How the Wall Street Reform Act Impacts Smaller Businesses

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On June 29, 2010, after months of wrangling, the House-Senate Conference Committee issued the conference report on the Dodd-Frank Wall Street Reform and Consumer Protection Act, a 2,319 page amendment to H.R. 4173 (the "Dodd-Frank Act"). The House of Representatives approved the bill on June 30, 2010, the Senate approved it on July 15, 2010, and it became law when President Obama signed it on July 21, 2010. This bill has its genesis in the financial crisis of 2007-2008 and the perceived abuses by financial institutions, investment advisors, and credit rating organizations with respect to asset backed securities, sub-prime mortgages, collateralized debt obligations, and other derivative securities, as well as a backlash against what was perceived to be excessive executive compensation in publicly traded companies and financial institutions.

There has been a large amount written in law firm memoranda and news articles on how the Dodd-Frank Act impacts major banks and broker dealers, attempts to control derivative securities, and otherwise impacts Wall Street's financial practices. Other sections deal with mortgage-backed securities and mortgages in general which will be of significant interest to the real estate lawyer. In this author's experience, there has been little written on the Dodd-Frank Act's impact on smaller public and private businesses, which is potentially significant. The Dodd-Frank Act implements a number of measures, from revising the definition of accredited investor, changing eligibility for Rule 506, enhancing whistleblower protections, and enhancing the Securities and Exchange Commission's enforcement powers, to mandating a number of studies that may further impact small businesses. The following describes some of these measures and their potential impact both on smaller businesses and the lawyers who represent them.

Summary of the Act

A large part of the Act deals with matters that impact Wall Street and major financial institutions. For example, the Dodd-Frank Act establishes a Financial Stability Oversight Council[1] with the authority to regulate non-bank financial companies and to resolve supervisory and jurisdictional disputes between various supervisory agencies (such as the Securities and Exchange Commission (the "SEC"), the Commodities Futures Trading Commission (the "CFTC"), and the Federal Reserve Board (the "FRB")). The Dodd-Frank Act also:

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[1] Title I, Subtitle A.

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- Modifies the existing provisions regarding liquidation of financial institutions and the Securities Investor Protection Act,[2]

- Reorganizes powers among various governmental agencies,[3]

- Creates an office of national insurance[4] and enacts improvements to regulation of bank and savings association holding companies and depository institutions,[5]

- Improves the regulation of credit rating agencies,[6] asset backed securities,[7] and municipal securities,[8]

- Establishes the Bureau of Consumer Financial Affairs Protection with broad regulatory and enforcement powers,[9] and

- Adopts the "Mortgage Reform and Anti-Predatory Lending Act."[10]

The foregoing is a broad summary of some of the Dodd-Frank Act's major provisions, each of which is worth discussing at length. The purpose of this article, however, is to focus on the provisions of the Dodd-Frank Act likely to be of interest to lawyers who represent public and private companies. These provisions are generally (but not solely) found in Titles IV ("regulation of advisors to hedge funds and others") and IX ("investor protections and improvements to the regulation of securities") of the Dodd-Frank Act. Many of the Dodd-Frank Act's provisions will not become effective until the SEC completes its rule-making actions, but some of the provisions became effective on or shortly after enactment.

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[2] Title II; Title IX, Subtitle B, Section 929H; among others.

[3] Title III, entitled "Transfer of Powers to the Comptroller of the Currency, the [Federal Deposit Insurance] Corporation, and the Board of Governors."

[4] Title V.

[5] Title VI.

[6] Title IX, Subtitle C.

[7] Title IX, Subtitle D.

[8] Title IX, Subtitle F.

[9] Title X.

[10] Title XIV.

Investor Protection – Amendments to the 1933 Act[11] and the 1934 Act[12]

Changes to SEC Regulation D

The SEC adopted Regulation D in 1982[13] to provide a safe harbor exemption from registration for certain offerings of securities. The operative provisions of Regulation D are Rules 504 and 505 which were adopted pursuant to the SEC's authority under § 3(b) of the 1933 Act, and Rule 506, adopted under § 4(2) of the 1933 Act. The National Securities Markets Improvement Act of 1996 ("NSMIA") provides that offerings conducted under Rule 506 are exempt from state review and qualification.[14]

New Definition of 'Accredited Investor.' Among its several sections aimed at SEC Regulation D, § 413 of the Dodd-Frank Act requires the SEC to adjust the definition of "accredited investor"[15] so that (for natural persons) the net worth calculation specifically excludes the value of such person's primary residence. The Section makes that legislative determination effective immediately, notwithstanding the SEC's rule making authority. Additionally, the Dodd-Frank Act requires the SEC to review the net worth requirement for natural persons[16] after four years of the enactment of the Dodd-Frank Act. The basis for and the amount of the increase is not set forth in the Dodd-Frank Act but is left to future SEC rule-making. The Dodd-Frank Act did not change the income alternative for determining accredited investor status ($200,000 annual income for an individual, $300,000 if joint with spouse).

In connection with the changes to the definition of the term "accredited investor" for the purposes of Section 413(a) of the Dodd-Frank Act discussed above, on July 23, 2010, the Securities and Exchange Commission Division of Corporation Finance issued a new Compliance and Disclosure Interpretation 179.01 (and an identical CDI 255.47) to explain CorpFin's interpretation of Section 413(a) when the value of an accredited investor's residence is less than

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11 The Securities Act of 1933, found at 15 U.S.C. § 77a, *et seq.*

12 The Securities Exchange Act of 1934, found at 15 U.S.C. § 78a, *et seq.*

13 SEC Rel. No. 33-6389, 24 S.E.C. Docket 1166, 1982 WL 35662 (Mar. 8, 1982). When adopted, Regulation D consolidated and replaced former Rules 146, 240 and 242.

14 NSMIA amended § 18 of the 1933 Act to provide that states no longer have jurisdiction to require registration or qualification of any "covered security" or securities that "will be a covered security upon completion of the transaction." § 18(a)(1). "Covered securities" include those issued pursuant to Rule 506. §18(b)(4)(D). NSMIA also prohibits state review and critique of an offering document "that is prepared by or on behalf of the issuer." SEC Rule 146 defines the term "by or on behalf of an issuer." *See* discussion in Lidstone, *Securities Law Deskbook* (Bradford Publishing Co.) at §11.3.

15 *See* Regulation D, Rule 501(a).

16 Currently $1,000,000, excluding the value of the natural person's primary residence. Rule 501(a) as amended by § 413 of the Act. Before the Act, the $1,000,000 requirement had not changed since originally enacted in 1982. An early version of the Senate bill would have required the SEC to increase the definitions for inflation since 1982, which would have resulted in net income of up to $459,000 for an individual, $688,000 for a couple, or a net worth requirement of $2,300,000.

the mortgage(s) outstanding against that residence. The CDI states that, when "determining net worth for purposes of Securities Act Rules 215 and 501(a)(5), the value of the person's primary residence must be excluded. Pending implementation of the changes to the Commission's rules required by the Dodd-Frank Act, the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth." In other words, the primary residence cannot be used as an asset when determining net worth for the accredited investor calculation; excess liabilities will be a reduction from net worth. On January 25, 2011, the SEC proposed rules to amend the accredited investor exemption to the same effect.[17] The SEC may make changes to this alternative part of the definition in the future.

New Eligibility Requirement for Rule 506. Section 926 of the Dodd-Frank Act requires the SEC to adopt rules that prevent certain 'bad actors' from being able to use Rule 506 of Regulation D. The current "bad boy" rules only apply to Rule 505 offerings. The Dodd-Frank Act requires that the new rules expand upon the existing rules found in Rule 262 of Regulation A,[18] which are incorporated into Rule 505. On May 25, 2011, the SEC proposed rules which would, if adopted, disqualify "felons and other bad actors" from reliance on the safe harbor from 1933 Act registration provided by Rule 506 of Regulation D.[19] Under the rule as proposed, an offering would be unable to rely on the Rule 506 exemption if the issuer or any other person covered by the rule[20] had a "disqualifying event" such as a criminal conviction, court injunction, or restraining order.[21] The substance of the proposal is derived from Section 926 of the Dodd-Frank Act and existing Rule 262.

The amendments may have a significant effect on private placements in the United States. According to the proposing release, Rule 506 accounts for an estimated 90-95% of all Regulation D offerings and the overwhelming majority of capital raised in Regulation D

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17 Rel. 33-9177 (January 25, 2011).

18 17 C.F.R. § 230.262.

19 Rel. 33-9211 (May 25, 2011).

20 The "covered persons" are defined in proposed Rule 506(c)(1) and include:

- the issuer and any predecessor of the issuer or affiliated issuer (as defined);
- any director, officer, general partner, or managing member of the issuer;
- any beneficial owner of 10% or more of any class of the issuer's equity securities;
- any promoter connected with the issuer at the time of the sale;
- any person who has been or will directly or indirectly be paid remuneration for the solicitation of purchasers or in connection with the sales of the securities in the offering; and
- any director, officer, general partner, or managing member of any such compensated solicitor. (At page 12 of the proposing release, the SEC raised the concern that financial institutions who act as placement agents may have a large number of people meeting the "officer" test under Rule 405 who may result in the financial institution being disqualified. The SEC asked for comments on whether the definition should be narrowed.

21 This includes a proposed amendment to Rule 501 (adding a definition of "final order" at Rule 501(g)) and proposed Rule 506(c).

transactions.[22] One of the principal reasons is that securities issued pursuant to Rule 506 are "covered securities" under 1933 Act §18(b)(4)(D) and thus are generally exempt from state regulation. The proposing release acknowledges this, saying, "[o]nce Section 926 is implemented, a substantially greater number of exempt securities offerings than before will be subject to bad actor disqualification requirements, effectively imposing a new burden of inquiry on many issuer with respect to potential disqualifying events."[23]

Renumbering of Section 4(6). Section 944 of the Dodd-Frank Act eliminated 1933 Act §4(5), thereby renumbering former §4(6). Former §4(6) provided an exemption from the 1933 Act's registration requirements for offers or sales of an issuer to one or more accredited investors if the offering price does not exceed $5,000,000.

