

SEC Adopts New Disclosure Brochure for Investment Advisers

New Rules Will Expand Disclosure on Fees, Conflicts of Interest & Disciplinary Events

BY JENNIFER L. KLASS, MONICA L. PARRY & BEAU YANOSHIK

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On July 21, the Securities and Exchange Commission (SEC) adopted changes to Form ADV, Part 2, the principal disclosure document that registered investment advisers must provide to their clients and prospective clients.¹ Under new Form ADV, Part 2, the disclosure document is divided into three distinct components: the firm “brochure” (Part 2A), the wrap fee program brochure (Appendix 1 to Part 2A) and the “brochure supplement” (Part 2B).

Form ADV, Part 2A, commonly referred to as the “brochure,” provides clients with an adviser’s qualifications, investment strategies, and business practices. Currently, the brochure requires advisers to respond to a series of “check-the-box” questions organized in a format that frequently does not correspond well to an adviser’s business.

In some cases, the required disclosure may not describe clearly the adviser’s business practices or any conflicts of interests. The

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One Year Subscription ■ 12 Issues ■ \$618.30
(ISSN#: 1095-2985)

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From the EDITOR

SEC's Settlement with Countrywide's Mozilo, Draws Praise & Criticism

True to recent form, the Securities and Exchange Commission's most recent settlement—this time with former Countrywide CEO Angelo Mozilo for \$67.5 million—has been roundly criticized as being a weak, slap-on-the-wrist even as the SEC pats itself on the back for reaching the deal.

The SEC called the Mozilo settlement “the largest ever paid by a public company's senior executive in an SEC settlement.” Robert Khuzami, Director of the SEC's Division of Enforcement, added that the penalty is “the fitting outcome for a corporate executive who deliberately disregarded his duties to investors by concealing what he saw from inside the executive suite.”

Of course, critics of the settlement are quick to point out that about two-thirds of Mozilo's “record penalty,” roughly \$45 million, will be paid for by Bank of America, which acquired Countrywide in 2008 as the toxic mortgage lender was tanking. Critics also note that the sum doesn't even begin to dent the nearly \$140 million regulators concede that Mozilo amassed by dumping Countrywide stock before the whole truth about the company came out. The settlement was approved in the U.S. District Court for the Central District of California by Judge John F. Walter. The court also approved settlements with two other former Countrywide executives, including former CFO Eric Sieracki, in related SEC cases.

This isn't the first time—or even the first time this year—the SEC has been slammed for reaching settlements with accused high-profile wrongdoers wherein the final penalty doesn't seem to measure up to the actual crimes alleged. Federal judges even refused to approve previously reached SEC settlements with Bank of America and Citi-

group in cases related to the financial meltdown because they felt the SEC could have gotten a better deal. Other SEC settlements—like Goldman Sach's \$550 million fine in August, or Steven Ratner's more recent \$5 million penalty—also were regarded by some as too paltry considering the players and the crimes involved. (While Goldman's half-billion fine was large, it did represent just a couple of weeks' worth of the firm's annual profits.)

Worse yet, some contend the SEC is more focused on getting cases off its docket and into its rear-view mirror than actually meting out justice. Thomas O. Gorman, a partner at Porter Wright Morris & Arthur LLP and keeper of the blog, *SEC Actions*, is dismayed that the SEC chose not to pursue injunctive relief under Rule 13(a)-14 (*Certification Of Disclosure in Annual and Quarterly Reports*). Most certainly given some of the evidence in the case, including very damning emails sent by Mozilo, clear violations of Rule 13(a)—14 were evident. The CEO and CFO certification of disclosure requirements, part of the Sarbanes-Oxley Act, were created to hold executives accountable for the accurate financial reporting of their companies. “[A]ccording to the SEC,” Gorman wrote in a blog post, “CEO Mozilo and CFO Sieracki executed certifications attesting to the financial health of the company—precisely the opposite of what SOX sought.”

Whether this is the end of the Mozilo saga or not—he still faces potential criminal investigation—the simmering issue of the toughness and fairness of SEC settlements isn't likely to ebb soon.

In this issue... The November issue of *Wall Street Lawyer* features authors Jennifer L. Klass, Monica L. Parry and Beau Yanoshik of Morgan, Lewis & Bockius LLP, detailing the SEC's revised disclosure document for registered investment advisers. The rule revision breaks Form ADV into three parts to provide clearer disclosure to clients and potential clients about advisers' business practices, conflicts of interest and even past disciplinary actions.

—GREGG WIRTH, MANAGING EDITOR

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amendments are intended to: (i) improve the format and update the requirements of the brochure; and (ii) expand the brochure's content to better include details most relevant to clients.

The principal differences between the previous and new Part 2 are the adoption of the new brochure supplement and increased disclosure of conflicts of interest. The new Part 2A also requires additional disclosure about disciplinary events affecting the adviser and its personnel, as well as risk factors relating to an adviser's primary investment strategies. Advisers with fiscal years ending on or after December 31, 2010 must include the narrative brochure in their next annual updating amendment. The new Part 2B requires clients to receive one or more "brochure supplements" that provide information about the supervised persons responsible for providing advisory services to each particular client.

Brochure—Content Requirements

The narrative brochure is intended to improve the ability of clients and prospective clients to evaluate an adviser and to understand conflicts of interest that an adviser faces, the effects of those conflicts on the adviser's services, and the steps the adviser takes to address the conflicts. The brochure is intended to be a document that is organized in a consistent, uniform manner and that uses plain English to describe the adviser's business practices, activities, fees, conflicts of interests and disciplinary information. For federally registered investment advisers, the narrative brochure must address 18 topics the SEC believes are most relevant to clients when evaluating and comparing advisers. The items in the narrative brochure are drawn largely from disclosures that advisers have long been required to make in response to the previous Part 2, with the addition of several items that are intended to address more recent regulatory concerns.

Included in the 18 topics are the following:

Advisory Business (Item 4)—The brochure must describe the adviser's business, including the types of advisory services offered and whether the adviser holds itself out as specializing in a

particular type of advisory service (e.g., financial planning, quantitative analysis or market timing). Although not the subject of comment in the Adopting Release, the new brochure requires an adviser to explain whether it tailors its services to the individual needs of clients and explain whether clients may impose restrictions on investing in certain securities or types of securities. These requirements relate to the considerations under Rule 3a-4 under the Investment Company Act of 1940, as amended (the 1940 Act), which creates a safe harbor under which discretionary investment advisory programs are not deemed to involve the operation of a mutual fund or the issuance of securities.

The brochure must also disclose the amount of assets the adviser manages. In computing the amount of assets, an adviser may use a method that differs from the method used in Part 1A of Form ADV so long as the adviser keeps documentation describing the methodology used. An adviser need not disclose any aspect of an alternative methodology used to compute assets under management, although it may be prudent to do so to lessen the chance that the SEC or others would claim that the alternative methodology was misleading.²

Advisers also must update the amount of their assets under management annually and on an interim basis when the advisers are filing an "other than annual amendment" for separate reasons. In this connection, the SEC states that "as a fiduciary, an adviser has an ongoing obligation to inform its clients of any material information that could affect the advisory relationship, which could include a material change to assets under management."³ The two positions—that an adviser has an ongoing obligation to advise clients about material changes to assets under management; and that these amendments are only required as part of annual or interim updates—seem to conflict with one another. The new requirement and the conflicting guidance may prove troublesome to advisers that suffer a significant decline in their assets under management, especially in the context of a loss of major clients or the defection of key personnel.

Fees and Compensation (Item 5)—The adviser must describe how it is compensated for its advisory services, the adviser’s fee schedule, and whether the adviser’s fees are negotiable. A brochure provided only to clients who are “qualified purchasers” (as defined under Section 2(a)(51)(A) of the 1940 Act) may omit this information.⁴ In this regard, the SEC recognizes that standard fee schedules are likely “not useful to institutional and large, sophisticated clients who are often in a position to negotiate fee arrangements with their adviser.”⁵ While permitting the omission is helpful, it is unclear how advisers that offer services to a broad range of investors (both qualified and non-qualified) would take advantage of this flexibility. Such an adviser likely would have to create two separate brochures and “qualify” investors before providing the brochure omitting the fee schedule.

The adviser must also describe whether it bills clients or deducts fees directly from clients’ accounts, how often it assesses fees, and the types of other fees and expenses a client may pay, such as brokerage and custody fees and fund expenses in connection with the advisory services provided by the adviser. With respect to the last point, advisers should consider clarifying that many of these other fees and expenses are not paid to the adviser itself.

Additionally, if an adviser receives compensation attributable to the sale of a security, it will be required to disclose this practice, the conflicts of interest it creates and how they are addressed. The brochure and supplement both elicit disclosure of compensation received by an adviser and its supervised persons that can raise conflicts of interest, including transaction-related compensation. In discussing these requirements, the SEC stated that it was not expressing a preference for a fee-based compensation structure over a transaction-based compensation structure. Instead, “the item simply recognizes that an adviser that accepts compensation from the sale to a client of securities has an incentive to base investment recommendations on the amount of compensation it will receive, rather than on the client’s best interests, and thus involves a significant conflict of interest.”⁶ Although these requirements are not,

in substance, different from the requirements in previous Part 2,⁷ the more detailed focus in this area on the related conflicts and how the adviser addresses these conflicts could arguably be read as a tacit endorsement of the receipt by advisers of transaction-based compensation notwithstanding the conflicts involved, subject to appropriate disclosure. Indeed, the SEC stated that “nothing in the [the Investment Advisers Act of 1940 (the Advisers Act)] precludes an investment adviser from accepting transaction-based compensation.”⁸ Advisers that receive transaction-based compensation, however, must consider whether they are subject to applicable broker-dealer registration requirements.⁹

Performance-Based Fees and Side-by-Side Management (Item 6)—Advisers that charge performance-based fees will be required to disclose this fact. If the adviser also manages accounts that are not subject to performance-based fees, the adviser must explain any conflicts of interest that arise from the simultaneous management of these accounts and how they are addressed. Interestingly, in its discussion of conflicts that can arise in connection with performance-based fees, the SEC notes that an adviser who charges performance-based fees “may have an incentive to direct the best investment ideas to, or to allocate or sequence trades in favor of, the account that pays a performance fee.”¹⁰ This is the first time we are aware of that the SEC has specifically identified the sequencing of transactions as a form of favoritism to clients that pay performance-based (or higher) advisory fees.

