



## FINANCIAL REGULATORY REFORMS UPDATE

### Title IX — Investor Protections and Improvements to the Regulation of Securities

- **Fiduciary Duty.** After conducting a study, the SEC is empowered to impose a higher standard of care (*i.e.*, a fiduciary duty) on brokers and dealers that provide personalized investment advice to retail investors. If the SEC decides to impose such a duty, brokers and dealers would not be subject to a continuing duty and payments of commissions would not, *per se*, violate such duty. [Subtitle A]
- **Mandatory Predispute Arbitration Agreements.** The SEC may, by rule, prohibit or impose conditions or limitations on the use by brokers, dealers and investment advisers of mandatory predispute arbitration agreements with customers or investors. [Subtitle B]
- **Securities Lending.** Brokers and dealers must notify customers that they may elect not to allow their fully paid securities to be used in connection with short sales. [Subtitle B]
- **Custody Recordkeeping Relating to Investment Companies and Investment Advisers.** Custodians for Investment Companies and Investment Advisers will be subject to reasonable periodic, special or other SEC examinations. [Subtitle B]
- **Securities Act Rule 436(g) Rescinded.** The rescission of Rule 436(g) opens NRSROs to liability under Section 11 of the Securities Act if they consent to be named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement. [Subtitle C]
- **Securitization Risk Retention Requirement.** The Federal banking agencies (the OCC, the Federal Reserve Board and the FDIC) and the SEC (and, in the case of transactions involving residential mortgage assets, the FHFA and the Secretary of Housing and Urban Development) (the “applicable regulators”) must jointly adopt regulations requiring securitizers to retain an unhedged economic interest in a portion of the credit risk on the assets they transfer, subject to certain exemptions and exceptions. Regulations adopted under the Act will provide for the risk to be allocated, as is determined to be appropriate, between the securitizer and an originator if the securitizer purchases assets from an originator. [Subtitle D]
- **Amount of Risk Retention.** The Act requires the applicable regulators to jointly adopt regulations that set the minimum level of risk retention at not less than 5% of the credit risk or, if the originator of the assets meets certain underwriting standards established by the Federal banking agencies, less than 5% of the credit risk. [Subtitle D]

- **Exemption for “Qualified Residential Mortgages.”** The regulations adopted under the Act must exempt securitizations of “qualified residential mortgages” from the risk retention requirement. [Subtitle D]
- **Effective Date of Regulations.** The Act requires the risk retention regulations to be adopted within 270 days of the Act’s passage and to become effective one year, in the case of securities backed by residential mortgages, or two years, for all other asset-backed securities, after the date of publication of the final regulations in the Federal Register. [Subtitle D]
- **Increased Disclosure and Reporting by Issuers.** The Act requires the SEC to impose asset-level registration statement disclosure requirements if the data are necessary for investors to independently perform due diligence, and imposes ongoing Exchange Act reporting obligations on issuers of registered asset-backed securities. [Subtitle D]
- **Corporate Governance and Executive Compensation.** The Act includes a number of corporate governance and executive compensation-related provisions that apply to all public companies (or, in some instances, to all companies with securities listed on a securities exchange) without regard to industry. These provisions include:
  - shareholder use of the proxy materials to nominate directors;
  - shareholder “say on pay” voting;
  - independence of compensation committees and their advisers;
  - clawback requirements for incentive compensation paid to executives based on misstated financial statements;
  - increased compensation disclosure in proxy statements;
  - increased oversight of compensation arrangements at large financial institutions;
  - restrictions on the voting of shares by brokers; and
  - increased disclosure requirements of companies that use certain minerals sourced from the Democratic Republic of Congo or its adjoining countries, companies engaged in coal or other mining operations and companies engaged in the development of oil, natural gas or other minerals. [Subtitles E&G and Title XV]
- **Municipal Advisers.** Municipal advisers must register with the SEC and will owe a fiduciary duty to any municipal entity for whom such municipal adviser acts as a municipal adviser. [Subtitle H]
- **SOX External Audit of Internal Controls.** Certain small public issuers are exempt from the Sarbanes-Oxley Act’s external audit of internal control requirement. [Subtitle I]

### Subtitle A – Increasing Investor Protection

- *Fiduciary Duty for Brokers, Dealers and Investment Advisers.* Not later than six months from the enactment of the Act, the SEC shall complete a study and submit a report to Congress that addresses the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers and their respective associated persons for providing personalized investment advice concerning securities to retail investors, and whether there are legal or regulatory gaps or overlap in such standards of care. The SEC must seek public comments in preparing its report. Retail customer means a natural person, or the legal representative of a natural person, who receives personalized investment advice about securities and who uses such advice primarily for personal, family or household purposes. For Advisers Act purposes, the term “customer” will not include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.

The Act authorizes the SEC to engage in rulemaking, in its discretion, to address the standard of care for brokers, dealers, investment advisers and their associated persons and, in particular, authorizes the SEC to establish a fiduciary duty for brokers and dealers. The SEC may promulgate rules to provide that brokers and dealers that provide personalized investment advice about securities to retail customers (and such other customers as the SEC deems appropriate) shall owe the same standard of care as applicable to investment advisers under the Advisers Act. The receipt of compensation based upon commissions or other standard compensation by brokers or dealers for the sale of securities shall not, in itself, be considered a violation of this standard of care. In addition, brokers, dealers and their registered persons will *not* have a continuing duty of care or loyalty to the customer after providing the personalized investment advice about securities.

If a broker or dealer sells only proprietary or other limited range of products, the SEC may require, by rule, that the broker or dealer provide notice and obtain the consent or acknowledgement of each retail customer.

The SEC shall facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers and investment advisers, including any material conflicts of interest. The SEC further shall, if appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest and compensation schemes.

The Act harmonizes the SEC's enforcement authority for prosecuting violations of standards of care owed by brokers, dealers and investment advisers under both the Advisers Act and the Exchange Act.

- *Investor Advisory Committee, Office of Investor Advocate and Ombudsman.* The Act codifies the formation and continuation of an Investor Advisory Committee to advise and consult with the SEC on, among other things, regulatory priorities, fee structures, effectiveness of disclosures and investor protection. The SEC established this committee in June 2009. An Office of the Investor Advocate is also established within the SEC. The purpose of this office is, in general, to assist investors in resolving problems with the SEC and self-regulatory organizations. The Investor Advocate must appoint an Ombudsman to act as a liaison between the SEC and retail investors, and review and make recommendations regarding policies and procedures to encourage persons to present questions to the Investor Advocate regarding compliance with the securities laws. The Investor Advocate will be a member of the Investor Advisory Committee as will a representative of State securities commissions, a representative of interests of senior citizens, and individuals representing the interests of individual equity and debt investors and investors in mutual funds, and individuals representing the interests of institutional investors including pension funds and registered investment companies.
- *SEC Rule-Making Procedures.* The Act amends the Exchange Act to streamline rule filings submitted by self-regulatory organizations for approval or disapproval by the SEC. Moreover, within 180 days after the date of enactment, the Act requires the SEC to promulgate rules setting forth the procedural requirements for rule-making proceedings.
- *Clarification of SEC Authority to Require Investor Disclosures before Purchase of Investment Products and Services.* The Exchange Act is amended to clarify that the SEC may issue rules designating documents or information to be provided by a broker or dealer to a retail investor before the purchase of an investment product or service. Any documents or information provided to retail investors must be in summary format and contain clear information about costs, risks and any compensation or financial incentive to be received by a broker, dealer or other intermediary.
- *Study on Enhancing Investment Adviser Examinations.* The SEC must conduct a study, and report its findings within 180 days of enactment of the Act, on the need for enhanced examination and enforcement resources for investment advisers. Among other things, the SEC must consider the frequency of examinations, whether a self-regulatory organization would augment the SEC's oversight of investment advisers, and current and potential

approaches to examining the investment adviser activities of dually registered broker-dealers and investment advisers or affiliated broker-dealers and investment advisers.