Changes to Sarbanes-Oxley § 404 for Smaller Reporting Companies

Section 404 of the Sarbanes-Oxley Act of 2002, as originally enacted, imposed two requirements on all issuers filing periodic reports with the SEC. First, each issuer filing an annual report with the SEC must state that the issuer's management was responsible for establishing and maintaining adequate internal control over financial reporting and also contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the issuer's internal control structure and financial reporting procedures.[24] The SEC adopted these rules in September 2002 and has amended them several times.[25]

Second, each auditor of an issuer filing reports with the SEC must attest to and report on management's assessment of its internal controls.[26] In rulemaking, the SEC had exempted smaller reporting companies[27] from this attestation requirement through fiscal years ended June 15, 2010.[28]

Section 989G of the Dodd-Frank Act continues the exemption for smaller reporting companies permanently, stating that the attestation requirements "shall not apply with respect to any audit report prepared for an issuer that is neither a 'large accelerated filer' nor an

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[22] Rel. 33-9211 (May 25, 2011) at page 4.

[23] Rel. 33-9211 (May 25, 2011) at pages 39-40.

[24] Sarbanes-Oxley Act of 2002, § 404(a).

[25] The SEC adopted Rules 13a-14, 13a-15, 15d-14 and 15d-15, and included the certification found in Exhibit 31 as a required exhibit for all annual and quarterly reports in Item 601 of SEC Regulation S-K.

[26] This attestation report is specifically required in Item 9A to Form 10-K and Part I, Item 4 of Form 10-Q.

[27] "Smaller reporting company" is defined in 1934 Act Rule 12b-2 means an issuer that is not an investment company, an asset-backed security issuer, or a majority owned subsidiary of a parent that is not a smaller reporting company that has a public float of less than $75,000,000 as of the last business day of its most recently completed second fiscal quarter (determined each year).

[28] See Item 9A(T) to Form 10-K and Part I, Item 4(T) to Form 10-Q.

'accelerated filer.'"[29] As a result, smaller reporting companies are no longer subject to the attestation requirement. In SEC Rel. No. 33-9142[30] the SEC amended its rules to make it clear that smaller reporting companies are exempt from the § 404(b) requirements, but also made it clear that smaller reporting companies are not exempt from the § 404(a) requirement.

The Dodd-Frank Act also requires the SEC to study ways of reducing the burden of § 404(b) compliance on companies with market capitalizations between $75,000,000 and $250,000,000.

Corporate Governance Changes

Broker Discretionary Voting. The Dodd-Frank Act amends Section 6(b) of the 1934 Act to require national securities exchanges to prohibit proxy voting by a broker in connection with the election of directors (other than a vote with respect to the uncontested election of a member of the board of any registered investment company), executive compensation or any other significant matter (as determined by the SEC), unless the beneficial owner of the security has specifically instructed the broker to vote in such way.[31] Broker discretionary voting was eliminated by New York Stock Exchange ("NYSE") Rule 452 for director elections starting in the 2010 proxy season. The Dodd-Frank Act extends the prohibition of broker discretionary voting to say-on-pay votes, among other matters. The NYSE has issued an information memorandum advising its members that it intends to file an amendment to Rule 452 to prohibit NYSE members from voting uninstructed shares if the matter to be voted on relates to executive compensation, including "say-on-pay" proposals, at meetings after July 21, 2010.[32] The information memorandum indicates that NYSE Amex and NYSE Arca will file identical amendments to their rules.

Proxy Access. The Dodd-Frank Act also provides that the SEC may adopt provisions for "proxy access," allowing shareholders who want to propose a slate of directors to include their slate in the company's proxy statement that also includes the slate proposed by the board,[33] rules that the SEC adopted (on a 3-2 vote) on August 25, 2010 in the "Proxy Access Release,"[34] although the SEC subsequently stayed the effectiveness of those rules.[35]

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[29] Section 989G adds subsection (c) to § 404 of the Sarbanes-Oxley Act of 2002 which contains the exemption from the requirements of § 404(b).

[30] Published September 15, 2010. This release also makes conforming amendments to Item 2.02(f) of Regulation S-X, and Items 308(a)(4) and 308(b) of Regulation S-K.

[31] Section 957 of the Dodd-Frank Act, amending § 6(b) of the 1934 Act.

[32] NYSE Regulation Information Memorandum 10-36 (Aug. 4, 2010).

[33] Section 971 of the Act, adding § 14(a)(2) to the 1934 Act.

[34] Rel. 33-9136 (Aug. 25, 2010), effective November 16, 2010. Two commissioners, Kathleen Casey and Troy Paredes, voted against the adoption of the rules, expressing their concern that the rules exceeded the authority of the SEC, the SEC staff will be "brokering disputes and addressing a broad array of issues arising from the operation of this new federal right every proxy season," and questioned whether "theory [or] data adequately

Prior to the effectiveness of the new rules, unless companies voluntarily provide proxy access to their shareholders, shareholders must mount their own (usually quite expensive) proxy campaign if they desire to nominate even a single director in opposition to the company slate. As a result of the proxy access rules (should they become effective), it will become easier for certain dissident shareholders[36] to present their director nominees to the shareholders for consideration because the company will have to include the relevant information in its own proxy statement. Eligible shareholders may only nominate directors not exceeding 25 percent of the total board (but at least a single director if the board consists of three or fewer persons).[37] Because of the 3 percent/3 year holding requirement described in note 30, activist shareholders will not be able to purchase shares and act quickly using the proxy access provisions.[38]

It is important to note that proxy access under Rule 14a-11 (should it become effective) and state law has three components:

1. The right of access, granted by Rule 14a-11. This is a right of eligible stockholders to require that certain stockholder-nominated candidates appear in the corporate proxy materials. In addition to Rule 14a-11, some state statutes permit (but do not require) their corporations to grant proxy access.[39]

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substantiate the Commission's imposition of the mandatory Rule 14a-11 proxy access right." 42 Sec. Reg. & L. Rep. (BNA) 1622 (Aug. 30, 2010).

[35] On September 29, 2010, Business Roundtable and the Chamber of Commerce of the United States of America filed a petition with the United States Court of Appeals for the District of Columbia Circuit seeking review of recent changes to the Commission's proxy and related rules, and on October 4, 2010, the SEC issued an order staying the effectiveness of Rule 14a-11 and the amendments to Rule 14a-8 as adopted in Rel. 33-9136 (Aug. 25, 2010). *See* SEC Rel. 33-9149 (Oct. 4, 2010). As of December 1, 2010, this stay has not been lifted.

[36] All shareholders are not eligible for access to the company's proxy statement:

a. Rules 14a-2(b)(7) and 14a-11(b)(6) provide that if a shareholder is holding shares with the purpose of effecting a change of control or to gain a number of seats that exceeds the number of nominees required, the shareholder is not eligible for proxy access.
b. The shareholder (or shareholder group) must have held at least 3 percent of the company's stock for at least three years (Rule 14a-11(b)(1) and (2)).

Additionally, Rule 14a-11, when it becomes effective, imposes a number of procedural requirements on shareholders wishing to access the company's proxy statement, including the filing of a Schedule 14N no later than 120 days before the anniversary of the last shareholders' meeting, or (pursuant to Rule 14a-18), where the date has changed by more than 30 days or a meeting was not held the previous year, "a reasonable time before the registrant mails its proxy materials as specified in Item 5.08 of Form 8-K (a new Item requiring a Form 8-K report be filed announcing the date for an annual meeting within four business days after determination of the date).

[37] Rule 14a-11(d). Where the directors are elected on a staggered basis, the 25 percent will be calculated as though all directors were up for election at the meeting in question.

[38] On September 29, 2010, the Chamber of Commerce and the Business Roundtable sued the SEC to enjoin the implementation of the proxy access rules, alleging that the rules, as adopted, were arbitrary and capricious. On October 4, 2010, the SEC stayed implementation of the rules, pending resolution of the litigation. SEC Rel. 33-9149 (Oct. 4, 2010).

[39] *See, for example,* § 112 of the General Corporation Law of the State of Delaware.

2. The right to nominate director candidates is distinct from the right of access. The Proxy Access Release itself said that Rule 14a-11 "will apply only when applicable state law or a company's governing documents do not prohibit shareholders from nominating a candidate for election as director."[40] Most states allow companies to impose reasonable procedural requirements (which may include disclosure requirements) on shareholders who desire to nominate directors at a meeting and their proposed nominees, and SEC rules require disclosure of nominating procedures in a reporting company's proxy statement.[41]

3. The requirement that a director meet reasonable qualifications is also separate from access and the right to nominate. Most state laws authorize corporations to impose qualification requirements on directors, such as they must be at least 18 years of age.[42] These statutes allow the corporation to establish other qualifications (such as age, independence, agreement to certain corporate policies, etc.) which all directors or all outside directors must meet. Rule 14a-11 sanctions the continuing viability of qualification provisions, although they state that candidates have a right of access even if not qualified as long as the procedural requirements of the rules are met.[43]

Thus, application of Rule 14a-11 (should it become effective) may result in the situation where a person is included in the company's proxy statement because the shareholder met the requirements of Rule 14a-11, but the nomination cannot be made at the meeting because the shareholder failed to follow the company's procedural requirements or, if elected, the nominee cannot be seated because he or she failed to meet the qualification requirements.

Smaller reporting companies will not be subject to the proxy access rules until three years after the effective date of the new rules.[44] Because of the SEC's stay of the effectiveness of the

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[40] *See* Proxy Access Release at page 38.

[41] Schedule 14A, Item 6 (proxy statement) incorporating Regulation S-K, Item 407(c)(2)(ii).

[42] *See* Colo. Rev. Stat. § 7-108-102 and DGCL § 141(b).

[43] Item 5(e) of Schedule 14N requires the shareholder proposing the nomination to disclose whether, to the best of its knowledge, the person to be nominated meets the director qualification requirements set forth in the company's governing documents. In the Proxy Access Release (at page 131, the SEC said: "Where a company's governing documents establish certain qualifications for director nominees that, consistent with state law, would preclude the company from seating a director who does not meet these qualifications, we believe this would be important disclosure for shareholders."