Types of Clients (Item 7)—An adviser must describe the types of clients to whom it provides advisory services. In addition, the adviser must disclose any requirements for opening or maintaining an account, such as minimum account size.

Methods of Analysis, Investment Strategies and Risk of Loss (Item 8)—The brochure must explain the adviser’s methods of analysis and investment strategies and state that the client bears the risk of loss on his or her investment. For the first time, the SEC is expressly requiring advisers to describe the material risks that may arise in connection with the adviser’s investment strategies, includ-

ing specific disclosures of how frequent trading can affect investment performance. In this connection, the SEC requires that advisers “explain the material risks involved for each significant investment strategy or method of analysis they use and particular type of security they recommend, with more detail if those risks are *unusual*.”¹¹ The SEC refrained from defining “frequent trading of securities,” but instead stated that “we would expect advisers to respond to this Item only if their intended investment strategies involve frequent trading of securities that a reasonable client would otherwise not expect in light of the other disclosures contained in the brochure.”¹²

An adviser must include each significant investment strategy or method of analysis it uses. The Adopting Release states that a method of analysis or strategy would be considered “significant” if more than a small portion of the adviser’s clients’ assets are advised using the method or strategy.¹³ The SEC noted that the brochure may not always be the best place for a multi-strategy adviser to disclose risks associated with all of its methods of analysis or strategies because it would unnecessarily lengthen the brochure. “Accordingly, [the SEC] would not require these advisers to list in the brochure the risks involved in each type of security or trading strategy. In such cases, required risk disclosure with respect to particular strategies could be made separately to those clients to whom such disclosure is relevant”¹⁴ (such as an investment policy statement or separate risk disclosure statement). It is not clear, however, whether the ability to disclose material risks outside the brochure applies to all of the adviser’s methods of analysis or strategies or only those that are considered to be “insignificant.” If it is the latter, the result may be that the brochure includes a substantial amount of prospectus-like risk disclosure that would significantly lengthen brochures for multi-strategy investment advisers and obscure the presentation of other information critical to a client’s understanding of the services and conflicts associated with an adviser’s business.

Disciplinary Events (Item 9)—The brochure will include disclosure about any legal or disciplinary event that is material to a client’s evaluation of the adviser’s business or the integrity of

the adviser’s management persons.¹⁵ Much of this information overlaps with disclosure required by Item 11 of Part 1A, however, the brochure requirement is limited to the firm and its management personnel. The amended Part 2 provides a nonexclusive list of material disciplinary events that are presumptively material to clients. This disclosure generally addresses disciplinary events within the last 10 years, but it also potentially reaches back beyond 10 years if it is so serious that it remains material to a client’s evaluation of the firm’s advisory business or the integrity of its management. Disclosure about arbitration awards and claims is not required.

An adviser may rebut the presumption that a disciplinary event is material and avoid disclosure of the event. The note to the Item states that when considering the materiality of a disciplinary event for this purpose, an adviser should consider the proximity of the person involved in the event to the advisory function, the nature of the infraction that led to the disciplinary event, the severity of the disciplinary sanction and the time elapsed since the date of the disciplinary event.¹⁶ If an adviser determines that the materiality presumption has been overcome, the adviser must prepare and maintain in its files a memorandum of that determination in accordance with the amended record-keeping rule, Rule 204-2(a)(14)(iii).

Because Item 9 incorporates disciplinary disclosures formerly required by Rule 206(4)-4 directly into the brochure, the SEC is rescinding Rule 206(4)-4. The rescission of Rule 206(4)-4 will be effective, with respect to any particular investment adviser, on the date by which that adviser must deliver its narrative brochure to existing clients and begin delivering its brochure to prospective clients under the amendments as adopted. Although the SEC is rescinding Rule 206(4)-4 because it has incorporated the related disclosures into the brochure, the SEC made clear its view that the fiduciary principles underlying that rule’s disclosure requirements would continue to apply for any clients of an investment adviser to whom the adviser is not required to deliver the brochure, such as clients receiving only impersonal investment advice, registered investment companies and business development companies.¹⁷

Other Financial Industry Activities and Affiliations (Item 10)—The brochure must describe any relationship or arrangement it has with another financial industry participant, the conflicts of interest this creates and how the conflicts are addressed. In addition, if an adviser selects or recommends other advisers for clients, the brochure must disclose any compensation arrangements or other business relationships between the advisory firms that create material conflicts of interest and how they are addressed. The disclosure required by this Item is intended to highlight an adviser's other financial industry activities and affiliations that can create conflicts of interest that may impair the objectivity of the adviser's investment advice.

Code of Ethics, Participation in Client Transactions and Personal Trading (Item 11)—The brochure must summarize the adviser's Code of Ethics and state that the code is available upon request. The requirement that an investment adviser provide a copy of its Code of Ethics is a new requirement and is not reflected in the SEC's rule governing investment adviser codes. The new requirement to deliver a copy of the code on request may prompt many investment advisers to set forth their Code of Ethics in a separate document or discrete policy if they have not already done so.

The brochure also must state: (i) whether the adviser or an affiliate recommends to clients, or buys or sells for client accounts, securities in which the adviser or an affiliate has a material financial interest and, if so, the conflicts of interest associated with that practice and how these conflicts are addressed; and (ii) whether the adviser or an affiliate may invest in the same securities that it recommends to clients or in related securities, such as options or other derivatives, and, if so, explain the conflicts involved and how these conflicts are addressed. If the adviser trades in the recommended securities at or around the same time as the client, the adviser must also describe the specific conflicts inherent in that practice and how it addresses these conflicts.

Brokerage Practices (Item 12)—The adviser must describe the factors it considers in selecting or recommending broker-dealers for client transactions and determining the reasonableness of

brokers' compensation. The brochure also must describe the adviser's soft dollar practices; use of client referrals; directed brokerage practices; trade aggregation practices; and how the adviser addresses the conflicts of interest associated with these practices.

With respect to the adviser's soft dollar practices, the SEC has made clear that the "description must be specific enough for clients and prospective clients to understand the types of products or services the adviser is acquiring and permit them to evaluate associated conflicts of interest,"¹⁸ with more detailed disclosure for products or services that do not qualify for the safe harbor under § 28(e). In this connection, the SEC requires the disclosure of the types of conflicts an adviser encounters when accepting soft dollar benefits and how it addresses those conflicts. This includes disclosure of whether the adviser uses soft dollars to benefit all clients or only those accounts whose brokerage commissions pay for the benefits and whether the adviser seeks to allocate benefits to clients proportionately to the soft dollar credits those accounts generate. The Item also requires, in the SEC's words, the adviser to explain whether it "pays up" for soft dollar benefits by paying more than the lowest available commission rate in exchange for soft dollar products or services.¹⁹ For the most part, these required disclosures correspond to common disclosure practices relating to soft dollar arrangements, but advisers will have to be careful to answer these questions in a way that reflects any flexibility they may need under the § 28(e) safe harbor (e.g., by not disclaiming paying up).

With respect to the adviser's directed brokerage practices, the SEC requires an explanation that the adviser "may be unable to obtain the most favorable execution of client transactions if the client directs brokerage."²⁰ While true, advisers need to be careful when framing this disclosure to avoid suggesting that it otherwise is in a position to "obtain the most favorable execution of client transactions," when in actuality the adviser's obligation generally is simply to *seek* best execution.

With respect to the adviser's trade aggregation practices, the SEC requires an adviser to describe whether and under what circumstances the advis-

er aggregates trades with the stated assumption that clients can benefit “when the adviser aggregates trades to obtain volume discounts on execution cost.”²¹ While disclosure of trade aggregation is appropriate, one can reasonably question whether in today’s institutional trading markets aggregation or disaggregation has any affect on the level of client commissions, which are increasingly negotiated on a broader relationship basis depending upon the type of execution required. At best, the assumptions seem over simplistic, and institutional investment advisers will want to have a more nuanced discussion of trade aggregation and trade disaggregation and the related considerations.

Review of Accounts (Item 13)—Advisers must disclose whether, and how often, they review client accounts or financial plans. An adviser that reviews accounts on other than a periodic basis must describe the circumstances that trigger a review. This Item also requires advisers to describe the content and frequency of any reports they provide to clients.

Client Referrals and Other Compensation (Item 14)—The brochure must describe any arrangement under which an adviser compensates another party for client referrals, including the type of compensation. The brochure must also disclose any arrangement whereby the adviser receives any economic benefit for providing advisory services from a person who is not a client, the conflicts of interest this creates and how the conflicts are addressed.

Custody (Item 15)—Advisers with custody of client funds or securities must explain that clients will receive account statements directly from the qualified custodian. If the adviser also provides an account statement it must include a statement urging clients to compare both statements to determine whether account transactions are proper.²²

Investment Discretion (Item 16)—An adviser must disclose if it has discretionary authority over client accounts and any limitations clients may place on this authority. An adviser may cross reference to Item 4 if this information is already provided in the description of advisory services.

Voting Client Securities (Item 17)—The brochure must disclose the adviser’s proxy voting practices; whether the adviser has or will accept authority to vote client securities; whether (and how) clients can direct the adviser to vote in a particular solicitation; how the adviser addresses conflicts of interest when it votes securities; and how clients can obtain information from the adviser on how the adviser voted their securities. Advisers that do not accept authority to vote securities must disclose how clients receive their proxies and other solicitations. This disclosure is consistent with that required under Rule 206(4)-6 of the Advisers Act.

Financial Information (Item 18)—Advisers that require prepayment of more than \$1,200 in fees per client, six months or more in advance, must include an audited balance sheet showing the adviser’s assets and liabilities as of the end of the most recent fiscal year. Advisers with discretionary authority over client assets, custody of client funds or securities, or requiring prepayment of more than \$1,200 in fees per client and six months or more in advance must also describe any financial condition reasonably likely to impair the adviser’s ability to meet contractual commitments. In addition, an adviser must disclose whether it has been the subject of a bankruptcy petition during the past 10 years.²³

Wrap Fee Program Brochure

Appendix 1 to Part 2A contains the requirements for a wrap fee program brochure. Advisers whose entire advisory business is sponsoring wrap fee programs will prepare a wrap fee program brochure but will not be required to prepare a standard advisory firm brochure. Advisers that sponsor wrap fee programs and provide other types of advisory services will be required to prepare both types of brochures, and will deliver both to clients who receive both types of services.

