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Dodd-Frank Act the 'Worst of Both Worlds,' says David Hirschmann

President and CEO of U.S. Chamber of Commerce's Center for Capital Markets Competitiveness says Legislative Fixes & More Reform Needed to Provide Business with Coherent Regulation

BY GREGG WIRTH, WSL MANAGING EDITOR

David Hirschmann, the President and CEO of the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness, has been at the forefront of just about every legal issue impacting Wall Street and the regulatory environment that oversees it. Born out of the business community's reaction to earlier regulatory reform, the Center for Capital Markets Competitiveness under Mr. Hirschmann has spent the last decade trying to reshape the regulatory structure of the markets into a system that would be more coherent, efficient and easier for businesses to navigate.

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From the EDITOR

Story of the Year: Occupy Wall Street Shifts the Debate on Wall Street

When we look back at 2011, assessing the important stories of the year that impacted Wall Street and financial industry regulation, there appears to be no end of contenders for the top slot.

Still, one story loomed just slightly larger, perhaps because its emergence was so unanticipated, or perhaps because it stirred debate about Wall Street, its practices and its socio-economic role among lots of people across the country who normally don't even think about Wall Street. That's why the Occupy Wall Street protests that shifted the debate about the financial crisis, jobs and the economy—a shift that put Wall Street and investment banks squarely on the defensive—is our pick for *WSL*'s top story of the 2011.

On October 5, *WSL* ventured down to the Occupy Wall Street (OWS) encampment in Lower Manhattan's Zuccotti Park, to see what the then-fledgling protest movement was all about. (See "*View from Zuccotti Park*: Is Wall Street Underestimating the 99%?", Editor's Letter, by Gregg Wirth, *WSL* Managing Editor, in the November 2011 issue of *WSL*, vol. 15, issue 11.) Among the scattering of tarps, tents, and sleeping bags, we found a disparate group of people who, despite their differing demographics and backgrounds (or perhaps because of them), were forging a movement that had at its core a keen understanding of how Wall Street worked and for whom. And they weren't happy about it.

Since that October day, support for OWS surged massively around the world, even as city governments began to crack-down on the protests. When New York City police cleared Zuccotti Park in mid-November, the OWS protests did not end. In fact, it seemed to go viral, or more accurately, ethereal. The change in group-mindset was now in the air, fed by politicians, economists and pundits who seemed to openly question the "what's good for Wall Street" mantra that had permeated national economic debate for the past several decades. Warned one OWS activist, "the public has caught Occupy fever, a sign that while we may no longer Occupy Zuccotti, we are continuing to Occupy the Debate."

While it's uncertain right now where this debate will go, or what real-world results it will produce, it is unlikely to stand still. OWS leaders have refused to call for any organized agenda or political electioneering, but as more politicized elder statesmen move into the organization that may be coming. In fact, no less than *The Economist* suggested that OWS needs to "get on with the tiresome and frustrating grind of actual democratic politics."

The rules and regulations that could come from that collective might leave Wall Street wistful for the halcyon days of Dodd-Frank.

***To Keep an Eye on in 2012:* The SEC's Make or Break Year**—In 2011, the Securities and Exchange Commission (SEC) was the Rodney Dangerfield of the regulating world. It got no respect—not from federal judges who threw out its long-fought-for proxy access rules or landmark settlement agreements concerning issues at the heart of the financial crisis; and not from Congress, who hamstrung it with the mandate-heavy Dodd-Frank Act even while debating cuts to its budget.

Worse yet, it got no respect comes from the public, who listened to all the SEC speeches about "leveling the playing field" but saw scandals—such as the illegal destruction of documents or the SEC's revolving door—and worried about for whom the SEC really works.

Most disheartening, it's evident that so many of the SEC's wounds are self-inflicted or are born out of its timidity and lack of adherence to its core mandate. That becomes tougher to excuse again and again.

In 2012, the SEC needs to get its act together and make its case for its continued preeminence, or respect will not be the only thing it stands to lose.

—GREGG WIRTH, MANAGING EDITOR

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Mr. Hirschmann sat down with *Wall Street Lawyer* recently to discuss the Center's efforts, its views on the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), the Securities and Exchange Commission (SEC), its lawsuit that invalidated the SEC's proxy access rules, and what to do if you're confronted with conflicting requirements from 32 different regulators.

***Wall Street Lawyer**: Briefly, what is the Chamber of Commerce's Center for Capital Markets Competitiveness, and how does it relate to the Chamber?*

David Hirschmann: We were created post-Sarbanes-Oxley, mostly because of the way the new rules on the 404 assessment and attesting were implemented. A large number of businesses came to us and said regulators didn't get it right. So we wanted to examine that question a bit, and see what the purpose of the rule was that Congress created and the regulators were implementing, and what should have been done instead.

And that goes to a large degree of what we strive to do—we examine regulations, how they're being implemented and how they could affect the flow of capital that is so essential to the U.S. economy. I mean, we had a regulatory structure that has served us well for the past 75 years, but now we're increasingly seeing there are getting to be too many layers of regulation, too many regulators that don't communicate with each other, a regulatory architecture that is obsolete, and an upgrade of technology and innovation that is missing.

All this negatively impacts the U.S. capital markets, which thrives on the ability to drive capital into the hands that will use it efficiently to create jobs and keep the economy robust. Unfortunately, that ability is being eroded by the out-dated regulatory structure we have in this country.

So, we were created by the Chamber several years ago to study this problem, and we immediately came to see that the U.S. economy is threatened by obsolete and in some cases overburdensome regulations and by the overlapping agencies that enforce them. We saw directly that there had to be large-scale and systemic changes to this regulatory regime, or it could easily lead the economy into financial crisis.

Within a short time of that realization, the economy did plunge into crisis. I guess we're good at predicting the need to dramatically address the regulatory situation, just not so good on the timing.

***Wall Street Lawyer**: Of course, the entire blame for the financial crisis of 2007-'08 cannot be placed at the door of the regulators alone. And Congress did act fairly quickly to create legislation—the Dodd-Frank Act—to address some of these problems.*

David Hirschmann: It's easy to vilify Wall Street, too. But at the end of the day, what is in everyone's interest is driving capital to the places it is needed, and avoiding having outside forces picking the winners and losers.

When the crisis hit, the legislative answer to it was created in one of the most polarized political climates we've seen—and the final product shows it. We were given more than 3,000 pages of mandated regulations, studies and reports that many thought would address the problems that caused the crisis. Instead we got the worst of both worlds: a situation where, on one hand, a raft of new, overlapping and in some cases needless rules were created; and on the other, where hugely important problems were not addressed at all.

It's a big myth that American businesses want little or no regulation—what they want is coherent regulation. And that not what they got with Dodd-Frank.

***WSL**: What is coherent regulation?*

Hirschmann: Before Dodd-Frank, I was talking recently to a foreign bank executive as his bank was beginning to make investments in the U.S. The bank's management was invited by the Fed to meet with its regulators to ensure the bank understood its obligations under U.S. rules. When the bank managers got there, they were greeted by 31 different regulators across the table. Thirty-one!

But that's not what bothered the executive I spoke to. What he had contacted me to ask about was what to do when one regulator tells them to turn left, and another tells them to turn right.

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Think of it this way, every morning I, like millions of Americans, get in my car and drive to work. I know what the speed limit is, and I know that having a speed limit is in my best interest, because it keeps other drivers from flying past me and endangering my daughter, who is a passenger in my car. But as a driver, I need to know that the speed limit will not change from day to day, will not be enforced differently for different drivers, and will not allow each police officer to set their own speed limit. Under that system, it would be hard to navigate and most people would be afraid to leave their driveways.

In fact, if you think of a situation where each police officer gets to determine, but not post, his or her own specific speed limit, then you are very close to the essence of the regulatory system we have in this country. And it's that lack of coherence that prevents cars—or in this case, businesses—from leaving their driveways.

