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MARCH 1, 2010

### Highlights from "SEC Speaks in 2010"

#### SEC Update

To view this Sidley Update as a PDF, [click here](#).

The Practising Law Institute held its annual "SEC Speaks" conference in Washington, D.C. on February 5, 2010. This Sidley Update summarizes the highlights of the conference. Due to weather conditions, Day Two of "SEC Speaks" was canceled and has been rescheduled for March 26, 2010.

#### **I. Chairman's Speech - Mary L. Schapiro**

Chairman Mary L. Schapiro discussed the steps the Securities and Exchange Commission (SEC or Commission) has taken since the economic crisis to improve its effectiveness, promote investor interests, and regain the public's trust. The Chairman noted that these steps fall into three categories: internal reforms, a new rulemaking agenda, and market structure review.

**Internal Reforms.** According to Chairman Schapiro, the SEC has restructured the Division of Enforcement (Enforcement) and streamlined its procedures, focused the Office of Compliance Inspections and Examinations (OCIE) on risk assessment, is in the process of revamping its technology systems, and has undertaken efforts to increase information sharing among its staff. In connection with the Division of Enforcement, Chairman Schapiro noted that lawyers no longer need to receive Commission approval before initiating an investigation or entering into a settlement, and they have more power to bring about cooperation from corporate insiders. In addition, a layer of middle management has been redeployed to the front lines and specialized units have been created with the expertise needed to better police the markets. Chairman Schapiro explained that the SEC revamped and centralized its complaint system and will have a new set of guidelines and protocols that will govern how the staff handles tips received. She added that the SEC has been focusing on promoting a culture of collaboration — stressing the importance of sharing information and sharing ideas — including integrating broker-dealer and investment adviser examinations.

Chairman Schapiro further stated that OCIE, with its new director Carlo V. di Florio, is emphasizing risk assessments by, among other things, reviewing firms before examiners go on-site and by routinely verifying the existence of client assets. To promote information sharing, the Commission has created the Division of Risk, Strategy, and Financial Innovation (DRSFI). Chairman Schapiro said that the DRSFI has recruited personnel who have a broad range of experience to assist the SEC in keeping pace with Wall Street. The DRSFI is involved in financial reform and is working with other divisions and offices on a wide variety of matters such as credit derivatives-based insider trading litigation, securitization, proxy access rule-making and life settlements.

**Rulemaking Agenda.** Chairman Schapiro highlighted

several rulemaking initiatives which, among other things, aim to increase disclosure and protection of investors. In the realm of disclosure, besides already putting forward rules for proxy enhancement, the SEC has proposed rules to require more comprehensive and timely information about municipal securities. Chairman Schapiro also stressed that the SEC intends to take action to prevent abuse relating to target date funds, which are funds marketed in retirement plans that contain a "target" retirement date in their name and which are designed to become more conservatively invested as the target approaches. Among other things, in crafting rules for such funds, the staff will focus on how these funds are marketed to investors.

To bolster investor protection, Chairman Schapiro emphasized that the SEC has initiated surprise inspections of money managers who hold or control their clients' assets as well as an annual custody control review for custodians affiliated with investment advisers. In the coming months, the Chairman further noted that the SEC intends to enhance point of sale disclosures and disclosures relating to 12b-1 fees. The SEC is also considering strengthening the regulatory framework for credit rating agencies, and establishing an on-line disclosure regime with regard to money market funds.

**Market Structure.** Chairman Schapiro stated that, over the past year, with Robert Cook as the new director of the Division of Trading and Markets (DTM), the SEC began a review of market structure, targeting such issues as high frequency trading, co-locating trading terminals, and markets that do not publicly display price quotations. As part of the process, the SEC will be voting on proposed rules concerning flash orders, making public an investor's interest in stock (rather than to a select group in a dark pool), and prohibiting broker-dealers from giving customers unfiltered access to exchanges or alternative trading systems. Moreover, the Commission is working on proposals for an inter-market audit trail so that regulators

will be better able to stop wrongdoing in trading activities that take place across several markets. Finally, following the adoption in 2009 of rules to prevent "naked" short selling, further proposals for restricting short selling will be considered.

*The full text of Chairman Schapiro's speech may be found online at*

<http://www.sec.gov/news/speech/2010/spch020510mls.htm>.

## **II. Division of Enforcement**

Following Chairman Schapiro's remarks, there was a panel from Enforcement, which included the following individuals: Robert S. Khuzami, Director; Lorin L. Reisner, Deputy Director; Scott W. Friestad, Associate Director; David P. Bergers, Regional Director of the Boston Regional Office; and George S. Canellos, Regional Director of the New York Regional Office. The panel also included the new Chiefs and Co-Chiefs of the Specialized Units — Foreign Corrupt Practices, Market Abuse, Municipal Securities and Public Pensions, Asset Management, Structured and New Products, and Office of Market Intelligence.

The Enforcement panel commented on the effectiveness of the recent changes to Enforcement, specifically the delegation of formal authority which has allowed the staff to bring cases more quickly, coordinate better with other regulators, obtain asset freezes, and collect access to evidence on a real-time basis when such evidence otherwise may have been lost. The panel also discussed the new cooperation initiatives, recent enforcement trends, coordination with other regulatory agencies, and the goals of each of the new specialized units.

### **Cooperation Initiatives**

With respect to cooperation, the SEC recently implemented new initiatives, similar to those of the Department of Justice (DOJ), which are designed to encourage early cooperation

and, in turn, provide the SEC with more detailed information in a more efficient and quicker manner. The initiatives are outlined in the SEC's revised Enforcement Manual and in the SEC's Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions (Policy Statement).

The staff now has a variety of new tools to encourage individuals and entities to cooperate. The staff may enter into a cooperation agreement with an individual or entity. A cooperation agreement is a written agreement between the cooperating witness and Enforcement pursuant to which an individual agrees to provide substantial assistance to the SEC during an investigation and, in turn, the staff agrees to recommend to the Commission that the individual or entity receive "credit" for cooperating. The staff may also enter into deferred enforcement agreements, non-prosecution agreements, or agreements to provide limited immunity.

