Company Accounting Oversight Board (PCAOB) Changes

Foreign public accounting firms will be subject to the jurisdiction of the SEC, the PCAOB, and the U.S. Courts under the terms of the Act. A foreign public accounting firm that issues an audit report, performs audit work, conducts interim reviews, or performs material services upon which a registered public accounting firm relies must produce its records if requested by the SEC or PCAOB. Additionally, any registered public accounting firm that relies on the work of a foreign public accounting firm in issuing an audit or interim review must secure the

agreement of the foreign firm that it will cooperate as a condition of such reliance and must produce the foreign firm's audit work papers to the SEC or PCAOB, if requested.

The Act also permits the PCAOB to make information available to foreign auditor oversight authorities if that foreign authority provides certain information and assurances of confidentiality. The PCAOB has the discretion to make the information available if it is in the interest of investor protection.

The Act gives the PCAOB new oversight authority over auditors for broker-dealers and the ability to impose fees upon broker-dealers to cover the costs related to that authority. The PCAOB is given authority to conduct inspections of auditors for broker-dealers, to conduct investigations and bring disciplinary proceedings against auditors for broker-dealers, and to make referrals to a self-regulatory organization regarding information concerning the audit of a broker-dealer.

Commentary: The establishment of SEC and PCAOB authority over foreign audit firms is a positive change although it is not certain whether foreign firms will comply and whether foreign jurisdictions will assist in the enforcement of this requirement. More significant is the requirement that a U.S. accounting firm must secure the agreement of a foreign firm before relying on the audit or review performed by that foreign audit firm, including for example audits of a company's foreign subsidiary. Public companies should be prepared to assist their audit firms in obtaining the cooperation of the foreign subsidiary or related entity and their audit firm in this process.

Broker-Dealer Fiduciary Standard

Congress did not address or resolve the controversy regarding the duty of care applicable to broker-dealers and their registered persons. Instead, the SEC is directed in the Act to conduct a study on the standards of care applicable to investment advisers and broker-dealers. The study will be focused on determining whether investors understand and are impacted by the different standards of care currently in place, whether there are regulatory gaps that should be addressed, and the impact of imposing a higher fiduciary duty upon broker-dealers. The SEC must submit a report on the study by January 2011. Thereafter, the SEC may begin rulemaking regarding standards of care. The Act requires additional protections for investors where a broker-dealer sells proprietary products and where broker-dealers and investment advisers have conflicts of interest.

Commentary: By failing to affirmatively end the debate surrounding the application of the same fiduciary standard to both investment advisers and broker-dealers and directing the SEC to conduct a study, Congress has allowed the decision to be made. The expressed preference of a majority of the current SEC commissioners, along with information from prior studies on the subject showing that investors believe both investment advisers and broker-dealer representatives are looking out for their "best interests," means that a fiduciary standard and heightened duty of care is in the future for broker-dealers and their associated individuals.

Additional Provisions Designed to Increase Investor Protection

The Act establishes an Office of the Investor Advocate within the SEC charged with, among other things:

- Assisting retail investors with problems they may have with the SEC or self-regulatory organizations or with industry participants and products; and
- Analyzing the impact of regulations and rules upon investors.

An Investor Advisory committee within the SEC is also established to advise and consult with the SEC on regulatory priorities, market issues, and initiatives for investor protection and confidence. The committee will include between ten and 20 individuals representing the interests of investors, the Investor Advocate, a representative of the state securities commissions and a representative of the interests of senior citizens. The committee must meet at least twice a year and the members serve four-year terms.

For both the Investment Company Act and the Investment Advisers Act, the recordkeeping requirements are extended to cover any person having custody or use of funds or securities of an investment company or investment adviser. Individuals and entities with custody or use of such assets are subject also to examinations by the SEC.

The SEC is directed to promulgate new rules for money managers subject to Section 13(f) of the Exchange Act to disclose at least monthly the amount of short sales in any security. The Act makes manipulative short selling unlawful and directs the SEC to adopt rules to address such manipulation.

Every registered broker-dealer must now provide notice to customers regarding securities lending. Broker-dealers must disclose that a customer may elect not to allow their securities to be loaned in connection with short sales by others and disclose that the broker-dealer may receive compensation for lending the customer's securities. The SEC by rule may specify the form and content for such disclosures.

