July 29, 2011

# U.S. Dodd-Frank Act's Application to Non-U.S. Issuers That are Not Financial Institutions – Rulemaking Progress Report

Since July 21, 2010, when President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**"), U.S. regulatory agencies have been engaged in an intense period of rulemaking to implement the various provisions of the Act. This memorandum summarizes the rulemaking progress of those provisions of the Act most likely to be of interest to foreign private issuers that are not financial institutions.[1] For a summary of the Act generally, please see our previous memoranda on the topic: *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010* (July 21, 2010) and *Dodd-Frank Wall Street Reform and Consumer Protection Act, Preliminary Assessment of Provisions Effective Immediately or Very Soon After Enactment* (July 21, 2010). For a summary of our original memorandum on the Act relating to Non-U.S. issuers that are not financial institutions, see *U.S. Dodd-Frank Act's Application to Non-U.S. Issuers That are Not Financial Institutions* (August 13, 2010).

## Whistleblower Protection and Incentives/Final Rules Adopted

The SEC has recently adopted final rules to implement the whistleblower provisions of the Act. Under the Act, any eligible whistleblower who voluntarily provides the U.S. Securities and Exchange Commission (the "**SEC**") with original information that leads to the successful enforcement of an action brought by the SEC under the U.S. federal securities laws must receive an award of between 10 and 30 percent of the total monetary sanctions collected if the sanctions exceed $1,000,000. Information relating to a possible violation of foreign securities laws will not qualify for a whistleblower award. The rules also prohibit retaliation against persons who qualify as whistleblowers under the rules.

For more information on the final whistleblower rules, see Davis Polk's newsflash: *SEC Adopts Final Whistleblower Rules* (May 25, 2011).

## Beneficial Ownership Reporting Provisions

As previously reported, Section 929R of the Act amended Section 13 of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), to authorize the SEC to shorten the 10-day period in which greater than 5% beneficial owners must initially report their ownership of a company's equity securities[2] to the SEC on Form 13D. To date the SEC has not taken any steps to shorten the 10-day reporting period.

Section 766 of the Act, which became effective on July 16, 2011, amends Section 13 of the Exchange Act to preclude security-based swap agreements[3] from being deemed as beneficial ownership positions in the underlying securities unless the SEC, by rule, determines (after consultation with the prudential regulators and the Treasury) that (1) the purchase or sale of the security-based swap provides incidents of

[1] For an update of rulemaking under the Act more generally, including with respect to non-U.S. financial institutions, see the Davis Polk report: *One-Year Anniversary of Dodd-Frank Progress Report* (July 22, 2011).

[2] The securities must be of a class registered under Section 12 of the Exchange Act, which would include any equity security listed on a U.S. exchange.

[3] A "security-based swap agreement" is defined as a swap agreement of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.

ownership comparable to direct ownership of the equity security, and (2) it is necessary to achieve the purposes of Section 13 of the Exchange Act that the purchase or sale of the security-based swaps be deemed the acquisition of beneficial ownership of the equity security.

To ensure that Section 766 of the Act does not supersede existing beneficial ownership rules relating to security-based swaps, the SEC has readopted current Exchange Act Rules 13d-3 and 16a-1 without change. Under these rules, deemed beneficial ownership exists where a security-based swap (i) gives a person voting or investment power over the underlying security, (ii) is used as part of a plan or scheme to evade beneficial ownership reporting requirements or (iii) gives a person the right to acquire the underlying security within 60 days or the person holds such right to acquire with the purpose of changing or influencing control. For more information on the beneficial ownership provisions, see Davis Polk's newsflash: *SEC Adopts Rule on Beneficial Ownership of Security-Based Swaps* (June 9, 2011).

## Credit Ratings

As previously reported, the Act imposes new governance and compliance requirements, penalties and liability on nationally recognized statistical rating organizations ("**NRSROs**"), which are expected to impact how NRSROs conduct their business and their relationship with their customers. The Act, among other things, increases internal controls requirements, requires greater transparency of rating procedures and methodologies, provides investors with a private right of action against credit rating agencies, and provides the SEC with greater enforcement and examination tools.

As part of its efforts to reduce U.S. securities rules, regulations and forms reliant on credit ratings, the SEC has adopted final rules that revise the Form S-3 and Form F-3[4] transaction eligibility criteria so that issuers of non-convertible debt securities will no longer qualify to use Form S-3 and Form F-3 on the basis of issuing investment grade securities. Companies often rely upon this investment grade criterion to establish that their Form S-3 or Form F-3 eligibility for issuances of corporate debt securities if they do not meet the alternate transaction requirement that they have at least $75 million in common equity held by unaffiliated shareholders. Under the final rules, the investment grade transaction eligibility criterion will be replaced with four alternative transaction criteria, which will allow issuers that meet the Form S-3 or Form F-3 registrant requirements to register primary offerings of non-convertible debt securities on these forms if they:

- have issued, for cash, more than $1 billion in non-convertible securities, other than common equity, through registered primary offerings over the prior three years;
- have outstanding $750 million of non-convertible securities, other than common equity, that were issued through registered primary offerings for cash;
- are a wholly-owned subsidiary of a well-known seasoned issuer as defined under the Securities Act; *or*
- are a majority-owned operating partnership of a real estate investment trust that qualifies as a well-known seasoned issuer.