The Policy Statement provides guidance regarding the Commission's assessment process prior to agreeing to provide an individual or entity with cooperation credit. Specifically, the Commission will assess the assistance provided by the cooperating individual by considering, among other things, the timeliness, thoroughness, and usefulness of the information. The Commission expects the cooperating witness to provide information in a timely manner by producing all non-privileged documents, appearing for meetings and interviews, responding fully and truthfully to questions, and testifying truthfully at any trial or proceedings. In addition, the Commission will consider the importance of the underlying matter. Finally, the Commission will consider the societal interest in accountability as well as the appropriateness of providing credit in light of the risk profile of the cooperating witness. If the cooperating witness abides by the terms of the cooperation agreement, the staff is required to inform the Commission of the cooperation and recommend that the Commission provide cooperation credit. In certain circumstances, the staff may also agree to make a

particular enforcement recommendation to the Commission.

The panel noted that the SEC will be interested in entering into cooperation agreements when the potential cooperating witness is able to provide substantial assistance. Ideally, the SEC is looking to enter into such agreements with individuals who are "lower down" in terms of hierarchy, have less culpability, and can provide evidence that establishes violations by individuals "higher" in an organization who have greater degrees of culpability. Regardless, the SEC will not enter into a cooperation agreement with an individual who engaged in "particularly egregious conduct" or if doing so will place the investing public at risk.

The panel further noted that the SEC will offer "significant credit and benefits" to incentivize individuals and entities to enter into cooperation agreements. Moreover, those who refuse to cooperate "should expect" the staff to seek the "full extent" of the remedies available and to inform the Commission regarding the refusal to cooperate at the time the staff makes its recommendation to the Commission.

The cooperation agreements that are part of the new initiative are different from the SEC's current policies regarding cooperation because they are set forth in a "defined and reliable framework." This clarity regarding the expectations and obligations as it relates to cooperation is expected to encourage greater and earlier cooperation. In addition, such clarity allows the staff to evaluate the viability of a cooperation agreement as it relates to a potential cooperating witness.

The availability of cooperation agreements could undoubtedly lead to potential conflicts of interest when an attorney represents multiple clients in connection with an SEC investigation. For example, potential conflicts could arise when one client is in a position to cooperate and another client is not in such a position. Other conflicts issues may arise because only one client can be the first to

come forward with information regarding a violation and the client who does so benefits more as a result of such cooperation as compared to a client who may come forward later. The SEC expects defense counsel to assess these issues regularly and consider them carefully. Similarly, the SEC made clear that it will focus on these conflict considerations and, where appropriate, may raise conflicts concerns with defense counsel.

### **Recent Enforcement Trends**

The panel explained that Enforcement has implemented new initiatives and made changes over the past year in light of an uptick the SEC has seen in institutional insider trading, which has led the SEC to devote more resources to investigating such matters. In addition, the SEC has been using different investigation techniques in the context of large-scale insider trading matters where the SEC is focusing on multiple individuals trading in multiple stocks and where large international trading networks may be involved. This contrasts with the SEC's historical focus on single issuers. The SEC is also currently exploring other techniques that will enable it to identify a trading ring, along with patterns and links in trading. These techniques, in turn, will enable the SEC to commence an investigation with a broader perspective and uncover the full scope of the fraud more quickly.

With its new focus and use of techniques, the SEC's regional offices have brought a number of important enforcement actions. In particular, the SEC brought two recent insider trading cases involving trading by Raj Rajaratnam and Arthur Cutillo. According to the SEC, in the Galleon hedge fund matter, Mr. Rajaratnam relied on an extensive network of connections to obtain inside information, which he used to trade on behalf of Galleon. According to the SEC, in the Cutillo matter, Mr. Cutillo obtained tips from various attorneys in advance of transactions in exchange for kickbacks. Several of the attorneys have already pled guilty. The Rajaratnam and

Cutillo cases involved close collaboration of multiple SEC offices, which the SEC expects to be a model for future investigation, especially in connection with investigations that involve expansive criminal enterprises, such as insider trading rings.

The panel also discussed the current status of subprime cases, as many investigations that began at the height of the credit crisis "came to fruition" in the past year. These matters tend to include several types of issues, including underwriters who misled investors regarding the quality of the loans underlying the securities and brokers and advisers who disclosed certain information only to select clients.

In addition, the SEC described as a "success story" the action it brought against State Street on February 4, 2010 relating to State Street's alleged misleading of investors regarding their exposure to subprime investments. According to the SEC, State Street told investors generally that their investments were diversified and nearly as safe as money market accounts, while at the same time State Street's internal advisory groups advised certain select clients about their exposure to subprime investments and recommended that they sell their investments. The action reflected coordination with the Massachusetts Attorney General and Massachusetts Securities Division. At the same time as the action was brought, the SEC announced that it had reached a global settlement with State Street. The SEC received a total of \$313 million as part of the settlement, and declared that "every penny" will go back to investors within two weeks after the entry of judgment.

### **Coordination with Other Regulators**

The panel also discussed the current legal landscape in which federal and state regulators often have overlapping jurisdiction and yet they may or may not have similar objectives. Given this landscape, the panel explored the benefits and challenges of parallel investigations and



federal-state coordination.

The panel acknowledged the existence of competition among regulators with similar statutes. It was noted that this competition pressures regulators positively to remain efficient and up-to-date on new investment products being offered as well as the changing markets. On the other hand, the overlapping jurisdiction makes it difficult to maintain consistent national standards given that there are many regulators, each with its own views. For example, there may be different disclosure rules; or the reasons that may lead the SEC to refrain from bringing an enforcement action may not be consistent with the views of other regulators. Another challenge relates to the pressure on regulators to be the first agency to bring an action, which may cause a regulator to act too quickly and not fully investigate a matter. Thus, there is a tension between "real-time enforcement," on the one hand, and thoroughness and diligence, on the other hand. Moreover, the pressure may cause a regulator to file an action against a lower-level, less culpable individual instead of spending the time to uncover a larger criminal enterprise.

An additional challenge relates to the efficient use of scarce resources. For example, it is important in parallel investigations to try to avoid having multiple agencies engaging in duplicative investigations, such as by reviewing the same documents and interviewing the same witnesses. The better approach would be for the agencies to work together and allocate responsibilities. Moreover, the panel noted that it is important for the regulators to coordinate to avoid inconsistent burdens on the regulated community.