- *Additional Studies.* The Act requires several additional studies to be conducted:
  - *Financial Literacy.* The SEC must conduct a study to identify: (1) the level of financial literacy among retail investors, (2) methods to improve the timing, content and format of disclosures to investors with respect to financial intermediaries, (3) the most useful and understandable relevant information that retail investors need to make informed financial decisions before engaging a financial intermediary or purchasing an investment product or service (including open-end investment companies), (4) methods to increase transparency of expenses and conflicts of interest in transactions (including open-end investment companies), (5) the most effective existing private and public efforts to educate investors and (6) in consultation with the Financial Literacy and Education Commission, a strategy to increase financial literacy of investors to bring about a positive change in investor behavior. The SEC must provide a report of this study to Congress within two years after the date of enactment of the Act.
  - *Mutual Fund Advertising.* The Comptroller General must conduct a study on mutual fund advertising to identify, among other things, existing and proposed regulatory requirements for open-end investment company advertisements and current marketing practices for open-end investment companies, including the use of past performance data, funds that have merged and incubator funds. The study must be submitted to Congress not later than 18 months after enactment of the Act.
  - *Research Analysts.* The Comptroller General must conduct a study to identify and examine potential conflicts of interest between the staffs of the investment banking and equity and fixed income securities analyst functions within the same firm. The Comptroller General is to consider the Global Analyst Research Settlement of 2003 and whether the undertakings set forth in that settlement should be codified. The report summarizing the study must be submitted to Congress not later than 18 months after the date of enactment of the Act.
  - *Investor Access to Registration Information.* Within six months of enactment of the Act, the SEC must complete a study, including recommendations, of ways to improve the access of investors to registration information (including disciplinary actions, regulatory, judicial and arbitration proceedings and other information) about registered and previously registered investment advisers, brokers, dealers and their associated persons on the Central Registration Depository and Investment Adviser Registration Depository systems. Among other things, the SEC must consider consolidating the two systems. Not later than 18 months after the completion of the study, the SEC must implement any recommendations set forth in the study.
  - *Financial Planners.* The Comptroller General must conduct a study on financial planners and the use of financial designations. The Comptroller General must consider the role of financial planners, whether there are sufficient ethical and professional standards for financial planners and the appropriate structure for regulation of financial planners and for persons who provide or offer financial planning services. The Comptroller General's report of financial planners must be submitted to Congress not later than 180 days after enactment of the Act.

### **Subtitle B – Increasing Regulatory Enforcement and Remedies**

- *Mandatory Predispute Arbitration Agreements.* The SEC is given leeway to, by rule, prohibit or impose conditions or limitations on the use of agreements that require customers or clients of any broker, dealer, municipal securities dealer or investment adviser to arbitrate any future dispute if the SEC finds that such prohibition or limitation is in the public interest and appropriate for the protection of investors.

- *Whistleblower Protection.* The Act amends the Exchange Act to require the SEC, in any judicial or administrative action brought by the SEC under the securities laws that results in monetary sanctions exceeding \$1 million, to pay awards to whistleblowers who voluntarily provide original information that leads to a successful enforcement of an action. The amount of payment would be not less than 10%, and not more than 30%, in total, that has been collected. Employers would be prohibited from firing or discriminating against a whistleblower because of any lawful act done by the whistleblower. The statute of limitations for a whistleblower to bring an action against his or her employer for unlawful retaliation is six years from the date of the violative conduct or three years from the date when facts material to the right of action are known or reasonably should have been known by the employee, but in no case may an action be brought more than ten years after the date of the violation. The SEC Inspector General must conduct a study of the whistleblower protections established by this amendment, including whether the SEC is prompt in responding to information provided by whistleblowers. The Inspector General must submit a report on his findings to Congress, and must make the report publicly available on the SEC's website, not later than 30 months after enactment of the Act.
- *Collateral Bars.* The Act expands the administrative sanctions that the SEC can impose under the Exchange Act (Sections 15(b)(6), 15B(c)(4) and 17A(c)(4)) and the Advisers Act (Section 203(f)) to include collateral bars (*i.e.*, bars under each provision from associating with broker-dealers, investment advisers, municipal securities dealers, transfer agents or nationally recognized statistical rating organizations).
- *Regulation D Bad Actors.* The Act disqualifies any offering or sale of securities by felons and other "bad actors" under Rule 506 of Regulation D. The SEC must issue rules in this regard no later than one year of enactment.
- *Section 205 of the Investment Advisers Act and State-Regulated Advisers.* Section 205(a) of the Advisers Act is amended to clarify that the section, which imposes various restrictions on investment advisory contracts, does not apply to State-registered investment advisers.
- *Nationwide Service of Subpoenas.* The Securities Act, the Exchange Act, the Investment Company Act and the Advisers Act are amended to permit nationwide service of SEC subpoenas in civil actions filed in Federal court.
- *Formerly Associated Persons.* Through amendments to the Exchange Act, the Investment Company Act and the Sarbanes-Oxley Act, the SEC has the power to sanction persons who were formerly associated with the Municipal Securities Rulemaking Board ("MSRB"), the Public Company Accounting Oversight Board ("PCAOB"), a government securities broker or dealer, a national securities exchange or registered securities association, registered clearing agency or public accounting firm as well as officers and directors of self-regulatory organizations and investment companies.
- *SIPC Reforms.* The Securities Investor Protection Act is amended to increase the amount payable to a customer if his or her net equity claim is for cash from \$100,000 to a "standard maximum cash advance amount," which is \$250,000. The Board of Directors of the Securities Investor Protection Corporation ("SIPC") shall determine whether such amount should be adjusted for inflation every five years.

The minimum assessment paid by SIPC members is increased from \$150 per annum to 0.02 % of the gross revenues of the securities business of the SIPC member. The sanctions for prohibited acts and misrepresenting SIPC membership also are increased.

- *Confidentiality of Materials Submitted to the SEC.* The Exchange Act, the Investment Company Act and the Advisers Act are amended to state that the SEC shall not be compelled to disclose records or information, or records or information based upon or derived from such records or information, if obtained in furtherance of the purpose of those acts, including surveillance, risk assessments and other regulatory and oversight activities.
- *Sharing Privileged Information with Other Authorities.* The SEC shall not be deemed to have waived any privilege applicable to information shared with certain Federal agencies, the PCAOB, any self-regulatory organization, any

foreign securities authority, any foreign law enforcement authority or any State securities or law enforcement authority. The SEC shall not be compelled to disclose privileged information obtained from any foreign securities authority or law enforcement authority. Federal agencies, State securities and law enforcement authorities, self-regulatory organizations and the PCAOB shall not be deemed to have waived any privilege by sharing information with the SEC, except that, if the SEC uses such information in an action against the PCAOB or a self-regulatory authority, those entities will be deemed to have waived any applicable privilege.