WSL*: What happened to the foreign bank after Dodd-Frank?*

Hirschmann: The legislation added two more regulators for it to deal with. Worse yet—and this goes to what I was saying about Dodd-Frank avoiding bigger issues—the Act did nothing to improve communication among all those regulators. They have absolutely no requirement to coordinate or work together to make regulations simpler and more coherent for the entities they regulate. Nothing in the Act mandates that.

In fact, it made it worse. Dodd-Frank came out of the heart of a major financial crisis, and a lot of regulatory agencies took a lot of heat—some rightfully so. But as the legislation was being crafted, so many of these regulatory agencies went into turf-protection mode, and tried to compile and generate reams of data to show they were doing their jobs. Now, we don't object to data and its collections—that's important for transparency—but in that environment, it was just used to preserve an agency's agenda or protect its turf.

But in Dodd-Frank, the Congress seemed to create a list of what it wanted to see and purposefully left the full creation of the new regulations and their implementation to the regulators. Isn't that a better way than issuing all the details from the House floor?

Yes, definitely, legislation should be the blueprint, not the house itself. However, that's a lot different than not tackling the larger issues and providing real structural reform. In a way, we got the worst of both worlds—a score of new regulations, and other major problems left alone.

And that's what makes Dodd-Frank such a lost opportunity. I mean, if this financial crisis didn't teach us that we needed to really make substantial changes to the oversight of the financial markets, what will? Do we need an even bigger crisis?

Your group recently released a report detailing five areas that you think the Dodd-Frank Act missed. Can you tell us about that?

Certainly. Briefly, the five areas that our study showed should have been addressed by the Dodd-Frank Act but were not, include: 1) addressing the regulatory structure itself, that is, real and practical changes to how regulations are approached and regulators function; 2) fixing broken regulators, like the SEC; 3) establishing global rules, in areas like derivatives for example, and leveling the playing field globally; 4) making accountable the scores of self-regulatory organizations—including standard-setters, like Institutional Shareholder Services (ISS)—to provide better transparency; and 5) ensuring that enforcement is not used as a regulatory short-cut.

On that last one, too many times an enforcement action will include, as condition of settlement, promises by the settling entity to establish future "best practices" to better monitor its behavior. Unfortunately, these best practices too often are then put into the mainstream and other entities, especially those structurally similar to the settling party, feel compelled to adopt these best practices also. And that's not the way enforcement was intended to work, it was not to be used as a regulation-making force.

However, you have enforcement agencies like the New York Attorney Generals' office, for example, establishing these best practice settlement requirements all the time, and it becomes a big "gotcha" game for businesses.

You talk a lot about reforming the regulatory structure—in fact, it's the first of your group's five points. In the view of your group and the U.S. Chamber of Commerce as a whole, what would

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the perfect regulatory structure for the U.S. markets look like?

First, I guess we'd have to say we'd have a lot less regulators than the hundreds we do now. Of course, we can't say we have come up with the right number—is it 50, 15 or one? We don't know. I mean, obviously, you can make a good argument that the U.S. markets need more than a single regulator, so that's not the answer either.

But we know that what we and U.S. businesses don't want is what we have now, hundreds of regulators at many, many agencies issuing overlapping and contradictory guidance, battling over turf and generally making it very difficult for businesses to understand and comply with what is being asked of them.

And this system fails everyone. It makes it hard for the honest business to navigate through the confusion, and it makes it very easy for the dishonest business to exploit the seams in the regulatory environment.

Second, a better system would have much more coordination between its differing agencies and would better eliminate the gaps in oversight that occur now. Even the Financial Stability Oversight Council, which has as sitting members every regulatory chief in the U.S. and was created by Dodd-Frank ostensibly to be a type of financial crisis first-responder, is mandated to focus almost solely on monitoring systemic risk and not on regulatory coordination or better coherence.

You also talk about "broken regulators" and you specifically mention the SEC. What do you see as the problems there?

Within a few weeks, we are planning to release an updated version of our 2009 report that described in detail the fundamental reform we'd like to see at the SEC. (*Editor's Note*: The updated report from the Center for Capital Markets Competitiveness, entitled *U.S. Securities and Exchange Commission: A Roadmap for Transformational Reform*, became available just before press time. The report can be found here: http://www.uschamber.com/reports/us-securities-and-exchange-commission-roadmap-transformational-reform.)

However, despite some small progress on reform and enhancements, many of the problems we described in the 2009 report still remain. To give some examples: 1) the SEC is still heavily siloed; 2) there are far too many direct-reports to the SEC Chairman—more than 30 by last count; and 3) the technology upgrades that are desperately needed at the SEC either are not being done or are not being handled very well.

All of these examples contribute to an environment in which far too often the communication between divisions or between parts of the same division isn't there, there is a top-heavy hierarchy that confuses and overburdens managers, and the technological and financial expertise that is desperately needed isn't utilized in the best way.

But there seems to be a Catch-22 with certain members of Congress in that they want the SEC to perform better, but they also want to starve the agency of funding. What's the solution there?

Look, I would agree that the SEC needs more resources, but they would have to be tied to performance and progress on reform. The assessment that Boston Consulting Group did for the SEC in March was a good start, but it didn't complete the full job. Boston Consulting did an analysis of some of the SEC's current shortcomings but did not produce a comprehensive list of recommendations for transforming the agency into a modern regulator.

Let's touch on another subject the Chamber has been directly involved with—proxy access. Your group was party to the suit Business Roundtable and U.S. Chamber of Commerce v. SEC, which in July saw the U.S. Court of Appeals for the District of Columbia Circuit invalidate the SEC's adopted proxy access rules, stating the SEC "neglected its statutory responsibility to determine the likely economic consequences" of its rules. Do you consider that a victory?

I would consider it a victory over the SEC's check-the-box approach to rule-making, which has resulted in problems and confusion for the business community over the years. The SEC often would decide the outcome it wanted, then try to find the data that supported it. That is not how responsible rule-making is done, and I think the judge agreed on that, and ruled that determining a cost/benefit analysis was necessary to the process.

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Now, that might mean the SEC has to hire more economists or find a decent procedure for determining the costs and the benefits of any rule proposal, but if they build it into the rule-making process from the beginning instead of adding it as an after-thought, it won't be a problem. In fact, it will make the entire process more efficient. Most importantly—and what the judge acknowledged—is that from the outset you have to start by asking a simple question: What is this rule supposed to do?

Then, you conduct the rule-making process, including a cost/benefit analysis, forward from there.

Of course, the end-result of the D.C. Circuit's invalidation of the SEC's proxy access rules is that companies are now left with "private ordering"—a process in which proxy access can be implemented by shareholders on a company-by-company basis rather than through a market-wide mandate. Is that a better solution?

The Chamber is comfortable with that. What we didn't want to see is the shareholder or group of shareholders with a special interest getting a free pass to the front of the line ahead of all other shareholders to nominate their agenda or slate of candidates. I think private ordering to a degree mitigates that and allows shareholders at each company to decide how they want to approach the proxy access issue.

I guess another theoretical question this process does leave open, however, and one we're seeing increasingly as social issues—the so-called ESG issues [Environmental, Social, and Governance issues]—are moved to the forefront, is that: Do we think the corporate boardroom is the best place to solve all these social problems?

Finally, what do you see for the regulatory environment in 2012 and beyond?

I think the main story on this front is going to continue to be Dodd-Frank implementation, especially a discussion on what the Act got wrong and how it can be fixed; and secondly, whether we're going to have a real discussion on genuine SEC reform.

As we look forward, it is going to become more and more clear that 1) Dodd-Frank did get some things right; and 2) Dodd-Frank did get some things wrong, and those things are going to need a regulatory fix. In some cases, I think Congress may have to reinsert itself into the process to make a legislative change. The area of derivatives is one example—how can we protect the ability of institutions to continue to use derivatives to reduce their risk while avoiding the problems with derivatives seen in the crisis?

Overall, however, I think we're going to see that we are not done on regulatory reform, even with the raft of rules embodied in Dodd-Frank. And that is simply because a financial crisis is never the right time to propose future regulations—there becomes a pressure for speed over substance.