Finally, the panel discussed the interplay of the new cooperation initiatives in the context of multiple regulatory agencies and parallel investigations. The SEC made clear that where an individual has cooperated with the SEC, the staff will seek to encourage other regulators and law enforcement agencies to treat the individual in a similar manner as the SEC. In addition, as part of the new

cooperation initiatives, the SEC is revising its standard proffer agreement. Whereas the prior agreement provided limited immunity in circumstances in which another regulator or law enforcement agency requested access to certain information, the revised proffer agreement states that the SEC will provide other regulators or law enforcement agencies with information from a cooperating witness only where the other regulator or agency provides the cooperating witness with the same protections, unless the SEC is otherwise required by law to provide the information. Mr. Khuzami added that the SEC expects defense counsel to demand this term in the agreements, and said it is good law enforcement practice to coordinate the protections of a cooperating witness with other agencies.

### **Specialized Units**

Mr. Khuzami introduced the Chiefs and Co-Chiefs of the specialized units and the Office of Market Intelligence, by discussing the benefits of specialization, which include, among other things, a more efficient use of resources so that the SEC can accomplish more than it has in the past. Specifically, he stated that specialization deepens the SEC's understanding and therefore its ability to prevent the use of complexity to commit fraud. It also enables the SEC to identify fraudulent schemes more quickly so that the SEC will act before investors lose money.

### ***Foreign Corrupt Practices***

Cheryl J. Scarboro, the Chief of the Foreign Corrupt Practices Unit (FCPA Unit), stated that this unit's overall goals are to be more proactive regarding investigations and to be more coordinated and consistent in its approach. In turn, the FCPA Unit hopes to be more "impactful" in bringing actions. In terms of being more proactive, the FCPA Unit will engage in more "targeted sweeps" and look at various industries, such as the oil-for-food programs. In addition, the FCPA Unit will seek to build closer relationships with regulators and investigators abroad. The FCPA Unit also

intends to be more consistent in its investigation approach and outcomes and therefore hopes to send unified messages to the regulated community regarding the cases the FCPA Unit will bring and the resolutions that will be reached in those cases. As to having a greater impact, the FCPA Unit anticipates that the enhanced understanding of the issues due to specialization will enable cases to be brought more quickly and efficiently. Finally, the FCPA Unit intends to raise the bar by motivating foreign regulators to step-up their enforcement activities relating to the same issues as the FCPA Unit.

### ***Market Abuse***

Daniel M. Hawke, the Chief of the Market Abuse Unit (Market Abuse Unit), said this unit's primary focus is to sustain and enhance the efforts to understand how individuals and entities engage in insider trading. The unit's focus will be to identify organized insider trading rings, including the large entities, organizations and individuals who are a part of such trading rings. It will also focus on detecting violations that occur on a systematic basis, such as best execution, front running, and large-cap market manipulation. The Market Abuse Unit seeks to learn how such organizations and individuals engage in insider trading and conceal such conduct in order to target the networks and individuals who act in concert. Additionally, the Market Abuse Unit will focus on the following, among other types of activity: collusive and manipulative trading; market manipulation; and abusive short-selling. Where appropriate, the Market Abuse Unit will work closely with criminal authorities. In addition, it will use novel investigative technical approaches to gain strategic evidence before an investigation begins. For example, it will use technology to analyze large amounts of data in order to understand patterns of trading and relationships. It will also hire specialists who know the techniques used by traders. In addition, it will seek to be more aggressive and develop its own leads and will not wait for self-regulatory organization (SRO) referrals, media reports or other tips. The Market

Abuse Unit will also be selective in the cases it brings. In this regard, when it approaches a person or entity to obtain information, it should be assumed that the Market Abuse Unit is very interested in the information.

### ***Municipal Securities and Public Pensions***

Elaine C. Greenberg, the Chief of the Municipal Securities and Public Pensions Unit, explained the vastness of the municipal securities marketplace. She noted that there are \$2.8 trillion of municipal bonds outstanding, a large volume of which traded in 2009 and 70% of which are held by individual investors. There are 50,000 municipal issuers, which are varied and offer new products, including complex financial instruments. While these securities are exempt from the SEC registration requirements and are therefore "thinly regulated," they are subject to the anti-fraud provisions. As a result, she noted that an enhanced response by Enforcement will be helpful. The Municipal Securities and Public Pensions Unit intends to build "comprehensive municipal reform" through precedent, including by bringing cases that send a strong message that will have a deterrent effect in the industry. This unit will be proactive in identifying the greatest risk in the municipal securities and public pensions marketplace, and will focus on the following five areas: (1) offering and disclosure fraud; (2) tax/arbitrage; (3) pay-to-play; (4) public pension accounting; and (5) valuation and pricing fraud.

### ***Structured and New Products***

Kenneth R. Lench, the Chief of the Structured and New Products Unit, said the SEC's recent enforcement actions reflect the need to understand new and complex investment products and structures that are being used in the market. The Structured and New Products Unit's short-term goal is to complete the investigations regarding the credit crisis that are already underway, such as investigations relating to the securitization and CDO market and whether the market was provided with the relevant information. Its

ultimate goal is to bring high impact enforcement actions based on assessments of areas with greatest risk. To achieve its goals, it intends to hire industry experts and employ technology to help level the playing field in light of the technology used by the companies issuing complex products.

### ***Asset Management***

Robert B. Kaplan, Co-Chief of the Asset Management Unit, said this unit intends to focus on, among other things, investment advisers, private equity firms, hedge funds, and mutual funds. It will be working to identify its priorities in order to determine the high impact investigations on which it should focus. The Asset Management Unit will also serve as a resource given its expertise and it intends to develop a more specialized understanding of the industry. In terms of priorities, the Asset Management Unit intends to focus on cases involving such issues as preferential disclosures and preferential treatment provided to institutional investors (such as preferential trading) and valuation (where the investments made are contrary to the representations made to investors).

### ***Office of Market Intelligence***

Thomas A. Sporkin, Chief of the Office of Market Intelligence, said his office's first priority is to revise the system relating to tips and to update the complaint-handling infrastructure. He noted that this office will work to implement a new system to keep track of tips, analyze information and provide it to the "right people." It intends to build a state of the art "intelligence room" that will retrieve various information, such as audit trail data.