The items in Appendix 1 are substantially similar to those in Schedule H, the separate wrap fee program brochure in previous Part 2, and incorporate many of the requirements of the Part 2 brochure. Appendix 1 requires an adviser that sponsors a wrap fee program to identify whether

any of its related persons is a portfolio manager in the program and, if so, to describe the associated conflicts and how they are addressed. As an example, the SEC notes that “an adviser may have an incentive to select a related person to participate as a portfolio manager based on the person’s affiliation with the adviser, rather than based on expertise or performance.”²⁴ In addition, advisers are required to disclose whether related-person portfolio managers are subject to the same selection and review criteria as the other portfolio managers who participate in the wrap fee program and, if they are not, how they are selected and reviewed.

In response to comments received and long-standing industry lobbying, the SEC confirmed that an adviser can delegate its brochure delivery requirement to the sponsor of a wrap fee program and that the adviser could satisfy its recordkeeping obligation to evidence delivery of its brochure by relying on records maintained in an appropriate office of the sponsor, not the investment adviser. The SEC stated “that a sponsor may deliver the adviser’s brochures and maintain certain records as long as the sponsor, upon request of the Commission’s staff, will produce promptly the records for the staff at the appropriate office of the adviser or the sponsor.”²⁵ The SEC noted, however, that advisers still have a legal delivery obligation, and should take the necessary steps to ensure a sponsor is performing the tasks delegated to it by the adviser.²⁶

Brochure Supplements—Content Requirements

Advisers will be required to provide clients with separate brochure supplements containing information about the individuals who provide advisory services to clients, thereby allowing clients to assess each individual’s background and qualifications.²⁷ These résumé-like documents will be required for each supervised person who: (i) formulates investment advice for the client and has direct client contact; or (ii) makes discretionary investment decisions for the client’s assets, even if the supervised person has no direct client contact.²⁸ If a team of more than five supervised

persons provides investment advice, brochure supplements need only be provided for the five supervised persons with the most significant responsibility for the day-to-day advice provided to the client.²⁹ The term “formulating investment advice” is a new concept not otherwise used in the Advisers Act. As a result, there are a number of interpretive questions as to which employees require a supplement.

Brochure supplements must include the following:

- *Cover Page (Item 1)*—Each brochure supplement must include a cover page identifying and providing contact information for the supervised person(s) covered by the supplement, as well as the adviser. The cover page must also include a statement informing the client that they should have also received a brochure, as well as contact information to request a brochure or ask any questions.
- *Education Background and Business Experience (Item 2)*—Each brochure supplement must describe the individual’s formal education and business background for the past five years, including positions at prior employers. This requirement includes information required to be disclosed in Item 6 of the previous Part 2, but significantly expands the category of people for whom disclosure is required.³⁰ Information regarding professional designations, although not mandated, may be included so long as it also includes a “sufficient explanation of the minimum qualifications required for the designation to allow clients and potential clients to understand the value of the designation.”³¹ The SEC also notes that the disclosure “cannot be materially false or misleading by suggesting, for example, that the designation implies more qualifications or experience than the actual designation standards require.”³² An adviser is required to include disclosure of any event in which the supervised person has resigned or otherwise relinquished a professional attainment, designation or license in anticipation of it being suspended or revoked (other than for failure to pay membership dues) that

the adviser knew or should have known. Like other Items covered by the supplement, this will require an adviser to elicit information from supervised persons and to be alert for any red flags that call into question whether the loss of a professional designation is a discloseable event.

- *Disciplinary Events (Item 3)*—Each brochure supplement must include material facts about any legal or disciplinary event that is material to a client’s evaluation of the individual’s integrity.³³ Similar to disciplinary events related to the adviser in the brochure, the amended Part 2 provides a nonexclusive list of disciplinary events that are presumptively material to clients and also permits the rebuttal of this presumption. In addition, as in the brochure, this disclosure generally addresses disciplinary events within the last 10 years, but it also potentially reaches back beyond 10 years in the case of a disciplinary event that is material to a client’s evaluation of the supervised person’s integrity. If the adviser is providing a brochure supplement electronically, the adviser may omit this information and provide a hyperlink to the SEC or FINRA website provided the Investment Adviser Public Disclosure (IAPD) or BrokerCheck system contains the individual’s disciplinary events.
- *Other Business Activities (Item 4)*—Each brochure supplement must describe other business activities of the individual, any conflicts of interest this creates and how the conflicts are addressed. This expands upon the previous Form ADV requirement to disclose whether the principal business of the principal executive officers of the adviser involves something other than providing investment advice. This requirement includes all activities, both investment related and unrelated, that involve a “substantial” amount of the supervised person’s time or pay. Both the Adopting Release and Part 2B state that if a business activity represents less than 10% of the supervised person’s time and income, it may be presumed not substantial.³⁴ A supplement must also include information about any compensation (e.g., commissions, bonuses, distribution and service or “trail” fees from mutual funds and non-cash compensation) an individual receives based on the sale of securities and the incentives this type of compensation creates.
- *Additional Compensation (Item 5)*—Each brochure supplement must describe any arrangement in which someone other than a client provides an individual with an economic benefit for providing advisory services. This disclosure is intended to address sales awards or prizes and similar incentive structures that may create conflicts of interest and bias the advice presented. It expands upon the previous Form ADV requirement to disclose additional compensation by applying the requirement to each supervised person rather than general firm-wide disclosure that covers a variety of supervised persons with a range of compensation arrangements. Although Item 5 specifically identifies sales awards and prizes, neither the Adopting Release nor Part 2B provides a clear definition of what constitutes additional compensation (e.g., gifts and entertainment), and this Item will likely raise questions when advisers are determining how to respond.
- *Supervision (Item 6)*—Each brochure supplement must explain how the adviser monitors the advice provided by an individual as well as the name, title and telephone number of the person responsible for supervising the individual’s advisory activities.

Conflicts of Interest Disclosure

The SEC’s approach throughout the brochure and supplement often is to require disclosure about conflicts and how an adviser and its supervised persons address them, but not about the specific procedures. That said, there are a number of items in both forms that require greater specificity and reflect an inconsistent approach to disclosure of conflicts.³⁵ For example, in connection with the disclosure of personal trading, the SEC

requires disclosure of conflicts when an adviser or a related person trades in the same securities and, according to the SEC, should include an explanation of how the adviser's "internal controls, including its code of ethics, prevent the firm and its staff from buying or selling securities contemporaneously with client transactions."³⁶ Additionally, an adviser that uses client brokerage business to compensate or otherwise reward brokers for client referrals, is required to disclose this practice, the related conflicts and "any procedures the adviser used to direct client brokerage to referring brokers during the past fiscal year."³⁷

Delivery Requirements and Material Changes

Brochures

Advisers must deliver brochures to new and prospective clients before or at the time the adviser enters into an advisory contract with a client.³⁸ The SEC has revised the requirements for brochure delivery to require that brochures be delivered at or before the time an adviser enters into an advisory contract with the client, abandoning the prior requirement that, if such delivery occurred less than 48 hours before entering into an advisory contract, the client had to have the right to terminate the agreement without penalty within five business days thereafter.³⁹ This is a welcome change, albeit one that may require that advisers revise their investment advisory agreements (or any separate acknowledgments of brochure delivery) to delete reference to this outmoded concept.

Annually, 120 days after the end of its fiscal year, an adviser must provide existing clients with either (i) a copy of the current brochure that includes or is accompanied by a summary of material changes; or (ii) a summary of material changes that includes an offer to provide the client a copy of the brochure, along with the contact information that a client can use to obtain the current brochure and the Investment Adviser Registration Depository (IARD) website address.⁴⁰ If there are no material changes from the previous annual amendment and the brochure continues

to be accurate in all material respects, the adviser will not have to prepare or deliver a summary of material changes or an updated brochure to clients. Summaries of changes, like all other summaries of complicated legal documents, are fraught with risks to the extent the summary excludes certain information or plays down certain facts. The SEC's guidance may contribute to this tension. Specifically, the SEC states "we emphasize that we intend this document to be a summary that identifies and broadly discusses the material changes, and that it should not be a lengthy discussion that replicates the brochure itself. Instead, the summary need contain no more than is necessary to inform clients of the substance of the changes to the adviser's fees, practices or conflicts of interest so that they can determine whether to review the brochure in its entirety or to contact the adviser with questions about the changes."⁴¹

In this regard, the notions of brevity and disclosure of the "substance" of changes may be at odds with one another. At the very least, advisers should include statements in the summary to the effect that the summary is modified in its entirety by the substance of the revised brochure.

Brochures must be updated promptly if the information becomes materially inaccurate (an "interim amendment"). Interim amendments must be delivered to clients if there is a change to any required disciplinary action.⁴² Advisers should note, however, that between annual updating amendments they have a fiduciary duty to disclose material changes to clients even if those changes do not trigger delivery of an interim amendment.

Although requested during the comment period, the SEC declined to adopt changes to its guidance on electronic delivery in order to permit brochures that are publicly available through the adviser's or the SEC's website to be deemed to be delivered to clients (so-called "access equals delivery") or to permit advisers to send clients a notice informing them that the brochure is available on the adviser's or the SEC's website (so-called "notice equals delivery"). Accordingly, advisers may rely on electronic delivery for the brochure and brochure supplements only for those clients that have consented in accordance with the SEC guid-

ance regarding the electronic delivery of required documents.⁴³

Both the Adopting Release and the new form make clear that a brochure prepared under Form ADV's requirements may not fully satisfy an adviser's disclosure obligations under the Advisers Act or other applicable law.⁴⁴ Nevertheless, there is certainly a reasonable argument that Form ADV's requirements create a presumption that an adviser's disclosure of matters that are specifically addressed in Form ADV in the specific manner required by the form should satisfy the adviser's obligations, at least for purposes of the Advisers Act.

Brochure Supplements

Advisers must deliver brochure supplements to new and prospective clients before or at the time the adviser enters into an advisory contract with a client.⁴⁵ Advisers must provide existing clients with brochure supplements before or at the time a new individual begins offering advisory services to that client.⁴⁶ Brochure supplements must be updated promptly if the information becomes materially inaccurate.⁴⁷ Although there is no requirement to update or deliver brochure supplements annually, amendments to brochure supplements must be delivered to clients if there is a change to any required disciplinary information.⁴⁸ Amendments may be delivered in the form of a "sticker" that identifies the information that has become inaccurate and provides the new information and the date of the sticker. As with the brochure, advisers should note that they have a fiduciary duty to disclose material changes to clients even if those changes do not trigger delivery of an updated supplement.