I mean, I don't fault the desire for regulatory reform coming out of the crisis, but as I said, the Dodd-Frank Act gave us the worst of both worlds—a mass of sometimes confusing and overlapping regulations, and at the same time, big holes in the regulatory structure that the Act didn't even bother to address.

What is in Store for the Corporate Boardroom in 2012?

BY MARTIN LIPTON

Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, and specializes in advising major corporations on mergers and acquisitions and matters affecting corporate policy and strategy. This article is taken from a pair of legal memos written by Mr. Lipton concerning issues that will likely be faced by corporate boardrooms in the coming year. Contact: mlipton@wlrk.com.

Key Issues for Directors in 2012

For a number of years, as the new year approached, I have prepared a one-page list of the key issues that are newly emerging or will be especially important for boards of directors in the coming year. Each year, the legal rules and aspirational best practices for corporate governance matters, as well as the demands of activist shareholders seeking to influence boards of directors, have increased. So too have the demands of the public with respect to health, safety, environmental and other socio-political issues. Below, I have compiled a list of the roles and responsibilities that boards today are expected to fulfill. Looking forward to 2012, it is clear that in addition to satisfying these expectations, the key issues that boards will need to address include:

1. Working with management to navigate the dramatic changes in the domestic and worldwide economic, social and political conditions, in order to remain competitive and successful.

2. Coping with the increase in regulations and changes in the general perception of business that have followed the financial crisis. Once it was said, "The business of America is business." Today, it could be said, "The business of America is government, and a dysfunctional government at that."

3. Dealing with populist demands, such as criticism of executive compensation and risk management, in a manner that will preempt increased regulation and avoid escalation of activist demands while at the same time furthering the best interests of the corporation.

4. Organizing the business, and maintaining the collegiality, of the board so that each of the increasingly time-consuming matters that the board is expected to oversee receives the appropriate attention of the directors.

5. Working with management to encourage entrepreneurship, appropriate risk-taking, and investment to promote the long-term success of the company, despite the pressures for short-term performance.

6. Retaining and recruiting directors who meet the requirements for experience, expertise, diversity, independence, leadership ability, and character; and providing compensation for directors that fairly reflects the significantly increased time and energy that they must now spend in serving as board members.

7. Developing an understanding of shareholder perspectives on the company, as well as coping with the escalating requests of union and public pension funds and other activist shareholders for meetings to discuss governance and business proposals.

8. Developing an understanding of how the company and the board will function in the event of a crisis. Most crises are handled less than optimally because management and the board have not been proactive in planning to deal with crises, and because the board cedes control to outside counsel and consultants.

The Spotlight on Boards

The focus on the performance of corporate boards prompts a revisiting of what is expected from the board of directors of a major public

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company—not just the legal rules, but also the aspirational "best practices" that have come to have almost as much influence on board and company behavior.

Boards are expected to:

- Establish the appropriate "Tone at the Top" to actively cultivate a corporate culture that gives high priority to ethical standards, principles of fair dealing, professionalism, integrity, full compliance with legal requirements, and ethically sound strategic goals.
- Choose the CEO, monitor his or her performance and have a detailed succession plan in case the CEO becomes unavailable or fails to meet performance expectations.
- Work with management to navigate the dramatic changes in economic, social, and political conditions, in order to remain competitive and successful.
- Plan for and deal with crises, especially crises where the tenure of the CEO is in question, where there has been a major disaster or risk management crisis, or where hard-earned reputation is threatened by product failure or a socio-political issue.
- Determine executive compensation to achieve the delicate balance of enabling the company to recruit, retain and incentivize the most talented executives, while avoiding media and populist criticism for "excessive" compensation.
- Interview and nominate director candidates, monitor and evaluate the board's own performance and seek continuous improvement in board performance.
- Approve the company's annual operating plan and long-term strategy, monitor performance and provide advice to management as a strategic partner.
- Determine the company's reasonable risk appetite (financial, safety, reputation, etc.), set state-of-the-art standards for managing risk and monitor the management of those risks within the parameters of the company's risk appetite.
- Set state-of-the-art standards for compliance with legal and regulatory requirements, monitor compliance and respond appropriately to "red flags."
- Take center stage whenever there is a proposed transaction that creates a seeming conflict between the best interests of stockholders and those of management, including takeovers.
- Set the standards of social responsibility of the company, including human rights, and monitor performance and compliance with those standards.
- Oversee government and community relations.
- Pay close attention to investor relations to develop an understanding of shareholder perspectives on the company, and interface with shareholders in appropriate situations.
- Work with management to encourage entrepreneurship, appropriate risk-taking, and investment to promote the company's long-term success, despite pressures for short-term performance. (This is also among the key issues listed above.)
- Review corporate governance guidelines and committee charters and tailor them to promote effective board functioning.

To meet these expectations, it will be necessary for major companies 1) to have a sufficient number of directors to staff the requisite standing and special committees and to meet expectations for diversity; 2) to have directors who have knowledge of, and experience with, the company's businesses, even though meeting this requirement may result in boards with a greater percentage of directors who are not "independent"; 3) to have directors who are able to devote sufficient time to preparing for and attending board and committee meetings; 4) to provide the directors with regular tutorials by internal and external experts as part of expanded director education; and 5) to maintain a truly collegial relationship among and between the company's senior executives and the members of the board.

Say-on-Pay & the Business Judgment Rule—Lessons from *Cincinnati Bell* and *Beazer Homes*

BY ARTHUR KOHN & JANET FISHER

Arthur Kohn and Janet Fisher are partners in the New York office of Cleary Gottlieb Steen & Hamilton LLP. Mr. Kohn's practice focuses on compensation and benefit matters, and Ms. Fisher's practice focuses on corporate governance, financing transactions and securities law matters. Samuel Bryant, a law clerk in the firm's New York office, contributed to this article. Contact: akohn@cgsh.com or jfisher@cgsh.com.

More than 40 companies received negative say-on-pay advisory votes in 2011, the first year for those votes under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[1] Despite the advisory nature of the votes and Dodd-Frank's helpful language that the votes are not intended to affect director fiduciary duties,[2] at least 10 derivative lawsuits have been filed after failed votes. Two present an interesting contrast insofar as they address the "business judgment rule" and the requirement of presuit demand in the context of executive compensation.

The first involves Cincinnati Bell and was brought in federal court in Ohio under Ohio law. It is the only such suit to survive a motion to dismiss to date.[3] The other is a case involving Beazer Homes, which was dismissed by a Georgia state court applying Delaware law.[4] We believe that the *Cincinnati Bell* case is inconsistent with the historical application of the business judgment rule and that *Beazer Homes* will ultimately prove the majority approach. Nonetheless, both cases bear consideration for what they suggest about the importance of process in making compensation decisions.

The Citadel of Business Judgment?

The new say-on-pay derivative suits come in the context of a decade-long reevaluation, in the Delaware courts and elsewhere, of the fiduciary duties of directors and executives in the compensation context. Traditionally, the courts interpreted the so-called "business judgment rule" as an almost unassailable citadel of discretion for directors determining management pay.[5] Under the rule, "informed decisions regarding employee compensation by independent boards"[6] are shielded from judicial review unless plaintiffs can overcome a presumption that directors acted on an informed basis, in good faith, and in the honest belief that those decisions were in the best interests of the company."[7] Unless shareholders allege particular facts calling these elements into question, the presumption stands and a motion to dismiss for failure to state a claim is granted. If the presumption is defeated, defendants must prove the "entire fairness" of a transaction—both that it was arrived at through a process of fair dealing and that it was substantively fair.[8]

Even as litigation involving corporate governance matters has increased, Delaware courts have repeatedly affirmed the continuing vigor of the business judgment rule.[9] But it is clear that courts will carefully scrutinize the factual allegations to determine the appropriateness of its application in a given context. In the case of executive compensation, several cases in recent years have suggested a greater willingness of the courts to find that plaintiffs have overcome the presumption.