[44] *See* "Compliance Dates" at page 2 of Rel. 33-9136. In adopting the delayed effective date for smaller reporting companies, the SEC said: "We believe that a delayed compliance date for smaller reporting companies will allow those companies to observe how Rule 14a-11 operates for other companies and may allow them to better prepare for the implementation of the rules and, as noted, will give us a further opportunity to consider adjustments for smaller reporting companies." Rel. 33-9136 at pg. 394.

rules as a result of litigation, these rules will likely not be effective for accelerated filers and large accelerated filers until the 2012 proxy season.[45]

As an alternative means of providing proxy access, the release also amends Rule 14a-8(i)(8) (the effectiveness of which provisions were also stayed by the SEC). Rule 14a-8 required that a shareholder seeking inclusion of a matter in a company's proxy statement follow a specified procedure and have held at least $2,000 in market value of the company's securities or one percent of the outstanding voting securities (whichever is less) for at least one year – a threshold substantially lower than Rule 14a-11's three percent/three year requirement. Rule 14a-8(i)(8) previously provided that a company could reject a shareholder proposal for inclusion in a proxy statement if the proposal related "to a nomination or an election for membership on the company's board of directors or analogous governing body or a procedure for such nomination or election" (generally referred to as the "election exclusion"). As amended, Rule 14a-8(i)(8) will require the inclusion of shareholder proposals that would amend or request an amendment to the company's governing documents regarding a shareholder's right to nominate directors or that relate to other disclosure or procedural matters concerning that nomination right (so long as the proposals do not conflict with applicable law, including Rule 14a-11). This will permit shareholders to propose their own, custom-tailored, proxy access system that may provide shareholders a greater right to nominate candidates than included in Rule 14a-11. Unlike Rule 14a-11, the Rule 14a-8 amendment applies to smaller reporting companies immediately upon effectiveness, although the SEC has also stayed the effectiveness of the Rule 14a-8 amendments.[46]

Chairman and Chief Executive As The Same Person? The Dodd-Frank Act also requires the SEC to adopt rules requiring an issuer to disclose in its proxy statement why the issuer has chosen the same person to serve as chairman and CEO (if that is the case) or, conversely, why the issuer has chosen different persons to serve in those roles.[47] The Dodd-Frank Act requires the SEC to adopt these rules within 180 days.

Executive Compensation

Say-on-Pay – Non-Binding Shareholder Consideration. The Dodd-Frank Act addresses the continuing public outcry over executive compensation in a number of ways. First, it requires that companies subject to the SEC's proxy rules submit executive compensation to a non-binding shareholder vote at least once every three years, commencing with the first meeting held on or after January 21, 2011.[48] Secondly, at least once every six years, the company must ask shareholders whether the shareholders desire to vote on executive compensation every one, two,

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[45] 1934 Act Rule 3a12-3(b) exempts securities of foreign private issuers from the requirements of § 14(a) of the 1934 Act. Foreign private issuers (defined in Rule 3b-4(c)) includes non-U.S. issuers except where more than 50 percent of the outstanding securities are held by residents of the United States and certain other requirements are met.

[46] SEC Rel. 33-9149 (Oct. 4, 2010).

[47] Section 972 of the Act, adding § 14B to the 1934 Act.

[48] Section 951 of the Act, adding § 14A(a)(1) to the 1934 Act.

or three years – also required to be held at the first meeting held on or after January 21, 2011.[49] Shareholders also have to be asked to approve golden parachute provisions in executive employment contracts (provisions that are contingent on a merger, consolidation, sale of the company, or its assets).[50] Institutional Shareholder Services Inc. ("ISS") will be reviewing all corporate decisions with respect to "say-on-pay" and executive compensation in making its recommendations to its clients for voting at corporate meetings.[51]

In none of the foregoing cases are the shareholder votes considered to be binding, but the results of the votes must be disclosed to the shareholders.[52] The Dodd-Frank Act further provides that the shareholder vote may not be construed as overruling any company or board decision, changing, or creating any additional fiduciary duties for the company or board or limiting the ability of shareholders to submit executive compensation proposals for inclusion in the company's proxy materials. A negative say-on-pay vote is likely to raise significant issues regarding shareholder relations and embolden activist shareholders, even within smaller public companies. The Company's response to a negative vote will also impact the ISS recommendation for the next meeting at which directors are elected.

As discussed above, brokers will not be entitled to cast uninstructed votes with respect to any say-on-pay resolution. The Dodd-Frank Act requires that institutional investment managers who are subject to § 13(f) of the 1934 Act report their say-on-pay voting activity to their clients at least once each year.[53] In connection say-on-pay votes, ISS recommends:

- Annual say on pay votes;[54]
- Case-by-case evaluation of executive compensation;[55]
- Votes against the reelection of compensation committee members (or the entire board) where there are "problematic" pay practices.[56]

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[49] Section 951 of the Act, adding § 14A(a)(2) to the 1934 Act.

[50] Section 951 of the Act, adding § 14A(b) to the 1934 Act.

[51] ISS (www.issgovernance.com) advertises itself as "the leading provider of corporate governance solutions to the global financial community. More than 1,700 clients rely on ISS' expertise to help them make more informed investment decisions on behalf of the owners of companies. ISS' services include objective governance research and analysis, end-to-end proxy voting and distribution solutions, turnkey securities class-action claims management, and reliable governance data and modeling tools. Our team of more than 600 research, technology and client service professionals are located in financial centers worldwide. Investors, regulators and media regularly turn to ISS experts for insight and data on trends in corporate governance, proxy voting operations and mechanics, and securities litigation."

[52] Section 951 of the Act, adding § 14A(c) and (d) to the 1934 Act.

[53] Section 951 of the Act, adding § 14A(d) to the 1934 Act.

[54] *See* ISS U.S. Corporate Governance Policy, 2011 Updates (issued November 19, 2010) at page 16.

[55] *See* ISS U.S. Corporate Governance Policy, 2011 Updates (issued November 19, 2010) at page 16 (executive compensation) and 19-20 (golden parachutes).

Unlike many other provisions of the Dodd-Frank Act, the say-on-pay requirement is self-implementing and by its terms does not require regulatory guidance from the SEC or the exchanges. The SEC has adopted the say-on-pay rules on January 25, 2011 and, in doing so, exempted smaller reporting companies "until the first annual or other meeting of shareholders at which directors are elected . . . or occurring on or after January 21, 2013."[57]

Smaller reporting companies are not wholly exempted from the say-on-pay rules, however. Rule 14a-8 discusses when shareholders may make proposals to companies and require the proposals to be included in the company's proxy statements. Rule 14a-8(i)(10) provides that a company may exclude a shareholder's proposal where the company has already substantially implemented that proposal. Until a smaller reporting company actually implements the say-on-pay requirements, it will not be able to use the Rule 14a-8(i)(10) exclusion should it receive a shareholder demand for a say-on-pay vote.

Furthermore, the note to Rule 14a-8(i)(10) says that companies that have held a say-on-pay vote or a say-when-on-pay vote may exclude a shareholder proposal only where the most recent vote required by Rule 14a-21(b) received the approval of a majority of votes "and the company has adopted a policy on the frequency of say-on-pay votes that is consistent with the choice of the majority of votes cast in its most recent shareholder vote." Where there are three choices as in say-when-on-pay (one, two or three years), none of the proposals may have

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[56] *See* ISS U.S. Corporate Governance Policy, 2011 Updates (issued November 19, 2010) at page 16-18. "Problematic pay practices" that may result in a negative recommendation from ISS include:

- Multi-year guarantees for salary increases, non-performance based bonuses, and equity compensation;
- Including additional years of unworked service that result in significant additional benefits, without sufficient justification, or including long-term equity awards in the pension calculation;
- Perquisites for former and/or retired executives, and extraordinary relocation benefits (including home buyouts) for current executives;
- Change-in-control payments exceeding three times base salary and target bonus;
- Change-in-control payments without job loss or substantial diminution of duties ("Single Triggers");
- New or materially amended agreements that provide for "modified single triggers" (under which an executive may voluntarily leave for any reason and still receive the change-in-control severance package);
- New or materially amended agreements that provide for an excise tax gross-up (including "modified gross-ups");
- Tax Reimbursements related to executive perquisites or other payments such as personal use of corporate aircraft, executive life insurance, bonus, etc;
- Dividends or dividend equivalents paid on unvested performance shares or units;
- Executives using company stock in hedging activities, such as "cashless" collars, forward sales, equity swaps, or other similar arrangements; or
- Repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts and voluntary surrender/subsequent regrant of underwater options).

[57] SEC Rel 33-9178 (Jan. 25, 2011) adding Rule 14a-21 and amending Rules 14a-4, 14a-6, 14a-8, schedules 14A and 14C and Regulation S-K, among other provisions. On Friday, February 11, the SEC issued six CD&Is discussing say-on-pay (in Section 169 interpreting Rule 14a-21) and one discussing golden parachute votes (in Section 128B, interpreting Regulation S-K Item 402(t)).

received a majority, meaning that even if the company implements the vote receiving a plurality it would not avoid a shareholder submission under Rule 14a-8.

Compensation Committee. A company's board of directors must establish a compensation committee consisting of independent directors before the company's securities can be listed on a stock exchange. Proxy statements and annual reports filed with the SEC[58] must describe certain information about compensation committees where they exist. Section 952 of the Dodd-Frank Act adds § 10C to the 1934 Act to further define the requirements for an independent compensation committee. It also mandates that compensation committees shall have the right (and be allocated the necessary funding) for the retention of compensation consultants, legal advisers, and other advisers. The Dodd-Frank Act sets forth certain independence factors that the compensation committee must consider before selecting any such advisor – with Congress' goal in all cases being to minimize or eliminate conflicts of interest between the advisors to the compensation committee and the other work, if any, the compensation consultant or its affiliated persons may perform for the company itself.[59]

Under prior amendments to the proxy rules and Regulation S-K,[60] companies are required to make more extensive disclosure with respect to the role of compensation consultants and (in the Compensation Discussion and Analysis[61]) the extent to which compensation policies and practices create risks that are reasonably likely to expose the company to risk. This is also specifically addressed in Item 402(s) of Regulation S-K which states:

> To the extent that risks arising from the registrant's compensation policies and practices for its employees are reasonably likely to have a material adverse effect on the registrant, discuss the registrant's policies and practices of compensating its employees, including non-executive officers, as they relate to risk management practices and risk-taking incentives.[62]

ISS advises that it "will no longer consider prospective commitments with respect to problematic pay practices," and it encourages companies "to adopt forward-looking policies to address problematic pay practices."