## **III. Division of Corporation Finance**

### **Rulemaking Agenda**

Meredith B. Cross, Director of the Division of Corporation

Finance (DCF), described the SEC's rulemaking agenda, which includes items to improve disclosure and procedures in connection with proxy solicitations, items designed to address "gaps" in financial reporting highlighted by the recent financial crisis and items to adapt to changing market practices, particularly derivative strategies and products. A common objective in the rulemaking projects is to modernize disclosure rules so that companies provide the right information to investors, not just more information.

### **New Developments**

Thomas J. Kim, Chief Counsel and an Associate Director of the DCF, addressed new developments in this division:

- The staff is committed to including explanations in no-action letters to allow a better understanding of the staff's rationale and to explain its consistency with precedent.
- Staff Legal Bulletin No. 14E announced the new position that a company may not rely on Rule 14a-8(i)(7) to exclude from its proxy statement a proposal regarding CEO succession planning, which the staff no longer considers ordinary business. Going forward, in proposals calling for risk assessments, the staff will consider the subject to which the risk relates. Unless that subject is ordinary business, the proposal may not be excluded.
- The SEC has proposed amendments to Securities Act Rule 163(c) to allow well-known seasoned issuers to appoint an underwriter or dealer to act as its agent or representative to solicit interest in securities offerings before filing a registration statement, a practice otherwise forbidden by Section 5(c) of the statute.
- A recently issued no-action letter recognizes the availability of the exemption provided in Section 3(a)(9) of the Securities Act for the issuance of a security in an exchange offer where the outstanding security is supported by a guarantee from a 100%-owned

subsidiary, a new position that the staff intends to be reliable for any similarly situated party.

### Proxy Disclosure Enhancements

Brian V. Breheny, Deputy Director for Legal and Regulatory Policy in the DCF, discussed the new disclosure requirements in the proxy rules regarding risk management, executive compensation, and corporate governance matters. The amendments were made partly in response to the New York Stock Exchange's (NYSE) amendment to NYSE Rule 452, which eliminated discretionary brokers' voting in all elections for directors.

The DCF has deferred interpretation of the new proxy rules until the SEC makes a decision on the proposed proxy access rules. The proxy access proposal could have a large impact on policy issues, such as how ownership of securities should be defined and determined. The DCF staff is engaged in a study of proxy mechanics considering a broad array of topics. A concept release including the results of the study is expected in the first half of 2010.

Larry M. Spirgel, an Assistant Director in the DCF, addressed changes to executive compensation disclosure requirements. The amended rules require narratives relating to risk management and executive compensation policies. Any company that does not provide enhanced executive compensation disclosure should be prepared to provide an analysis to the staff explaining why it is not required to make such disclosure under the new rules.

Felicia H. Kung, the Chief of Office of Rulemaking in the DCF, discussed the amended disclosure requirements for director qualifications in proxy statements. Under the new rules, the experiences that led to the determination that a nominee is fit to serve on the board must be disclosed separately with respect to each nominee.

### Executive Compensation

Mr. Spigel noted that the staff is looking for increased discussion of management's analysis of executive compensation, which should focus on "how" and "why" executives are compensated, particularly with regard to incentive-based compensation. If a particular standard, such as a performance target, is material to an understanding of incentive-based compensation, it should be disclosed. It was noted that an unsupported claim of competitive harm is not an adequate reason for a company to forego disclosure of incentive-based compensation benchmarks.

Although the staff has in the past generally issued "futures" comments, that is, comments to alter disclosure in future filings, on executive compensation disclosure, the staff now plans to require amendments to reports on issues where it believes that the staff's positions have been made well known. As a result, companies should not automatically assume they will receive a futures comment on issues of executive compensation and should be prepared for the possibility that they will be required to amend part III of Form 10-K.

### **Rulemaking and Interpretation**

Michele M. Anderson, Chief of the Office of Mergers and Acquisitions in the DCF, described Compliance and Disclosure Interpretations ("C&DIs") issued by the staff. Beneficial ownership of securities remains an important issue for the staff, as reflected by the issuance of over 35 C&DIs relating to filing obligations under Section 13(d) and 13(g) of the Securities Exchange Act.

One of the staff's views is that a Schedule 13D must be filed when an investor forms a plan to effect the takeover of a company. The C&DIs do not yet address what constitutes such a plan. Comprehensive rulemaking in this area is planned in the near future.

Ms. Anderson discussed *In the Matter of Perry Corp.*, File



No. 3-13561 (SEC July 21, 2009). In this matter, Perry Corp. had acquired beneficial ownership of more than five percent of Mylan Laboratories Inc. common stock and filed a short-form Schedule 13G in claimed reliance on Rule 13d-1(b). Because Perry Corp. had not acquired beneficial ownership of the stock as part of its ordinary course of business and as a passive investor, but rather for the purpose of voting such shares in a proposed merger, it was ineligible to file on Schedule 13G and should have filed on Schedule 13D.

Two new C&DIs, Securities Act items 139.29 and 139.30, relate to certain types of transactions involving tender offers. Recognizing the legitimate business reasons for seeking lock-up agreements in these transactions, these C&DIs describe the circumstances where the staff will not object to the registration of offers and sales when lock-up agreements have been obtained from certain security holders. Although Section 5 implications can arise in the negotiation of lock-up agreements, Rules 165 and 166 can provide safe-harbor protection for such communications.

Ms. Felicia Kung discussed a rulemaking release under preparation to address credit ratings disclosure in registration statements. The proposal would call for disclosure regarding shopping for credit ratings, the scope of credit ratings and conflicts of interest that could have influenced a company's credit ratings.

It was noted that the DCF will revisit Regulation S-K in 2010. Proposals under consideration would address the requirements for risk disclosure both in risk factors as well as in management's discussion and analysis (MD&A).

## **Regulation D**

Gerald J. Laporte, the Chief of the Office of Small Business Policy in the DCF, said the staff continues to consider revisions to Regulation D, which may include the definition of an "accredited investor." Any new amendments to Regulation D would be accomplished through a new

proposing release and would not be a continuation of the August 2007 proposing release. The staff is working closely with state regulators to adopt a uniform Form D that could be used to satisfy both federal and state securities filing requirements.