Most often, the allegations in these cases have involved facts suggesting that directors were not sufficiently independent. Independence is a deal-specific inquiry under Delaware state law, separate from similar requirements under stock exchange listing rules, securities law and the tax code. In 1998, for example, when shareholders of the Walt Disney Co. challenged the severance package paid to outgoing president Michael Ovitz, the Chancery Court found that a reasonable doubt had been raised about the independence of one purportedly independent director (although not others) who had approved the compensation.[10]

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Similarly, a suit by shareholders of ICN Pharmaceuticals (now called Valeant Pharmaceuticals International, Inc.) went to trial on allegations that the process for awarding bonuses was compromised by management domination and the advice of conflicted compensation consultants.[11]

In other cases, even when directors were found to be independent, courts have concluded that plaintiffs pled facts suggesting that the board failed to act in an informed and faithful manner. In a suit against directors of Integrated Health Services, for example, shareholders alleged that the compensation committee and the full board approved, and later forgave, loans to the CEO without any deliberation or consideration.[12] The court found in 2004 that these allegations, if true, implied that the board "consciously and intentionally disregarded [its] responsibilities."[13]

Cincinnati Bell and *Beazer Homes*

In May 2011, Cincinnati Bell shareholders voted against approval of the company's 2010 executive compensation.[14] Following the vote, the NECA-IBEW Pension Fund brought a derivative suit against the board of directors in the U.S. District Court for the Southern District of Ohio.[15] The plaintiff alleged that directors had breached their fiduciary duty of loyalty when they approved salary increases and bonuses for Cincinnati Bell's CEO and other top executives. To support this allegation, the plaintiff made two factual claims: first, that the bonuses, which totaled more than $4 million for the top five executives, and salary increases awarded were inconsistent with the company's performance, as measured by net income, earnings per share, share price and annual shareholder return; and second, that the negative say-on-pay vote provided "direct and probative evidence that the 2010 executive compensation was not in the best interests of the Cincinnati Bell shareholders."[16] The directors moved to dismiss the suit, arguing that the facts alleged were insufficient to overcome the presumption of the business judgment rule. Under Ohio law, the presumption applies unless directors are shown to have acted with "a deliberate intent to cause injury to the corporation" or "reckless disregard for the best interests of the corporation."[17]

The court denied the motion to dismiss. Stating that the business judgment rule "imposes a burden of proof, not a burden of pleading,"[18] the court accepted that plaintiff's factual allegations were sufficient for the case to proceed. Specifically, it stated:

> **[t]hese factual allegations raise a plausible claim that the multi-million dollar bonuses approved by the directors in a time of the company's declining financial performance violated Cincinnati Bell's pay-for-performance compensation policy and were not in the best interests of Cincinnati Bell's shareholders and therefore constituted an abuse of discretion and/or bad faith.[19]**

This finding is particularly notable—and troubling. By reaching this conclusion without any facts suggestive of abuse of discretion or bad faith having been pled, the court seemed prepared to engage in the kind of second-guessing that the business judgment rule is intended to foreclose.

The *Cincinnati Bell* court also concluded that presuit demand on the board was excused as futile.[20] The court argued that the directors who devised and approved the compensation package, and whose recommendation to approve the package failed, were unable to make "unbiased, independent business judgments about whether to sue" on behalf of the company.[21] The court reached this conclusion despite the fact that all of the company's directors were independent, other than the CEO. This reasoning is also troubling. The requirement of presuit demand would have little import if mere involvement as a director in a board-level matter disqualifies directors from evaluating a derivative claim.

Cincinnati Bell stands in stark contrast to *Beazer Homes* on both procedural and substantive grounds. The *Beazer Homes* court granted defendants' motion to dismiss on multiple grounds, but in particular found that presuit demand was not excused.[22] Like the board in *Cincinnati Bell*, only one Beazer director (the CEO) received the compensation at issue, and there were no allega-

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tions that the challenged compensation "was not in fact awarded consistent with executives' performance against[…] predetermined financial and non-financial goals and targets," that the Beazer board failed to act in good faith, or that directors did not "believe that those performance goals and targets were critical to enhancing stockholder value, and, thus, appropriate metrics upon which to base executives' compensation."[23]

The *Beazer Homes* court also rejected the contention that the failed say-on-pay vote rebutted the presumption of the business judgment rule. Since the pay decisions preceded the vote, the outcome of the vote could not be evidence that directors had not acted properly: "[h]indsight second-guessing and Monday morning quarterbacking of the sort plaintiffs urge are fundamentally inconsistent with the business judgment analysis."[24] In reaching its decision, the court nevertheless suggested that an adverse vote, together with other evidence, could rebut the presumption: "[t]his Court will not conclude that an adverse say on pay vote alone suffices to rebut the presumption of business judgment protection."[25]

Takeaways

We believe that the court in *Cincinnati Bell* went too far, and we expect that the logic of the *Beazer Homes* court will ultimately prevail in these new say-on-pay suits. The facts in *Cincinnati Bell* are not remarkable: the directors awarded compensation based on satisfactory performance under prearranged metrics, and shareholders disappointed by poor performance on other measures returned a negative say-on-pay vote. If these facts alone are sufficient to survive a motion to dismiss, it would constitute a shocking and harmful exception to the business judgment rule.

Pending the outcome in other say-on-pay cases, *Cincinnati Bell* increases the risk associated with executive compensation decisions. The case underscores the importance of a thoughtful, well-documented compensation-setting process. While judicial action will remain unpredictable in the short term, companies with careful practices should face lower risks in the courtroom. Companies and their compensation committees should therefore:

- Carefully consider the independence of directors, particularly compensation committee members. Among other steps, companies should seek to ensure proper attention by directors to their responses to director and officer questionnaires.

- Scrupulously document compensation decision-making processes in pre-read materials and board and committee minutes, so as to demonstrate that directors were informed and engaged in a good faith evaluation of pay decisions and made them in the best interests of shareholders and the company.

- Pay special attention to the rationale for compensation decisions where the company has underperformed its designated peers or the industry, even as executive compensation has increased. Even if not required as part of determining performance under the company's executive compensation plans, the compensation committee should review the company's one-, three- and five-year performance and total compensation relative to these groups. The committee should likewise be informed about components of the company's compensation programs and or recommendations about pay decisions that may not conform to current trends in executive compensation, even where the deviations may be justified. In each of these cases, compensation disclosures should clearly and cogently set out the rationale for the committee's determinations, and management should consider with the committee whether additional engagement with both proxy advisory services and shareholders before the annual meeting is appropriate.

- Consider carefully how they formulate their executive compensation objectives and related Compensation Discussion and Analysis (CD&A) disclosures. In today's environment, "pay-for-performance" has become something of a slogan, and broad policy assertions may not be appropriate without more nuanced explanations of how the policy is

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expected to be applied in both good and bad times.

- Avoid unnecessarily attracting the attention of opportunistic potential plaintiffs by adopting "best practices" to the extent practical, including for example the use of fully independent compensation consultants who report exclusively to the compensation committee and whose interactions with management are subject to committee oversight.

- Prepare appropriate responsive action, either through changes in pay practices or renewed shareholder engagement, in the event of a say-on-pay vote that is either negative or indicates significant dissent. As required, these actions should be disclosed, together with the rationale accompanying changes in pay practices as part of the next year's CD&A.