58 See Item 407(e) of Regulation S-K, incorporated into Form 10-K by Items 10 and 11 and into the proxy statement by Items 7 and 8 of Schedule 14A. A compensation committee is also a requirement of the NYSE Listed Company Manual (§ 303A05) and Rule 5605(d) of the Nasdaq Corporate Governance Requirements.

59 The Act requires the SEC to act within 360 days after enactment.

60 SEC Rel. 33-9089, effective February 28, 2010, the SEC extensively amended Item 407 of Regulation S-K (entitled *Corporate Governance*).

61 Regulation S-K, Item 402(b).

62 Among the things to be considered in making this determination are the company's "risk assessment" and incentive considerations in structuring its compensation policies, how the compensation policies relate to the realization of short- and long-term risks resulting from the actions of employees through claw-back policies (*inter alia*), and identification of and adjustments made in response to changes in risk profiles. *See* Regulation S-K, Item 402(s)(1) through (6).

As a result, compensation committees should monitor performance and risk-taking throughout the year, rather than merely at year end (as historically has been the case), and must look more carefully at compensation incentives for all employees, not just senior management. Furthermore, compensation practices should be designed to avoid "excessive risk taking" or risk an unfavorable ISS recommendation.[63]

Disclosure of All Compensation. In another provision regulating the disclosure of executive compensation, § 953 of the Dodd-Frank Act adds § 14(i) to the 1934 Act which requires the disclosure of compensation payable to executives and the relationship between executive compensation actually paid and the financial performance of the issuer and distributions to shareholders.[64] In addition, Congress directs the SEC to amend its executive compensation disclosure rules[65] to disclose the compensation of the chief executive officer as compared to the median annual total compensation of the issuer paid to all employees other than the chief executive officer, as well as the ratio thereof.[66] The Dodd-Frank Act does not suggest the inferences to be drawn from whatever ratio develops, or differentiates between "good ratios" and "bad ratios."

Performance Compensation. Because performance compensation may be calculated on financial information that is later discovered to be incorrect, the Dodd-Frank Act also requires (as a listing standard) all listed companies to develop and implement a policy providing for the disclosure of incentive-based compensation and, if there is an accounting restatement, a provision to recover erroneously paid incentive-based compensation – the "clawback" provision.[67] In this consideration, it is important to note that ISS has long recommended "pay for performance" and the alignment of executive pay with long-term shareholder value when recommending the reelection of compensation committee members and (in some cases) the entire board.[68]

Director or Employee Hedging. The Dodd-Frank Act also requires each issuer to disclose whether any employee or member of the board of directors, or any designee of any employee or board member, is permitted to purchase hedges – that is, financial instruments that

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[63] ISS 2010 U.S. Proxy Voting Guidelines Summary (issued February 25, 2010) at page 41, available at www.issgovernance.com.

[64] Section 953(a) of the Act. Compensation consultant disclosure must be included in proxy statements for any annual meeting occurring on or after one year from enactment – suggesting that the SEC must complete its rule making well before that date.

[65] Found in Item 402 of Regulation S-K.

[66] Section 953(b) of the Act.

[67] Section 954 of the Act, adding § 10D to the 1934 Act.

[68] ISS 2010 U.S. Proxy Voting Guidelines Summary (issued February 25, 2010) at pages 38-43, available at www.issgovernance.com.

are designed to hedge or offset against any decrease in the market price for the issuer's securities.[69]

Shareholder Reporting – Schedule 13D and Section 16(a)

The Dodd-Frank Act amends § 13(d) and § 16 of the 1934 Act. Section 13(d) imposes certain reporting requirements on persons who own more than five percent of the outstanding securities of a company registered under Section 12 of the 1934 Act.[70] Section 16 imposes other reporting requirements on officers and directors of companies that have securities registered under the 1934 Act (as well as persons owning more than ten percent of the outstanding securities of such companies) and also imposes potential liability for trading in those securities within a six month period.[71] Currently the requirements for an initial filing (made under § 13(d) in a Schedule 13D and under § 16(a) on a Form 3) is ten days after the event that imposes the reporting requirement.[72] Section 929R of the Dodd-Frank Act gives the SEC the discretion to reduce the ten days to a lesser number of days under both § 13(d) and § 16(a).

Changes to Pre-Dispute Arbitration?

Since *Wilko v. Swan*[73] (relating to the 1933 Act) and *Shearson/Am. Express Inc. v. McMahon*[74] (relating to the 1934 Act), pre-dispute arbitration agreements in securities matters have unquestionably been enforceable, and most (if not all) agreements between broker-dealers and their customers contain mandatory arbitration provisions.[75] In *Peterson v. Beale*,[76] a brokerage client was required to arbitrate the claims even though the customer agreement was signed by his broker on the customer's behalf (not by the customer). In *Janiga v. Questar*

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[69] Section 955 of the Act, adding § 14(j) to the 1934 Act. This was previously covered, in part, in the disclosure required by Item 402(b)(2)(xiii) of Regulation S-K. ISS considers executive use of company stock in hedging transactions to be a "problematic pay practice" that may result in a recommendation against voting for certain compensation committee members or the entire board. *See* ISS U.S. Corporate Governance Policy, 2011 Updates (issued November 19, 2010) at page 17.

[70] SEC Rel. 33-9136 (the proxy access release, adopted August 25, 2010) amended Schedule 13D and Schedule 13G to provide that the filer make a representation that "such person has acquired such securities in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer, no in connection with or as a participant in any transaction having such purpose or effect, . . . other than activities solely in connection with a nomination under § 240.14a-11."

[71] *See* the general discussion in Lidstone, *Securities Law Deskbook* (Bradford Publishing Co.) at § 16.18 and § 17.7.

[72] 1934 Act, § 13(d)(1) and § 16(a)(2)(B).

[73] 346 U.S. 427, 74 S. Ct. 182, 98 L. Ed. 168 (1953).

[74] 482 U.S. 220, 107 S. Ct. 2332, 96 L. Ed. 2d 185 (1987).

[75] *See* general discussion in Lidstone, *Securities Law Deskbook* (Bradford Publishing Co.) at §§ 14.2-14.3.

[76] Fed. Sec. L. Rep. (CCH) ¶ 98,980, 1995 WL 479425 (S.D.N.Y. 1995).

Capital Corp.,[77] the court upheld a predispute arbitration agreement even where the evidence showed that the plaintiff who signed the agreement could not have read or understood the contract if he had tried because of his limited English ability.

Section 921 of the Dodd-Frank Act gives authority to the SEC to "prohibit, or impose conditions or limitations on the use of" pre-dispute arbitration agreements involving any broker, dealer, municipal securities dealer, or investment adviser.[78]

Expansion of the Anti-Fraud Rules and SEC Enforcement

The Dodd-Frank Act also enhances the application of the anti-fraud provisions under the securities laws. Section 9(e) of the 1934 Act[79] grants a civil remedy for damages to the plaintiff if the plaintiff bought or sold stock during a time when the market for that stock on a national securities exchange was being manipulated in violation of §§ 9(a), (b), or (c).[80] The Dodd-Frank Act removes the phrase "registered on a national securities exchange" from §§ 9(a), (b), and (c), thus expanding the reach of Section 9(e) to the over-the-counter market for securities.[81] The Dodd-Frank Act makes a similar change to § 10(a) (regulating short sales of securities) and § 15(c)(1)(A) (regulating broker-dealers).[82]

The Dodd-Frank Act makes it clear that the SEC has the right to prosecute persons who "knowingly or recklessly" aid and abet securities law violations under the 1933 Act,[83] the Investment Company Act of 1940 (the "Company Act"),[84] the Investment Advisers Act of 1940 (the "Advisers Act"),[85] and the 1934 Act.[86] The Dodd-Frank Act also requires that the Comptroller General study the effect that authorizing private rights of action against persons

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[77] 42 Sec. Reg. & L. Rep. (BNA) 1506 (7th Cir. Aug. 2, 2010).

[78] Adding § 15(o) to the 1934 Act and § 205(f) to the Advisers Act.

[79] Section 9(e) of the 1934 Act will become 9(f), as a result of amendments to § 9 of the 1934 Act included in § 929X(b) of the Act.

[80] *See* general discussion in Lidstone, *Securities Law Deskbook* (Bradford Publishing Co.) at § 16.2.

[81] Section 929L of the Act.

[82] Section 929L of the Act.

[83] Section 929M of the Act amending § 15 of the 1933 Act (providing for control person liability).

[84] Section 929M of the Act amending § 48 of the Company Act, 15 U.S.C. § 80b-1, *et seq.*

[85] Section 929N of the Act adding § 209(f) to the Advisers Act, 15 U.S.C. § 80a-1, *et seq.*

[86] Section 929O of the Act amending § 20(e) of the 1934 Act by adding "recklessly" where the 1934 Act already provided for "knowingly."

aiding and abetting securities law violations may have on the market for securities. The Comptroller General must submit its report within one year.[87]

Section 8A of the 1933 Act gives the SEC the authority to act by cease and desist order, and in cease and desist proceedings to order an accounting, a disgorgement of profits, and a bar against a person serving as an officer or director of a company with securities registered under § 12 of the 1934 Act. The Dodd-Frank Act expands the SEC's cease and desist authority by giving the SEC the right to impose civil penalties ranging from $7,500 for a natural person ($75,000 for any other person) to $150,000 for minor violations and up to $725,000 for more serious violations.[88] Similar amendments were made to § 21B(a) of the 1934 Act,[89] § 9(d)(1) of the Company Act,[90] and § 203(i)(1) of the Advisers Act.[91]

In June 2010, the United States Supreme Court issued its much anticipated "foreign cubed" decision, which limited the jurisdiction of U.S. courts in cases where foreign plaintiffs sued foreign and American defendants for misconduct in connection with securities traded on foreign exchanges.[92] In that case, the foreign plaintiffs sued for violations of Rule 10b-5 in a United States federal court. In the decision, the Supreme Court noted that when a statute gives no clear indication of an extraterritorial application, it has none. In apparent anticipation of that decision, Congress specifically gave the SEC (but not private plaintiffs) extraterritorial jurisdiction in proceedings brought by the SEC alleging a violation of § 17(a) of the 1933 Act,[93] or any violations of the 1934 Act[94] or the Advisers Act[95] by persons outside the United States for conduct within the United States that constitutes significant steps in furtherance of securities violations even where the transaction occurs outside the United States and involves only foreign investors. Jurisdiction also is available where conduct occurred outside the United States but which had a foreseeable substantial effect within the United States. The Dodd-Frank Act also

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[87] Section 929Z of the Act. The U.S. Supreme Court determined that there was no private right of action for aiding and abetting a violation of 1934 Act Rule 10b-5 (adopted under § 10(b)) in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). *See* general discussion of aiding and abetting liability under the federal securities laws in Lidstone, *Securities Law Deskbook* (Bradford Publishing Co.) at §§ 16.11.