An adviser may elect to prepare a supplement for each supervised person or separate supplements for different groups of supervised persons. Alternatively, an adviser may include the information required to be provided in the brochure supplement within the firm's brochure, an approach that may be attractive to smaller firms. An adviser that does not have any clients to whom a supplement will have to be delivered will not have to prepare any supplements.⁴⁹

Filing Requirements

Advisers must file brochures electronically with the SEC in PDF format. The brochures will be publicly available on the SEC's website.⁵⁰ Brochures must be updated and filed with the SEC *promptly* if the information becomes materially inaccurate. Brochure supplements will not be filed with the SEC, but advisers should maintain copies as a record to provide examiners for review.

Compliance Dates

SEC-registered investment advisers with fiscal years ending on or after December 31, 2010, will be required to include the narrative brochure when they file their next annual updating amendment. Advisers will then have an additional 60 days to deliver new brochures to existing clients. New advisers applying for registration after January 1, 2011, will be required to file and deliver narrative brochures.

NOTES

1. Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) ("Adopting Release") available at <http://www.sec.gov/rules/final/2010/ia-3060.pdf>.
2. As noted in the Adopting Release, the SEC has brought a range of enforcement cases against investment advisers for false or misleading statements concerning their assets under management. See Adopting Release n.48.
3. Adopting Release, at 15.
4. "Qualified purchasers," as defined under Section 2(a)(51)(A) the 1940 Act, include, among others, natural persons who own \$5 million or more in investments and persons who manage \$25 million or more in investments for their account or other accounts of other qualified purchasers.
5. Adopting Release, at 17.
6. Adopting Release, at 18.
7. See Adopting Release n.62.
8. Adopting Release n.63.
9. Adopting Release n.63.
10. Adopting Release n.67.
11. Adopting Release, at 20.
12. Adopting Release, at 21.
13. See Adopting Release n.74.
14. Amendments to Form ADV, Investment Advisers Act Release No. 2711 (March 3, 2008) ("Proposing Release") available at <http://www.sec.gov/rules/proposed/2008/ia-2711.pdf>.

15. "Management Persons" are defined as anyone with the power to exercise, directly or indirectly, a controlling influence over the firm's management or policies, or to determine the general investment advice given to clients. Generally, all of the following are management persons: (i) the adviser's principal executive officers, such as the chief executive officer, chief financial officer, chief operations officer, chief legal officer, and chief compliance officer; directors, general partners, or trustees; and other individuals with similar status or performing similar functions; (ii) members of the adviser's investment committee or group that determines general investment advice to be given to clients; and (iii) if the adviser does not have an investment committee or group, the individuals who determine general investment advice provided to clients (if there are more than five people, an adviser may limit its response to their supervisors).
16. See Note to Item 9 for Part 2A of Form ADV.
17. See Adopting Release, at 28.
18. Adopting Release, at 34.
19. See Adopting Release, at 34 and Item 12.A.1.c for Part 2A of Form ADV.
20. Adopting Release, at 36.
21. Adopting Release, at 37.
22. This disclosure is similar to the statement required to be made by advisers under the recently amended custody rule. *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) available at <http://www.sec.gov/rules/final/2010/ia-2968.pdf>.
23. This item maintains the requirements in previous Form ADV, but raises the prepayment thresholds to \$1,200 from \$500.
24. Adopting Release, at 45-46.
25. Adopting Release, at 46.
26. See Adopting Release, at 46.
27. The disclosure requirements in the brochure supplement pertain to an adviser's "supervised persons." Supervised persons are defined in the New Part 2, which adopts the same definition of supervised persons as Section 202(a)(25) of the Advisers Act—any officers, partners, directors (or other persons occupying a similar status or performing similar functions), or employees of an investment adviser, or any other person who provides investment advice on the investment adviser's behalf and is subject to the investment adviser's supervision or control.
28. Adopting Release, at 63.
29. Adopting Release, at 64.
30. Previous Part 2 required such information for each member of the investment committee or each individual that determines investment advice given to clients; and each principal executive officer or each person with similar status performing similar functions. New Part 2 requires such information for supervised persons. See definition of supervised person at *supra* note 26.
31. Adopting Release, at 57.
32. Adopting Release, at 57.
33. Item 11 for Part 1A of Form ADV includes disciplinary information that is provided to the SEC for registration purposes, but does not focus specifically on what would be important to a client for purposes of evaluating an adviser's business or integrity. Accordingly, Item 11 includes broad disclosure about advisory affiliates (current employees, officers, partners or directors and all persons directly or indirectly controlling or controlled by adviser). The disclosure requirement for the supplement focuses on disciplinary information relating specifically to a supervised person covered by the brochure supplement requirement. In addition, many of the disciplinary information in Item 3 for Part 2B overlaps with the disclosure questions in Item 14 for Form U4, the "Uniform Application for Securities Industry Registration or Transfer". Form U4 is used by representatives of broker-dealers, investment advisers, or issuers of securities to become registered in appropriate jurisdictions and/or self-regulatory organizations.
34. See Adopting Release, at 61 and Item 4.B for Part 2B of Form ADV.
35. The SEC appears to recognize this inconsistency as, with respect to Item 11.B, it states "we agree with these commentators that the requirement was inconsistent with the Commission's general approach throughout the brochure of requiring disclosure about conflicts and how they are addressed, but not about procedures." Adopting Release, at 31. On the SEC's general approach of disclosing how conflicts are addressed but not the related procedures, see Item 11 for Part 2A of Form ADV and the Adopting Release n.119.
36. Adopting Release, at 32. Note also that the practice of trading alongside of clients is permissible in accordance with the considerations outlined in the SMC Capital, Inc. No-Action Letter, 1995 Fed. Sec. L. Rep. (CCH) ¶ 77,049 (Sept. 5, 1995).
37. Adopting Release, at 36.
38. See Adopting Release, at 47. Unlike the pre-existing requirements of Rule 204-3, which carves out from brochure delivery requirements contracts for impersonal advisory services, the SEC amended this rule to require delivery of the brochure to any client who receives impersonal investment advice and is charged \$500 or more for such advice. As a result,

various types of impersonal investment advice will become subject to brochure (but not supplemental brochure) delivery requirements, including subscriptions for investment advisory publications and hard dollar research provided by broker-dealers that are registered as investment advisers.

Under current SEC interpretation, SEC-registered advisers organized outside of the United States must prepare a Part 2 but do not need to deliver it to any clients other than clients that are "U.S. Persons" as that term is defined in Regulation S under the Securities Act of 1933. We expect that the SEC will continue to support the position that foreign advisers only need deliver a Part 2A to U.S. Persons. The Adopting Release indicates that an adviser is not required to prepare or file a Part 2A if the adviser has no clients to whom it must deliver a brochure. It is unclear whether a registered adviser organized outside of the United States with no U.S. Person clients must prepare and file the Part 2A.

39. See Adopting Release n.188.
40. See Adopting Release, at 48. The Adopting Release includes a brief footnote discussion of materiality, including the statement that "the standard of materiality under the Advisers Act is whether there is a substantial likelihood that a reasonable investor (here, client) would have considered the information important. This is a facts and circumstances test, requiring an assessment of the "total mix of information," in the characterization of the Supreme Court. Given that materiality depends on the factual situation, which may vary with each situation, we do not believe that it is appropriate to specifically define or provide any bright line test for what is and is not material." Adopting Release n.35 (citations omitted).
41. Adopting Release, at 12.
42. Adopting Release, at 67.
43. See, e.g., "Use of Electronic Media for Delivery Purposes," Securities Act Release No. 7233 (Oct. 6, 1995) available at <http://www.sec.gov/rules/interp/33-7233.txt>.
44. See Adopting Release n.7 and Instruction 3 of General Instruction for Part 2 of Form ADV.
45. Instruction 2 of Instructions for Part 2A of Form ADV.
46. See Adopting Release, at 66.
47. See Adopting Release, at 67.
48. Adopting Release, at 67.
49. Advisers are not required to deliver supplements to three types of clients: (i) clients to whom the adviser is not required to deliver a brochure (e.g., investment companies registered under the 1940 Act and certain business development companies); (ii) clients

that receive only impersonal investment advice for which the adviser charges less than \$500 per year; and (iii) certain "qualified clients" that also are officers, directors, employees and other persons related to the adviser. "Qualified clients" are (i) any executive officers, directors, trustees, general partners, or persons serving in a similar capacity, of the advisory firm; or (ii) any employees of the advisory firm (other than employees performing solely clerical, secretarial or administrative functions) who, in connection with their regular functions or duties, participate in the investment activities of the firm and have been performing such functions or duties for at least 12 months.

50. The SEC also clarified that the provision of information concerning private funds that are required by Part 2 would not preclude reliance on the private offering exemptions under the Securities Act of 1933. Specifically, the SEC stated "we believe registrants can provide information required by the Part 2 without jeopardizing reliance on those exemptions," but cautioned that "the inclusion of private fund information beyond that required in Part 2, however, such as subscription instructions, performance information, and financial statements, may jeopardize such reliance by constituting a public offering or conditioning the market for the securities issued by those funds." Adopting Release, at 70.

EU's Highest Court Refuses to Extend Privilege to Communications with In-House Lawyers

BY HUGH F. BANGASSER, NEIL A. BAYLIS & VANESSA C. EDWARDS

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In September, the Court of Justice of the European Union (ECJ) delivered its long-awaited judgment in *Akzo Nobel Chemicals Ltd and Akros Chemicals Ltd v. Commission*.¹ The case was based on an appeal brought over the seizure of copies of emails exchanged between in-house counsel and their employers in a “dawn raid” of offices of the appellants (Akzo Nobel) by the European Commission’s Competition Directorate. The ECJ held that communications between in-house lawyers and their employers are not protected by legal professional privilege in EU competition law investigations. The judgment suggests that the legal professional privilege would be similarly restricted in other types of EU investigations. Companies with dealings in the EU should be alert to the ruling and how it may affect their coordination between outside counsel and in-house lawyers in the provision of legal services, particularly in regulatory matters subject to EU jurisdiction.

In the litigation, Akzo Nobel claimed that certain seized documents were protected by legal privilege because the documents were internal communications between an in-house Akzo Nobel lawyer and a line manager. The Commission decided that such documents were not privileged in the context of its competition law investigations. Akzo Nobel appealed that decision to the EU General Court which, in turn, affirmed the Commission’s decision by upholding the existing case-law denying the application of legal professional privilege to communications between a company and in-house lawyers or non-European Economic Area (EEA) external lawyers. Akzo Nobel then appealed to the ECJ.