NOTES

1. ***See*** Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 951 (codified at Securities Exchange Act of 1934 § 14A, 16 U.S.C.A. § 78n-1).
2. Section 951(c) of the Act provides that "the shareholder vote… may not be construed… to create or imply any change to the fiduciary duties of such issuer or board of directors [or] to create or imply any additional fiduciary duties for such issuer or board of directors."
3. ***NECA-IBEW Pension Fund, derivatively on behalf of Cincinnati Bell, Inc., v. Cox, et al.***, No. 1:11-cv-451, slip op. at 9 (S.D. Ohio Sept. 20, 2011) (order denying defendants' motion to dismiss) (***Cincinnati Bell***).
4. See ***Teamsters Local 237 Additional Security Benefit Fund***, derivatively and on behalf of ***Beazer Homes USA, Inc. v. McCarthy, et al.***, No. 2011-cv-197841, slip op. at 11 (Ga. Super. Ct. Sept. 15, 2011) (***Beazer Homes***). Public reports state that two other suits have been settled, including one involving KeyCorp that included the company's commitment to several additional governance practices relating to executive compensation. ***See*** Alison Frankel, ***Federal Judge Gives Shareholders Green Light for Say-on-Pay Suit***, THOMPSON REUTERS NEWS & INSIGHT (Sept. 21, 2011), http://newsandinsight.thomsonreuters.com/Legal/News/2011/09_-_September/Federal_judge_gives_shareholders_green_light_for_say-on-pay_suit/; ***see also*** Stipulation and Agreement of Settlement, ***In re KeyCorp Derivative Litig.***, No. 1:10-cv-01786-DAP (N.D. Ohio Mar. 25, 2011), available at http://sec.gov/Archives/edgar/data/91576/000095012311029164/l42257exv99w2.htm.
5. Directors' authority to manage the affairs of a company includes "wide discretion" to set executive pay. ***Brehm v. Eisner***, 746 A.2d 244, 262 n.56 (Del. 2000).
6. ***Production Resources Group, L.L.C. v. NCT Group, Inc.***, 863 A.2d 772, 799 (Del. Ch. 2004).
7. See ***Aronson v. Lewis,*** 473 A.2d 805, 812 (Del. 1984) (rejected by, ***Kamen v. Kemper Financial Services, Inc.,*** 908 F.2d 1338, Fed. Sec. L. Rep. (CCH) P 95363, 17 Fed. R. Serv. 3d 224 (7th Cir. 1990)) and (overruled by, ***Brehm v. Eisner,*** 746 A.2d 244 (Del. 2000)).
8. See ***Weinberger v. UOP, Inc.***, 457 A.2d 701, 711 (Del. 1983).
9. See, e.g., ***In re Citigroup Inc. Shareholder Derivative Litigation***, 964 A.2d 106 (Del. Ch. 2009); ***see also In re Walt Disney Co. Derivative Litigation***, 906 A.2d 27, 37 Employee Benefits Cas. (BNA) 2756 (Del. 2006).
10. See ***In re Walt Disney Co. Derivative Litigation.***, 731 A.2d 342, 357-8 (Del. Ch. 1998), aff'd in part, rev'd in part and remanded, 746 A.2d 244 (Del. 2000).
11. See ***Valeant Pharmaceuticals, Intern. v. Jerney***, 921 A.2d 732 (Del. Ch. 2007). The court found following trial that the burden of proving "entire fairness" had not been met: "[T]he extravagant payments… cannot be adjudged fair by any rational measure." ***Valeant*** at 736.
12. See ***Official Committee of Unsecured Creditors of Integrated Health Services, Inc., v. Elkins***, 30 Del. J. Corp. L. 535, 2004 WL 1949290, *12 (Del. Ch. 2004) (memorandum opinion).
13. ***Integrated Health Services***.
14. Approval of the say-on-pay proposal required the affirmative vote of the holders of a majority of the company's common shares and its convertible preferred shares, voting as one class, present in person or by proxy and entitled to vote (with abstentions counting as a vote against). The proposal received a 29.8% favorable vote.
15. See ***Cincinnati Bell*** at 1-3. Although it was not at issue, an interesting question is whether a challenge to the decision by the fiduciaries of the pension plan to spend plan resources to pursue this litigation would meet the fiduciary standards imposed upon them by the Employee Retirement Income Security Act of 1974, as amended (ERISA). Section 404(a) of ERISA requires a fiduciary of a plan to discharge his duties with respect to the plan prudently and "for the exclusive purpose of providing benefits to participants and defraying reasonable

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expenses of administering the plan." This raises the question whether a concern for paying pension benefits was the only purpose of the fiduciaries' pursuing the claim in ***Cincinnati Bell***, and whether the expense incurred could be justified as prudent in light of the reasonably expected return to the plan.

16. ***Cincinnati Bell*** at 6 n.4.
17. ***Cincinnati Bell*** at 4.
18. ***Cincinnati Bell*** at 5 (quoting ***In re Nat'l Century Financial Enterserprises, Inc.,*** 504 F.Supp.2d 287, 312 (S.D. Ohio 2007)).
19. ***Cincinnati Bell*** at 6. As disclosed in its 2011 proxy statement, the company's compensation policy stated that "a significant portion of the total compensation for each of our executives is directly related to the Company's earnings and revenues and other performance factors… tied to the achievement of specific short-term and long-term performance objectives, principally the Company's earnings, cash flow and the performance of the Company's common shares thereby linking executive compensation with the returns realized by shareholders."
20. ***Cincinnati Bell*** at 9.
21. ***Cincinnati Bell***.
22. ***Beazer Homes*** at 6-7.
23. ***Beazer Homes*** at 10.
24. ***Beazer Homes*** at 11.
25. ***Beazer Homes*** at 12 (emphasis in original).

After Rakoff Rejection, SEC Files Appeal in *Citigroup* Case

BY WSL STAFF

On December 15, the Securities and Exchange Commission (SEC) filed a Notice of Appeal in *SEC v. Citigroup Global Markets, Inc.*,[1] moving the case before the U.S. Court of Appeals for the Second Circuit.

The SEC's appeal—called "a rare and historic step" by Forbes[2]—came after a November 28 order from Judge Jed S. Rakoff, of the U.S. District Court for the Southern District of New York. Judge Rakoff rejected a $285 million settlement agreed upon by the SEC and Citigroup concerning securities fraud charges brought by the SEC in October concerning Citigroup's marketing of a $1 billion mortgage-backed securities fund.

The securities fraud charges at the heart of the settlement alleged that Citigroup had misrepresented how it chose mortgage-back securities to be included in the fund, and had indeed, taken a short position in the fund, betting against its success. Investors lost about $700 million, while Citigroup took in about $160 million in profits, the SEC alleged.

In rejecting the settlement agreement, Judge Rakoff leveled scathing criticism at the SEC, saying the settlement was "neither fair, nor reasonable, nor adequate, nor in the public interest." On aspect of the settlement that particularly drew Judge Rakoff's ire—and certainly an issue that will come up in the appeal—is the SEC's practice of allowing defendants to neither admit to nor deny their guilt in the charges. Judge Rakoff opined that such a practice "deprives the Court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose

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has any basis in fact." The order also directed the parties to prepare for trial in July 2012.

The SEC's use of the boilerplate "neither admit, nor deny" language in its settlement agreements has long rankled many federal judges, but it seems to particularly set off Judge Rakoff. In March 2011, in another order on an SEC settlement agreement, Judge Rakoff ripped the SEC's continued use of this particular enforcement practice, saying its use creates a "stew of confusion and hypocrisy unworthy of such a proud agency as the SEC."[3]

Indeed, the SEC's Citigroup settlement agreement is not the first one to be scuttled by Judge Rakoff, or even the first one involving Wall Street banks or the fallout of the financial crisis. In September 2009, the judge scrapped the SEC's initial $33 million settlement agreement with Bank of America over allegations that bank officials made misleading disclosures in its proxy material for its purchase of Merrill Lynch during the height of the financial crisis. Judge Rakoff "reluctantly" approved a revised settlement agreement between the two parties in February 2010.