### **Foreign Private Issuers**

Paul M. Dudek, the Chief of the Office of International Corporate Finance in the DCF, noted that many rules for foreign private issuers adopted in the past will only become effective in 2010. As a result, changes to annual reports on Form 20-F will be required. The change to Form 20-F requiring changes in an issuer's certifying public accountant will bring the relevant disclosure for foreign companies to be more in line with the similar disclosure required by Form 8-K, with the exception of the timing of such disclosure. Form 20-F will now require disclosure regarding fees paid between the issuer and the bank issuing American Depository Receipts for the company's shares. To ensure that the staff can contact all reporting foreign private issuers, Form 20-F will require disclosure of contact information, including a fax number or email address.

### **Goodwill Impairment Disclosures**

Craig C. Olinger, a Deputy Chief Accountant in the DCF, noted that the objective of goodwill disclosure is to provide information to the investor about the probability of a future impairment charge. If a reporting unit is at risk of a goodwill impairment charge, the staff expects disclosure in MD&A to focus on a description of key assumptions, known uncertainties, the probability that an impairment charge to goodwill will be required, and the materiality of such impairment. Companies that believe they are not at risk of an impairment charge to goodwill should include disclosure in MD&A explaining their view. The staff believes that well-developed goodwill impairment disclosure should always be included in MD&A.

## **Segment Reporting**

The staff's assumption is that disaggregation of business units is usually the most meaningful presentation of disclosure. To aggregate business segments properly, the segments must have "similar economic characteristics." The staff views this as a stringent condition to aggregation and often raises concerns on the issue. A current divergence in economic behavior is not necessarily a bar to aggregation, especially in light of the current economic crisis, but the staff expects the aggregated business units to have exhibited historical similarities. In other words, a mere prediction of future convergence does not provide a sufficient basis for aggregation. Even when aggregation is permitted, a company's goodwill impairment analysis is still required to be conducted at each operating segment level (or one level below) and, as a result, companies must be cautious to conduct adequate impairment testing.

## **Management's Discussion and Analysis**

Larry Spigel stated that the DCF's examiners spend a significant amount of time on MD&A during reviews and look both "inside and outside" of filings. The staff pays particular attention to consistency across all of a company's public disclosures.

It was noted that companies should concentrate on MD&A, as this is their best opportunity to tell their stories. In addition, the staff looks for management to discuss the most significant issues the company faces, which is often best accomplished through an overview section at the beginning of MD&A. Management's discussion of internal control over financial reporting and the company's disclosure controls and procedures is of particular interest to the staff reviewing such information. A company with a deficiency in its internal controls over financial reporting should make specific disclosures of what it has done and what it plans to do to resolve the deficiency.

## Non-GAAP Financial Measures

Jonathan A. Ingram, the Deputy Chief Counsel in the DCF, described updated C&DIs in connection with the use of non-GAAP financial measures. Highlights of the new C&DIs include:

- elimination of the high burdens on the use of non-GAAP financial information in SEC filings under former interpretations;
- clarification of permissible use of per share information including certain non-GAAP per share *performance* measures, so long as they are reconciled to GAAP earnings per share, but not including non-GAAP *liquidity* measures, such as cash flow;
- guidance on how companies should disclose the tax effect of reconciliation to GAAP; and
- clarification on the use of a constant currency, which is a non-GAAP financial measure, to isolate the effect of exchange rate changes when comparing historical financial results over multiple years.

The staff's views on non-GAAP financial information follows a "two-bucket" approach: (1) for non-GAAP financial measures used in materials appearing outside of SEC filings, Regulation G applies, which only requires reconciliation to GAAP, and (2) for non-GAAP financial measures used in SEC filings, Item 10(e) of Regulation S-K controls. In addition to reconciliation, Item 10(e) requires management to disclose why it believes the use of a non-GAAP financial measure is helpful to an investor's understanding and, to the extent material, a statement why the GAAP financial measure was not deemed sufficient. The staff now believes its earlier interpretations placed excessive burdens on the use of non-GAAP financial measures in SEC filings and, as a result, companies would often omit this information from their SEC filings but would

continue to use non-GAAP financial measures in materials not filed with the SEC. So long as a non-GAAP financial measure is not misleading, the staff prefers that companies use such a measure consistently both in its SEC filings as well as in materials the company does not file with the SEC.

#### **IV. Accounting**

##### **Recent Developments**

James L. Kroeker, the SEC's Chief Accountant, summarized rule-making and policy developments the Commission's Office of the Chief Accountant (OCA) has been pursuing in recent months. The OCA, dealing with the current economic crisis, has been working closely with the Financial Accounting Standards Board (FASB) to improve financial accounting and reporting. Despite significant differences between fair value and actual realized value due to deteriorations in market conditions, "fair value is here and here to stay," Kroeker said. The OCA does pay attention to differences between fair value and actual realized value, but it believes such differences do not automatically signal that a fair value estimate was incorrect. The OCA and FASB are engaged in a review of all financial accounting practices, which includes examining the impact that reporting at fair value across the balance sheet would have on companies.

Mr. Kroeker discussed GAAP and International Financial Reporting Standards (IFRS), a continuing priority for the OCA. The pending roadmap for convergence contemplated mandatory adoption of IFRS by all reporting companies beginning in 2011, with a select group of companies adopting IFRS by an earlier date. The OCA seeks to ensure there are no major differences between the financial results of leading U.S. and foreign private issuers simply because of differences between GAAP and IFRS. Convergence must be completed with the adoption of high-quality combined standards taken from both GAAP and IFRS through a process that does not have a major impact on financial reporting during the transition. Although Mr. Kroeker

encouraged companies to prepare for the convergence of GAAP and IFRS, he cautioned that investing in new accounting systems would be premature.

Wayne E. Carnall, Chief Accountant in the DCF, described the main objectives of his program as increased transparency and enhanced disclosure in the current economic crisis. The staff issued a number of "Dear CFO" letters in the past year, all of which appear on the DCF's website. With changes in the economic environment, the staff expects disclosure in MD&A to adapt accordingly.

The DCF published a Financial Reporting Manual for the first time last year. The manual is updated quarterly, with the next update expected within the coming weeks. The DCF is also compiling the staff's views expressed at seminars and other meetings in past years, which will be consolidated into the manual.