Despite the detailed pleadings presented to the Court by Akzo Nobel, the governments of the U.K., Ireland and the Netherlands, and numerous business and legal organizations, the ECJ declined to update the law on legal privilege and to permit broader legal privilege protection than had been granted in the leading earlier decision in 1982 which had expressly excluded communications with in-house counsel from those protections. The ECJ held that in-house counsel, even when members of a national bar, did not have a level of independence similar to members of law firms, and as such the privilege could not be invoked for their communications.

Despite the rapid growth and sophistication of in-house legal departments in the past three decades since that decision, the ECJ merely confirmed its earlier narrow application of legal privilege solely to external lawyers. The judgment has effectively settled the law on this issue for the foreseeable future, pending any EU legislation to overrule the judgment (which is unlikely).

In confirming and restating the law in this manner, the Court has strengthened the position of the Commission in any competition investigation (and other regulatory investigations it may carry out under EU law) by allowing the Commission to seize and/or seek disclosure of correspondence passing between a company and its in-house lawyers.

As well as giving the Commission renewed confidence to seize and/or seek copies of written communications in conducting its investigations, it is foreseeable that plaintiffs’ lawyers in the U.S.

and other jurisdictions may use the judgment to argue that in respect of in-house lawyer communications, there was never any legitimate expectation that the materials would be privileged (even where privilege would normally apply).

The judgment therefore makes it clear that in relation to any subject matter that might give rise to a Commission investigation, or indeed litigation flowing from that investigation (which may and frequently does arise from conduct or agreements carried out or made outside the EEA), companies should ensure that advice is sought from (or provided through) independent, external legal advisers who are qualified to practice within the EEA. The rigid position taken by the ECJ will also likely impede the regulatory compliance roles increasingly performed by experienced in-house counsel and shift the role in internal investigations to outside law firms who retain the benefits of legal privilege but who often lack a thorough knowledge of the business and the implications of various business practices.

As to advice provided to a company operating in the EU by lawyers not qualified to practice in the EEA, the Advocate General's Opinion earlier this year asserted the position that legal privilege would not be justified under any circumstance to such advice. The ECJ's decision was, however, silent on that issue.

Finally, some commentators have suggested that the judgment removes all legal professional privilege as a matter of EU law. That is not correct. The ECJ noted that the Commission's powers under EU law may be distinguished from those in national investigations and that the judgment was not intended to remove national rules on legal professional privilege as they apply to national regulatory investigations or to civil litigation generally.

NOTES

1. *Akzo Nobel Chemicals Ltd and Akros Chemicals Ltd v. Commission* (Case C-550/07 P). For the full case law, See <http://curia.europa.eu/jurisp/cgi-bin/form.pl?lang=en&Submit=Rechercher&alldocs=alldocs&docj=docj&docop=docop&docor=docor&docjo=docjo&numaff=C-550/07%20P&datefs=&datefe=&nomusuel=&domaine=&mots=&resmax=100>.

Corruption of Legal Profession a Problem, Global Survey Says

BY THE INTERNATIONAL BAR ASSOCIATION

The survey and this report were prepared by the International Bar Association (IBA), with input from the Organisation for Economic Cooperation and Development (OECD) and the United Nations Office on Drugs and Crime (UNODC). The findings of this survey, its interpretations and conclusions expressed do not necessarily represent the views of the IBA, the OECD, the UNODC, or their member countries, including the States Party to the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the UN Convention against Corruption (UNCAC). The IBA, OECD and UNODC do not guarantee the accuracy of the data included in this article and accept no responsibility for any consequences of their use. The term 'country' or 'jurisdiction' does not imply any judgment by the OECD or the UN as to the legal or other status of any territorial entity. The full report from the survey can be found at <http://www.ibanet.org/Article/Detail.aspx?ArticleUid=ED0B2923-91C9-4E61-9FCA-0FDB399C9FED>.

In April 2010, the International Bar Association (IBA), in cooperation with the Organisation for Economic Cooperation and Development (OECD) and the United Nations Office on Drugs and Crime (UNODC), launched the AntiCorruption Strategy for the Legal Profession, a project focusing on the role lawyers play in fighting corruption in international business transactions and the impact on the legal practice of international anti-corruption instruments and associated implementation of national legislation with extra-territorial application.

Survey Results

In the globalized economy of the early 21st Century, an uncountable number of international business transactions take place every day. Each poses an array of new opportunities for lawyers, but also challenges. Lawyers' involvement in these transactions exposes them to the risks and threats of international corruption. Unfortunately, however,

lawyers often remain unaware of these risks and threats. In recognition of this lack of awareness, this survey was organized to address the following four subjects:

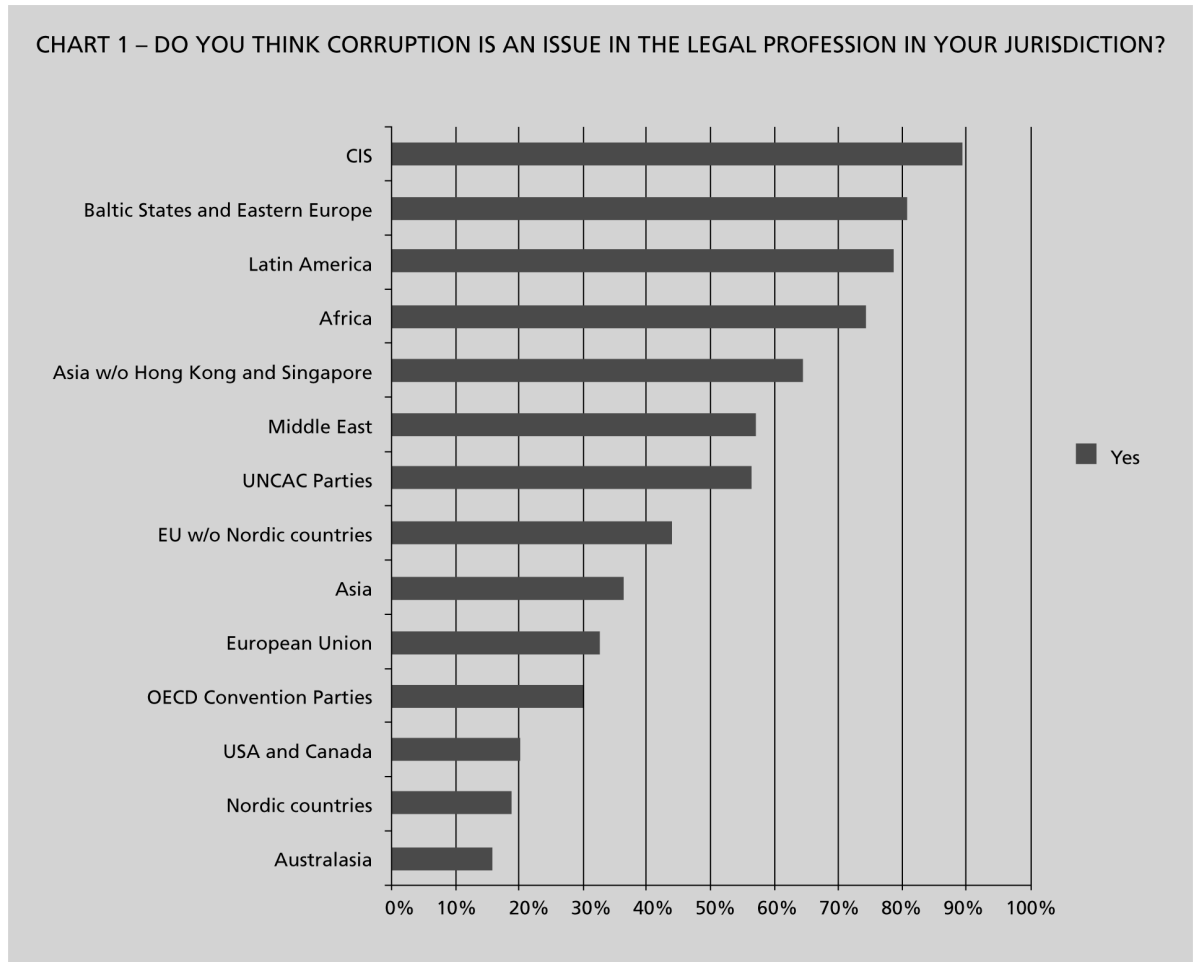
1. The legal profession’s perception of the impact of corruption on their profession at home and abroad;
2. Perceptions of the risks associated with international corruption for the legal profession;
3. Levels of awareness of the international anti-corruption regulatory framework that exists to address these risks; and
4. The role which local bar associations, law societies and law firms play in addressing the challenge of corruption in the legal profession.

Perceptions of the Impact of Corruption on the Legal Profession at Home

Survey respondents were asked whether corruption is an issue in the legal profession in their own jurisdiction. (See Chart 1, which represents the affirmative responses received, which are grouped by world regions.)

Nearly half of all respondents recognized corruption to be an issue affecting the legal profession in their own jurisdiction. However, responses varied significantly from region to region. For example, only 16% of respondents from Australasia saw corruption as an issue, versus nearly 90% of respondents from the CIS (Commonwealth of Independent States) region, which includes Ukraine, Azerbaijan, Kyrgyz Republic, Moldova and Russia.

CHART 1 – DO YOU THINK CORRUPTION IS AN ISSUE IN THE LEGAL PROFESSION IN YOUR JURISDICTION?



Note: Respondents could answer 'yes' or 'no'.

Timetable for SEC's Implementation of the Dodd-Frank Act

**TESTIMONY BY SEC CHAIRMAN
MARY L. SCHAPIRO**

Mary L. Schapiro, chairman of the Securities and Exchange Commission (SEC), testified before the U.S. Senate Committee on Banking, Housing, and Urban Affairs on September 30, detailing the SEC's timetable to implement the Dodd-Frank Act, passed earlier this year. This is a partial transcript of her testimony.

[...] As you know, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "the Act") fills a number of significant regulatory gaps, brings greater public transparency and market accountability to the financial system, and gives the [Securities and Exchange Commission] SEC important tools to better protect investors.

The Act includes more than 100 rulemaking provisions applicable to the SEC, many of which require action within one year. It also requires the SEC to conduct more than 20 studies and create five new offices. While this is a very significant task, we are fully committed to fulfilling our mandates under the Act, as well as our preexisting responsibilities.