Khuzami Fires Back

In filing its appeal of Judge Rakoff's order, the SEC also issued a statement[4] from Robert Khuzami, its Director of the Division of Enforcement, concerning the rejected *Citigroup* settlement. That statement read:

> **Last month, a federal district court declined to approve a consent judgment because, in its view, the underlying allegations were 'unsupported by any proven or acknowledged facts.' As a result, the court rejected a $285 million settlement between the SEC and Citigroup that reasonably reflected the relief the SEC would likely have obtained if it prevailed at trial.**
>
> **We believe the district court committed legal error by announcing a new and unprecedented standard that inadvertently harms investors by depriving them of substantial, certain and immediate benefits. For this reason, today we filed papers seeking review of the decision in the U.S. Court of Appeals for the Second Circuit.**
>
> **We believe the court was incorrect in requiring an admission of facts—or a trial—as a condition of approving a proposed consent judgment, particularly where the agency provided the court with information laying out the reasoned basis for its conclusions. Indeed, in the case against Citigroup, the SEC filed suit after a thorough investigation, the findings of which were described in extensive detail in a 21-page complaint.**
>
> **The court's new standard is at odds with decades of court decisions that have upheld similar settlements by federal and state agencies across the country. In fact, courts have routinely approved settlements in which a defendant does not admit or even expressly denies liability, exactly because of the benefits that settlements provide.**
>
> **In cases such as this, a settlement puts money back in the pockets of harmed investors without years of courtroom delay and without the twin risks of losing at trial or winning but recovering less than the settlement amount—risks that always exist no matter how strong the evidence is in a particular case. Based on a careful balancing of these risks and benefits, settling on favorable terms even without an admission serves investors, including investors victimized by other frauds. That is due to the fact that other frauds might never be investigated or be investigated more slowly because limited agency resources are tied up in litigating a case that could have been resolved.**
>
> **In contrast, the new standard adopted by the court could in practical terms press the**

SEC to trial in many more instances, likely resulting in fewer cases overall and less money being returned to investors.

To be clear, we are fully prepared to refuse to settle and proceed to trial when proposed settlements fail to achieve the right outcome for investors. For example, in the cases that the SEC identifies as core financial crisis cases, we filed unsettled actions against 40 of the 55 (70%) of the individuals charged—including the action filed against Brian Stoker[5] in this matter. Similarly, we filed unsettled actions against 11 of the 26 (42%) of the entities we charged—eight of which we did not litigate against because they were bankrupt, defunct or no longer operating.

In deciding whether to settle, the SEC considers, among other things, limitations under the securities laws. In a case like *Citigroup*, the applicable statute does not entitle the SEC to recover the amount lost by investors. Instead, in addition to recovering a defendant's ill-gotten gains, the statute allows a monetary penalty only up to the amount of a defendant's gain.

The $285 million obtained from Citigroup under the proposed settlement, while less than investor losses, represents most of the total monetary recovery that the SEC itself could have sought at trial. An SEC settlement does not limit the ability of injured investors to pursue claims for additional relief.

Moreover, while the court alluded to Citigroup's size, the law does not permit the Commission to seek penalties based upon a defendant's wealth.

As of *Wall Street Lawyer*'s press time, the Second Circuit Court had not yet set a date to hear the SEC's appeal.

NOTES

1. ***U.S. S.E.C. v. Citigroup Global Markets Inc.***, Fed. Sec. L. Rep. (CCH) P 96597, 2011 WL 5903733 (S.D. N.Y. 2011).
2. ***See*** Singer, Bill "SEC Files Historic Appeal of Judge Rakoff's ***Citigroup*** Settlement Rejection," Forbes.com (Dec. 16, 2011), available at http://www.forbes.com/sites/billsinger/2011/12/16/sec-files-historic-appeal-of-judge-rakoffs-citigroup-settlement-rejection/.
3. ***SEC v. Vitesse Semiconductor Corp.***, 771 F. Supp. 2d 304, Fed. Sec. L. Rep. (CCH) P 96250 (S.D. N.Y. 2011).
4. ***See*** "SEC Enforcement Director's Statement on ***Citigroup*** Case," (2011-265); available at http://www.sec.gov/news/press/2011/2011-265.htm.
5. On the same day it filed charges against Citigroup, the SEC separately charged Brian H. Stoker, whom it identified as "the Citigroup employee primarily responsible for structuring the [...] transaction" at the heart of the charges against Citigroup. See ***SEC v. Brian H. Stoker***, 11-Civ.-7388 (S.D.N.Y. filed Oct. 19, 2011).

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Form PF:

SEC Adopts Private Fund Systemic Risk Reporting

BY DAVID A. VAUGHAN, JANE A. KANTER & MICHAEL L. SHERMAN

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On October 26, the Securities and Exchange Commission (SEC) unanimously adopted a new rule (Rule) and new Form PF (Form PF, or the Form) under the Investment Advisers Act of 1940 (Advisers Act), that must be completed by certain SEC registered investment advisers that manage private funds.[1] Among other things, Form PF will provide the new Financial Stability Oversight Council (FSOC or the Council) with information necessary to help it monitor the systemic risk created by private funds and to determine whether particular entities should be designated as "significant financial institutions" (SIFIs).[2]

In addition, the information obtained by FSOC from Form PF filings is intended to enable the Council to consider and recommend to primary financial regulators (such as the SEC) new regulations designed to mitigate systemic risk.

New Form PF

While those who commented on the proposed rule generally supported the goal of Form PF to serve as part of a regime to monitor systemic risk, many were concerned about the scope, frequency and timing of the proposed reporting under Form PF. In response to commenters, the SEC sought to tailor the Rule and the Form to ease the reporting burden on private fund advisers without materially impacting the quality of information from a systemic risk monitoring perspective.

As adopted, the Form seeks a broad array of information, including: identifying information, assets under management, leverage and performance information for each private fund advised; information regarding aggregate fund asset values and portfolio holdings; and fund-specific data about such characteristics as portfolio liquidity, concentration, collateral practices, and risk metrics.

Two-Tier Reporting Requirement

Form PF provides for a two-tier reporting requirement, whereby "large" advisers to particular types of funds will be subject to a more detailed reporting requirement than are smaller advisers and large advisers to other types of funds. The largest fund managers are also subject to accelerated initial filing dates for Form PF.

Advisers to hedge funds having, in the aggregate, at least $1.5 billion in "regulatory assets under management" (RAUM) in hedge funds will be subject to the more detailed reporting requirements.[3] RAUM consists of the assets of the applicable funds managed by an adviser and is calculated gross of outstanding indebtedness and other accrued but unpaid liabilities. RAUM also includes investors' uncalled capital commitments. Advisers may use the total assets on the fund's balance sheet to determine gross assets. This calculation methodology is the same as that used for determining RAUM for purposes of Form ADV. Advisers to private funds with less than $150 million in RAUM need not file Form PF.

Advisers to liquidity funds having, in the aggregate, at least $1 billion in RAUM in liquidity funds and money market funds will be subject to the more detailed reporting requirements.[4] With respect to liquidity fund advisers, such advisers must count registered money market fund assets towards the RAUM threshold.

Advisers to private equity funds having, in the aggregate, at least $2 billion in RAUM in private equity funds will be subject to the more detailed reporting requirements.[5]

Aggregation of Assets

For purposes of determining whether an adviser meets any of the asset thresholds described above, an adviser must aggregate assets of accounts that pursue substantially the same investment objective and strategy and invest side-by-side in substantially the same positions as the private funds managed by the adviser (Parallel Accounts), unless the value of the Parallel Accounts exceeds the value of the private funds. This provides significant relief to advisers that are not primarily private fund advisers. Further, an adviser must aggregate assets of persons advised by any "related person" that is not operated separately from the adviser.

Liability for the Information Filed

Form PF does not contain an initially proposed certification requiring an authorized individual from the adviser to affirm under penalty of perjury that the statements made in the Form PF are true and correct. Commenters had expressed concern that the estimates and judgment calls required by Form PF would not allow an officer to state with certainty that the Form is true and correct, and officers could not rightly be held liable for perjury in such circumstances. However, advisers can still be held liable under the Advisers Act for willful misstatements or omissions of a material fact in any report filed with the SEC.

When calculating the data required by Form PF, the Rule allows advisers to use the methodologies that they use for internal and investor reporting purposes, rather than detailed formulas initially prescribed by the SEC in the proposed form. Further, Form PF permits, but does not require, an adviser to explain any assumptions it makes in responding to the Form's questions. Given the opportunity, it could prove useful to an adviser to explain its assumptions in order to demonstrate its good faith in completing the Form, particularly if the staffs of the SEC or the Commodity Futures Trading Commission (CFTC) disagree with the data reported on the Form.