Numerous studies are outlined in the Act, all designed to increase investor protection, including:

- A study by the SEC, based upon the past five years of data, on the need for additional examination and enforcement resources for regulating investment advisers. The SEC's report is due within 180 days of the enactment on July 21, 2010.
- An SEC study on the financial literacy of retail investors, methods to increase financial literacy, and methods to increase investor information relevant to decision making. The SEC's report on this study is due within two years.
- A study by the GAO on mutual fund advertising, to be reported to Congress by January 2012.
- The GAO is also directed to conduct a study and report by January 2012 on the conflicts of interest between investment banking and analyst functions at broker-dealers.
- An SEC study of ways to improve investor access to information about investment advisers and broker-dealers. The SEC must complete the study within six months and, within 18 months of the study's completion, implement recommendations including possible improvements to the central databases of information on investment advisers, broker-dealers, and their associated persons.
- A study by the GAO regarding the use of titles and designations by persons who hold themselves out as financial planners. Among other things, the GAO is to consider and report by January 2011 whether additional regulation and oversight of financial planners is appropriate.

Commentary: These provisions are relatively uncontroversial and summarized primarily for information purposes as they will have little impact upon public companies.

Increasing Regulatory Enforcement and Remedies

More SEC enforcement remedies and tools are provided by the Act:

- The SEC is given authority to bring actions for aiding and abetting violations of the Securities Act of 1933, the Investment Advisers Act of 1940, and the Investment Company Act of 1940, in addition to the currently existing authority under the Exchange Act. Moreover, the liability for aiding and abetting is specified to include reckless, in addition to knowing, conduct. While private rights of action for aiding and abetting are not authorized by the Act, the GAO is directed to conduct a study on the impact of allowing such private rights of action.
- The Act grants the SEC the authority to impose civil penalties in cease-and-desist proceedings brought under the Federal securities laws.
- The Act amends the SEC's ability to use penalties imposed in enforcement actions, even if no disgorgement is ordered, to create a fund for the repayment of investors.
- The SEC's ability to suspend or bar individuals who have violated the securities laws is expanded. The SEC can now impose sanctions "collaterally" to prevent or limit association with any regulated entity.
- The SEC is given power to issue subpoenas and compel appearances in judicial actions in any place in the United States, for nationwide service of process.
- The information which registered persons and entities such as broker-dealers, investment companies, and investment advisers, provide to the SEC in connection with any examination, or other surveillance activities will now be confidential and protected from disclosure.

The reach of SEC and Justice Department in actions under the anti-fraud provisions is extended by the Act to include conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; and conduct occurring outside the United States that has a foreseeable substantial effect within the United States. The SEC is directed to solicit public comment and conduct a study to determine whether to apply extraterritorial jurisdiction to private rights of action. The report of the study must be submitted to Congress by January 2012.

Commentary: These new powers and authority are items that have been requested by the SEC for several years. However, they are balanced by various reforms to and reports by the SEC as noted below.

Improvements to and Reform of the SEC

While the Act gave the SEC new tools and powers, it also established new reporting and guidelines designed to keep the SEC under Congress' watchful eye. Congress has imposed deadlines for the completion of SEC enforcement investigations and examinations. Within 180 days after sending a Wells notice to any party, the SEC staff must file an action unless the Director of the Division of Enforcement grants an extension and notifies the SEC Chairman. Similarly, within 180 days after completing the on-site portion of an examination, the SEC staff must provide the registered entity being examined with a written notification of the exam's conclusion and findings if any.

The Director for the staff conducting the examination may extend the deadline in complex matters upon notice to the SEC Chairman.

Both the SEC and the GAO are required to produce new periodic reports regarding the function of the SEC including:

- An annual report by the SEC on the conduct of the SEC in examining registrants, conducting investigations and reviewing corporate filings. In the annual reports, the SEC must assess the effectiveness of the procedures applicable to the staff performing the functions and of the internal supervisory controls.
- The GAO is directed to prepare a report every three years reviewing the adequacy and effectiveness of the SEC's internal supervisory control structure and procedures.
- Every three years, the GAO also must prepare a report on the quality of the SEC's personnel management and the SEC must respond to and reimburse GAO for the reports.
- The SEC is required to report within six months after the end of each fiscal year on its internal controls and procedures for financial reporting.

Additionally, with regard to improving and reforming the SEC, numerous one-time studies are required of the SEC's processes, structure, management and personnel.