- *Foreign Public Accounting Firms.* If a foreign public accounting firm performs material services upon which a registered public accounting firm relies in the conduct of an audit or interim review, issues an audit report, performs audit work or conducts interim reviews, the foreign public accounting firm must produce audit work papers and related documents to the SEC or the PCAOB upon request and be subject to U.S. jurisdiction for enforcement purposes. Any registered public accounting firm that relies, in whole or in part, upon a foreign public accounting firm also is responsible for producing the audit work papers and related documents of the foreign public accounting firm upon request. The foreign firm must furnish the domestic registered public accounting firm with a written irrevocable consent and power of attorney designating the domestic firm as an agent upon whom service of process may be made in connection with SEC or PCAOB requests. The SEC and the PCAOB may allow a foreign public accounting firm to meet these requirements through alternative means.
- *Manipulation.* Sections 9 (relating to market manipulation) and 10(a)(1) (relating to short sales) of the Exchange Act are amended to expand their application to securities that are *not* registered on national securities exchanges other than government securities. In addition, violations of rules relating to transactions involving puts, calls, straddles or options are no longer required to have been effectuated “by use of any facility of a national securities exchange.” Broker-dealers can be held liable for violating rules and regulations regarding endorsements or guarantees on puts, calls, straddles or options.
- *Short Sale Reforms.* The SEC will prescribe rules providing for the public disclosure of the following information on short sales of equity securities: name of the issue and title, class, CUSIP number, aggregate amount of the number of short sales of each security and any additional information that the SEC deems appropriate. At a minimum, such disclosures must be made on a monthly basis.

Section 9 of the Exchange Act is amended to make it unlawful for any person, directly or indirectly, alone or with one or more persons, to effect a manipulative short sale of any security. The SEC is to issue rules to ensure that appropriate enforcement options and remedies are available to it.

- *Securities Lending.* Brokers and dealers must notify customers that they may elect not to allow their fully paid securities to be used in connection with short sales. If such securities are used, the broker or dealer must provide the customer with notice that the broker or dealer may receive compensation in connection with lending the customer’s securities. The SEC may, by rule, prescribe the form, content, time and manner of any such notice.
- *SEC Aiding and Abetting Authority.* The Act in several ways expands the SEC’s ability to bring enforcement actions in district court against aiders and abettors. First, the Act authorizes the SEC to bring district court enforcement actions against persons who aid and abet violations of the Securities Act and the Investment Company Act. Second, the Act expands the enforcement provisions of the Advisers Act by making clear that the SEC in district court can seek civil monetary penalties against persons who aid and abet Advisers Act violations. Third, in those sections, and in amendments to the existing aiding and abetting language in Section 20(e) of the Exchange Act, the Act allows the SEC to predicate a district court action against aiders and abettors for knowingly *or recklessly* providing substantial assistance to primary violators.
- *Study on Securities Litigation.* The Comptroller General must conduct a study on the impact of allowing aiding and abetting claims in private securities actions. To the extent feasible, the study shall include, among other things, the types of lawsuits decided under the Private Securities Litigation Act of 1995. Given the parameters of this study,

the Comptroller General will be reexamining the results of *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008). The report is due one year from the date of enactment of the Act.

- *SEC Cease and Desist Proceedings.* The Act amends the securities acts to give the SEC uniform authority to seek civil penalties in cease and desist proceedings.
- *Extraterritorial Jurisdiction.* Pursuant to amendments to the Securities Act, the Exchange Act and the Advisers Act, the SEC shall have jurisdiction over an action it brings (or Federal prosecutors bring) if the conduct within the United States constitutes significant steps in furtherance of the violation even if the securities transaction occurs outside the United States and involves only foreign investors or conduct occurring outside the United States that has a foreseeable substantial effect within the United States.
- *Extraterritorial Private Rights of Action.* The SEC shall solicit public comment and conduct a study to determine the extent to which private rights of action under the antifraud provisions of the Exchange Act should be extended to cover conduct within the United States that constitutes a significant step in the furtherance of the violation even if the securities transaction occurs outside the United States, and conduct occurring outside the United States has a foreseeable substantial effect within the United States.
- *Custody Recordkeeping Relating to Investment Companies and Investment Advisers.* The Investment Company Act is revised to require each person having custody or use of assets of a registered investment company to maintain and preserve records for such period as the SEC may prescribe and subject such custodians to reasonable periodic, special or other SEC examinations. The Advisers Act is amended to provide that a custodian having custody or use of client assets also is subject to SEC examination. A custodian that is subject to regulation by a Federal financial institution regulatory agency may satisfy the SEC's examination request by providing a detailed written list of the assets within its custody or use.
- *Deadline for Completing Examinations, Inspections and Enforcement Actions.* The Act requires the SEC to file an enforcement action no later than 180 days after it has provided any person with a written "Wells" notification. The SEC must inform the subject, in writing, of any examination that the SEC has concluded, has concluded without findings or that the staff requests the entity to undertake corrective action within 180 days after the SEC staff completes its on-site portion of the examination or receives all records requested of the examinee (whichever is later). The enforcement and examination timing may be extended by an additional 180 days in complex matters.

### **Subtitle C – Improvements to the Regulation of Credit Rating Agencies**

- The Act will subject nationally recognized statistical rating organizations ("NRSROs") to greater oversight by the SEC.
  - NRSROs will be required to submit an annual internal controls report, attested to by the CEO, to the SEC describing the responsibility of management in establishing and maintaining an effective internal control structure for determining credit ratings and assessing that structure.
  - NRSRO compliance officers will have to write annual reports (and certify to the accuracy of such reports) that would be submitted to NRSRO management and filed with the SEC. Such reports will have to describe any material changes to the code of ethics and conflict of interest policies.
  - The SEC must issue rules to prevent sales and marketing considerations of an NRSRO from influencing the production of ratings although the SEC could make exceptions for small NRSROs.
  - An NRSRO must report to the SEC when it knows or can reasonably be expected to know where a person associated with the NRSRO within the last five years obtains employment with an obligor, issuer, underwriter or sponsor of a security or money market instrument for which the NRSRO issued a credit rating during the preceding one year period, if such employee was a senior officer, participated in determining the credit rating

or supervised a person who participated in determining the credit rating. The SEC will make any such report available to the public.

- *Sanctions of Associated Persons of NRSROs and NRSRO Suspension or Revocation for a Particular Class of Securities.* The SEC will be able to censure or place limitations on the activities of a person who is associated with, or is seeking to become associated with, or who at the time of any misconduct was associated with an NRSRO. Sanctions can include a one-year suspension or a bar from association with an NRSRO. The SEC also has the authority to sanction persons who fail to reasonably supervise an associated person with the view to preventing a violation of the securities laws.

The SEC may temporarily suspend or permanently revoke the registration of a NRSRO with respect to a particular class or subclass of securities if the SEC finds that the NRSRO does not have adequate financial and managerial resources to consistently produce credit ratings with integrity.