### **Disclosure Issues**

Companies should consider several particular issues for the 2009 Form 10-K. The staff reviewing these filings will concentrate on impairment charges for goodwill because of its belief that this measure provides useful information about a reporting unit of a company. Affected companies should enhance their disclosure regarding the current conditions in Venezuela, which was recently classified as a hyperinflationary economy. Venezuela's economy presents a "perfect storm of events" that could have a material adverse impact in the foreseeable future on companies doing business there. The staff has been disappointed in the lack of disclosure on this matter in recent years. Going forward, it will be expecting companies to present comprehensive disclosure on realized and anticipated losses resulting from exposure to Venezuela.

The DCF's objectives for the future include rule amendments to Regulation S-B to increase efficiency of financial reporting for small business issuers and possible

changes to S-X Rule 4-08(g) to improve disclosure with respect to subsidiaries.

### **Advisers Act Custody Rule**

Richard F. Sennett, Chief Accountant of the Division of Investment Management, discussed amendments to the Investment Advisers Act Rule 206(4)-2 — known as the Custody Rule. The staff has published interpretations to guide accountants on the Custody Rule regarding surprise exams to which all investment advisers must submit at least once a year if they maintain custody of any client's assets. Auditors are no longer required to conduct surprise exams with respect to 100% of the assets in the custody of an investment manager, but may use a sampling of assets. Auditors are now required to complete an exam within 120 days. Further, registration with the Public Company Accounting and Oversight Board is now required for auditors of investment managers that have self-custody of assets or that are affiliated with the custodian and investment managers that are general partners of a pooled investment entity.

### **Enforcement**

Jason S. Flemmons, an Associate Chief Accountant in Enforcement, noted that accounting enforcement remains a primary area of the staff's concern. In various actions during the past year, the SEC obtained over \$100 million in penalties from eleven different issuers and approximately \$500 million in disgorgement penalties. Forty-six accountants and seven attorneys were prosecuted for professional misconduct under Rule 102(e), mainly with respect to the backdating of stock option grants. In *Bally Total Fitness*, the SEC charged the accounting firm of Ernst & Young (E&Y) with issuing false and misleading audit opinions, a case that underlines the importance of strict due diligence for auditors. In addition to an \$8.5 million penalty, one of the largest penalties against an accounting firm, six individual partners at E&Y were personally sanctioned.

## **Auditor Independence**

Jeffrey J. Minton, Chief Counsel of the OCA, discussed the importance of auditor independence to private equity firms. Unless an investee's auditing firm is independent, which would require abstaining from providing certain non-audit services, among other things, the company wishing to make an IPO would be unable to produce three years of independently audited financial statements without a new audit by a qualified firm. To similar effect, companies experiencing liquidity shortages cannot compensate their auditors with stock without immediately impairing auditor independence.

## **Work Product Privilege for Tax Accrual Workpapers**

Mr. Minton addressed the recent First Circuit decision in *United States v. Textron, Inc.* 560 F.3d 513 (1st Cir. 2009), holding that there is no work product privilege protection for tax accrual work papers on the ground that they are regulatory financial statements and not prepared in anticipation of litigation. Textron has filed a petition for certiorari with the U.S. Supreme Court appealing the decision. In response to the *Textron* case, the Internal Revenue Service is seeking comment on a proposed annual schedule on which certain business taxpayers would be required to disclose uncertain tax positions that may affect liability.

## **V. Division of Trading and Markets**

James A. Brigagliano, Deputy Director of the DTM began the session addressing recent short sale initiatives by the Commission, highlighting the Commission's recent decision to make permanent Rule 204 to address potentially abusive short sales. In general, Rule 204 requires the close out of fails to deliver on short sales by T+4 through either the borrowing or purchasing of the security, and close out for bona fide purchases on T+6. Mr. Brigagliano noted the dramatic effect of Rule 204 on reducing fails to deliver,



stating that they are down approximately 63% for all equity securities and by approximately 80% for all "threshold securities" (*i.e.*, securities that have fails to deliver exceeding a certain threshold defined under Regulation SHO). Additionally, Mr. Brigagliano noted that while there were 632 threshold securities in June 2008, this number has been reduced to 61 threshold securities as of September 2009, thereby making Rule 204 extremely successful.

In addressing the recent price test proposals put forth by the Commission in 2009, that focus on either a market-wide price test or a stock-by-stock test through the use of a circuit breaker, Mr. Brigagliano noted that the comment period has expired and the matter is currently pending with the Commission. Mr. Brigagliano stressed that one of the concerns of the Commission is that short sellers are not successfully hitting bids which therefore results in causing long sellers to bail out of the market, with such activity having very little to do with the actual economics of the issuer. No time-frame was provided for a possible final rule concerning a short sale price test. Mr. Brigagliano also discussed recent measures to increase disclosure of short sales, noting the work the Commission has done with various SROs relating to three types of disclosures: (1) daily publication of short sales volume information for equity securities; (2) trade-by-trade disclosure of short sale transaction information on a one-month delayed basis; and (3) twice-monthly disclosure of fails to deliver. Concluding the discussion on short sales, Mr. Brigagliano mentioned the recent September 2009 Roundtable on short sales and securities lending, noting that the Commission is continuing to look at other issues relating to pre-borrows and "hard" locates for short sales and other disclosure measures.

Mr. Brigagliano then moved on to the recent Concept Release regarding high frequency trading and dark liquidity. The Concept Release posed several questions on the topic of high frequency trading, specifically trying to determine the effects of different types of trading and whether they are

beneficial or harmful to markets, and whether these types of arrangements give proprietary trading firms and other market participants an unfair advantage. On the topic of dark liquidity, Mr. Brigagliano noted the focus is on the fair access to these types of trading platforms and whether price discovery is affected through this form of trading. Lastly, the Concept Release also inquires into the standards to be used to determine market quality.

Mr. Brigagliano mentioned the Commission's ongoing review of market structure, in which the Commission had identified targeted proposals dealing with market integrity, fairness and risk. Mr. Brigagliano noted that the Commission is also focusing on co-location services, which are currently permissible provided there is no discrimination against participants.