[88] Section 929P(a)(1) of the Act.

[89] Section 929P(a)(2) of the Act.

[90] Section 929P(a)(3) of the Act.

[91] Section 929P(a)(4) of the Act.

[92] *Morrison v. National Australia Bank, Ltd.*, 130 U.S. 2869 (2010).

[93] Section 929P(b)(1) of the Act, amending § 22 of the 1933 Act.

[94] Section 929P(b)(2) of the Act, amending § 27 of the 1934 Act.

[95] Section 929P(b)(3) of the Act, amending § 214 of the Advisers Act.

requires the SEC to study whether these extraterritorial rights should extend to private rights of action.[96]

Frequently targets of SEC investigations are given an opportunity to make their case before the SEC institutes a formal proceeding in a process known as a "Wells submission."[97] Many times, however, the SEC never advises the target whether or not any recommendation has been made to the SEC. Section 929U of the Dodd-Frank Act added a new § 4E to the 1934 Act which requires the SEC staff either to file an action against the enforcement target within 180 days of the date the staff provided the target with the written Wells notification, or provide notice of the staff's intent not to file any action. The Dodd-Frank Act does provide exceptions for certain complex actions.

The Dodd-Frank Act amends the 1933 Act, the 1934 Act, the Company Act, and the Advisers Act by giving the SEC nationwide service of process for *subpoenas* issued in enforcement actions.[98]

Changes to the Securities and Exchange Commission

Investor Advisory Committee. Title IX of the Dodd-Frank Act is entitled the "Investor Protection and Securities Reform Act of 2010." The first substantive provision of this Title is found in § 911 of the Dodd-Frank Act which amends the 1934 Act to establish an investor advisory committee to "advise and consult with the [SEC] on a number of different issues, including "regulatory priorities of the [SEC]."[99] Section 915 requires the SEC to establish an office of the Investor Advocate within the SEC to (among other things) assist retail investors in resolving problems such investors may have with the SEC and to identify areas where retail investors would benefit from changes in SEC regulations (or those of self-regulatory organizations).[100] Although a part of the SEC, the Office of Investor Advocate is intended to be independent of the SEC. As a further requirement of the Dodd-Frank Act, the SEC must conduct and within two years submit to Congress a study to (among other things) identify "the existing level of financial literacy among retail investors" and to determine "methods to improve the timing, content and format of disclosure to investors."[101]

New Disclosure to Retail Investors. In further protection of retail investors, the Dodd-Frank Act specifically gives the SEC authority to issue rules designating the documents and

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[96] Section 929Y of the Act. The SEC requested comments on various questions relating to this issue in its Rel. 34-61374 (Oct. 25, 2010).

[97] *See* general discussion in Lidstone, *Securities Law Deskbook* (Bradford Publishing Co.) at §§ 13.1.3.

[98] Section 929E of the Act, amending § 22(a) of the 1933 Act, § 27 of the 1934 Act, § 44 of the Company Act, and § 214 of the Advisers Act.

[99] Section 911 of the Act adds § 39 to the 1934 Act.

[100] Section 915 adds § 4(g) to the 1934 Act.

[101] Section 917 of the Act.

information that a broker-dealer must provide to a retail investor "before the purchase of an investment product or service by the retail investor."[102] In addition, the Dodd-Frank Act amends Section 15 of the 1934 Act to allow the SEC to promulgate rules providing that broker-dealers giving personalized investment advice about securities to a "retail customer" —a customer who uses such advice primarily for personal, family, or household purposes —may be subject to the same fiduciary duty as investment advisors.[103]

SEC Financial Controls. The Dodd-Frank Act also requires the SEC to improve its own financial controls[104] and to conduct a study on what has been referred to as the SEC's revolving door – where it is perceived that the regulators move directly to the regulated.[105] This study is to be conducted by the Comptroller General.

Freedom of Information Act Exemption. Section 929I of the Dodd-Frank Act gives the SEC enhanced authority to refuse to provide records in response to requests under the Freedom of Information Act ("FOIA"). As reported in the *Wall Street Journal*,[106] the congressional lawmakers who passed the Dodd-Frank Act "fear that [the SEC's] Freedom of Information Act exemption will be applied too widely, making it harder for the public to keep tabs on the agency." To the contrary, the SEC testified that it believes giving it broader power to withhold FOIA disclosure will gain it better cooperation from the industries it regulates. On August 5, 2010, four senators introduced a bipartisan bill to address § 929I issues,[107] and on October 4, 2010, President Obama signed the bill into law. Amended § 929I narrows, but did not eliminate, the SEC's ability to protect certain documents from public disclosure. The amended law focuses on FOIA Exemption 8, which exempts from disclosure matters that are "[c]ontained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions."[108] Under the amended law, the SEC is expressly identified as an agency responsible for regulating and supervising "financial institutions," and any entity that the SEC is responsible for regulating, supervising, or examining is deemed a "financial institution" under Exemption 8.

In clarifying the definition of "financial institution," the amended law extends at least some level of FOIA protection to documents related to examination, operating, or condition reports for all entities regulated by the SEC. For some regulated entities (e.g., credit rating

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[102] Section 919 of the, adding § 15(n) to the 1934 Act. It should be noted that the SEC has believed it has had this authority in the past, as is evidenced by Rules 15c2-11 and the penny stock rules, 15g-1 through 15g-6.

[103] Section 913(g) of the Act, adding § 15(k) to the 1934 Act.

[104] Section 961 of the Act.

[105] Section 968 of the Act.

[106] August 5, 2010, online edition at http://online.wsj.com/article/BT-CO-20100805-717273.html.

[107] "Senators Introduce Bill to Delete SEC Exemption in Dodd-Frank Law," 42 Sec. Reg. & L. Rep. (BNA) 1497 (Aug. 9, 2010).

[108] 5 U.S.C. § 552(b)(8).

agencies, transfer agents, and municipal advisors), the amended law removes any ambiguity as to the reach of FOIA Exemption 8. For others, the amended law changes nothing. For example, registered broker-dealers and investment advisers have long held the view that Exemption 8 applies to them, and that view has been supported by the courts. More importantly, by relying exclusively on FOIA Exemption 8 for protection, the amended law provides no certainty to regulated entities that records and information collected by the Commission in its examination or surveillance efforts — including proprietary and customer information — will not be disclosed to third-parties.

Compared to the potentially broad scope of Section 929I, Exemption 8 applies only to examination, operating, or condition reports prepared by or for the SEC. The extent to which documents produced to the SEC's staff outside of the examination process are covered by FOIA Exemption 8 remains unclear. In addition, there is case law that supports the position that records and information collected during the examination are "related to" examination reports and, therefore, are covered under Exemption 8. The extent to which a particular record will be deemed "related to" an examination report, however, depends on the individual facts and circumstances, and is subject to some litigation risk in the event that a FOIA request is filed.

Even if FOIA Exemption 8 applies to a particular record, the SEC takes the view that it has the power to authorize discretionary public disclosures where the need for confidentiality is outweighed by the public's interest in accountability and transparency. As long as a party producing records to the SEC makes a request for confidential treatment under the SEC's FOIA regulations, those regulations afford that party an opportunity to object to any such disclosure and to appeal an adverse decision, but do not guarantee non-disclosure.

The amended law does not apply to third-party subpoenas. Perhaps the most significant difference between the original version of Section 929I and the amended law is the loss of important protections in the context of non-FOIA third-party litigation. The SEC often receives third-party subpoenas seeking documents provided by regulated entities, and the FOIA exemptions are unavailable in those situations. Without the express protections afforded by the original version of Section 929I, the SEC is left to rely on arguments of undue burden, relevance, or common law privileges to protect information provided by regulated entities from discovery in non-FOIA litigation. Historically, those arguments have met with varying degrees of success, but provide no comfort to regulated entities that documents produced to the SEC will be protected from disclosure.

Increased Coverage for Whistleblowers

The Sarbanes-Oxley Act of 2002 provided whistleblower protection for persons reporting wrongdoing at companies registered or reporting under the 1934 Act.[109] Sections 1057, 922, 923, and 748 of the Dodd-Frank Act expand the whistleblower protections. Section 1057 creates a private right of action for employees in the financial services industry who are retaliated

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[109] Sarbanes-Oxley Act, § 806, adding 18 U.S.C. § 1514A entitled "Cdoptedivil Action to Prevent Against Retaliation in Fraud Cases."

against for disclosing information about unlawful conduct related to an offering or the provision of a consumer financial product or service. Section 922 of the Dodd-Frank Act added Section 21F to the 1934 Act to provide significant financial incentives to would-be whistleblowers.

On May 25, 2011, the SEC adopted new Regulation 21F under the Exchange Act to implement the Dodd-Frank Act's directions to provide monetary incentives for whistleblowers.[110] The rules apply to voluntary, original information about any securities violation by a private or public company in which the monetary sanctions exceed $1 million.

The Dodd-Frank Act also prohibits retaliation by employers against individuals providing the SEC with information about potential securities violations. Under the proposed rule, the anti-retaliation provisions would not be dependent on an ultimate finding that the conduct reported constituted a violation of securities laws or on whether the whistleblower satisfied all of the proposed rule's requirements and qualifies for a reward.