The final rules also include a temporary grandfather provision that allows an issuer to use Form S-3 or Form F-3 for a period of three years from the effective date of the amendments if it would have been

[4] Form F-3 is the short form registration statement for foreign private issuers.

eligible to register the securities offerings under the old investment grade debt issuance registrant requirements.

For more information on the final rules removing investment grade ratings from Form S-3 and Form F-3 eligibility criteria, see the Davis Polk client newsflash: *SEC's Final Rules Modify Form S-3 and F-3 Transaction Eligibility Criteria for Debt Issuances* (July 26, 2011).

The SEC has also issued proposed rules that would eliminate the current exemption in Rules 101 and 102 of Regulation M for investment grade securities and replace it with an exemption based on a non-equity security's trading characteristics. Rules 101 and 102 of Regulation M are designed to prevent market manipulation by prohibiting issuers, selling security holders, distribution participants, and their affiliates from directly or indirectly bidding for or purchasing a "covered security" during a restricted period. Rules 101(c)(2) and 102(d)(2) currently exempt "investment grade nonconvertible and asset-backed securities." The SEC is proposing to remove these references to credit ratings and replace them with new standards relating to the trading characteristics of covered securities. Under the proposal, nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities would be exempt from Rules 101 and 102 if they (i) are liquid relative to the market for that asset class, (ii) trade in relation to general market interest rates and yield spreads, and (iii) are relatively fungible with securities of similar characteristics and interest rate yield spreads. The comment period for the proposed rules expired on July 5, 2011, and the timing of any adoption of final rules remains uncertain.

For more information on the proposed amendment to Regulation M, see Davis Polk's memorandum: *SEC Proposal Would Replace Regulation M Exemption for Investment Grade Securities with Exemption Based on Non-Equity Security's Trading Characteristics* (May 18, 2011).

## Sarbanes-Oxley Act Internal Controls for Certain Accelerated Filers

The Staff of the Office of the Chief Accountant of the SEC has published a study recommending that no exemption be granted to reporting companies with a market capitalization of greater than $75 million but less than $250 million from the requirement to provide an auditor attestation report on internal controls pursuant to Section 404(b) of the Sarbanes-Oxley Act. The study, which was prepared in response to a requirement under Section 989G of the Act, also concluded that granting an exemption to issuers that would expect to have between a $75 million and $250 million public float following an IPO would not, by itself, encourage companies in the United States or abroad to list their initial public offerings in the United States. The SEC has expressed no views regarding the conclusions of the study.

## Corporate Governance and Executive Compensation

As previously reported, many of the corporate governance and executive compensation provisions contained in the Act amend the U.S. proxy rules or the executive compensation disclosures required in proxy statements by Item 402 of Regulation S-K (for example, proxy access, say-on-pay and new executive compensation disclosures) and are not expected to apply to foreign private issuers. The following corporate governance and executive compensation provisions, however, are subject to further definition by SEC rulemaking and could apply to foreign private issuers. While not certain, the SEC may ultimately exempt foreign private issuers from some or all of these requirements as they have done with other corporate governance and executive compensation-related items in the past.

**Compensation Committee and Adviser Independence.**

The SEC has proposed rules to implement the Act's requirements regarding the independence of compensation committees and their advisers. In its proposing release, the SEC expressed the view that, for those foreign private issuers with a two-tier board, the supervisory or non-management board would be better equipped to comply with the proposed rules. As such, to the extent that the supervisory or non-management board forms a separate compensation committee, the proposed rules would apply to that committee. *The compensation committee independence requirements do not apply to foreign private issuers that disclose annually the reasons why they do not have an independent compensation committee in place.*

The proposed independence rules largely mirror the provisions of Section 952 of the Act and delegate to the national securities exchanges the work of developing their own rules. As a result, companies will not be able to assess the impact of the rules on their compensation committees and advisers until the exchanges propose their listing standards. The comment period for the proposed rules expired on May 19, 2011. Upon publication of the final rules in the Federal Register, the exchanges will have 90 days to propose listing standards implementing the rules.

For more information on the proposed independence rules for compensation committees, see the Davis Polk memorandum: *SEC Proposes Independence Rules for Compensation Committees and Advisers* (April 1, 2011).

**Executive Compensation and Clawback.**

As previously reported, Section 954 of the Act provides that the SEC must direct national securities exchanges to adopt clawback policies enabling the recovery of incentive-based compensation from current or former executive officers following a restatement of financial results. The trigger would be based on material noncompliance with any financial reporting requirements that led to a restatement, during the three-year period preceding the date on which a company is required to prepare the restatement. The amount to be clawed back is the amount in excess of what would have been paid under the restated results. The SEC is planning to propose and adopt rules relating to clawback policies between August and December 2011.

