Securities Advisory

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JANUARY 18, 2011

The Dodd-Frank Act and Foreign Private Issuers: U.S. Financial Reform Creates New Risks and Obligations for Foreign Businesses Listed in the United States or Otherwise Subject to SEC Reporting Requirements

BY LAURENCE A. SCHOEN, ADAM L. SISITSKY, ARI N. STERN, JONATHAN L. KRAVETZ, YAEL BIRAN, AND JOHN T. RUDY

Overview

On July 21, 2010, U.S. President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Intended as a response to the financial crisis of 2008, this legislation is both fundamentally changing the regulatory landscape for the financial services industry and reforming numerous areas of U.S. securities regulation that impact U.S. public companies in general. Certain provisions of Dodd-Frank apply to foreign private issuers as of its enactment, while other provisions either do not apply or may apply at a later date subject to rulemaking by the Securities and Exchange Commission (the SEC). Key impacts of Dodd-Frank on foreign companies are highlighted below and described in greater detail later in this client advisory.

Foreign Companies Likely to Face Increased Scrutiny from the SEC

Dodd-Frank includes important new provisions that expand the SEC's ability to pursue enforcement actions against foreign companies and have the potential to subject foreign private issuers to increased scrutiny, including the following:

- Expanded extraterritorial jurisdiction for enforcement actions by the SEC against foreign private issuers;
- Large bounties available to encourage whistle-blowers to report violations of U.S. securities laws by foreign private issuers;
- Heightened liability imposed on secondary actors, such as lawyers and accountants, for "aiding and abetting" securities violations; and
- Increased financial resources for the SEC and more flexibility in the use of SEC administrative proceedings, likely leading to increased enforcement activity overall.

More Stringent Corporate Governance Standards for Foreign Companies Listed in the United States

Dodd-Frank imposes a number of new corporate governance and executive compensation requirements on foreign private issuers, including the following:

- Obligating foreign private issuers to have a compensation committee that is entirely

independent or disclose the reasons for not complying;

- Forcing companies to clawback compensation paid to executives in the event of a restatement of financial results (the applicability of this to foreign private issuers will depend on future SEC rulemaking); and
- Requiring companies to disclose the median compensation of their employees other than the CEO and the ratio of that median to the CEO's compensation (the applicability of this to foreign private issuers will depend on future SEC rulemaking).

With much of Dodd-Frank's ultimate impact on foreign private issuers yet to be determined, Mintz Levin will be following the SEC rulemaking and interpretative guidance as they develop. The following client advisory is intended solely as a summary of certain of the provisions to which foreign private issuers are now or may become subject and does not provide an exhaustive list or analysis.

Please do not hesitate to contact your Mintz Levin attorney if you have any questions or concerns about Dodd-Frank generally or any of the specific provisions discussed briefly below.

Extraterritorial Jurisdiction

With Dodd-Frank, the U.S. government has sought to significantly expand U.S. regulatory enforcement's extraterritorial jurisdiction. Section 929P of Dodd-Frank grants jurisdiction to U.S. federal district courts over actions brought by the SEC or the U.S. Department of Justice alleging violations of the U.S. securities laws in securities transactions where (1) conduct within the United States constitutes a significant step in furtherance of a violation, even if the transaction occurs outside the United States and involves only foreign investors, or (2) conduct occurring outside the United States has a foreseeable substantial effect within the United States.

This provision appears to reverse the U.S. Supreme Court's recent decision in *Morrison v. National Australia Bank Ltd.*, No. 08-1191 (U.S. June 24, 2010), which held that the antifraud provisions of the U.S. securities laws do not apply to transactions that take place outside of the United States and rejected past decisions by lower courts that had used "conduct" and "effect" tests to determine whether the U.S. securities laws could apply extraterritorially. While some legal commentators have questioned whether the actual statutory language of Dodd-Frank as currently formulated is sufficient to expand the geographic scope of the securities laws, the legislative history of Dodd-Frank indicates that the intent of most of its drafters was to do just that.

It should be noted that Dodd-Frank does not create an extraterritorial cause of action for private individuals, meaning that *National Australia* remains a bar on a foreign private individual bringing suit against a foreign company in connection with a securities transaction occurring outside the United States. However, Section 929Y of Dodd-Frank directs the SEC to, within 18 months of Dodd-Frank's enactment, "solicit public comment" and "conduct a study to determine the extent to which private rights of action" under the antifraud provisions of the U.S. securities laws should extend extraterritorially.