Confidentiality

The CFTC and SEC will share information collected on Form PF with FSOC to the extent requested by FSOC in furtherance of its assessment and monitoring of systemic risk. Under amendments to the Advisers Act added by the Dodd-Frank Act, the CFTC, SEC, and FSOC may be compelled to reveal any information provided on Form PF, but only under very limited circumstances. For example, upon proper request, Form PF data may be shared with other federal departments or agencies or with self-regulatory organizations, in addition to the CFTC and FSOC, for purposes within the scope of their jurisdiction. Information may also be shared with Congress, but only in accordance with a confidentiality agreement. Form PF information may be used in examinations as well as enforcement actions brought by the U.S. Department of Justice or the SEC.

The SEC is working to design controls and systems to protect the confidentiality of the information contained in Form PF. If the SEC Staff does not believe that such systems are adequate by the compliance date for required Form PF filings, the SEC will consider delaying the compliance date.

International Coordination

The Dodd-Frank Act requires the FSOC to coordinate with foreign regulators in monitoring systemic risk. Therefore, the SEC Staff consulted with the United Kingdom's Financial Services Authority (FSA), the European Securities and Markets Authority (ESMA), the International Organization of Securities Commissions and Hong Kong's Securities and Futures Commission, to develop a consistent regime for hedge fund reporting. The collection of comparable information regarding private funds in each regulator's jurisdiction will better allow for the coordinated assessment of systemic risk on a global basis. ESMA has published its advice on implementing these requirements.

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Although the SEC Staff did draw on ideas from the FSA's voluntary semi-annual survey of hedge funds and ESMA's draft guidance on the form of systemic risk reporting that may be required under the Alternative Investment Fund Managers Directive, ultimately the scope and frequency of the reporting and the data required to be reported on Form PF does differ from the reporting proposed by ESMA in its recently published advice. The differences in these systemic risk reporting regimes will present challenges for managers and funds that are subject to both sets of reporting requirements.

Compliance Date

The SEC adopted a two-stage phase-in period for compliance with the Form PF filing requirements. Advisers with at least $5 billion in RAUM attributable to hedge funds, liquidity funds or private equity funds as of the last day of the fiscal quarter most recently completed prior to June 15, 2012 must begin filing for periods on or after June 15, 2012. Advisers who do not meet that threshold must begin filing for periods on or after December 15, 2012. All others advisers must file their first Form PF for the first period ending after December 15, 2012.

Conclusion

The Form PF, as adopted, incorporates many significant revisions that should ease the burden on reporting advisers. The SEC Staff clearly considered the comments it received and implemented suggestions, such as increasing the threshold for advisers subject to the detailed reporting requirements, delaying the compliance date for the rule, increasing the amount of time after the end of the fiscal period for filing, eliminating the certification under penalty of perjury and allowing advisers to use their internal methods for calculating the information required by Form PF. These revisions allowed Form PF to be unanimously adopted by the SEC, which praised the SEC Staff's efforts to reduce the reporting burden while still gathering the information required by the FSOC.

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Type of "Private Fund"[1] Managed	**Definition**	**Asset Thresholds**	**Filing Deadlines[2]**	**Required Section(s) of Form PF**
"Hedge Fund"	A *private fund* (other than a *securitized asset fund*) having any one of three common characteristics of a hedge fund: (a) a performance fee that takes into account market value (instead of only realized gains); (b) high leverage; or (c) short selling, other than for purposes of hedging currency or managing duration. Also, any commodity pool, even if not required to rely on Section 3(c)(1) or 3(c)(7)	$5B or more in *relevant assets*[3]	Quarterly within 60 days after end of fiscal quarter. Initial filing due for first fiscal quarter ending on or after 6/15/2012 (For most advisers, 8/29/2012, with a fiscal quarter ending 6/30/2012)[4]	1a (aggregate data) 1b and 1c (fund-by-fund data) 2a (aggregate data) 2b (fund-by-fund data)
		At least $1.5B but less than $5B in *relevant assets*	Quarterly within 60 days after end of fiscal quarter. Initial filing due for first fiscal quarter ending on or after 12/15/2012 (For most advisers, 3/1/2013, with a fiscal year ending 12/31/2012)	
		At least $150M but less than $1.5B in *relevant assets*	Annually within 120 days after end of fiscal year. Initial filing due for first fiscal year ending on or after 12/15/2012 (for most advisers, 4/30/2013, with a fiscal year ending 12/31/2012)	1a (aggregate data) 1b and 1c (fund-by-fund data)
"Liquidity Fund"	A *private fund* that seeks to generate income through investment in short-term obligations in order to maintain a stable NAV or minimize principal volatility. Essentially, an	$5B or more in *relevant assets*[5]	Quarterly within 15 days after end of fiscal quarter. Initial filing due for first fiscal quarter ending on or after 6/15/2012 (For most advisers, 7/15/2012)	1a (aggregate data) 1b (fund-by-fund data) 3 (fund-by-fund data)
		At least $1B but less than	Quarterly within 15 days after end of fiscal quarter.	

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Type of "Private Fund"[1] Managed	**Definition**	**Asset Thresholds**	**Filing Deadlines[2]**	**Required Section(s) of Form PF**
	unregistered money market fund.	$5B in *relevant assets*	Initial filing due for first fiscal quarter ending on or after 12/15/2012 (For most advisers, 1/15/2013)	
		At least $150M but less than $1B in *relevant assets*	Annually within 120 days after end of fiscal year. Initial filing due for first fiscal year ending on or after 12/15/2012 (For most advisers, 1/15/2013)	1a (aggregate data) 1b (fund-by-fund data)
"Private Equity Fund"	A *private fund* that is not a *hedge fund, liquidity fund, real estate fund, securitized asset fund* or *venture capital fund* and does not provide investors with redemption rights in the ordinary course.[6]	$5B or more in *relevant assets*[7]	Annually within 120 days after end of fiscal year. Initial filing due for first fiscal year ending on or after 6/15/2012 (For most advisers, 4/30/2013) Thus, the accelerated filing for these private equity fund managers impacts only those with June, July, August, September, October or November fiscal years	1a (aggregate data) 1b (fund-by-fund data) 4 (fund-by-fund data)
		At least $2B but less than $5B in *relevant assets*	Annually within 120 days after end of fiscal year. Initial filing due for first fiscal year ending on or after 12/15/2012 (For most advisers, 4/30/2013)	
		At least $150M but less than $2B in *relevant assets*		1a (aggregate data) 1b (fund-by-fund data)

RIDERS For Form PF OnPoint

Type of "Private Fund"[1] Managed	Definition	Asset Thresholds	Filing Deadlines[2]	Required Section(s) of Form PF
Other Types of *Private Funds*:	Any *private fund* that is not a *hedge fund, liquidity fund* or *private equity fund*. Including:	At least $150M in *relevant assets*[8]	Annually within 120 days after end of fiscal year. Initial filing due for first fiscal year ending on or after 12/15/2012 (For most advisers, 4/30/2013)	1a (aggregate data) 1b (fund-by-fund data)
"Real Estate Fund"	A *private fund* that is not a *hedge fund*, does not provide redemption rights in the ordinary course and invests primarily in real estate and real estate related assets.			
"Securitized Assets Fund"	A *private fund* whose primary purpose is to issue asset backed securities and whose investors are primarily debt-holders.			
"Venture Capital Fund"	Any *private fund* which represents that it is a venture capital fund; invests only in equity securities and acquired at least 80% of such securities directly from the issuer; uses less than 15% leverage that must be short-term; provides investors with no withdrawal rights except in extraordinary circumstances; and is not registered under the Investment Company Act of 1940. Rule 203(l)-1 under the Investment Advisers Act of 1940 provides the definition of a venture capital fund.			
"Other Private Fund"	A *private fund* that is not a *hedge fund, liquidity fund, private equity fund, real estate fund, securitized asset fund* or *venture capital fund.*			

NOTES

1. A "Private Fund" is any issuer that must rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940.
2. The asset threshold for quarterly filings (*i.e.*, $1.5B for hedge funds or $1B for liquidity funds) is measured as of the last day of each month within the fiscal

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the private equity funds (or other types of private funds) within 120 days after fiscal year-end). When filing a subsequent update of this type, the adviser is not required to alter or update information previously filed for the quarter.
3. For hedge funds, “relevant assets” means AUM attributable to hedge funds, taking into account aggregation principles for parallel accounts and affiliates.
4. As noted in the adopting release for Form PF, the overwhelming majority of advisers that will report on Form PF have 12/31 fiscal year ends.
5. For liquidity funds, “relevant assets” means AUM attributable to liquidity funds and registered money market funds, taking into account aggregation principles for parallel accounts and affiliates.
6. As there is no requirement that a private equity fund make “equity” investments, other types of funds that are not commonly referred to as private equity (*e.g.*, “mezzanine funds”) often will fall into this category.
7. For private equity funds, relevant assets means AUM attributable to private equity funds, taking into account aggregation principles for parallel accounts and affiliates.
8. For other private funds, relevant assets means AUM attributable to private funds of all types, taking into account aggregation principles for parallel accounts and affiliates.