David S. Shillman, Associate Director of the DTM, spoke about three recent proposals that address the Commission's concerns with certain discrete market problems related to two-tiered markets, which have the potential to discriminate between market participants. Mr. Shillman addressed flash orders, whereby if orders are placed on exchanges or Alternative Trading Systems (ATs), but not at the best price, the exchange or ATS will flash the order, giving sophisticated market participants the ability to step in and take action before other market participants. Mr. Shillman noted that the Commission proposed to amend the Quote Rule to prohibit the use of flash orders. The comment period on this proposal has expired and should be presented to the Commission mid-year. Mr. Shillman pointed out that about half of the comments broadly oppose the proposal.

On the topic of dark pools, Mr. Shillman addressed the issue of indications of interest that, when disseminated, do not contain full information but nevertheless allow favored market participants to act. To address this issue, the Commission has proposed amending the Quote Rule to provide public dissemination of the trading information. Mr.

Shillman notes that by substantially lowering the trading volume threshold for displaying quotes to 0.25%, the Commission believes that it should be able to capture these "grey pools," thus leading to these pools being either dark or lit, but not in between.

Mr. Shillman also addressed the topic of sponsored access, a product provided by broker-dealers to allow customers to access markets directly through the broker-dealers' systems. Mr. Shillman noted these products create certain risks to broker-dealers, and that the Commission has proposed to prohibit providing sponsored access unless the broker-dealers have put in place risk and compliance procedures. Mr. Shillman noted that SROs already have rules in place dealing with sponsored access, but the Commission's proposals would strengthen these rules by imposing controls on a pre-trade basis. Further, broker-dealers would be required to have exclusive control over the risk and compliance procedures they put in place.

Elizabeth K. King, Associate Director of the DTM, focused her comments on issues related to options. She provided further insight on the proposed ban on flash orders, noting that many of the comments received focused on the effect of flash orders on the option markets. Ms. King also discussed the quoting of options in finer increments and the progress of the "Penny Pilot Rule," whereby in 2007, options markets were allowed to quote options in pennies and nickels for a limited number of option classes. Ms. King emphasized that this quoting methodology resulted in the narrowing of spreads and the lowering of costs to investors. In September 2009, the Commission approved expanding this program with 360 option classes to be quoted in these finer increments by August 2010. Ms. King also discussed the impact of these changes on quote traffic, noting that option markets produce an enormous number of quotes, but this is less of a concern as technology has improved, and there has been little problem with the handling of these additional quotes. Ms. King stated that the Commission has seen market participants adapt nicely and demonstrate the

ability to take in these additional quotes.

Ms. King also discussed the move to a new linkage plan. Under the plan, similar to Regulation NMS, compliance with trade-throughs is accomplished through private linkages. Ms. King pointed out that one of the more notable features of the linkage plan is the incorporation of Intermarket Sweep Orders allowing access to liquidity at multiple price levels. Lastly, Ms. King noted the addition of two new options exchanges, the BATS exchange and the CBOE's new "C2" exchange.

Brian A. Bussey, Associate Director for Trading Practices and Processing in the DTM, spoke on various clearing issues and the increased focus by the Commission on three fronts. First, Mr. Bussey addressed the central clearing of Credit Default Swaps (CDSs) and the combined efforts of the SEC and Commodity Futures Trading Commission to issue orders to facilitate the central clearing of CDSs. Mr. Bussey noted the Commission had granted four orders for relief to allow two domestic exchanges (ICE US Trust LLC and Chicago Mercantile Exchange Inc.) and two international exchanges (ICE Clear Europe Limited and LCH.Clearnet Limited) to clear CDSs. Mr. Bussey noted that, from a clearing perspective, the conditions for obtaining relief have largely been determined, and the focus is moving from dealer-dealer clearing towards customer clearing.

On the international front, Mr. Bussey noted the recent joint initiative by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions to update and harmonize guidance for securities settlements and payment systems. Mr. Bussey also touched on attempts to update the RCPP guidance related to OTC derivatives central counterparties. On the legislation front, Mr. Bussey stressed that the main focus has again been on central clearing and that much of the work related to the recent orders may be supplemented.

James L. Eastman, Chief Counsel and Associate Director in the DTM, addressed several recent Commission initiatives. Mr. Eastman began by discussing Point of Sale issues for representatives of broker-dealer clients, noting that some controversial elements related to this topic include: (1) what products are covered, in relation to the types of products that pose a conflict of interest; (2) what is actually disclosed (*e.g.*, the types of fees on various products); and (3) how should point of sale disclosure be delivered. On this last point, Mr. Eastman stressed that disclosure must be delivered at the point of sale and not afterwards, and that this issue itself raised many questions. Mr. Eastman said that the Commission was looking at ways to try to leverage the power of the internet in response to these issues and that social networking sites may come into play.

Mr. Eastman also addressed some post-Madoff initiatives by the Financial Industry Regulatory Authority, Inc. (FINRA), specifically addressing back-office issues and trying to determine what and where the risks are in back-office operations. Mr. Eastman said the focus is on whether more protection is possible through education and greater oversight.

With respect to CDSs, Mr. Eastman noted the next phase of CDS clearing would involve customer clearing, which raises questions concerning protecting customer assets. Even with segregation in place, the quest would be to determine how the protection of customer assets would play out in a bankruptcy. Mr. Eastman expressed the Commission's goal of trying to introduce conditions to enhance rules protecting customer assets.

On the topic of privacy, Mr. Eastman noted the model privacy forms recently adopted by the Commission, but stressed that compliance with other aspects of Regulation S-P would still be required. On a related note, Mr. Eastman also mentioned the recently approved Regulation S-AM, which regulates affiliate marketing and the information that can be shared and the limits placed on marketing efforts.

Michael A. Macchiaroli, Associate Director in the DTM, spoke on previously proposed amendments to the Net Capital Rule (Rule 15c3-1) and Customer Protection Rule (Rule 15c3-3), stating that the events of 2008 raised the need to re-address the proposed amendments. Mr. Macchiaroli noted the amendments should move forward to the Commission in the near future and will focus on tackling the issues between banks and broker-dealers with respect to customer assets. With respect to the Net Capital Rule, the Commission is also looking to clarify the relationship between stock borrowers. Further, in light of Madoff, the DTM is looking to recommend changes to Rule 17a-5 that would require each broker-dealer to answer certain questions on a quarterly basis and provide a schedule of custody of assets held for customers. Mr. Macchiaroli emphasized that the proposal is designed to serve as an alert to the Commission and FINRA on any possible issues with respect to custody of customer assets. The quarterly report would also be subject to independent audit review to test the veracity of the statements made therein. The proposal would also require broker-dealers to consent to review of the working papers by the Commission and various SROs.