- *Look-Back Requirements Relating to Employment.* Each NRSRO must establish, maintain and enforce policies and procedures reasonably designed to address conflicts of interest when an NRSRO former employee works for a person subject to the NRSRO's credit ratings, or an issuer, underwriter or sponsor of a security or money market instrument. Such look-backs must occur when the former NRSRO employee participated in determining the credit rating during the preceding year.
- *Office of Credit Ratings.* The SEC is required to establish an Office of Credit Ratings to administer the SEC's rules relating to NRSROs, to promote accuracy in NRSRO credit ratings and to ensure that ratings are not unduly influenced by conflicts of interest. The Office will conduct at least annual examinations of each NRSRO and will examine, among other things, whether each NRSRO acts in accordance with its policies and procedures and how conflicts of interest are managed. The SEC will make public the essential findings of examinations as well as any NRSRO responses to findings of material regulatory deficiencies.
- *Transparency.* NRSROs will have to increase the transparency of ratings, under rules to be promulgated by the SEC, by providing disclosures that would allow users of credit ratings to compare performance of credit ratings across NRSROs and for a variety of types of credit ratings, including for credit ratings that are withdrawn. Such disclosures would be available on each NRSRO website and in writing. Each NRSRO must include an attestation with any credit rating it issues affirming that no part of the rating was influenced by any other business activities, that the rating was based solely upon the merits of the instrument being rated and that such rating was an independent evaluation of the risks and merits of the instrument.
- *Disclosures.* The SEC would prescribe rules that would require each NRSRO to ensure that credit ratings are determined using procedures and methodologies, including qualitative and quantitative data and models, approved by each NRSRO's board. SEC rules further would require that, when there are material changes to credit rating procedures and methodologies, such changes are applied consistently and quickly and that the reason for the change is publicly disclosed. NRSROs would be required to notify users of credit ratings when a material change is made, when a significant error is identified in a procedure or methodology, and the likelihood of a material change resulting in a change to current credit ratings. NRSROs also would have to disclose information relating to assumptions, the data that was relied upon to determine the rating, how (if applicable) the NRSRO used servicer or remittance reports to conduct surveillance of credit ratings, the potential limitation of the credit ratings, the types of risks that were not evaluated in establishing the rating, information on the uncertainty of the credit rating, a statement of the overall assessment of the quality of information available and considered in producing a rating, an explanation or measure of the potential volatility of a rating, and information relating to conflicts of interest. The SEC will require most of these matters to be disclosed on a form accompanying the publication of each credit rating.

- NRSROs will have to disclose whether and to what extent third-party due diligence services were used by the NRSRO, a description of the information reviewed by such service, and a description of the service's findings.
- *Due Diligence Services for Asset-Backed Securities.* The Act requires the issuer or underwriter of an asset-backed security to make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter, and if a third-party due diligence service is employed by an NRSRO, an issuer or an underwriter, the person providing the due diligence service must provide to any NRSRO that produces a rating to which such services relate, a written certification in a form established by the SEC to ensure that providers of due diligence services have conducted a thorough review of data, documentation and other relevant information necessary for an NRSRO to provide an accurate rating. The SEC must also adopt rules requiring an NRSRO, at the time at which it rates the security, to disclose publicly the certification such that the public can determine the adequacy and level of due diligence services provided by the third party.
- *Credit Rating Agency Statements and State of Mind in Private Rights of Action.* The enforcement and penalty provisions of the Exchange Act would apply to statements made by a credit rating agency - not just an NRSRO - in the same manner and to the same extent as apply to statements made by a registered public accounting firm or a securities analyst under the securities laws. In addition, the Act rescinds Rule 436(g) of the Securities Act, known as the "expert exemption." As a result, NRSROs may be liable under Sections 11 and 12 of the Securities Act if an NRSRO were to consent to be named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement.

Statements by credit rating agencies would not be deemed forward-looking statements for the Exchange Act's Section 21E Safe Harbor.

For purposes of pleading a requisite state of mind for litigation against a credit rating agency – not just an NRSRO – it would be sufficient to state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to: (1) conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk or (2) obtain reasonable verification of such factual elements from other sources independent of the issuer and underwriter that the credit rating agency considered to be competent.

- *Referring Tips to Law Enforcement or Regulatory Authorities.* Each NRSRO must inform law enforcement or regulatory authorities of any information that the NRSRO receives from a third party and finds credible that alleges that an issuer of securities rated by the NRSRO committed or is committing a material violation of law. An NRSRO would not be required to verify the accuracy of such information.
- *Removal of References to Credit Ratings from Laws Governing Securities and Banking.* The Act removes references to credit ratings from, among other things, the FDIA, the Federal Housing Enterprises Financial Safety and Soundness Act, the Investment Company Act and the Exchange Act. Moreover, each Federal Agency must, within one year of enactment of the Act, substitute any references to credit ratings in regulations with other standards of credit-worthiness.
- *Regulation FD.* Within 90 days of enactment, the SEC must revise Regulation FD to remove the exemption for entities whose primary business is the issuance of credit ratings. The effect of this removal may only be that rating agencies will have to agree that they will maintain disclosed material nonpublic information in confidence.
- *Study and Rulemaking on Assigned Credit Ratings for Structured Finance Products.* The SEC must conduct a study of the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and subscriber-pay compensation models. The SEC must consider the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine the credit ratings of structured finance products and alternative means for compensating NRSROs that would create incentives for accurate ratings. The SEC must submit its report and recommendations to Congress not later than 24 months

after enactment of the Act. Following the study, the SEC will issue rules, as the SEC determines is necessary or appropriate in the public interest or for the protection of investors, creating a self-regulatory organization to assign NRSROs (including potentially through a lottery or rotating assignment system) unless it determines that an alternative mechanism would better serve the public interest and investor protection. This provision is the result of the amendment that was proposed by Senator Al Franken (D-Minn.).

- *Additional Studies.* The SEC must conduct a study of the independence of NRSROs and how their independence affects their ratings. The SEC must consider the management of conflicts of interest raised by NRSROs providing other services and the potential impact of rules prohibiting an NRSRO that provides a rating to an issuer from providing other services to the issuer. A report of the study must be submitted to Congress within three years of enactment of the Act. The Comptroller General must conduct a study on alternative means for compensating NRSROs within 18 months of enactment of the Act and the GAO must conduct a study on the feasibility and merits of creating an independent professional organization for rating analysts employed by NRSROs. The GAO study is due one year from the date of enactment of the Act.

### Subtitle D — Improvements to the Asset-Backed Securitization Process

The Act’s provisions related to securitization (the “ABS Provisions”) effect a number of significant changes to securitization transactions. In addition to these changes, in April, the SEC released proposed rules (the “SEC proposed rules”) that would significantly modify and expand the regulations governing structured finance securities and, in May, the FDIC issued a Notice of Proposed Rulemaking that proposes a number of securitization reforms (including risk retention and asset-level disclosure) (the “FDIC proposed rules”) as part of proposed changes to its securitization conservatorship and receivership safe harbor rule for FDIC-insured depository institutions.<sup>1</sup>

#### Securitization Risk Retention Requirement

- The applicable regulators must jointly adopt regulations:
  - Requiring securitizers to retain an unhedged economic interest in a portion of the credit risk on the assets they transfer, sell or convey through the issuance of asset-backed securities, subject to the exemptions and exceptions discussed below. An “asset-backed security” is broadly defined and is not limited to an “asset-backed security” as defined under the SEC’s Regulation AB. A “securitizer” is defined as an issuer of an asset-backed security or a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.
  - Providing for the allocation, as the Federal banking agencies and the SEC jointly determine to be appropriate, of the risk retention obligation between a securitizer and an originator if the securitizer purchases assets from an originator. An “originator” is defined as a person who creates a financial asset (through the extension of credit or otherwise) that collateralizes an asset-backed security and who sells that asset directly or indirectly to a securitizer.
    - The FDIC proposed rules on risk retention would apply only to a sponsor in a securitization that seeks to qualify for the FDIC’s safe harbor for securitizations and the SEC proposed rules would apply only to sponsors in shelf-registered asset-backed securities transactions. Neither the FDIC proposed rules nor the SEC proposed rules provide for allocation of the risk retention requirement between the sponsor and other entities.

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<sup>1</sup> See “Summary of SEC Proposals Regarding Asset-Backed Securities and Other Structured Finance Securities,” Sidley client update (April 19, 2010), available at <http://www.sidley.com/sidleyupdates/Detail.aspx?news=4394> and “FDIC Proposes Revised Safe Harbor for Securitizations,” Sidley client update (May 17, 2010), available at <http://www.sidley.com/sidleyupdates/Detail.aspx?news=4426>.