Who Can Participate. To be considered for an award, a whistleblower must voluntarily provide the SEC with original information about a violation of federal securities laws that leads to a successful enforcement action by the SEC in a federal court or administrative action in which the SEC obtains monetary sanctions in excess of $1 million. The bounty will be ten percent to thirty percent of the SEC's monetary sanctions.

Under Rule 21F-2, a "whistleblower" is defined as "an individual who, alone or jointly with others, provides original information to the [SEC] relating to a violation of the securities laws." Under Rule 21F-4(b)(1), "original information" is information derived from the whistleblower's independent knowledge or analysis and not already known to the SEC. Information is derived from "independent knowledge" if not obtained from publicly available sources.

Eligible whistleblowers are broadly defined and exclude only certain people with an existing legal or contractual duty to report the information, such as lawyers, auditors and internal compliance personnel, and people criminally convicted in connection with the misconduct. Compliance personnel can become eligible whistleblowers if, after disclosing a potential violation, the company acts in bad faith or fails to disclose the information to the SEC within a reasonable period of time. The rules define a "whistleblower" as "an individual who, alone or jointly with others, provides information to the [SEC] relating to a potential violation of the securities laws."

Original information need not be obtained first-hand, and may have been conveyed to the whistleblower by third-parties. A whistleblower that provides information already known to the SEC has not provided original information unless the whistleblower is the original source of that information. Under Rule 21F-4(b)(6), a whistleblower will be considered the "original source" of any information derived from his or her independent knowledge or analysis that materially adds to information already possessed by the SEC.

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[110] SEC Rel. 34-64545 (May 25, 2011), codified at 17 C.F.R. parts 240 and 249. Although Mary Schapiro, SEC Chairman, described these as "simple, straightforward" rules in the opening statement at the November 3, 2010 meeting, the proposing release measured 181 pages, and the adopting release 305 pages.

Additionally, the information must be provided "voluntarily." Under Rule 21F-4(a)(1), information would be provided voluntarily if provided before the whistleblower receives any formal or informal request, inquiry or demand from the SEC, Congress, any federal, state or local authority, any self-regulatory organization, or the Public Company Accounting Oversight Board. Information would not be provided voluntarily if the informant has an existing legal or contractual duty to report violations of the type at issue. In order to be eligible for a reward, the whistleblower's information must lead to successful enforcement of the SEC's action. Under Rule 21F-4(c)(1), information must:

(1) have caused the SEC staff to commence an examination, open an investigation, reopen a closed investigation, or inquire about new and different conduct as part of an open investigation or examination; and
(2) have significantly contributed to the success of an enforcement action.

Rule 21F-4(d) defines an "action" as a single captioned civil or administrative proceeding.

If all of the above criteria are satisfied, the whistleblower would be eligible for an award of ten to thirty percent of the monetary sanctions collected in the action.

Rule 21F-4(b)(4) defines seven circumstances in which information will not be considered to be derived from "independent knowledge." For example, attorneys and persons who assist attorneys on client matters, such as accountants and experts, are not eligible for a whistleblower award for reporting information obtained through communications subject to the attorney-client privilege. Also, persons who obtain information under engagements by an independent public accountant are not eligible for a reward relating to a violation by the engaging client or its directors, officers or employees. Additionally, persons who learn of violations within the scope of their corporate responsibilities—with the expectation that they will address the violations— generally would be precluded from eligibility as a whistleblower (subject to an exception described below). This can include officers, directors, employees and consultants, or those who learn information through legal, audit, compliance or similar functions.

Procedure to Claim Award. A whistleblower must follow certain procedures in order to perfect his or her status as a "whistleblower" under the SEC's whistleblower program.

First, the whistleblower must submit information on a standard form or via the SEC's online referral database.

Second, the whistleblower must complete a form regarding the truthfulness of the information provided and his or her eligibility to receive a reward.

Information may be submitted through an attorney to retain anonymity of the whistleblower.

Once an action results in the imposition of monetary sanctions exceeding $1 million, the whistleblower would be required to make a claim for an award within sixty days of publication of the notice of the eligible action. Eligible whistleblowers may also receive rewards based on

monetary sanctions collected in related actions that are based on the same original information in the first action.

Under the rules, a Whistleblower Office and SEC staff would evaluate the claim and assess whether to allow the claim and at what amount. The SEC has announced it would delay plans to set up the Whistleblower Office due to a lack of funding, but presumably the claims analysis would be handled by others within the SEC until the Whistleblower Office is operational. The Whistleblower Office or SEC staff would then send the claimant a preliminary determination of the award that, if not contested, would subsequently become a proposed final determination. The determination would then become a final order within thirty days, so long as a commissioner does not request a review of the determination.

Inclusion of Corporate Subsidiaries and Affiliates. The Dodd-Frank Act also makes it clear that the whistleblower provisions of the Sarbanes-Oxley Act of 2002 extends to employees of subsidiaries and affiliates of companies having publicly traded securities or required to file reports under Section 15(d) of the 1934 Act where the financial information of the subsidiary or affiliate is included in the consolidated financial statements of the covered company.[111] As a result, there is no longer any need to consider jurisdiction based on factors of agency, integration of subsidiary or affiliate organizations, or control by the covered publicly traded corporate entity.

Statute of Limitations. The Dodd-Frank Act extends the statute of limitations for Sarbanes-Oxley civil whistleblower complaints from ninety days after the violation occurs to one hundred eighty days.[112] Other provisions in the Dodd-Frank Act further extend the Sarbanes-Oxley statute of limitations by allowing a timely filing one hundred eighty days after the date on which the employee became aware of the violation.[113] This extension of the statute of limitations based on employee "knowledge" or "awareness" may generate some confusion that was not inherent in the Sarbanes-Oxley more definitive limitations period – commencing the date when the allegedly discriminatory decision has been both made and communicated to the complaining employee,[114] a period not based on the "awareness" of the employee.

Implications for Companies. Many observers have expressed the concern that the monetary incentive under the SEC's whistleblower program may hinder companies' ability to first investigate and handle reported violations internally. The proposed rules include provisions that are intended to encourage individuals to first report violations through their companies' internal compliance framework, however, the rules do not require – and arguably do not go far enough to incentivize – use of companies' internal compliance programs.

Rule 21F-4(b)(7) allows (but does not require) a potential whistleblower to first provide information to legal or compliance personnel at his or her company and preserve his or her status

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111 Section 929A of the Act, amending 18 U.S.C. § 1514A(a).

112 Section 922(c)(1)(A)(i), amending 18 U.S.C. § 1514A(b)(2)(D).

113 Section 922(c)(1)(A)(ii), also amending 18 U.S.C. § 1514A(b)(2)(D).

114 18 U.S.C. § 1514A(b)(2)(D); 29 C.F.R. § 1980.103(d).

as a whistleblower, so long as information is then provided to the SEC within 120 days. While this 120-day look back period affords companies the opportunity to first conduct their own internal investigations, it is questionable whether employees would proceed first through corporate channels and risk losing the high monetary incentives present in the SEC's whistleblower program. Additionally, even if employees do report potential violations through corporate compliance programs, the proposed rules preserve the opportunity for the whistleblower to disclose potential violations to the SEC if the employee is not subjectively satisfied with the results of the investigation.[115] This incentive to thereafter "tattle" to the SEC may effectively undermine companies' ability to conduct investigations and appropriately resolve allegations. Finally, if allegations are of widespread misconduct or involve complex facts requiring further investigation, this ninety-day period may be insufficient for companies to conduct a thorough and conclusive investigation.

While the proposed rules generally exclude from the class of potential whistleblowers persons performing compliance functions who are responsible for addressing potential violations of the securities laws, this exclusion ceases to apply—and such persons become eligible whistleblowers—if a corporate compliance program fails to lead to an appropriate response to violations. For example, the proposed rules contemplate that if a company does not disclose the potential violation to the SEC within a reasonable time or proceeds in bad faith, an individual performing a compliance function who knows of the undisclosed information may report the potential violations to the SEC and thereafter be eligible for a monetary reward.

The SEC's adopting release (and the proposing release before it) explains that this approach is intended to strike a balance between facilitating effective internal compliance and permitting persons to act as whistleblowers when a company knows of potential violations but has not responded appropriately. Despite this intended balance, the opportunity for persons performing compliance functions to participate in the whistleblower program and to potentially reap a monetary reward creates an incentive for individuals to second guess the efficacy and results of corporate investigations, which are often collaborative endeavors, if that person is subjectively unsatisfied with the result. Given the monetary awards available, there is great incentive for potential whistleblowers to repeatedly run to the SEC the first chance they get with rumors, piecemeal information, and other alleged "original information" of potential securities violations in the hopes of winning the whistleblower lottery. There is no requirement for a whistleblower to report up within the corporation, and little incentive to do so.

Procedural Requirements for Submitting a Claim. The rules provide for certain procedures for submitting whistleblower information. First, whistleblowers must provide their "original information" to the SEC, either by using the SEC's Electronic Data Collection System or by completing Form TCR (Tip, Complaint, Referral).[116] In response to the form, the

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[115] *See* SEC Rel. 34-664545 (May 25, 2011) at 229-231 which reflect the SEC's intention to encourage internal reporting and robust corporate investigatory practices by preserve the place in line of any whistleblower who first reports a potential securities violation to internal compliance personnel but reports out to the SEC within 120 days (90 days in the proposing release) of that initial internal disclosure, and considering higher percentage awards for whistleblowers who first report violations through internal compliance programs.

[116] *See* Rule 21F-9. Conveniently, the SEC has automated the process for filing whistleblower complaints at http://www.sec.gov/complaint.shtml.)

whistleblower must provide his or her background information or, if the whistleblower prefers to remain anonymous, the whistleblower must be represented by an attorney and provide the attorney's information. Even if acting anonymously, the whistleblower must "disclose his or her identity prior to receiving payment of an award."[117] The form must be signed "under penalty of perjury."