My testimony today will describe our progress and plans for implementing the Dodd-Frank Act, particularly with respect to those issues that you specifically inquired about: derivatives regulation, clearance and settlement activities, registration of private fund advisers, credit rating agency regulation, corporate governance and executive compensation regulation, reforms to the asset-backed securitization process, the standard of care applicable to financial intermediaries, and other improvements to investor protection.

Reform Initiatives

OTC Derivatives

Title VII of the Dodd-Frank Act provides a comprehensive framework for the regulation of the OTC derivatives market. Working with other regulators, and the [Commodity Futures Trading Commission] CFTC in particular, we are writing rules that address, among other issues, capital and margin requirements; mandatory clearing; the operation of execution facilities and data repositories; business conduct standards for swap dealers; and public transparency for transactional information. Under the Act, primary jurisdiction over swaps is divided between the SEC and the CFTC. The SEC has primary jurisdiction over security-based swaps, and the CFTC has primary jurisdiction over other swaps, such as energy and agricultural swaps. To prevent gaps, regulatory arbitrage and confusion, the SEC and CFTC will engage in joint rulemaking regarding issues including the definition of terms like "swap," "security-based swap" and "security-based swap agreement."

We have done much already in preparation for making rule proposals in this area. Jointly with the CFTC, we have held three staff roundtables on the topics of conflicts of interest, data repositories, reporting and dissemination, and execution facilities. We also solicited comment in our Advance Joint Notice of Proposed Rulemaking regarding key definitional terms. Based on input from these roundtables and the comment letters on key definitions, as well as other comment letters received, we anticipate soliciting public comment on a number of proposed rulemakings in this area in the coming months.

As part of our collaborative outreach, our rulemaking teams are working closely with the corresponding teams at the CFTC to coordinate our efforts. While the Act requires the SEC and CFTC to adopt joint rules further defining key definitional terms relating to jurisdiction and certain categories of market participants, we believe that collaboration with the CFTC, the Federal Reserve Board and other prudential regulators also is essential for the rulemakings where joint action is

not required by the Act. Our overarching goal is to build on the foundation established by Congress in Title VII of the Act to create a robust and workable framework for regulating the derivatives market.

We expect to propose and adopt Title VII rules in a series of actions, beginning in October and proceeding over the next few months. We fully expect to meet the deadlines described in the Act.

Clearance and Settlement

Our staff also is working closely with the Federal Reserve Board and the CFTC to develop, as required by Title VIII of the Act, a new framework to supervise systemically important financial market utilities, including clearing agencies registered with the Commission. For example, Commission staff has been actively coordinating with the other agencies to develop rules regarding submission of notices by systemically important financial market utilities with respect to rules, procedures, or operations that may materially affect the risks presented.

Commission staff also has discussed with the other agencies the new authority granted to SEC and CFTC to develop standards for these financial market utilities. Moreover, the SEC and CFTC staffs have begun working with staff from the Federal Reserve Board to develop a framework for consulting and working together on exams of systemically important financial market utilities consistent with Title VIII. This added layer of protection, or “second set of eyes,” called for by the Act provides assurance that the U.S. financial system receives well-coordinated oversight from all relevant supervisory authorities.

We expect to propose our first set of Title VIII rules in December.

Private Fund Adviser Registration and Reporting

By July 2011, all large hedge fund advisers and private equity fund advisers will be required to register with the Commission.¹ Under the Act, venture capital advisers and private fund advisers with less than \$150 million in assets under man-

agement in the United States will be exempt from the new registration requirements, although the Act does provide for recordkeeping and reporting by these advisers.² In addition, family offices will not be subject to registration.³ In order to implement the exemptions, the Commission must propose and adopt rules. The staff is planning to propose rules on all of these matters between October and December of this year.

Our staff also has begun work regarding the collection of systemic risk information from private fund advisers as required by Title IV of the Act. In this regard, our staff has had informal discussions with staffs from the CFTC and other regulators regarding what categories of potentially reportable information would be consistent with the Act. In addition, we are working with the International Organization of Securities Commissions and various foreign regulators, most particularly the United Kingdom Financial Services Authority, regarding hedge fund systemic risk reporting. The goal of these consultations is to gain a better understanding about what categories of data would be useful and necessary for assessing the potential systemic risks posed by hedge funds, and how comparable this data would be with data from other countries.

Credit Rating Agency Initiatives

The Dodd-Frank Act requires the SEC to establish a new Office of Credit Ratings, conduct annual exams of each nationally recognized statistical rating organization (NRSRO), report on the collective results of those exams, and conduct studies relating to credit rating agencies regarding, among other things, NRSRO independence,⁴ conflicts of interest⁵ and standardizing ratings terminology.⁶ We are in the process of establishing this office, and are actively recruiting for its new director. We also are identifying the staff from existing divisions who should be transferred to this new office, and have posted 25 new credit rating agency examination positions.

The Commission is required to undertake approximately a dozen NRSRO-related rulemakings. The Act requires the SEC to address internal controls and procedures, conflicts of interest,

credit rating methodologies, rating methodology transparency and performance, analyst training, credit rating symbology, and disclosures accompanying asset-backed securities ratings.⁷ To meet the July 2011 deadline for these rules, the staff plans to recommend rule proposals to the Commission by early next year. In addition, the SEC, and all other Federal agencies, must review and report to Congress on existing references to credit ratings in their rules and undertake rulemaking to eliminate these references.⁸ SEC staff has begun this review in preparation for drafting the report and proposed rulemaking.

In addition, [in September] the Commission issued an amendment to Regulation FD that implements Section 939B of the Act, which requires that the SEC amend Regulation FD to remove the specific exemption from the rule for disclosures made to NRSROs and credit rating agencies for the purpose of determining or monitoring credit ratings. The amendment will be effective upon publication in the Federal Register.

Many of the credit rating agency provisions of the Act became effective immediately upon enactment. Therefore, shortly after the Act was signed by the President, we sent letters to each NRSRO asking how it planned to comply with these new requirements. In addition, SEC staff asked each NRSRO to describe the impact of the repeal of the expert liability exemption formerly available to NRSROs for ratings used as part of a securities registration statement. We are evaluating the responses to these requests, will conduct appropriate follow-up, and will examine these issues as part of our annual examinations of the NRSROs.

Corporate Governance and Executive Compensation Reforms

Section 951 of the Act requires a shareholder advisory “say-on-pay” vote on executive compensation at least once every three years and a separate advisory vote at least once every six years on whether the say-on-pay resolution will be presented for shareholder approval every one, two, or three years. In addition, in any proxy statement asking shareholders to approve a merger or similar transaction, the Act requires

disclosure about, and a shareholder advisory vote to approve, compensation related to the transaction, unless the arrangements were already subject to the periodic say-on-pay vote. The Act also requires every institutional investment manager subject to Exchange Act Section 13(f) to report at least annually how it voted on any of the required votes. [...]

The Act also requires the rules of each national securities exchange to be amended to prohibit brokers from voting uninstructed shares on the election of directors (other than uncontested elections of directors of registered investment companies), executive compensation, or any other significant matter, as determined by the Commission by rule.⁹ The Commission previously approved changes to New York Stock Exchange (NYSE) Rule 452 to prohibit broker voting of uninstructed shares in director elections, as well as similar changes for several other national securities exchanges.¹⁰ On September 9, the Commission approved further changes to the NYSE rules to prohibit broker voting on all executive compensation matters.¹¹ On September 24, the Commission approved corresponding changes to the Nasdaq rules,¹² and we anticipate that corresponding changes to the rules of other national securities exchanges will be considered by the Commission in the near future.

By April 2011, the Commission is required to adopt—jointly with other financial regulators— incentive-based compensation regulations or guidelines that apply to covered financial institutions, including broker-dealers and investment advisers, with assets of \$1 billion or more.¹³ The regulations or guidelines will prohibit incentive-based compensation practices that encourage firms to take inappropriate risks and will require firms to disclose to their respective appropriate financial regulator their incentive-based compensation structures. The Commission staff has met with other regulators in preparation for drafting either proposed regulations or guidelines. To meet the April 2011 adoption deadline, we anticipate that the staff will submit proposed rules to the Commission for consideration as soon as December.

The Dodd-Frank Act also requires the Commission to write rules mandating new listing standards relating to the independence of compensation committees and establishing new disclosure requirements and conflict of interest standards that boards must observe when retaining compensation consultants.¹⁴ Under the Act, these rules must be adopted by the Commission within 360 days from the date of enactment of the Act, and we anticipate that the staff will submit proposed rules for the Commission's consideration by year-end.

In addition, the Act requires the Commission to amend our executive compensation disclosure rules to require public companies to disclose information showing the relationship between executive compensation actually paid and the financial performance of the company,¹⁵ as well as information about the total annual compensation of the chief executive officer, the median annual total compensation of all other employees, and the ratio of these two amounts.¹⁶ Rule amendments also are mandated that will require public companies to disclose in their annual meeting proxy materials whether any employee or director is permitted to purchase financial instruments designed to hedge any decrease in market value of equity securities granted as part of their compensation.¹⁷ Finally, the Act requires the Commission to adopt rules mandating changes to listing standards requiring companies to implement and disclose "clawback" policies for recovering from current and former executive officers incentive-based compensation paid during any three-year period preceding a material accounting restatement.¹⁸ We currently anticipate that the staff will submit proposed rules for the Commission's consideration by the middle of next year.

Also related to corporate governance, the Act confirmed the Commission's authority to adopt rules that facilitate shareholders' ability to nominate director candidates.¹⁹ The Commission had proposed such rules in May 2009, before the Act's enactment, and we approved final rules on August 25, 2010.²⁰ Further, Section 972 of the Act requires the Commission to adopt rules requiring an issuer to disclose in its annual proxy statement the reasons why it has chosen the same or differ-

ent people to serve as chairman of the board and chief executive officer. The Commission adopted Item 407(h) of Regulation S-K in December 2009, which requires this information to be disclosed.

Asset-Backed Securities

Section 943 of the Dodd-Frank Act requires the Commission to adopt rules on the use of representations and warranties in the market for asset-backed securities (ABS). Also, Section 945 of the Act requires the Commission to issue rules requiring an asset-backed issuer in a Securities Act registered transaction to perform a review of the assets underlying the ABS, and disclose the nature of such review. Under the Act, both sets of rules must be adopted by the Commission by January 14, 2011, and we expect to propose rules in these areas within the next few weeks. We also are working on rules prohibiting material conflicts of interest in certain securitizations²¹ and rules requiring the disclosure of information regarding the assets backing each tranche or class of security.²² We expect that these rules also will be proposed by the end of the calendar year, and considered for adoption in early 2011. [...]