- Setting the minimum level of risk retention at not less than 5% of the credit risk or, if the originator of the assets meets certain prescribed underwriting standards, less than 5% of the credit risk. The underwriting standards are to be established by the Federal banking agencies and must specify the loan terms, conditions and characteristics that indicate a low credit risk with respect to loans within each asset class for which the applicable regulators have established separate rules.
- Additionally, under regulations to be jointly adopted by the Federal banking agencies, the SEC, the Secretary of Housing and Urban Development and the Director of the FHFA, securitizations of “qualified residential mortgages” will be exempt from the risk retention requirement if the issuer certifies to the SEC that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed securities are qualified residential mortgages. The exemption does not apply to asset-backed securities collateralized by other asset-backed securities (such as CDOs or other re-securitizations of RMBS with underlying qualified residential mortgages) or asset-backed securities collateralized by a combination of qualified residential mortgages and other assets, such as a pool of prime and Alt-A mortgage loans.
- The term “qualified residential mortgage” will be defined jointly by the regulators taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default, such as documentation and verification of financial resources, standards with respect to debt-to-income ratio and limits on features (*e.g.*, negative amortization or interest-only mortgage loans). The adopted definition can be no broader than the definition of “qualified mortgage” adopted under Title XIV of the Act. See “Title XIV—Mortgage Reform and Anti-Predatory Lending Act—Minimum Standards for Mortgages—Ability to Repay.”
- The regulations to be adopted by the applicable regulators are required to prohibit a securitizer from directly or indirectly hedging (or otherwise transferring) the retained risk.
  - The FDIC proposed rules would not permit a sponsor to directly or indirectly hedge its risk.
  - Under the SEC proposed rules, hedge positions not directly related to the securities or exposures taken by the sponsor or affiliate would not be counted against the sponsor’s risk retention requirement.
- The regulations to be adopted by the applicable regulators also are required to:
  - Establish appropriate standards for retention of an economic interest with respect to CDOs, securities collateralized by CDOs and similar instruments collateralized by other asset-backed securities.
  - With respect to commercial mortgages, specify the permissible types, forms and amounts of risk retention that would meet the risk retention requirement, which in the determination of the Federal banking agencies and the SEC may include:
    - retention of a specified amount or percentage of the total credit risk of the asset;
    - retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first-loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before the issuance of the asset-backed securities and meets the same standards for risk retention as the Federal banking agencies and the SEC require of the securitizer;
    - a determination by the Federal banking agencies and the SEC that the underwriting standards and controls for the asset are adequate; and
    - provision of adequate representations and warranties and related enforcement mechanisms.
- In addition, the applicable regulators must adopt regulations that provide for a total or partial exemption from the risk retention requirements:

- for any securitization, as may be appropriate in the public interest and for the protection of investors;
- for any securitization where the assets securitized are assets issued or guaranteed by the United States or an agency of the United States (other than Fannie Mae or Freddie Mac) as determined by the Federal banking agencies and the SEC to be appropriate in the public interest and for the protection of investors; or
- for any securitization where the asset-backed security is issued or guaranteed by any State (or political subdivision or public instrumentality thereof) and is exempt from the registration requirements of the Securities Act pursuant to Section 3(a)(2), or is a security defined as a qualified scholarship funding bond under the Internal Revenue Code of 1986, as amended, as may be appropriate in the public interest and for the protection of investors.
- Additionally, the Federal banking agencies and the SEC may jointly adopt or issue exemptions, exceptions or adjustments for classes of institutions or assets with respect to the risk retention requirement and the prohibition on hedging. The Act specifically exempts any loan or other financial asset made, insured, guaranteed or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation, from the risk retention requirement. Any residential, multi-family or health care facility mortgage loan asset, or securitization based directly or indirectly on such an asset, which is insured or guaranteed by the United States or an agency of the United States (other than Fannie Mae, Freddie Mac and the Federal home loan banks), is also exempted from the risk retention requirement.
- In contrast to the Act, neither the SEC proposed rules nor the FDIC proposed rules would provide any type of exemption or exceptions with respect to the risk retention requirements or any reduction of the risk retention amount below 5%.
- The Act leaves the determination as to permissible forms of risk retention and the minimum duration of the risk retention requirement to the applicable regulators.
  - The SEC proposed rules would require the sponsor (or an affiliate) in a shelf-registered issuance of securities to retain a vertical slice of 5% of each tranche of securities issued in the transaction (or, in the case of a master trust transaction, a 5% originator's interest) net of any directly related hedge positions so long as an unaffiliated entity owns securities issued in the transaction.
  - The FDIC proposed rules would require that 5% of each of the credit tranches sold or transferred to investors (or, that a "representative sample" of the securitized assets equal to not less than 5% of the principal amount of the financial assets at transfer) be retained for the life of the transaction.
- The regulations to be adopted by the applicable regulators must also establish asset classes with separate rules for securitizers of different asset classes, including residential mortgages, commercial mortgages, commercial loans, auto loans and any other class of assets that the Federal banking agencies and the SEC deem appropriate.
  - The FDIC proposed rules would distinguish securitizations of residential mortgage loans from other asset types and, in securitizations of residential mortgage loans, would require, in addition to the 5% risk retention requirement, establishment of a reserve fund equal to at least 5% of the cash proceeds of the securitization payable to the sponsor to cover, during the first year of the securitization, repurchase of any of the securitized assets required for breach of representations and warranties.
  - The SEC risk retention proposal does not vary by asset class (although the SEC proposed rules would distinguish between asset classes with respect to disclosure and reporting obligations).
- The Act also requires a study and report (within 180 days of the Act's enactment) by the Chairperson of the Oversight Council on the macroeconomic effects of the risk retention requirements (with particular emphasis placed on the potential beneficial effects with respect to stabilizing the real estate market), and an analysis on the feasibility of minimizing real estate price bubbles by proactively adjusting the risk retention requirements and

mortgage origination requirements. In addition, the ABS Provisions require a study and report within 90 days of the Act's enactment by the Federal Reserve Board (in consultation with the Comptroller of the Currency, the Director of the OTS, the Chairperson of the FDIC and the SEC) on the combined impact of the ABS Provisions' risk retention requirements, including the effect credit risk retention requirements have on increasing the market for Federally-subsidized loans, and Statement of Financial Accounting Standards Nos. 166 and 167. The report must include recommendations for eliminating any negative impacts on the continued viability of the securitization markets and on the availability of credit for new lending.

### **Effective Date of Regulations**

- The Act requires the risk retention regulations to be adopted within 270 days of the Act's passage and to become effective one year, in the case of securities backed by residential mortgages, or two years, for all other asset-backed securities, after the date of publication of the final regulations in the Federal Register. The Chairperson of the Oversight Council will coordinate all joint rulemaking required under the ABS Provisions.

### **Increased Disclosure and Reporting by Issuers; New Asset Review**

- The ABS Provisions exclude all publicly-registered asset-backed securities from the automatic reporting suspension provisions of Section 15(d) of the Exchange Act and the SEC is authorized to adopt new suspension or termination schemes for different classes of publicly-registered asset-backed securities under terms and conditions as it deems necessary or appropriate in the public interest or for the protection of investors. The SEC proposed rules would impose ongoing reporting obligations equivalent to Exchange Act reporting on issuers using shelf registration (independent of the ability to suspend reporting under Section 15(d)) as well as issuers relying on the Rule 144, Rule 144A or Rule 506 Safe Harbors.
- The SEC is required to:
  - Impose registration statement disclosure requirements on asset-backed securities issuers with respect to asset-level information, including loan-level data, if such data are necessary for investors to independently perform due diligence. The SEC proposed rules contain extensive new disclosure requirements for asset-backed securities that would appear to address these requirements.
  - Adopt rules requiring an issuer of registered asset-backed securities to perform a review of the assets underlying the asset-backed securities and to disclose the nature of the review in the issuer's registration statement.
- While the FDIC proposed rules would require a third-party diligence report on compliance with applicable statutory and regulatory standards for the origination of mortgage loans and compliance with representations and warranties in residential mortgage-backed transactions, there is no corollary in the SEC proposed rules.