**Employee and Director Hedging Disclosure.**

The Act requires issuers to disclose whether any employee or member of the board of directors is permitted to purchase financial instruments designed to hedge or offset any decrease in the market value of equity securities held by or granted to the employee or board member as part of his or her compensation. The SEC is planning to propose and adopt rules relating to hedging disclosure between August and December 2011.

**Separation of CEO and Chairman Roles.**

The Act requires the SEC to issue rules requiring companies to disclose why they have separated or combined the positions of chairman of the board of directors and CEO. Although the SEC's deadline for issuing the rules expired on January 17, 2011, the SEC has not yet proposed any rules relating to this requirement. Notably, this provision of the Act duplicates existing proxy disclosure rules, which do not apply to foreign private issuers, and it is unclear, what, if any, further steps the SEC will take in response to this directive.

## New Disclosures by Mining and Other Extraction Issuers

### Reporting Requirements Regarding Coal or Other Mine Safety.

The SEC has proposed rules to implement the requirements of Section 1503 of the Act that would require operators of coal or other mines located in the United States to provide disclosure about mine safety violations in their periodic reports. Although mine operators should already be complying with these requirements, the proposed rules, while not yet final, clarify and provide insight into the SEC's current interpretation of these provisions. The comment period for the proposed rules expired on March 2, 2011, and the SEC is planning to adopt rules relating to this disclosure requirement between August and December 2011. For more information, see the Davis Polk memorandum: *SEC Proposes Rules to Implement Dodd-Frank Mine Safety Disclosure Requirements* (January 18, 2011).

### Disclosure of Payments by Resource Extraction Issuers.

The SEC has proposed rules to implement Section 1504 of the Act, which requires resource extraction issuers to disclose payments made to U.S. or foreign governments for the commercial development of oil, natural gas or minerals. In large part, the proposed rules reiterate the text of the Act's provision and do not define many of the key terms in the provision, but request comment on whether and how to define these terms (such comment period has now expired). The proposed rules would apply to both U.S. and foreign private issuers that (i) file an annual report with the SEC and (ii) engage in the commercial development of oil, natural gas or other minerals, regardless of the size or extent of such commercial development operations. Foreign private issuers subject to the rules would be required to disclose, in an exhibit to their annual report on Form 20-F or 40-F, the total amount of payments made by the company or entities under its control to a foreign government or the U.S. federal government for each project related to the commercial development of oil, natural gas, or minerals that is "not *de minimis*." The comment period for the proposed rules expired on March 2, 2011, and the SEC is planning to adopt rules relating to this disclosure requirement between August and December 2011. For more information, see the Davis Polk memorandum: *SEC Proposes Rules Implementing Dodd-Frank Disclosure Requirements for Resource Extraction Issuers* (January 18, 2011).

### Conflict Minerals.

The SEC has proposed rules that implement Section 1502 of the Act, which requires companies that file Exchange Act reports (including foreign private issuers) to provide disclosures about conflict minerals that are "necessary to the functionality or production of a product manufactured by the company." This disclosure requirement is expected to impact companies in a wide variety of industries due to the broad use of the minerals classified as "conflict minerals" under the provisions. The proposed rules are also fairly broad in their definition of "manufacture" and could therefore impact companies that do not manufacture their own products. The comment period for the proposed rules expired on March 2, 2011, and the SEC is planning to adopt rules relating to this disclosure requirement between August and December 2011. For more information, see the Davis Polk memorandum: *SEC Proposes Rules to Implement Dodd-Frank Requirements for Conflict Minerals Originating in the Democratic Republic of Congo* (January 18, 2011).[5]

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[5] In accordance with Section 1502 of the Act, the US State Department on July 15, 2011 endorsed the OECD's guidance on establishing due diligence practices on the origin and chain of custody of conflict minerals. A copy of this press release can be found here.

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## Securities Law Enforcement

**Extraterritorial Jurisdiction of the Antifraud Provisions of the Federal Securities Law.**

As previously reported, Section 929P(b) of the Act extended the jurisdictional reach of the antifraud provisions of the U.S. federal securities laws, but only with respect to actions by the United States or the SEC. Section 929Y of the Act directed the SEC to study whether the U.S. courts' extraterritorial jurisdiction should be extended to private rights of action under the antifraud provisions of the U.S. federal securities law (which could ultimately lead to the adoption of additional regulation to overturn the *Morrison* decision). The SEC is scheduled to report the results of this study to Congress during the first half of 2012. For more on the *Morrison* case, see the Davis Polk memorandum: *Update: U.S. Supreme Court Limits Extraterritorial Application of U.S. Securities Laws - Morrison v. National Australia Bank* (June 28, 2010).

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