Expanded Liability of Secondary Actors

Aiding and Abetting Liability

Dodd-Frank provides the SEC with expanded authority to bring enforcement actions against secondary actors and "gatekeepers," such as lawyers and accountants, for "aiding and abetting" violations of the securities laws (§§ 929M and 929N). Whereas, prior to Dodd-Frank, such secondary actors would have to be shown to have "knowingly" provided substantial assistance to the alleged violator, Dodd-Frank permits aiding and abetting liability to be imposed on secondary actors who "knowingly or recklessly" provide such assistance (§ 929O). As is the case with expanded extraterritorial jurisdiction, Dodd-Frank does not create a private cause of action for aiding and abetting liability, but does direct the U.S. Government Accountability Office to conduct a study to determine the impact of such a cause of action (§ 929Z).

Control Persons Liability

In addition, Dodd-Frank provides express authority to the SEC to pursue enforcement actions against control persons, those who "directly or indirectly control" the registrant, unless they acted in "good faith" and did not "directly or indirectly induce" the alleged violation (§ 929P(c)).

Mandatory Whistle-Blower Bounties

Of great concern to both U.S. public companies and foreign private issuers, in particular those with U.S. subsidiaries, are the new "whistle-blower bounties" that provide significant monetary incentives for employees and others who learn of potentially fraudulent conduct to share such information with federal regulators first, rather than with their superiors or other internal compliance personnel. Prior to Dodd-Frank, the SEC possessed the authority to pay bounties to whistle-blowers, but such rewards were capped at 10% of collected penalties and restricted to the insider trading context.

Under Dodd-Frank, if information provided by a whistle-blower leads to an SEC enforcement action with monetary sanctions of more than $1 million, then the SEC is required to pay a whistle-blower a reward of between 10% and 30% of such monetary sanctions (§ 922). These bounties must even be paid to whistle-blowers who are violators themselves, unless the whistle-blowers are criminally convicted in connection with such violation (§ 922(a)).

Dodd-Frank also increases the existing protections available to whistle-blowers. Employers are prohibited from retaliating against or otherwise discriminating against whistle-blowers and, in the event of such retaliation or discrimination, such persons are provided a private right of action against their employers in federal court seeking a range of remedies, including reinstatement with appropriate seniority and double back pay (§ 922).

Expanded Enforcement

It is important for U.S. public companies and foreign private issuers alike to recognize the new enforcement environment in which the SEC is operating following the financial crisis of 2008. Dodd-Frank is a product, in part, of widespread dissatisfaction with perceived SEC failures to adequately protect investors from fraudulent activities in the marketplace. In addition to providing expanded statutory powers to enforce the U.S. securities laws, including extraterritorial jurisdiction, aiding and abetting liability and control persons liability as discussed above, Dodd-Frank significantly increases the SEC's financial and manpower resources in order to take advantage of both previously existing and new enforcement tools.

Dodd-Frank has preliminarily authorized a series of increases to the SEC budget that will effectively double it over the course of the next five years, from $1.3 billion in fiscal year 2011 to $2.25 billion in fiscal year 2015. Dodd-Frank also provides the SEC with access to a new reserve fund with a balance not to exceed $100 million that will be funded by SEC fees, with each annual deposit not to exceed $50 million, for use in supplementing its budget (§ 991).

We expect that these greatly increased resources will permit the SEC to increase its enforcement activity considerably over the next five years, and international businesses should be particularly vigilant of any practices that may come within the purview of the SEC. Examples of enforcement actions that the SEC may now take as a direct result of Dodd-Frank include the following:

- Commencing an enforcement action if there is a "foreseeable substantial effect" within the United States, even if the activity in question occurs outside the United States and involves only foreign investors (§ 929P(b));
- Litigating more "aiding and abetting" claims against secondary actors and "gatekeepers," such as lawyers and accountants, resulting in broadened monetary penalties (§ 929O); and
- Obtaining whistle-blower information from a foreign employee or other individuals in return for the significant monetary bounties made mandatory by Dodd-Frank (§

922).

Additionally, prior to Dodd-Frank, for those entities not directly regulated by the SEC (e.g., entities other than registered broker-dealers and investment advisors), the SEC could impose monetary penalties for violations of the securities law only by bringing an action in federal court. Dodd-Frank now permits monetary penalties to be imposed in administrative proceedings brought by the SEC before its own administrative law judges (such proceedings were previously limited to ordering that violations cease and desist and requiring disgorgement of illegal profits).

This may result in more enforcement actions being brought by the SEC as administrative proceedings, where the alleged violator will not enjoy the same rights as in federal court, including limited pretrial discovery and no right to a jury trial (§ 929P(a)). Section 929K of Dodd-Frank also permits the SEC to share information with both other U.S. and foreign securities and law enforcement authorities without waiving privilege with respect to such information.