### **Representations and Warranties; Repurchase Requests; Repeal of the Securities Act Section 4(5) Exemption**

- The SEC is required to adopt regulations requiring:
  - A description and comparison of the representations, warranties and enforcement mechanisms available to investors to be included in a report accompanying each rating of an asset-backed security.
  - A securitizer to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer. This is similar to the SEC's proposal to require sponsors and originators that have originated more than 20% of the pool assets to disclose the number of repurchase or replacement demands the entity has received in the last three years and the percentage of those where it did not repurchase or replace the asset.

- The Act repeals the transactional exemption from the Securities Act’s registration and prospectus delivery requirements, contained in Section 4(5) thereof, for the sale of certain promissory notes secured by first liens on residential and commercial real estate and participation interests therein.

### Securitization Conflicts of Interest

- Under Title VI of the Act, underwriters, placement agents, initial purchasers and sponsors (and their affiliates and subsidiaries) of asset-backed securities, as defined in the Act, and synthetic asset-backed securities are prohibited from engaging in any transaction during the one-year period following the date of the first closing of the sale of such securities that would involve or result in any material conflict of interest with respect to any investor in the transaction. The SEC is required to issue final rules, within 270 days of the Act’s passage, to implement this prohibition.
  - This prohibition does not apply to risk-mitigating hedging activities in connection with positions or holdings arising out of such activities if they are designed to reduce specific risks associated with those positions or holdings arising out of such activities, or to purchases or sales of asset-backed securities or synthetic asset-backed securities made pursuant to and consistent with commitments to provide liquidity for such securities or bona fide market-making activities.

### Credit Ratings of Structured Finance Securities

- Among the provisions that affect NRSROs, the Act contains a number of changes relevant for structured finance securities, including a provision to make due diligence reports publicly available, commissioning a two-year study to evaluate ratings for structured finance products, removing certain statutory references to NRSROs and repealing Rule 436(g) under the Securities Act. *See* “—Subtitle C—Improvements to the Regulation of Credit Rating Agencies.”

### Amendments to the Truth in Lending Act of 1968 (“TILA”)

- The Act’s amendments to TILA include restrictions on the origination of residential mortgage loans and on prepayment penalties, which could have a significant effect on the secondary mortgage loan market and on residential mortgage securitization transactions and sellers into these transactions. *See* “Title XIV—Mortgage Reform and Anti-Predatory Lending Act.”

### Covered Bonds

- The Act does not include the comprehensive framework for covered bonds proposed by Representative Scott Garrett (R-NJ). Although offered by the House, the Senate rejected the proposal because the Treasury Department and the FDIC were said to have expressed concerns about the framework. Senator Christopher Dodd (D-Conn.) promised to hold a hearing in the coming months to further explore covered bonds and Representative Barney Frank (D-Mass.) promised to hold a mark-up of Garrett’s covered bond bill in July.

## Subtitles E and G — Corporate Governance and Executive Compensation Requirements

### Proxy Access

- The Act gives the SEC the authority, but not a mandate, to issue rules that allow shareholders to nominate directors by using the company’s proxy solicitation materials. Under pre-existing law, there is some uncertainty as to whether the SEC has authority to adopt such rules. The Act gives the SEC the authority to exempt an issuer or

a class of issuers from this requirement and directs the SEC to consider whether the requirement disproportionately burdens small issuers.

### **Say on Pay**

- The Act requires that, at least once every three years, each company that is subject to the SEC's compensation disclosure requirements must include a separate non-binding "say on pay" vote in its proxy statement by which shareholders may approve the compensation of named executive officers as disclosed in the proxy statement. The vote will be purely advisory, and apply to the overall compensation disclosure, rather than the compensation of each executive or each program. In a separate non-binding vote held at least once every six years the shareholders will determine whether the say on pay vote is to occur every one, two or three years.
- The Act also provides that whenever an issuer seeks shareholder approval of an acquisition, merger, consolidation or sale of all or substantially all of the issuer's assets, the issuer must disclose in its proxy statement all compensation arrangements, which the statute refers to as "golden parachute compensation" with named executive officers that relate to the transaction and the amount of compensation that may be paid to them. The shareholders are then entitled to exercise a nonbinding vote to approve the disclosed compensation arrangements, unless such arrangements previously were subject to say on pay vote.
- Institutional shareholders who are subject to Section 13(f) of the Exchange Act are required to report annually how they voted in any say on pay vote.
- The say on pay requirements take effect at the first shareholder meeting that occurs more than six months after the date of enactment. For the first shareholder meeting, shareholders will vote on two items: (1) whether to approve the current compensation of named executive officers, as disclosed in the proxy and (2) whether future say on pay votes will be held every one, two or three years.
- The SEC is authorized to exempt issuers or classes of issuers, such as small issuers, from the say on pay requirement.

### **Compensation Committee Independence**

- The Act requires the SEC to adopt rules to direct the national stock exchanges and national securities associations to prohibit the listing of an issuer's equity securities if the issuer does not have an independent compensation committee.
- For purposes of determining independence, the SEC's rules will take into account:
  - consulting, advisory or other compensatory fees paid by the issuer to the member of the committee; and
  - whether the committee member is an affiliate of the company.
- The following entities are exempt from the independence requirement: (1) "controlled companies" that hold board of director elections in which more than 50% of the voting power is held by an individual, a group or another issuer, (2) limited partnerships, (3) companies in bankruptcy, (4) open-ended management investment companies registered under the Investment Company Act and (5) foreign private issuers that disclose to shareholders annually why they do not have an independent compensation committee.

### **Independent Compensation Consultants and Counsel**

- The Act also requires the SEC to adopt rules that would permit an issuer's compensation committee to engage compensation consultants, counsel and other advisers only after considering their independence. The Act directs the SEC to identify factors to be considered in assessing the independence of these advisers, including other

services performed for the company, the fees paid to the adviser as a percentage of total revenue, procedures for selection, business or personal relationships and any stock of the issuer owned by the adviser. These factors must be “competitively neutral” among categories of consultants, counsel and other advisers.

- The issuer’s compensation committee must have the authority to retain and oversee the work of any independent compensation consultant or legal counsel, and the company must fund the engagement.
- Any proxy statement for an annual meeting of shareholders occurring on or after the one-year anniversary of enactment must disclose whether the committee retained a compensation consultant, whether there are any conflicts of interest and how they are being addressed.
- The rules relating to the use of independent advisers do not apply to “controlled companies” that hold board of director elections in which more than 50% of the voting power is held by an individual, a group or another issuer.
- The Act directs the SEC to adopt these rules relating to Compensation Committee and advisor independence within 360 days of enactment.

### Expanded Clawback Requirements

- The Act requires the SEC to adopt rules to direct the national stock exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the compensation clawback requirements included in the Act. The SEC rules will require that:
  - Exchange-traded companies adopt a clawback policy covering incentive compensation paid to all executive officers.
  - The required clawback applies in the event of an accounting restatement due to material noncompliance with financial reporting requirements. If triggered, the policy would require recovery from current and former executive officers of any incentive compensation received (including options) during the three-year period preceding restatement, in excess of what otherwise would have been paid to the officer.
- In contrast, the clawback requirement found in the Sarbanes-Oxley Act of 2002 covers only a company’s CEO and CFO and applies only if noncompliance results from misconduct.