Mr. Macchiaroli also discussed the bank proposal letter being put together by the DTM, in which the Commission is looking to better understand the relationships among banks, broker-dealers and their customers with respect to particular customer assets.

Lastly, Mr. Macchiaroli addressed certain issues with the Securities Investor Protection Act (SIPA) relating to the lack of clarity and vagueness concerning the definition of customer. Mr. Macchiaroli noted three issues that were litigated in connection with the Lehman bankruptcy: (1) whether repo counterparties are customers; (2) whether TBAs (to be announced) are customers; and (3) whether soft dollars owed to broker-dealers or customers should be treated as customer receivables. Mr. Macchiaroli concluded that the question remains whether SIPA should be

superseded for systemically important firms and whether all rights thereunder should be retained.

## **VI. Commissioners' Remarks**

The following provides a summary of the SEC Commissioners' remarks at SEC Speaks. <sup>1</sup>

### **Commissioner Kathleen L. Casey**

Commissioner Kathleen Casey stated that she welcomed the recent intense scrutiny of the SEC's performance, saying that such attention is merited because of the agency's mission to protect investors. To succeed in protecting investors, and to earn the public's trust, Commissioner Casey stated that regulators should bear in mind the following ten rules:

- Act with humility;
- Consider unintended consequences;
- Regulate only when the market does not provide a solution, and justify such intervention each time;
- Clearly define the purpose of new regulation;
- Base regulatory decisions on empirical evidence (in her view, the SEC's actions regarding short selling activities departed from this rule);
- Consider the cost before moving forward, and bear in mind that marginal costs matter;
- Avoid regulatory uncertainty by making rules clear and applying them rationally;
- Pursue the most important regulatory actions first (the SEC violated this rule, she said, by concerning itself with

global warming);

- Scrutinize broad reforms so as not to encompass certain parties unnecessarily; and
- Do not fight the last war, especially because markets always respond faster than regulators.

### **Commissioner Elisse B. Walter**

Commissioner Elisse Walter spoke generally about the Commission's rulemaking procedures in an attempt to address misunderstandings and encourage more effective comments. She began with a detailed description of the workings of the entire process, emphasizing that every step is crucial to the SEC's reaching an informed decision. While it is impossible to satisfy all interested parties, the SEC carefully weighs the conflicting arguments urged upon it, and makes appropriate changes when merited by the facts or sound policy arguments. Commissioner Walter called for constructive comments that express not merely approval or disapproval but offer suggestions for better courses of action.

Furthermore, she discussed the SEC's efforts at streamlining the rulemaking process. Since Mary Schapiro became chairman, the pace of the rulemaking process has increased to an average of about six months. Two-thirds of self-regulatory rules are immediately effective, and all but 2% are approved within 35 calendar days. (At the same time, she added, while striving for efficiency, the SEC must prevent SROs from using their rules for anti-competitive purposes.)

Finally, Commissioner Walter echoed the achievements that Chairman Schapiro described more fully in her speech, such as the creation of specialized investigative groups and the restructuring of middle management in Enforcement.



*The full text of Commissioner Walter's speech may be found online at*

<http://www.sec.gov/news/speech/2010/spch020510ebw.htm>.

### **Commissioner Luis A. Aguilar**

Commissioner Luis Aguilar spoke warmly in favor of meaningful, structural, and sustainable regulatory reform. Although he acknowledged that Congress has taken steps to address financial reform, Commissioner Aguilar expressed doubts on the robustness of any bill that might be adopted. For example, he noted that the Wall Street Reform and Consumer Protection Act of 2009 that was passed by the House of Representatives contains loopholes such as an exemption for 50 percent of all US public companies from having an outside audit of their internal controls.

Commissioner Aguilar stressed that the SEC needs to continue to evolve to accomplish its goals of protecting investors, maintaining fair and orderly markets, and facilitating capital formation. While he applauded the Commission's creation of the Investor Advisory Committee and the streamlining of the formal order process, Commissioner Aguilar spoke of further reforms needed at the SEC. In connection with enforcement actions, Commissioner Aguilar would like the Commission's Penalty Statement of 2006 to be reconsidered. In his view, the Penalty Statement mistakenly favors two factors above others — the degree to which the penalty will recompense injured shareholders and to what extent the company benefited from the fraud. Commissioner Aguilar believes that the focus should, in fact, be on deterrence and punishment based upon the misconduct itself.

He further stressed that the SEC staff needs appropriate tools to monitor for market abuse and emphasized the importance of creating a uniform audit trail in a central, searchable repository that would provide a real-time view of market activity. He said that the proposed system should be

scalable to allow for the inclusion of new products and practices in securities markets, and, ideally, the derivatives markets. In addition to providing an effective tool for the staff, Commissioner Aguilar stated that such an audit trail would reduce the cost and complexity of current record keeping and reporting obligations of market participants.

Furthermore, Commissioner Aguilar was critical of e-Proxy (the SEC rule that allows companies to send shareholders a notice that proxy materials are available online, but not the materials themselves) because it had resulted in reduced voting by shareholders, especially retail investors. While he remains concerned about the use of e-Proxy, he said that he was encouraged that the Commission's plans to take action to help investors understand it and to make it less confusing.

Finally, Commissioner Aguilar argued that, in connection with financial reform, the single most important act Congress could do is to allow the SEC to be self-funded. This would enable the SEC to set multi-year budgets and respond promptly to drastically changing markets, while also maintaining appropriate staffing.

*The full text of Commissioner Aguilar's speech may be found online at*  
<http://www.sec.gov/news/speech/2010/spch020510laa.htm>.

**Questions regarding the "SEC Speaks in 2010" conference and any of the topics discussed herein may be directed to your primary Sidley Austin LLP contact.**

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<sup>1</sup> While Commissioner Troy A. Paredes did not speak at SEC Speaks due to poor weather conditions in the Washington DC area, Commissioner Paredes' speech can be read at  
<http://www.sec.gov/news/speech/2010/spch020510tap.htm>.

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