Municipal Securities

Section 979 of the Dodd-Frank Act requires the SEC to establish an Office of Municipal Securities to administer the rules pertaining to broker-dealers, advisors, investors, and issuers of municipal securities. The new office will coordinate with the Municipal Securities Rulemaking Board on rulemaking and enforcement actions. We expect to create the new office by the end of October, transfer existing staff performing these duties to that office, and begin recruiting for the new director, who will report directly to the Chairman.

Section 975 of the Act also requires the registration of municipal advisors with the Commission. This new registration requirement [became] effective on October 1. On that date, it [became] unlawful for any municipal advisor to provide advice to a municipality unless registered with the Commission. As noted above, on September 1, the Commission adopted an interim final rule establishing a temporary means for municipal ad-

visors to satisfy the registration requirement. The SEC staff is working on proposed final registration rules for the Commission's consideration.

Conclusion

The Dodd-Frank Act provides the SEC with important tools to better meet the challenges of today's financial marketplace. While implementation of the Act clearly will require a major effort, this effort is already well underway at the SEC. While we undoubtedly will encounter some bumps along the way, we are on track to meet the goals, mandates and deadlines specified in the Act and to do so in a transparent and inclusive manner. As we proceed with implementation, we look forward to continuing to work closely with Congress, our fellow regulators and members of the financial and investing public. [...]

NOTES

1. See Title IV of the Dodd-Frank Act.
2. See Section 408 of the Dodd-Frank Act.
3. See Section 409 of the Dodd-Frank Act.
4. See Section 939C of the Dodd-Frank Act.
5. See Section 939F of the Dodd-Frank Act.
6. See Section 939 of the Dodd-Frank Act.
7. See Subtitle C, Title IX of the Dodd-Frank Act.
8. See Section 939A of the Dodd-Frank Act.
9. See Section 957 of the Dodd-Frank Act.
10. See New York Stock Exchange Rule 452.11(19) and Listed Company Manual Section 402.08(B) (19); Securities Exchange Act Release No. 34-60215 (July 1, 2009), <http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf>; Securities Exchange Act Release No. 34-61732 (March 18, 2010), <http://www.sec.gov/rules/sro/cboe/2010/34-61732.pdf>; Securities Exchange Act Release No. 34-61733 (March 18, 2010), <http://www.sec.gov/rules/sro/chx/2010/34-61733.pdf>; Securities Exchange Act Release No. 34-61292 (January 5, 2010), <http://www.sec.gov/rules/sro/nyseamex/2010/34-61292.pdf>; and Securities Exchange Act Release No. 34-62775 (August 26, 2010), <http://www.sec.gov/rules/sro/phlx/2010/34-62775.pdf>.
11. See Securities Exchange Act Release No. 34-62874 (September 9, 2010), <http://www.sec.gov/rules/sro/nyse/2010/34-62874.pdf>.
12. See Securities Exchange Act Release No. 34-62992 (September 24, 2010), <http://www.sec.gov/rules/sro/nasdaq/2010/34-62992.pdf>.
13. Section 956 requires the SEC to adopt these regulations or guidelines jointly with the Federal Reserve, Office of the Comptroller of the Currency, the FDIC, the Office of Thrift Supervision, the National Credit Union Administration Board, and the Federal Housing Financing Agency.
14. See Section 952 of the Dodd-Frank Act.
15. See Section 953(a) of the Dodd-Frank Act.
16. See Section 953(b) of the Dodd-Frank Act.
17. See Section 955 of the Dodd-Frank Act.
18. See Section 954 of the Dodd-Frank Act.
19. See Section 971 of the Dodd-Frank Act.
20. See Release No. 33-9136, Facilitating Shareholder Director Nominations (Aug. 25, 2010), <http://www.sec.gov/rules/final/2010/33-9136.pdf>.
21. See Section 27B of the Securities Act, as added by Section 621 of the Dodd-Frank Act.
22. See Section 942(b) of the Dodd-Frank Act.

SEC/SRO Update: The Proxy Access Update; SEC Amends Internal Controls Attestation Requirements; SEC Approves New FINRA Rule Regarding Notification of Company-Related Actions; NYSE Adopts Changes to Rule 452 in Wake of New Dodd-Frank Act Requirements

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The Proxy Access Update

Following the Securities and Exchange Commission's (SEC's) historic adoption of shareholder proxy access rules on August 25,¹ the Business Roundtable and the U.S. Chamber of Commerce (the Chamber) filed suit on September 29 against the SEC in the U.S. Court of Appeals for the District of Columbia Circuit challenging these rules and asking the Court of Appeals to issue a per-

manent injunction prohibiting the SEC from implementing the requirements of these rules.² The petitioners also requested that the SEC grant a stay of the effective date of the proxy access rules until the litigation was concluded. The proxy access rules were initially scheduled to be effective November 15 and would have applied to proxy statements of public companies mailed after March 15, 2011.

The petition filed by the Business Roundtable and the Chamber alleges that the proxy access rules are "arbitrary and capricious" and that their adoption violated the Administrative Procedure Act, claiming that the SEC failed to adequately assess the effect of such rules on "efficiency, competition and capital formation" as required under applicable statutes and that the rules infringe on the First and Fifth Amendment rights of public companies.

The petition alleges that the access rules violate the First Amendment because they force companies "to fund and carry election-related speech that is opposed by a company's duly-elected board of directors." The petition claims that the rules mandate that a public company support the speech of third parties, which is contrary to prior First Amendment jurisprudence. Moreover, the petition noted that rules constitute a taking of corporate property because "even if holders of 95% of a company's shares find this use of the company proxy to be a waste of corporate assets, they are barred from preventing it."³

The petition also alleges that the SEC's rule is "arbitrary and capricious" in its treatment of state law. While the SEC stated in the adopting release that the purpose of the proxy access rules is to effectuate shareholders' state law rights to nominate directors, the petition alleges the SEC rule effectively overrides state law requirements related to the nomination of directors. Instead, the petitioners argue that the proxy access rules effectively establish "a proxy access regime by fiat" and disregard specific provisions under Delaware corporate law that permit stockholders to adopt director nomination bylaws.⁴

The petition further alleges that the SEC erred in determining the potential costs associated with the proxy access rules and ignored the comments and cost estimates of commentators related to proxy

contests that would result from the rule changes.⁵ The petition notes that the SEC suggested in the proxy access release—without support—that such contests might not materialize because directors might determine not to expend resources to oppose shareholder nominees and would instead simply include the shareholder nominees on the company's proxy statement. On the contrary, the petition cited comment letters indicating that, acting consistently with the board's fiduciary duties, significant corporate resources would be spent on defeating less qualified or unqualified shareholder nominees.⁶ The Chamber estimated that the cost of a proxy contest ranges from \$4 million to \$14 million for large companies, and \$800,000 to \$3 million for smaller companies, and that comparable costs could be expected for election contests under the SEC's proxy access rules.⁷

On October 4, the SEC issued a stay of the access rules and related changes to Rule 14a-8 pending further review and resolution of the Chamber's petition by the Court of Appeals.⁸ The SEC's action delayed the effective date of these rules indefinitely. The SEC acted quickly on the stay requested by the Chamber's petition related to the adoption of the access rules. The justification for the SEC's decision to issue the stay a week after the filing of the Chamber's petition was that, "under all of the circumstances of this matter, a stay of Rule 14a-11 and related rule amendments is consistent with what justice requires. Among other things, a stay avoids potentially unnecessary costs, regulatory uncertainty, and disruption that could occur if the rules were to become effective during the pendency of a challenge to their validity."⁹ However, the SEC's stay did not address the merits of the claims raised by the Chamber and the Business Roundtable in their petition.

Even though the SEC and the Chamber have sought expedited review of the Chamber's challenge to the access rules, it is anticipated that these questions related to the sufficiency of the SEC's process or the validity of the access rules will not be resolved quickly. Each party will submit briefs supporting their positions and oral arguments will likely be heard. Even in the best of circumstances, it will take several months for this matter to be resolved. Public statements by the SEC's

spokesperson estimate that the matter will not be resolved until late spring 2011. As a result, it is unlikely that the new access rules will be effective when most public companies hold their annual meetings in 2011; however, such rules could be effective in late-2011.

In addition to delaying the access rules contained in Rule 14a-11, the SEC also delayed the amendments to Rule 14a-8 which would have permitted shareholders to file shareholder proposals seeking to make amendments to a public company's by-laws to implement more liberal shareholder access procedures. This change to the proxy rules was not challenged by the Chamber and the Business Roundtable in their petition but the SEC determined to delay its implementation because the amendments to Rule 14a-8 went hand-in-hand with the changes to Rule 14a-11, and there was the potential for confusion if one rule was to become effective and the other rule was stayed.

The proxy access rules have been some of the most contentious and highly contested rules ever proposed by the SEC, and this litigation and the resulting SEC stay has proven to be additional hurdles in the proxy access saga. As a result, the debate continues... stay tuned!

SEC Amends Internal Controls Attestation Requirements

On September 15, the SEC adopted amendments to its rules governing internal controls¹⁰ over financial reporting related to non-accelerated filers.¹¹ This action conforms the SEC rules to the requirement of § 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) which adopted § 404(c) of the Sarbanes-Oxley Act of 2002 to provide that the auditor attestation requirement of the Sarbanes-Oxley Act contained in Section 404(b) does not apply to companies that are not accelerated filers or large accelerated filers.¹² The practical effect of this change is that smaller reporting companies and other companies that do not meet the definition of an accelerated filer will not be required to comply with the auditor attestation requirements contained in § 404(b) of the Sarbanes-Oxley Act. This change was effective September 21.