### Hedging Disclosure

- The Act requires the SEC to adopt rules requiring disclosure in a company’s proxy statement as to whether any director or employee of a company is permitted to hedge his or her position in any equity security of the company, whether granted to the employee or director as compensation or held, directly or indirectly, by the employee or director.

### Increased Compensation Disclosure

- The Act requires the SEC to adopt rules requiring additional disclosure of:
  - Information that shows the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the stock value and dividends paid. This disclosure may include a graphic representation of the information required to be disclosed.
  - Information on internal pay disparity, including:
    - the median annual total compensation of all employees, excluding the CEO,
    - the annual total compensation of the CEO; and
    - the ratio of the median non-CEO employee total compensation to that of the CEO.

### Disclosures Regarding Chairman and CEO Structures

- The Act requires the SEC to adopt rules that would require an issuer to disclose in its annual proxy materials why the issuer has chosen the same person to serve as chairman of the board of directors and CEO or different individuals to serve in those positions. The SEC already requires similar disclosure pursuant to existing Item 407(h) of Regulation S-K.

### Excessive Compensation of Covered Financial Institutions

- The Act requires the various regulators of covered financial institutions to jointly establish regulations, within nine months after enactment, that:
  - require financial institutions with assets of at least \$1 billion to disclose to the regulators the structures of their incentive-based compensation arrangements (but not actual individual compensation levels), and
  - prohibit any such incentive-based compensation arrangements that the regulators determine encourage inappropriate risks: (1) by providing executive officers, employees, directors or principal shareholders with excessive compensation, fees or benefits or (2) that could lead to a material financial loss to the institution.
- This requirement applies to: (1) depository institutions or holding companies, (2) broker-dealers registered under Section 15 of the Exchange Act, (3) credit unions, (4) investment advisers, (5) Fannie Mae, (6) Freddie Mac and (7) any other institution designated by the regulators.

### Broker Discretionary Voting

- The Act further restricts the ability of brokers to vote shares in the absence of a direction from shareholders by requiring the rules of the national securities exchanges to prohibit broker discretionary voting “with respect to the election of a member of the board of directors of an issuer, executive compensation, or any other significant matter, as determined by the [SEC].” The Act expressly exempts from this requirement votes with respect to the uncontested election of a member of the board of any registered investment company. The Act’s treatment of broker discretionary voting follows the amendment, in January 2010, of NYSE rules governing brokers, which prohibited broker voting in all director elections. The Act would appear to prohibit, contrary to current practice, broker discretionary voting on management say on pay proposals.

Note that there are several other provisions, not found in Subtitles E and G of Subtitle IX, that may be of relevance to public companies. These include: (1) the exemption for non-accelerated filers from the requirements of Section 404(b) of the Sarbanes-Oxley Act that is found in Title IX, Subsection H and is described below under “*SOX External Audit of Internal Controls*,” (2) the changes to required whistleblower procedures that is found in Title IX, Subsection B and is described above under “*Whistleblower Protection*” and (3) the disclosure-related provisions of Title XV, which are described in the section below.

### Disclosure Regarding Use of Certain Minerals

- The Act contains provisions that relate to the use of certain minerals (the “conflict minerals”) that are sourced from the Democratic Republic of Congo and its adjoining countries. The conflict minerals are “columbite-tantalite (coltan), cassiterite, gold, wolframite, or their derivatives” and other minerals specified by the Secretary of State.
- Specifically, the Act directs the SEC, within 270 days of enactment, to promulgate regulations that would require additional reporting by companies for which the use of conflict minerals is “necessary to the functionality or production of a product manufactured by such” company. Companies for which the use of conflict minerals is necessary as described above would have to disclose annually whether the conflict minerals it uses originated in the

Democratic Republic of Congo or an adjoining country. In cases in which the minerals did originate in any such country, the company would be required to submit to the SEC a report that includes a description of the measures taken by the company to “exercise due diligence on the source and chain of custody of such materials,” which measures will be required to include an independent private sector audit. The report to be submitted to the SEC would also be required to include a description of a number of other items relating to the use of the conflict minerals, including a description of any such products that are “not DRC conflict-free.” The term “DRC conflict-free” is defined to mean that the products “do not contain minerals that directly or indirectly finance or benefit armed groups in the Democratic Republic of Congo or an adjoining country.”

- These disclosure requirements will terminate on the date, not earlier than five years from the date of enactment, on which the President determines and certifies that “no armed groups continue to be directly involved and benefitting from commercial activity involving conflict minerals.”
- The Act contains several other provisions imposing obligations on the Secretary of State and the Comptroller General and the Secretary of Commerce that relate to the conflict in the Congo and the effectiveness of the new disclosure requirements.

#### **Disclosure Applicable to Mine Operators**

- The Act contains provisions that will require additional disclosure for issuers that operate, or have subsidiaries that operate, “coal or other mines.” Specifically, such companies will be required to include in each periodic report a number of items relating to the company’s mine-safety history.
- In addition, such companies will be required to file a Form 8-K upon the receipt of certain specified safety-related notices from regulators.
- This section of the Act, which is apparently self-effectuating, will take effect 30 days after enactment.

#### **Disclosure Applicable to Entities Engaged in Resource Extraction**

- The Act directs the SEC, within 270 days of enactment, to issue rules that require “resource extraction” issuer[s]” to include in “an annual report” of the issuer information relating to “any payment made by the resource extraction issuer, a subsidiary . . . or an entity under control of the resource extraction issuer to a foreign government or the Federal Government for the purpose of the commercial development of oil, natural gas, or minerals.” The term “resource extraction issuer” is defined to mean an issuer that is required to file reports with the SEC and “engages in the commercial development of oil, natural gas, or minerals.”

#### **Subtitle F — Improvements to the Management of the SEC**

- *Report and Certification of Internal Supervisory Controls.* Not later than 60 days after the end of each fiscal year, the SEC will be required to submit a report to Congress on the SEC’s conduct in examining registered entities, conducting enforcement investigations and reviewing corporate financial securities filings. Such report must assess the SEC’s internal supervisory controls and the directors of the Division of Enforcement, Division of Corporate Finance and the Office of Compliance and Inspections and Examinations must certify that there are adequate internal controls.
- *Triennial Report on Personnel Management.* The Comptroller General must submit a report once every three years Congress on the quality of personnel management by the SEC. This report will evaluate the effectiveness of, among other things, supervisors in achieving the goals of the SEC, the criteria for promoting employees to supervisory positions, the competence of the SEC staff, the efficiency of communication between units of the SEC and the efforts to promote such communications, and any initiatives to increase the competence of the staff. The SEC must submit a response to the Comptroller General’s report not later than 90 days after issuance.

