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SPECIAL FEATURE

SEC and industry battles over regulation: who prevails?

By Stephen M. Honig

"I have no conviction. ... I blow with the wind, and the prevailing wind is blowing from Vichy."

When Louis told Rick that he was at the mercy of Casablanca's prevailing winds, he surely was not thinking about the Securities and Exchange Commission. But the winds of change blow both in North Africa and in Washington, and, right now, the SEC is being blown by the winds of backlash.

Responding to the economic meltdown, Congress in 2010 passed the Dodd-Frank Act to regulate a wide range of securities law practices and asked the SEC to enforce most of them. The act, combined with the 2002 Sarbanes-Oxley Act, significantly injected the federal government into corporate practices.

Since Dodd-Frank, the winds have blown back and forth, sometimes in favor of regulation and sometimes back into the faces of the regulators.

Resistance to regulations

In response to litigation brought by the U.S. Chamber of Commerce, the SEC's mandatory rule requiring public companies to include shareholder nominees for board seats in proxy statements was struck down by the D.C. Court of Appeals so soundly that the SEC wholly abandoned the mandatory federal approach, leaving in place a rule acceptable to the business community whereby each company determines its own format for processing shareholder nominations.

The enforcement of Section 404(b) of SOX, requiring auditor sign-off on company internal financial controls, was eliminated entirely by Dodd-Frank for non-accelerated filers (public floats below $75 million); it is also odd to find this provision in a statute viewed as creating regulatory intrusion.

Business had resisted auditor review of internal controls on cost grounds. Dodd-Frank also required the SEC to study eliminating this auditor review requirement for companies with market caps below $250 million, but in April 2011, the SEC decided to retain the requirement, finding no evidence that it squelched U.S. IPOs for companies of that size.

The 2012 JOBS Act next blew away restrictions on public advertising of many private (Reg D) offerings; limits on certain offerings (Reg A in particular); limits on Internet securities offerings to less sophisticated and less solvent offerees (crowd-funding); certain '34 Act disclosure requirements for many companies; and SOX 404(b) (accountant review of internal financial controls) requirements for most new registrants.

The JOBS Act further tasked the SEC with several studies, suggesting a desire to further loosen regulatory controls.

In an unusual move, the SEC also invited public comments on regulatory burdens created by the JOBS Act. The comments can be read in a link from the SEC's home page (www.sec.gov).

Comments are numerous, but most suggest prompt implementation of deregulation of capital formation. Many comments focus on the mechanics of crowd-funding, which (if not utilizing a broker-dealer) require establishment of a registered "funding portal" akin to an online broker/dealer that would facilitate communication between the company and the crowd-funding investors.

The business community, long blaming over-regulation for job losses and for the decline of U.S. venture funding and IPOs, and emboldened by its successes in court and in the JOBS Act, has enlisted elements in Congress to assist in pressing for additional regulatory rollbacks.

Evidence of this blow-back against regulation also can be seen in the Public Company Accounting Oversight Board's current discussion about rotation of audit firms for public registrants.

The presumed problem is that a firm falls in love with the company it is auditing. Rotation forces a divorce. But changing firms can incur added cost and takes more management time.

At a recent congressional hearing, Rep. Scott Garrett of New Jersey warned the PCAOB not to invent new regulations. Quoted in Compliance Week, Garrett wanted "to remind the PCAOB that it is not a policy making entity" and that he was not pleased with recent PCAOB "activist type proposals. What is the specific problem? And what data or what cost-benefit analysis is being done?"

That followed the PCAOB criticizing the

Stephen M. Honig is a partner in Duane Morris' corporate department in the firm's Boston office. You can reach him at smhonig@duanemorris.com.

Chamber of Commerce for sticking its nose into the auditor rotation debate. There is draft legislation, which, relying on the questionable theory that this kind of government regulation has a negative impact on job creation, categorically prohibits PCAOB from rulemaking in this area.

FCPA and ISS

Another battlefield concerns the Foreign Corrupt Practices Act.