The whistleblower's submission must also include information about the person or entity that is the subject of the tip, the tip itself, and how the tip was obtained.[118] The whistleblower must also complete and submit Form WB-APP, "application for award for original information submitted pursuant to Section 21F of the" 1934 Act. This form must also be signed under penalty of perjury.[119] The SEC believes that by requiring the whistleblowers to sign under penalties of perjury it can place "greater reliance" on the information it receives while, at the same time, discouraging false reports.[120] The Department of Justice has stated that it will prosecute whistleblowers who provide false information.[121]

In determining the amount of the award to be paid, the SEC will consider amounts collected in certain "related actions"[122] as well as the significance of the information provided by the whistleblower and whether the whistleblower attempted to report internally before going to the SEC (which may warrant a higher percentage for the whistleblower).[123]

In a February 2011 interview, Sherron Watkins, the accountant who became the Enron whistleblower criticized the complexity and subjectivity of the proposed rules, and predicted that potential whistleblowers will be leery of walking down this new path.[124] Ms. Watkins spoke

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[117] *See* SEC Rel. 34-64545 (May 25, 2011) at 215.

[118] *See* Part C of Form TCR, 17 CFR §1800.

[119] *See* Part F of Form TCR, 17 CFR §1800. Without following this procedure, the whistleblower will be disqualified from receiving an award, although the SEC may waive these procedural requirements upon a showing of "extraordinary circumstances." Rule 21F-8(a).

[120] *See* SEC Rel. 34-63237 (Nov. 3, 2010) at 118.

[121] *See* comments of Preet Bharara, U.S. Attorney for the Southern District of New York on November 12, 2010, as reported in 42 Sec. Reg. & L. Rep. (BNA) at 2157. Section 21F(i) provides that a whistleblower shall not be entitled to an award if he or she knowingly provides false, fictitious or fraudulent information.

[122] *See* Rule 21F-11. A related action is a judicial or administrative action brought by the Attorney General, an appropriate regulatory agency, a self-regulatory organization, or a state attorney general in a criminal case and is based on the same original information that the whistleblower voluntarily provided to the SEC, and that led the SEC to obtain monetary sanctions totaling more than $1,000,000.

[123] *See* Rule 21F-6(a)(4). "Participation in internal compliance systems" is one of four named factors for increasing a whistleblower award. The other factors are "significance of the information provided by the whistleblower (Rule 21F-6(a)(1)), "assistance provided by the whistleblower" (Rule 21F-6(a)(2)), and "law enforcement interest" (Rule 21F-6(a)(3)).

[124] *Enron Whistleblower Predicts 'People Like Myself Will Go to WikiLeaks'*, 43 Sec. Reg. & L. Rep. (BNA) 288 (Feb. 7, 2011).

about the costs of being a whistleblower and then treated as a pariah or troublemaker in the corporate world – even while the Company is required to retain the whistleblower. She said that the new rules present "far too many barriers of entry for this to work," and "People will go to WikiLeaks" as being a much easier route to follow with a better ability to preserve anonymity.

Nationally Recognized Securities Ratings Organizations (NRSROs). The Dodd-Frank Act also requires that each NRSRO refer to appropriate law enforcement or regulatory authorities any information received by it from a third-party and found credible, alleging that an issuer of securities rated by it has committed or is committing a material violation of law that has not been adjudicated by a federal or state court.[125] Nevertheless, the NRSRO is not required to verify the accuracy of the information it has received, indicating that there may be no affirmative obligation to uncover an issuer's violation of law or corroborate information received.

The Dodd-Frank Act also amends the whistleblower provisions to include NRSROs among the companies prohibited from retaliating against individuals for their protected activity.[126] As a result, whistleblower protection is available to the officers, employees, contractors, subcontractors, and agents of NRSROs.

Considerations for Public Corporations. All of these incentives to report potential violations of the securities laws pose a challenge for effectively enforcing internal corporate policies and adequately managing internal investigations. In order to address this challenge, regular training should be provided for all directors, officers, and employees about corporate ethics policies and codes of conduct, as well as internal compliance programs and processes. This training may be accomplished through presentations by legal or compliance personnel, internal memoranda or posters in the workplace, disclosure of applicable policies on internal and external company websites, and reinforcement by senior management or supervisory personnel.

Companies should also review their internal communication policies and practices to ensure that they are effectively communicating the results of internal investigations to interested parties. Regularly reminding employees about a company's culture of compliance should decrease the risk that potential violations of securities or other laws may occur. Moreover, if employees understand that a corporate compliance program, such as an anonymous hotline or complaint system, is in place and consistently and effectively administered, they may be more likely to report potential violations through internal channels before looking to the SEC. Companies should consider reviewing their internal compliance program and code of conduct to ensure that employees may effectively voice their concerns to compliance personnel.

It has been argued that the whistleblower reward provisions place an incentive on the employee to go to the SEC when he or she sees company wrong-doing rather than going to the company supervisors. Where going to the SEC may result in a substantial whistleblower reward and going to the supervisors may result in (at most) a pat on the back, a perceptive employee

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[125] Section 934 of the Act, amending § 15E to the 1934 Act.

[126] Section 922(b) of the Act, amending 18 U.S.C. § 1514A(a).

may see the financial incentive to go to the SEC. In the adopting release, however, the SEC offered its opinion that "[a]nalysis of the academic literature, although not wholly conclusive, provides reason to believe that a sizable percentage of whistleblowers who currently report internally are motivated by non-monetary reasons. Thus, we anticipate that many whistleblowers would continue to report internally."[127]

The General Accountability Office (the "GAO") is directed to conduct a study as to the effectiveness of the whistleblower provisions and to issue a report within thirty months of the effectiveness of the Dodd-Frank Act.[128]

Enhanced Regulation of Short-Selling

The Dodd-Frank Act enhances the SEC's authority over "naked" short-selling – the practice of investors selling securities of an issuer that the investor does not then own, betting on the price decreasing, and then covering the short sale by purchasing the same security at a lower price. These practices are regulated by the SEC in Regulation SHO, originally adopted in 2004.[129]

Section 929X requires the SEC to enhance the reporting and enforcement requirements against short sellers involved in stock price manipulation. In the past and as required by Regulation SHO, broker-dealers have loaned stock belonging to one customer to other customers to cover short sales when needed. New 1934 Act § 15(e) requires each registered broker-dealer to notify their customers that they may prohibit the broker-dealer from lending the customers' fully-paid securities in short sale transactions.[130]

The SEC amended Regulation SHO in November 2010 to address the requirements of the Dodd-Frank Act.[131]

Hedge Fund Regulation –Advisers Act

Elimination of the Advisers Act Exemption for Advisers to Private Funds and Foreign Private Advisers.

Title IV[132] of the Dodd-Frank Act is the "Private Fund Investment Advisers Registration Act of 2010" and eliminates some exemptions from registration that previously existed.[133] In

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[127] SEC Rel. 34-664545 (May 25, 2011) at 230.

[128] Section 922(d) of the Act.

[129] SEC Rel. No. 34-50103, 83 S.E.C. Docket 1278, 2004 WL 1697019 (July 28, 2004). *See* general discussion in Lidstone, *Securities Law Deskbook* (Bradford Publishing Co.) at § 17.7.3.

[130] Section 929X(c) of the Act.

[131] Regulation SHO, SEC Rel. 34-63247 (Nov. 4, 2010).

[132] Sections 401-416.

Section 402, the Dodd-Frank Act adds definitions of "private fund" and "foreign private adviser" to the Advisers Act. A private fund is a fund that would be an investment company as defined in the Company Act but for the application of § 3(c)(1) or § 3(c)(7) of the Company Act.[134] A foreign private adviser is an investment adviser with no place of business in the United States, fewer than fifteen clients in the United States, and no marketing in the United States.[135]

Section 403 of the Dodd-Frank Act eliminates the exemption formerly found in § 203(b) of the Advisers Act for advisers to private funds (including those with fewer than fifteen clients under management in any twelve month period found in § 203(b)(3)) and creates only a limited exemption from Advisers Act registration for foreign private advisers. As a result, private fund investment advisers and many foreign private advisers will have to register under the Advisers Act when previously they were exempt from such registration.[136] Many of the other amendments to the Advisers Act will have to await SEC rule-making. The rule-making activities may include additional reporting and risk disclosure requirements for investment advisers to their clients and to the SEC. Section 406 of the Act (amending § 211 of the Advisers Act) adds a new reporting requirement for private fund investment advisers, which the SEC must establish after consultation with the CFTC and the new Financial Stability Oversight Council.[137] The Dodd-Frank Act does retain some exemptions, including an exemption for advisers to venture capital funds[138] and for advisers to private funds with less than $150,000,000 under management.[139]

The amendment potentially impacts entities that are established by wealthy families to manage their money and provide tax and estate planning and similar services to the family. Historically, family offices have not been required to register with the SEC under the Advisers Act because of an exemption provided to investment advisers with fewer than fifteen clients.[140]

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133 Section 419 provides that the provisions of Title IV become effective one year after enactment of the Private Fund Investment Advisers Registration Act of 2010.

134 The Act, § 402(a), amending § 202 of the Advisers' Act by adding § 202(a)(29). Section 3(c)(1) exempts entities that would otherwise be treated as investment companies if their outstanding securities are beneficially owned by not more than 100 persons; § 3(c)(7) provides an exemption from Company Act regulation if all of the entities outstanding securities are owned by "qualified purchasers" and is not planning to make a public offering, among other conditions. The term "qualified purchaser" is defined in § 2(a)(51) of the Company Act to include a natural person who owns not less than $5,000,000 in investments, or any person acting for his or her own account and for other qualified purchasers with more than $25,000,000 under discretionary management.

135 The Act, § 402(a), amending § 202 of the Advisers Act by adding § 202(a)(30).

136 The registration requirement is contained in § 203 of the Advisers Act.

137 Established by § 111 of the Act. The rules must be adopted within twelve months of the enactment of the Private Fund Investment Advisers Registration Act of 2010.

138 The Act, § 407, amending § 203 of the Advisers Act by adding subsection (*l*). The new section requires the SEC to adopt rules defining venture capital funds not later than one year after enactment.

139 The Act, § 408, amending § 203 of the Advisers Act by adding subsections (m) and (n).

140 Advisers Act, § 203(b)(3). *See* Lidstone, *Securities Law Deskbook* (Bradford Publishing Co.) at § 1.3.1.

The Dodd-Frank Act removed that exemption to enable the SEC to regulate hedge fund and other private fund advisers as described above, but § 409 of the Dodd-Frank Act created a new exclusion from the Advisers Act in § 202(a)(11)(G) under which family offices continue to be exempt from Advisers Act regulation. Both the removal of the fifteen-client exemption and the family office exemption become effective on July 21, 2011, and the family office exemption is subject to SEC rule-making. On October 12, 2010, the SEC proposed rules[141] to define a family office as any firm that:

- Provides investment advice only to family members, as defined by the rule; certain key employees; charities and trusts established by family members; and entities wholly owned and controlled by family members.
- Is wholly owned and controlled by family members.
- Does not hold itself out to the public as an investment adviser.