Consistent with § 404(a) and § 404(b) of the Sarbanes-Oxley Act, the SEC adopted in June 2003 amendments to its rules requiring each public company to include in its annual report on Form 10-K a report of management, as well as an auditor's attestation report, on the effectiveness of the company's internal control over financial reporting.¹³ Subsequent to the adoption of those rules, the SEC postponed the § 404(b) auditor attestation requirement for nonaccelerated filers several times. As a result of these postponements of the auditor's attestation report for these filers, and prior to the amendment of the Dodd-Frank Act, non-accelerated filers (other than a newly public company) would have been required to first include the auditor attestation report in their Forms 10-K for fiscal years ending on or after June 15, 2010.¹⁴

To conform the SEC's rules to new § 404(c) of the Sarbanes-Oxley Act as adopted pursuant to the Dodd-Frank Act, the amendments to the SEC rules remove the requirement to include an attestation report of the company's independent public accounting firm in the Form 10-K for nonaccelerated filers. The SEC also adopted a conforming change to its rules concerning management's disclosure in the Form 10-K regarding inclusion of an attestation report to provide that the disclosure only applies if an attestation report is included. Finally, the SEC amended Rule 2-02(f) of Regulation S-X to clarify that an auditor of a nonaccelerated filer is not required to include an assessment of the issuer's internal control over financial reporting in its audit report. These rule changes do not modify the requirement applicable to all public companies under § 404(a) of the Sarbanes-Oxley Act. § 404(a) and related SEC rules require that a public company's Form 10-K include a report of management on the public company's internal control over financial reporting.

SEC Approves New FINRA Rule Regarding Notification of Company-Related Actions

On September 27, new Rule 6490 of the Financial Industry Regulatory Authority (FINRA) took effect. This rule, which was originally approved by the SEC on July 1,¹⁵ authorizes FINRA

to review, process and charge a fee for filings and documents related to actions taken by publicly traded companies and described in Rule 10b-17 under the Securities Exchange Act of 1934 (the Exchange Act), as well as for certain other significant corporate actions.

Exchange Act Rule 10b-17 requires issuers of publicly-traded securities to provide notice to FINRA no later than 10 days prior to the record date or registration statement effective date relating to a dividend or other distribution, a stock split or reverse split, or a rights or other subscription offering. If the issuer's securities are traded on an exchange, the issuer must comply with the procedures of that exchange, so long as they are substantially comparable with Rule 10b-17. In addition, FINRA also processes documents related to other company actions, including the issuance of a ticker symbol, the change of a company name or ticker symbol, mergers, acquisitions, dissolutions, other company control transactions, bankruptcies and liquidations. Subsequently, FINRA notifies the marketplace of these corporate actions, including on the OTC Bulletin Board's website.

Recently, the SEC has brought civil charges against persons who have allegedly submitted false documentation to fraudulently obtain new ticker symbols on behalf of defunct or inactive corporations that had once been publicly-traded.¹⁶ The SEC noted that in many instances, fraudulent paperwork would be submitted to Nasdaq Corporate Data Operations (the predecessor to FINRA's OTC operations) in an effort to "hijack" these defunct or inactive corporations for the purpose of selling hundreds of millions of shares of purportedly unregistered stock in violation of the U.S. securities laws.¹⁷ In turn, FINRA has become concerned that its corporate action processing services may be unwittingly used to perpetuate acts involving securities and microcap fraud.¹⁸

To address the lack of regulatory authority to remedy these concerns, FINRA adopted Rule 6490, which authorizes FINRA to review and process documents related to Rule 10b-17 and other company-related actions. When a request is made to FINRA's Operations Department to process documentation related to a Rule 10b-17 notification or other corporate action, FINRA is permit-

ted not only to request additional information or documentation as it deems necessary but also for it to conduct in-depth reviews of a request and to verify the accuracy of the information submitted. A failure by a company to sufficiently respond (in the reasonable determination of FINRA) to any FINRA request for additional information within 90 days after FINRA's request will cause the request to lapse and be closed. FINRA can give its staff discretion not to process the documentation submitted by a company if FINRA's staff determines the submission is incomplete or if certain indicators of potential fraud exist.¹⁹

Specifically, FINRA may determine that a request is deficient and will decline to process it if:

- FINRA reasonably believes that the forms and supporting documentation may not be complete, accurate or have proper authority;
- the issuer is not current in its reporting obligations to the SEC or another regulatory authority;
- FINRA has actual knowledge that the issuer, associated persons, officers, directors, a transfer agent, legal adviser, promoters or other persons connected to the issuer or the reported action are the subject of a pending, adjudicated or settled regulatory action or investigation by a federal, state or regulatory agency, or a self-regulatory organization, or a civil or criminal action related to fraud or securities law violations;
- a state, federal or foreign authority or self-regulatory organization has provided information to FINRA, or FINRA otherwise has actual knowledge indicating that the issuer, associated persons, officers, directors, transfer agent, legal adviser, promoters or other persons connected with the issuer or the action may be potentially involved in fraudulent activities related to the securities markets and/or pose a threat to public investors; and/or
- there is significant uncertainty in the settlement and clearance process for the security.

Where FINRA determines that it is necessary for the protection of investors, the public interest

and to maintain fair and orderly markets not to process a deficient request, it must notify the requesting party, which then has the right to appeal the decision.

FINRA Rule 6490(c) establishes for the first time a schedule of non-refundable fees that issuers must pay for the review and processing of documentation related to Rule 10b-17 and other company actions covered by FINRA Rule 6490. Notably, the fees for a late Rule 10b-17 notification increase by 5- to as much as 25-times that of the fees for a timely notification, depending on when the notification is ultimately submitted. FINRA will use its best efforts to process documentation related to a Rule 10b-17 notification even without the required fee, but the unpaid fee will be noted and FINRA will not process documentation related to voluntary symbol request changes until all unpaid fees associated with that symbol have been paid.²⁰

NYSE Adopts Changes to Rule 452 in Wake of New Dodd-Frank Act Requirements

On August 26, the New York Stock Exchange (NYSE) proposed amendments to its member rules and listed company manual to prohibit NYSE member organizations from voting uninstructed shares held in “street names” as to matters relating to executive compensation. The proposed rule change was issued in accordance with Section 957 of the Dodd-Frank Act. The rule change was approved by the SEC on September 9 on an accelerated basis.²¹

Section 957 of the Dodd-Frank Act amended § 6(b) of the Exchange Act, which specifies the criteria for which a national securities exchange must satisfy to be registered under the Exchange Act as such. The amendment requires the rules of an exchange to prohibit any member that is not the beneficial owner of a security from granting a proxy to vote the security, unless the beneficial owner has provided voting instructions, in connection with a shareholder vote with respect to:

- the election of directors (other than an uncontested director election for a registered investment company);

- executive compensation; or
- any other significant matter, as determined by the SEC by rule.²²

The NYSE amended Rule 452 to prohibit its members from voting uninstructed shares as required under the Exchange Act with respect to any matter that “relates to executive compensation.”²³ The commentary to this rule states that such a matter would include, among other things, the advisory say-on-pay votes now required under § 14A of the Exchange Act, and any other matter “relating to” executive compensation, even if it would otherwise qualify for an exception to the voting prohibition. The NYSE also similarly amended § 402.08 of its Listing Manual with respect to the giving of proxies. The NYSE previously amended these provisions in July 2009 to prohibit members from voting shares without authorization from the beneficial owner in an uncontested election of directors.²⁴

At present, the SEC has not identified by rule any other significant matter on which members would not be able to vote uninstructed shares. According to the SEC’s Dodd-Frank Act regulatory timeline, it plans to issue these proposed rules in the second quarter of 2011.²⁵

Given that the rule changes were mandated by the Dodd-Frank Act, the SEC approved accelerated effectiveness of these rule changes, and they took effect immediately.

NOTES

1. See SEC Release No. 33-9136 (Aug. 25, 2010).
2. See *Business Roundtable v. SEC*, No. 10-1305 (D.C. Cir. filed Sept. 29, 2010) [hereinafter *Petition*].
3. See *Petition*, at 10.
4. *Petition*, at 7.
5. *Petition*, at 3.
6. *Petition*, at 3 (citing Comment Letter from The Business Roundtable, at 78 (Aug. 17, 2009); Comment Letter from the American Bar Association, at 35 (Aug. 31, 2009)).
7. *Petition*, at 3 (citing Comment Letter from the Chamber of Commerce, at 7 (Aug. 14, 2009)).
8. SEC Release No. 33-9149 (Oct. 4, 2010).
9. SEC Release No. 33-9149, at 2.
10. See SEC Release No. 33-9142 (Sept. 15, 2010).
11. Although the term “non-accelerated filer” is not defined in SEC rules, it is commonly used to refer to a reporting company that does not meet the definition of either an “accelerated filer” or a “large accelerated filer” under Exchange Act Rule 12b-2.
12. An accelerated filer under Exchange Act Rule 12b-2 is an issuer that “had an aggregate worldwide market value of the voting and nonvoting common equity held by its nonaffiliates of \$75 million or more, but less than \$700 million, as of the last business day of the issuer’s most recently completed second fiscal quarter” and a large accelerated filer is an issuer that “had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of \$700 million or more, as of the last business day of the issuer’s most recently completed second fiscal quarter.” In addition, for both definitions, the issuer needs to have been subject to the SEC’s reporting requirements for at least 12 calendar months, have filed at least one annual report, and not be eligible to use the requirements for smaller reporting companies for its annual and quarterly reports.
13. See SEC Release No. 33-8238, 68 FR 36636 (June 5, 2003).
14. See SEC Release No. 33-9072, 74 FR 53628 (Oct. 13, 2009).
15. See SEC Release No. 34-62434, 75 FR 39603 (July 1, 2010).
16. See, e.g., *SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. Irwin BOOCK, Stanton B. J. Defreitas, Nicolette D. Loisel, Roger L. Shoss and Jason C. Wong, Defendants; and Birte Boock and 1621566 Ontario, Inc., a Corporation, Relief, Defendants.*, 2009 WL 3232743 (S.D. N.Y. 2009) (*SEC v. Boock*).
17. *SEC v. Boock*, at 1.
18. SEC Release No. 34-62434, 75 F.R. at 39604.
19. FINRA also noted that it may, in its discretion, process a Rule 10b-17 notification or other company-related action based on information provided by third parties when necessary to protect investors or when FINRA is unable to obtain the information from the issuer. FINRA Rule 6490, Supplementary Material .02.
20. FINRA Rule 6490, Supplementary Material .01.
21. SEC Release No. 34-62874 (Sept. 9, 2010).
22. Exchange Act § 6(b)(10), 15 U.S.C.A. § 78f(b)(10).
23. NYSE Rule 452.11, Supplementary Material, item 21.
24. See SEC Release No. 34-60215 (July 1, 2009).
25. See SEC, Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Upcoming Activity, available at <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml> (last viewed Oct. 14, 2010).

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