Both public and private companies are prohibited by this act from payments to foreign officials or candidates in order to obtain improper action, and, further, are prohibited from hiding such payments by false accounting entries.

The SEC announced on several occasions that FCPA enforcement is a prime focus. This aspect of the U.S. regulatory scheme historically has been perceived as out of touch with the realities of doing business in emerging markets.

Although the United States has lobbied for and sometimes obtained similar legislation from about 30 other countries so as to level the international competitive playing field, rigorous enforcement of bribery prohibitions is the exception in many countries.

The business community itself, in the case of the FCPA, is banding together to explore the gray area of "facilitation payments." They are payments made to foreign officials in order to cause those officials more rapidly to perform wholly legal functions, such as customs clearance or permitting, and were allowed under FCPA.

Compliance executives from leading American companies have formed a Committee to Address Facilitating Payments in an effort to identify what these payments look like and so as to avoid foot-faults in this area. (The recent Bribery Act in the United Kingdom has made illegal all these facilitation payments and has extended the ban to payments not only made to government officials, but also to non-government officials.)

One of the goals of the committee is to eliminate facilitation payments in suspect countries — easier conceptualized than achieved.

It is possible to understand industry's FCPA self-regulatory effort as a triumph of regulation, causing industry to exhibit behavior that regulation was intended to foster.

Another way to look at it is that it's an attempt to keep the SEC and the Department of Justice off industry's back.

There is also resistance against the ISS, which advises institutional shareholders on whether to support director slates.

Recent changes in ISS standards for evaluating boards, changes viewed as part of a generally intrusive foray into corporate governance that de facto is jointly supported by ISS and SEC, have caused registrants to complain.

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Objections typically relate to the peer group in which a company has been placed for purposes of evaluating profitability and executive compensation. Companies have their own views as to identity of their peers, and the ISS is perceived as defining peer groups less favorable to higher executive compensation.

For the record, representatives of the ISS claim they are always open to discuss the accuracy of peer groups, but anecdotal feedback from the marketplace is not always consistent with that assertion.

SEC fights back

The SEC still is pursuing some, so far, wind-resistant initiatives.

- The SEC whistleblower hotline, opened in 2011 in response to the Dodd-Frank mandate, is receiving thousands of incoming calls. Hotline reporting resulting in recoveries in securities-related matters in excess of $1 million can result in bounty payments to whistle-blowers of as much as 30 percent of total recovery, encouraging avoidance of robust (but bounty-free) intracorporate reporting mechanisms, which were themselves the result of SOX and the SEC.
- The SEC is responding to the call for greater disclosure of corporate political contributions (see my May column, "Corporation political contributions and the SEC").

The SEC still must promulgate expanded compensation disclosure rules (pay disparity between the CEO and median worker being the most significant), which will apply to public companies (this requirement is delayed for five years, but not eliminated, for new registrants under the JOBS Act).

The SEC is fighting a head-wind there. While letters continue to pour into the SEC urging prompt issuance of disclosure rules on relative pay, the corporate bar and Congress have pushed back with repeal bills filed in the House and lengthy technical comment letters seeking delayed implementation if rules are promulgated.

The lawyers cite difficulty in data gathering, governmental prohibitions in data transfer from some countries, currency conversion issues and difficulty in consolidating payroll data.

There also are suggestions to exclude non-U.S. workers from the calculation; "apples-to-apples" issues (what do you do with the 50 percent of compensation for French workers that goes toward pensions?); and a clever proposal for a safe harbor (comparing CEO compensation to regularly published U.S. labor statistics, such as the average wage for private non-farm workers, to avoid difficulties in calculating median pay for a given company).

Conclusion

SEC back-end enforcement through litigation remains strong, often focusing on insider trading, Foreign Corrupt Practices Act and plain old fraud. You can go to the SEC website and sign up to receive emails of all SEC litigation releases; be prepared to receive numerous notices.

So it is not like the SEC has been left with no wind in its sails. It is just that there is a wind blowing against it also, and it is not yet clear which wind direction — pro-regulation or pro-business — will prevail. NEIH

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