- GAO is required to report to Congress by January 2011 on the SEC's internal controls and procedures for financial reporting. The SEC is required to reimburse the GAO for the report.
- Within two years, GAO must study and report to Congress on the SEC's oversight of national securities associations. The report will assess the national securities associations and their governance, compensation, advertising, cooperation with state securities administrators, funding, exam programs, and other matters. Again, the SEC is required to reimburse GAO for the report.
- The SEC is required to retain an independent consultant to perform a study of the operations, structure and funding of the SEC as well as the SEC's relationship with self-regulatory organizations. The consultant is directed also to consider the need for comprehensive reform of the SEC including elimination of redundant units, improving communication internally, improving the SEC's efficiencies, and revising hiring and pay practices.
- The Act directs the GAO to conduct a study and report within one year on the number of SEC employees who leave to work for financial institutions regulated by the SEC, make recommendations to strengthen controls regarding the conduct of employees, assess whether staff turnover has led to inefficiencies in enforcement or circumvention of rules and regulations, and determine if greater post-employment restrictions are needed.

- The Act specifies that the SEC's Division of Trading and Markets and Division of Investment Management shall have examiners to perform compliance examinations of the entities under the jurisdiction of those Divisions.

Commentary: The changes to the SEC are mixed; likely the result of differing political pressures in Congress. For example, on the one hand, there is duplication created by provisions such as the requirement for examiners on staff in the SEC's Divisions of Trading and Markets and Investment Management because another Division, the Office of Compliance, Inspections and Examinations, already has examiners with responsibility for examining the entities that would be examined by Trading and Markets or Investment Management. On the other hand, Congress has required the SEC to retain an independent consultant to study the existing SEC structure and make recommendations for, among other things, the elimination of redundant operations and duties. Similarly, the legislation requires the SEC to establish a new Office of Investor Protection with tasks that overlap many of those currently performed by the SEC's Office of Investor Education and Advocacy. By requiring numerous new reports, particularly when combined with Congress' decision to retain authority over the SEC's budget through the appropriations process, Congress has indicated that it continues to be concerned about the SEC's performance and wants to retain both the control over and the excess fees generated by the SEC.

SEC Funding

The Act establishes increased funding for the SEC through a "matched funding" process in which the SEC will collect transaction fees and assessments designed to equal the annual budget as appropriated by Congress. The SEC is allocated appropriations, in addition to any other amounts that may be appropriated by Congress, for fiscal year 2011 of \$1.3 billion, for fiscal year 2012 of \$1.5 billion, and increasing amounts to \$2.25 billion for fiscal 2015. The SEC will present its budget directly to Congress beginning for the 2012 fiscal year at the same time it presents a budget to the President; thus eliminating the possibility of reductions made frequently by the President or Office of Management and Budget before the SEC budget reaches Congress. The Act also provides a new Reserve Fund for the SEC to be funded out of the registration fees collected upon the filing of a registration statement by a public company or investment company issuer. The deposits to the Reserve Fund cannot exceed \$50 million in any one fiscal year and the Reserve Fund balance may not exceed \$100 million. The SEC may use up to the full balance of \$100 million in any one year for any costs necessary to carry out the agency's functions.

Commentary: This provision is far short of what the SEC sought in self-funding. The budget increases for the SEC over the next two fiscal years are unlikely to result in significant increases to investor protection through more staff in the enforcement, examination or filings review programs. Budget increases will be eaten largely by the staff needed to fill the three new offices created, complete the approximately 17 studies and resulting reports ordered in the legislation, and to engage in the rulemaking for more than 90 items throughout the Act. Although larger amounts in future years as well as a Reserve Fund to tap for needs beyond the amounts appropriated by Congress may lead to long-term improvements in the quality of the SEC's programs, the short-term budgets will present the SEC with numerous challenges.

For additional information regarding these provisions of the Act, please contact any corporate or securities attorney with whom you work, or one of the attorneys listed below:

[Katherine Addleman](#)

214.651.5783

kit.addleman@haynesboone.com

[Arthur S. Berner](#)

713.547.2526

arthur.berner@haynesboone.com

[Ronald W. Breaux](#)

214.651.5688

ron.breaux@haynesboone.com

[Greta E. Cowart](#)

214.651.5592

greta.cowart@haynesboone.com

[Michael J. Halloran](#)

202.654.4567

michael.halloran@haynesboone.com

[Bruce Newsome](#)

214.651.5119

bruce.newsome@haynesboone.com

[Gregory R. Samuel](#)

214.651.5645

greg.samuel@haynesboone.com

[Janice V. Sharry](#)

214.651.5562

janice.sharry@haynesboone.com

[Taylor H. Wilson](#)

214.651.5615

taylor.wilson@haynesboone.com