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NOTES

1. The Commodity Futures Trading Commission (CFTC) simultaneously adopted new Rule 4.27 under the Commodity Exchange Act, which requires private fund advisers that are registered with the SEC and registered as commodity pool operators or commodity trading advisors with the CFTC to file Form PF with the SEC. Because the CFTC's rule adds no reporting requirements, this article addresses the SEC's Rule only.
2. The Rule and Form implement provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Dodd-Frank gave FSOC a range of responsibilities including: (i) monitoring for potential threats to U.S. financial stability; (ii) designating nonbank financial companies for supervision by the Board of Governors of the Federal Reserve System (FRB) as a SIFI; (iii) making recommendations to the FRB as to the heightened capital and other prudential standards that will apply to SIFIs and bank holding companies with consolidated assets of $50 billion or more; and (iv) making recommendations to primary financial regulatory agencies to apply heightened prudential standards for activities and practices that are deemed to pose significant risks. The SEC and CFTC consulted extensively with the member agencies of FSOC in developing Form PF to tailor the information to what FSOC requires to exercise its responsibilities.
3. Form PF defines "hedge fund" generally to include any private fund having any one of three common characteristics of a hedge fund: (i) a performance fee that takes into account market value (instead of only realized gains); (ii) high leverage; or (iii) short selling. This definition excludes private equity funds that calculate currently payable performance fees in a way that takes into account unrealized gains solely for the purpose of reducing such fees to reflect net unrealized losses. It also excludes funds that use short selling solely to hedge currency exposure or to manage duration. Lastly, it excludes vehicles established for the purpose of issuing asset-backed securities. A commodity pool that is required to be reported on Form PF is treated as a hedge fund for such purpose.
4. A "liquidity fund" is defined in Form PF as any private fund that seeks to generate income by investing in a portfolio of short-term obligations, in order to maintain a stable net asset value per unit or minimize principal volatility for investors. Essentially, a liquidity fund is an unregistered money market fund.
5. A "private equity fund" is defined in Form PF as any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course.

SEC/SRO Update:

DOJ Not to Probe Ex-SEC Lawyer over Conflicts in the Madoff Matters; SEC Settles Jenkins "Clawback" Case; SEC Division of Enforcement Releases Its Enforcement Data for 2011

BY YELENA M. BARYCHEV, MELISSA PALAT MURAWSKY & CHRISTIN R. CERULLO

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DOJ Not to Probe Ex-SEC Lawyer over Conflicts in the Madoff Matters

The Department of Justice (DOJ) will not probe David Becker, former Securities and Exchange Commission (SEC) General Counsel, over his involvement in SEC matters relating to the Madoff

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Ponzi scheme. Becker advised the SEC on formulas to compensate Madoff clients, even though he had been a beneficiary of the Madoff Ponzi scheme. Becker inherited profits from a Madoff account held by his late mother. SEC Inspector General David Kotz had referred the matter to the DOJ at the request of the Office of Government Ethics.

Becker defended himself, denying any wrongdoing and indicating that he had sought guidance from the SEC's ethics counsel on two different occasions. Becker also said that he had informed SEC Chairman Mary Schapiro about his late mother's account before participating in the Madoff matters. The other four SEC commissioners were not, however, made aware of Becker's inheritance.

After reviewing Kotz's report, the DOJ determined that a formal probe was not warranted.

SEC Settles Jenkins "Clawback" Case

The SEC has recently announced[1] that it reached a settlement with Maynard L. Jenkins, the former chief executive officer and chairman of CSK Auto Corporation (CSK), in which Jenkins agreed to return approximately $2.8 million of the more than $4 million in bonus compensation received and stock profits realized during the 12-month periods following the issuance of CSK's financial statements contained in its annual reports for fiscal years 2002, 2003, and 2004. This settlement is subject to court approval.

The SEC's 2009 complaint against Jenkins alleged that, while Mr. Jenkins was CEO, CSK committed accounting fraud related to overstated vendor allowances, resulting in the filing of two restatements. The SEC charged several former CSK executives, including the chief operating officer, chief financial officer, controller, and a supervisor, for their involvement in the alleged accounting misstatements. The complaint did not allege that Mr. Jenkins engaged in the fraudulent conduct resulting in the fraudulent accounting.

The SEC reached the foregoing settlement under § 304(a) of the Sarbanes-Oxley Act, which provides that if an issuer is required to prepare an accounting restatement due to material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the CEO and CFO of such issuer must reimburse the issuer for any bonus or other incentive-based or equity-based compensation received, and any profits realized from the sale of the securities of the issuer, during the year following the issuance of the original financial report. This clawback provision can be used by the SEC even if the CEO or CFO of the company is not personally charged with the underlying misconduct, which was the case with Jenkins.

This settlement suggests that the SEC may approve settlements with executives not personally involved in the wrongdoing for less than the full amount of bonus compensation received and stock profits realized.

SEC Division of Enforcement Releases Its Enforcement Data for 2011

The SEC has recently announced[2] that it filed a record number of enforcement actions in the fiscal year ended September 30, 2011, (fiscal year 2011)—735 actions. There were more than $2.8 billion in penalties and disgorgement ordered in SEC enforcement actions during fiscal year 2011. SEC actions included financial crisis-related cases, insider trading cases, and other enforcement matters.

In fiscal year 2011, the SEC filed 15 separate actions naming CEOs, CFOs and other senior corporate officers, involving wrongdoing related to the financial crisis. The SEC also filed 57 insider trading actions in fiscal year 2011 charging, among others, hedge funds managers and traders involved in a $30 million expert networking trading scheme, a former NASDAQ Managing Director, a former Major League Baseball player, and a chemist employed by the U.S. Food & Drug Administration.

The SEC's Cross Border Working Group, which focuses on U.S. companies with substantial foreign operations, brought many actions in fiscal year 2011, including, but not limited to: 1) stop-orders for posteffective registration statements related to the resignation of a company's

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independent auditor; and 2) trading suspensions of securities based on the lack of accuracy and completeness of their publicly disclosed information. The SEC also brought enforcement actions against individuals and firms that were targeting vulnerable investors.

The SEC has significantly increased its number of enforcement actions related to investment advisers and broker-dealers during the past fiscal year. The SEC filed 146 enforcement actions related to investment advisers and investment companies, which represented a 30% increase over fiscal year 2010. The SEC also brought 112 enforcement actions related to broker-dealers—a 60% increase over the last year.

NOTES

1. ***See*** "Former CEO to Return $2.8 million in Bonuses and Stock Profits Received During CSK Auto Accounting Fraud" (Nov. 15, 2011) ***available at*** http://sec.gov/news/press/2011/2011-243.htm.
2. ***See*** "SEC Enforcement Division Produces Record Results in Safeguarding Investors and Markets" (Nov. 9, 2011) ***available at*** http://www.sec.gov/news/press/2011/2011-234.htm.

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