Corporate Governance and Executive Compensation

While many of the reforms related to corporate governance and executive compensation are to the U.S. proxy rules, which generally do not apply to foreign private issuers, Dodd-Frank will, in some cases, and may, in other cases, impact the corporate governance and executive compensation policies of foreign private issuers in a number of ways. These include the following:

Compensation Committee Independence

Dodd-Frank requires foreign private issuers either to have a compensation committee that is entirely independent, based on criteria established by the SEC, or to publicly disclose the reasons why they have not complied with the independence requirement (§ 952(a)).

Compensation Clawback

Dodd-Frank may potentially require foreign private issuers to implement clawback provisions in their compensation policies that would permit the recovery of incentive-based compensation of executive officers in the event of a restatement of financial results, regardless of whether there was fraud or other misconduct (§ 954). Whether or not these new rules will apply to foreign private issuers will be determined by the SEC and the national securities exchanges in their future rulemaking.

Internal Pay Ratio

Dodd-Frank may potentially require a foreign private issuer to disclose (1) the median of the annual total compensation of all of its employees other than its CEO, (2) the total annual compensation of the CEO, and (3) the ratio between these two figures (§ 953(b)). Whether or not these new rules will apply to foreign private issuers will be determined by the SEC in its future rulemaking.

Sarbanes-Oxley Auditor Attestation on Internal Controls

Dodd-Frank exempts nonaccelerated filers and smaller reporting companies from the auditor attestation on internal controls required by Section 404(b) of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), as amended, and directs the SEC to determine how to reduce the burden of complying with Section 404(b) for companies with a market capitalization between $75 million and $250 million (§ 989G). While the study on reducing the burden of the auditor attestation requirement may or may not result in rulemaking by the SEC, the exemption for nonaccelerated filers and smaller reporting companies means that foreign private issuers with a market capitalization of less than $75 million will now be exempt from the Section 404(b) requirements.

Definition of Accredited Investor in Securities Offerings

Dodd-Frank has amended the definition of an “accredited investor” (one who meets certain asset and other tests in order to qualify to purchase securities sold in a private placement exempt from U.S.

registration requirements) to exclude the value of their primary residence from the calculation of their net worth (§ 413). Foreign private issuers engaged in private placements in the United States should be mindful of this throughout the placement process as it may prevent investors who were previously accredited (including previous investors in the foreign private issuer) from purchasing securities.

Reporting of Beneficial Holdings

Dodd-Frank permits the SEC to accelerate the timeline under which persons who acquire beneficial ownership of more than 5% of a U.S. public company's or a foreign private issuer's securities are required to report such holdings on Schedules 13D or 13G (§ 929R). Whether the SEC reduces the deadline from the current 10 days will depend on future rulemaking. Dodd-Frank also provides that an entity who becomes the beneficial owner of a security upon the purchase or sale of a security-based swap will be subject to those same beneficial ownership reporting requirements (§ 766).

Foreign Accounting Firms

Dodd-Frank expands existing provisions in Sarbanes-Oxley impacting foreign public accounting firms. Such firms are now required to produce upon request their "audit work papers" to the SEC and the U.S. Public Company Accounting Oversight Board (PCAOB) if they provide services upon which a registered public accounting firm relies in conducting an audit or interim review of an issuer (§ 929J). Dodd-Frank also places foreign accounting firms under the jurisdiction of U.S. courts and permits PCAOB, under certain conditions, to share information provided by a foreign accounting firm with foreign auditor oversight authorities without waiving confidentiality or privilege (§§ 929J and 981).

Liability of Rating Agencies

Foreign private issuers that issue securities that are rated by a nationally recognized statistical-rating organization (such as Standard & Poor's or Moody's) should be aware that Dodd-Frank now provides that any rating information included in a registration statement will be considered an expert statement by the rating agency and will be subject to the concomitant enhanced liability for misstatements and omissions applicable to expert statements (§ 939G). However, the SEC has indicated in a *Compliance & Disclosure Interpretation* published on July 22, 2010, that it will not require issuers to obtain consent from a rating agency to include rating information in certain sections of the registration statement, which are the sections where such information is often located.

Recommended Actions by Foreign Private Issuers in Response to Dodd-Frank

Because so many of Dodd-Frank's provisions require rulemaking by the SEC and because the ultimate applicability of many of these reforms to foreign private issuers remains undetermined, we intend to monitor regulatory developments and rulemaking by the SEC and the national securities exchanges.

Every foreign private issuer has the opportunity to comment on the potential rules and regulations, and we encourage you to do so. Such comments may ultimately shape the new regulatory world in which foreign private issuers and their affiliates operate.

If you have any questions or concerns about these new risks and obligations or would like to discuss the comment process with regards to a specific proposed rule, please do not hesitate to contact your Mintz Levin attorney.

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0856-0111-NAT-SEC