As defined, a family office would be exempt from registration under the Advisers Act. The SEC has also proposed rules that are intended to implement the Dodd-Frank Act's requirements in Section 410 allocating to states the authority to regulate investment advisers with from $25,000,000 to $100,000,000 under management,[142] and implementing the provisions of Sections 403, 407 and 408 of the Dodd-Frank Act which provides for exemptions for advisers to venture capital funds, private fund advisers with less than $150 million in assets under management, and foreign private advisers.[143]

Possible Elimination of the Advisers Act Exemption for Broker-Dealer and Establishment of a Standard of Care.

Section 913 of the Dodd-Frank Act requires the SEC to undertake a study to, among many other things, consider the standard of care under the Advisers Act[144] and consider eliminating the current exemption from registration under the Advisers Act for broker-dealers.[145]

The Dodd-Frank Act goes on to give the SEC specific authority to commence rule making "as necessary or appropriate in the public interest" for the protection of retail customers and to address the standards of care for brokers, dealers, investment advisers, and associated persons when providing personalized investment advice about securities to retail customers.[146] In addition, the Dodd-Frank Act adds a section to the 1934 Act permitting the SEC to adopt rules with respect to a broker-dealer or an investment adviser that establishes a standard of conduct

141 SEC Rel. IA-3098 (Oct. 12, 2010).

142 SEC Rel. IA-3110 (Nov. 19, 2010). Previously the SEC's jurisdiction commenced at $25,000,000.

143 SEC Rel. IA-3111 (Nov. 19, 2010).

144 The Act, § 913(c)(9).

145 The Act, § 913(c)(10). The exemption is in § 202(a)(11)(C) of the Advisers Act.

146 The Act, § 913(f).

when dealing with customers, and directs that the standard of conduct for broker-dealers and investment advisers be the same.[147] On January 21, 2011, the SEC staff issued its study and concluded that (among other things) that:

> The standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.[148]

Increase in State Supervisory Responsibility

Under current law, investment advisers with less than $25,000,000 under management are subject to state regulation if (like Colorado[149]) the state has an investment adviser registration requirement. The Dodd-Frank Act increases this threshold to $100,000,000 "or such higher amount" as the SEC may determine.[150] Investment advisers with a lesser amount under management but who would otherwise be required to register with fifteen or more states are permitted to register under § 203 of the Advisers Act rather than be subject to so much duplicative and potentially contradictory state regulation.[151]

Additional Obligations Imposed on Investment Advisers

In direct response to the Bernard Madoff and other scandals, the Dodd-Frank Act adds § 223 to the Advisers Act which requires registered advisers to take steps necessary to safeguard client assets, including verifying assets through an independent audit "as the [SEC] may by rule prescribe."

A Couple of Provisions that Did Not Make the Final Dodd-Frank Act

There are several provisions that were included in either the House or Senate bills that did not survive the Conference Committee.

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[147] The Act, § 913(g), adding § 15(k) to the 1934 Act and 211(g) to the Advisers Act.

[148] "Study on Investment Advisors and Broker-Dealers" issued in January 2011, available at www.sec.gov

[149] Colorado regulates investment advisers as a result of 1998 amendments to the Colorado Securities Act, found at C.R.S. §§ 11-51-101 through 11-51-908.

[150] The Act, § 410, amending § 203A(a) of the Advisers Act by adding a new subsection (2).

[151] For a good discussion of the impact of the federal investment advisor changes on Colorado law, see Stephens, *Dodd-Frank Act Expands Federal and State Regulation of Investment Advisers*, 40 The Colo. L. (CBA) 15 (Feb. 2011).

Gustafson not overturned.

As adopted, the Act does not include a proposed amendment that would have effectively overturned the Supreme Court's 1995 decision in *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995). The amendment, which received publicity due to its implications for liability in connection with private placements of securities, would have created prospectus liability under the 1933 Act for offering memoranda issued in connection with private placements.

No majority voting for director elections.

In a compromise with the House version of the financial reform bill, the requirement for all public companies to adopt majority voting for the election of directors was been eliminated. Under the Senate version of the bill, companies would have been required to accept the resignation of any director who received less than a majority vote in an uncontested election, unless the board unanimously declined to accept the resignation. Notwithstanding the elimination of the majority voting requirements from the Act, companies should continue to evaluate whether this standard is appropriate for their boards because majority voting will remain on the wish lists for shareholders and corporate governance activists. Shareholder proposals requesting companies to adopt majority voting continue to be among the top corporate governance shareholder proposals submitted in 2010 and will likely continue until there is significant adoption of majority voting across all public companies. Currently, majority voting is the predominant standard at larger companies. According to ISS data, approximately seventy percent of the S&P 500 (as compared to approximately thirty-seven percent of the S&P 1500) have a majority voting standard.[152]

Continuing Federal Preemption for Rule 506 Offerings

At the urging of the North American Securities Administrators Association, the House bill originally included a provision that would restrict and effectively eliminate the federal preemption over state regulation of Rule 506 offerings found in § 18 of the 1933 Act. That provision was not included in the Senate bill and was not addressed in the House-Senate conference.

Conclusion

Clearly there are a significant amount of additional legislative and statutory changes in the Act that may be of interest to a large number of lawyers, accountants, bankers, mortgage bankers, broker-dealers, real estate professionals, and business men and women. The foregoing only deals with a small slice of the Act.

[152] ISS 2010 U.S. Proxy Voting Guidelines (February 25, 2010) does not specifically address the existence of majority voting for directors in determining whether to recommend a vote for or against directors. On page 17, however, the ISS 2010 Guidelines do state that ISS will generally recommend a "vote for management proposals to adopt a majority of votes cast standard for directors in uncontested elections."

It is important to note that many of the provisions are subject to future rule making, although some, such as the definition of "accredited investor" and many of the SEC enforcement provisions were effective immediately upon enactment notwithstanding the fact that rule making is also required.[153]

Writing in January 2011, it is clear that the SEC is significantly delayed in its rule-making obligations under the Act. In September 2010 the SEC published its rule-making agenda. Among the rules promised by the end of 2010 which had not (as of 2010 year-end) been proposed are:

§ 413 – rules to revise the definition of 'accredited investor'

§ 926 – rules disqualifying the offer or sale of securities in certain exempt offerings by certain felons and others similarly situation.

§ 952 – propose exchange listing standards regarding compensation committee independence and factors affecting compensation adviser independence, and regarding compensation consultant conflicts;

§ 942 – propose rules regarding the reporting obligations for issuers of asset backed securities (that prior to the Act were not required to report under § 15(d) of the 1934 Act);

§ 929W – propose revisions to rules regarding due diligence for the delivery of dividends, interest, and other valuable property to missing securities holders;

§ 961 – report and certification to Congress regarding internal supervisory controls; and

§ 916 – adopt streamlined procedural rules regarding filings by self-regulatory organizations.

In addition, the SEC has deferred a number of activities required by the Act, including the creation and staffing of the Office of Women and Minority Affairs (§ 342), creation of the Investor Advisory Committee (§ 911), creation and staffing of the Office of Investor Advocate (§§ 915 and 919D), creation and staffing of the Whistleblower Office (§ 924), creation and staffing of the Office of Credit Ratings (§ 932), and creation and staffing of the Office of Municipal securities (§ 979). Most of these activities are already being managed in other SEC offices pending the creation of the required offices.

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[153] Section 413 of the Act provides as follows: "The Commission shall adjust any net worth standard for an accredited investor, as set forth in the rules of the Commission under the Securities Act of 1933, so that the individual net worth of any natural person, or joint net worth with the spouse of that person, at the time of purchase, is more than $1,000,000 (as such amount is adjusted periodically by rule of the Commission), excluding the value of the primary residence of such natural person, except that during the 4-year period that begins on the date of enactment of this Act, any net worth standard shall be $1,000,000, excluding the value of the primary residence of such natural person." Note that in mandating this definition, the Congress did not address § 2(a)(15) of the 1933 Act which contains a definition of the term "accredited investor."

On the other hand, certain commentators have argued that the SEC and other agencies are moving too quickly in proposing rules responding to directors in the Act. In a December 15, 2010, letter addressed to Senate and House leaders written by The Committee on Capital Markets Regulation,[154] the authors noted that the speed of SEC, CFTC, and FDIC rule making under the Act significantly exceeds rulemaking before the Act when the SEC issued an average of 9.5 rule proposals per year (5.5 for the CFTC; 8 for the FDIC, and 4.5 for the Federal Reserve). The authors also noted that the period between proposal and adoption has been drastically shortened, a period too short for the deliberative processes necessary for such extensive rulemaking, "particularly in view of the fact that in November [2010] alone, the financial regulators issued nearly 40 proposed rules."

The most significant provisions of the Act require studies by the SEC or the Comptroller General and the General Accounting Office (the "GAO"). In the few provisions discussed in this article, there are at least twenty provisions that require studies within the next two years or less. In the entire Act, it has been reported that there are more than two hundred fifty provisions requiring that regulations be adopted, and more than seventy studies to be accomplished. Some of these studies are narrowly defined, and others will be far-reaching. In any event, there will be a significant amount of SEC and GAO staff time devoted to these studies and the anticipated rulemaking activities. As a result, the enactment of the Act should be viewed not as the end, but rather as the beginning of a significant amount of regulatory and administrative activity which will come to fruition over the next two to three years, some of which has already commenced.

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[154] The Committee on Capital Markets Regulation is a non-partisan group co-chaired by Glenn Hubbard, Dean of Columbia Business School, and John L. Tornton, Chairman of the Brookings Institute. The letter can be found at http://http//www.capmktsreg.org/pdfs/2010.12.15_Rulemaking_Timeline_Letter.pdf and is discussed at www.secactions.com (January 5, 2011).