- *Annual Financial Controls Audit.* Not later than six months after the end of each fiscal year, the SEC must publish and submit to Congress a report assessing the responsibility of SEC management for establishing and maintaining an adequate internal control structure and procedures for financial reporting. The chairman and chief financial officer must provide attestations to such report. The Comptroller General must attest to, and report on, the SEC's assessment on annual financial controls not later than six months after the end of the first fiscal year after the date of enactment of the Act.
- *Report on Oversight of National Securities Associations, i.e., FINRA.* Not later than two years after enactment of the Act and every three years thereafter, the Comptroller General must submit to Congress a report evaluating the SEC's oversight of national securities associations (*i.e.*, FINRA). The report will review, among other things, the governance of FINRA (including the identification and management of conflicts), examinations conducted by FINRA (including a review of the expertise of examiners), FINRA executive compensation packages, the cooperation provided to State securities administrators and the policies regarding the employment of former FINRA employees by regulated entities.
- *SEC Organizational Study and Reform.* Not later than 90 days after enactment of the Act, the SEC shall hire an independent consultant to examine the internal operations, structure, funding and the need for comprehensive reform of the SEC as well as the SEC's relationship with, and reliance upon, self-regulatory organizations. The independent consultant must, at a minimum, consider, among other things, the possible elimination of unnecessary or redundant units at the SEC, improving the communications between SEC offices and divisions and the need to establish a clear chain of command structure (particularly for enforcement examinations and compliance inspections). The independent consultant shall issue its report to the SEC and Congress no later than 150 days after being retained. Six months after the independent consultant issues its report, and every six months for the next two year period, the SEC must issue a report to Congress describing the SEC's implementation of the regulatory and administrative recommendations made by the consultant.
- *Study on SEC Revolving Door.* The Comptroller General must conduct a study that, among other things: (1) reviews the number of SEC employees who leave the SEC to work for financial institutions regulated by the SEC, (2) determines how many employees who leave the SEC worked on cases that involved financial institutions regulated by the SEC and (3) determines if greater post-employment restrictions are necessary to prevent SEC employees from being employed by financial institutions regulated by the SEC. The Comptroller General must submit this report to Congress not later than one year after the enactment of the Act.
- *Match Funding.* Title J of the Act states that the SEC shall collect transaction fees and assessments that are designed to recover the costs to the government of the annual appropriation to the SEC by Congress.

### **Subtitle H — Municipal Securities**

- *Municipal Advisor.* The Act creates a new category of entity – a municipal advisor – that must register with the SEC. A municipal advisor would be a person who “(i) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues; or (ii) undertakes a solicitation of a municipal entity.” The Act expressly excludes a broker, dealer or municipal securities dealer serving as an underwriter, any registered investment adviser or persons associated with registered investment advisers who are providing investment advice, any commodity trading adviser who is providing advice related to swaps, attorneys providing legal advice, and engineers providing engineering advice.
- *Fiduciary Duty.* A municipal advisor and any associated person shall owe a fiduciary duty to any municipal entity for whom such municipal advisor acts as a municipal advisor, and no municipal advisor may engage in any act, practice or course of business which is not consistent with a municipal advisor's fiduciary duty.

- The MSRB generally would have the same authority in relation to municipal advisors that it has with transactions in municipal securities effected by brokers, dealers and municipal securities dealers.
- “*Municipal financial products*” is defined as municipal derivatives, guaranteed investment contracts, and investment strategies.
- “*Obligated persons*” includes any person, including an issuer of municipal securities, who supports the payment of all or part of the obligations on the municipal securities to be sold in an offering of municipal securities.
- *FINRA Requests for Guidance.* FINRA is required to request guidance from the MSRB concerning the interpretation of MSRB rules and provide information to the MSRB about enforcement actions and examinations so that the MSRB may assist in such actions and examinations and evaluate MSRB rules.
- *SEC Office of Municipal Securities.* The Act establishes an Office of Municipal Securities to administer the SEC’s rules relating to the practices of municipal securities brokers and dealers, municipal securities advisors, municipal securities investors, and municipal securities issuers as well as to coordinate with the MSRB regarding rulemaking and enforcement actions.
- *Studies.* The Comptroller General shall conduct a study of the disclosures required to be made by issuers of municipal securities within 24 months of enactment of the Act. The Comptroller General also shall conduct a study of the municipal securities markets and provide it to Congress within 18 months of enactment of the Act. The Comptroller General will consider, among other things, the mechanics for trading, quality of trade executions, market transparency and credit enhancements. Not later than 180 days after the Comptroller General’s report on the municipal securities markets, the SEC shall submit a response to Congress including the actions taken by the SEC in response to the Comptroller General’s findings.

### **Subtitle I — Public Company Accounting Oversight Board, Portfolio Margining and Other Matters**

- *Foreign Oversight Authorities.* The PCAOB is authorized to share, at its discretion, documents and information prepared or received by the Board, as well as its deliberations, in connection with an inspection with foreign auditor oversight authority without the information losing its privileged status if, among other things, the PCAOB finds that sharing the information is necessary to protect investors and the foreign auditor oversight authority provides assurances of confidentiality.
- *Auditors of Broker-Dealers.* The Act gives the PCAOB the authority to inspect registered public accounting firms that audit brokers and dealers. The PCAOB would be authorized to refer investigations with respect to an audit of a broker or dealer to that broker’s or dealer’s self-regulatory association.
- *Securities Lending.* Within two years of enactment, the SEC shall issue rules to increase the transparency of information available to brokers, dealers and investors with respect to the loan or borrowing of securities.
- *GAO Study on Proprietary Trading.* The Comptroller General must conduct a study of the risks and conflicts associated with proprietary trading by insured depository institutions, affiliates of insured depository institutions, bank holding companies, financial holding companies, or subsidiaries of bank holding companies and financial holding companies. The study is to evaluate whether proprietary trading presents: (1) a material systemic risk to the stability of the financial system, (2) a material risk to the safety and soundness of such entities and (3) material conflicts of interests between such entities and clients. The study also is to evaluate whether adequate disclosure is provided to depositors, trading and asset management clients, and investors in such entities as well as whether banking, securities, and commodities regulators have adequate systems and controls to monitor and contain any risks and conflicts of interest relating to proprietary trading. The Comptroller General must submit his findings to Congress not later than 15 months after enactment of the Act.

- *SOX External Audit of Internal Controls.* The Act exempts issuers that are neither “large accelerated filers” nor “accelerated filers” from the Sarbanes-Oxley Act’s external audit of internal control requirement. The SEC is to conduct a study to determine how it could reduce the burden of complying with Section 404(b) of the Sarbanes-Oxley Act for companies whose market capitalization is between \$75 million and \$250 million. The Comptroller General further is to conduct a study on whether issuers that are exempt from Section 404(b) requirements have fewer or more restatements of published accounting statements.
- *Equity Indexed Annuities.* The Act states that certain indexed annuities will be treated as exempt securities under the Securities Act. This provision, in effect, nullifies much of Securities Act Rule 151A. To qualify for the exemption: (1) the value of the annuity may not vary based on the performance of a separate account, (2) the annuity contract must satisfy standard nonforfeiture laws and (3) the insurer implements or is subject to minimum suitability requirements for the sale of such products.

This Sidley update is a collaboration of several of our practices serving the financial services industry. Our Financial Institutions practice serves depository and nondepository financial institutions and their holding companies. Sidley’s Structured Finance and Securitization practice is one of the most experienced in the world, and has been involved in virtually every industry innovation since the 1970s. Lawyers in our Securities practice handle all aspects of corporate finance and capital markets, and our Securities and Futures Regulatory practice represents major investment banks, broker-dealers, futures commission merchants, commercial banks, insurance companies, hedge fund complexes and exchanges on all aspects of securities and broker-dealer regulation. Our Investment Funds, Advisers and Derivatives practice team advises clients in the formation and operation of all types of alternative investment vehicles including mutual, private equity and hedge funds. Lawyers in our Executive Compensation practice advise employers, Boards of Directors and their Compensation Committees, as well as individual executives and directors. Our Insurance practice offers comprehensive services to insurers, reinsurers, receivers, brokers, creditors and guaranty associations. Sidley’s Tax practice provides legal services related to U.S. Federal, state and local, and UK tax laws.

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