2011 Skadden INSIGHTS

Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

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Dear Clients and Friends:

I am pleased to provide our third annual collection of commentaries on the critical legal issues our clients may face in the coming year. Economic recovery and improvement in the global capital markets are creating new opportunities. At the same time, we have witnessed a number of legislative and regulatory actions that have profound implications.

In our analysis, we follow a number of macro themes: First, how will governments use their newly expanded powers, including those in formerly unregulated spheres? Second, how will business and the global capital markets respond to the legal challenges of the new environment? And third, how will controversies be affected, and what strategies might parties use to assert and protect their interests in this new world?

The commentaries are arranged in seven broad sections. We hope that our insights within the range of subjects covered help you meet the challenges and capitalize on the opportunities ahead:

- **Capital Markets.** Many of our clients are focused on how the current financial environment might impact their capital structure and ability to raise capital. We also examine opportunities in various sectors of the financial markets.
- **Corporate Restructuring.** While global restructuring activity declined in 2010, certain companies and industries continue to be burdened by high leverage and other financial difficulties. We discuss which sectors are likely to see an increase in restructuring activity in 2011, and techniques to assist both stressed entities looking to restructure their balance sheets and entities seeking to benefit from financial duress.
- **Financial Regulation.** We expect 2011 to be marked by the transition into a new regulatory environment arising from the laws, such as the Dodd-Frank Act, enacted in response to the global financial crisis. We review the potential scope, reach and impact of these regulations, and discuss how the regulations might develop going forward.
- **Global Litigation.** Resolution of disputes continues to become more global and complex. We discuss recent developments, the direction of various trends, pending cases to watch that likely will impact these trends and strategies to consider in managing disputes.
- **Global M&A.** In 2010, global M&A and other transactional activity continued to be somewhat constrained by ongoing challenges in the financial and economic environments. Although predictions of magnitude are difficult, we believe that the global markets for M&A will see greater activity in 2011, and we review trends we think will impact the increased activity.
- **Governance.** The financial crisis of the past few years and responses by governmental bodies, investors and activists highlight the importance of proper corporate governance. We explore subjects directors and members of management confront and offer guidance on a range of issues, including executive compensation, shareholder activism and engagement, and changes to governance processes.

- **Regulatory.** Shifting governmental priorities will impact our clients across a wide range of industries. With specific focus on developments in the United States, we assess these developments in a variety of governmental arenas.

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We hope you find these materials interesting and informative and would be happy to discuss them further with you. If you have a particular interest in any of these topics, please call your usual Skadden contact. We also will continue to provide our periodic *Insights* publication during the course of the coming year.

With best wishes for peace and prosperity in 2011,

Eric J. Friedman
Executive Partner

Skadden

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Capital Markets

Capital Markets

During 2010, a year of busy capital markets, several trends were noteworthy. For example, in the United States and Europe, there was a record amount of high-yield issuance, with more than $294 billion of new issuance in the U.S. and more than $42 billion in Europe, with the substantial majority of the proceeds used to refinance existing debt maturities. In addition, in the syndicated loan markets, we continued to see a significant number of amend-to-extend transactions, where borrowers were able to extend a portion of their loan maturities with their existing lenders. In Asia, G3 currency bonds (bonds in euros, U.S. dollars or yen) had another record year, with $84 billion from 209 deals. In the equity capital markets, a large number of companies filed for initial public offerings in the United States, with more than 150 completed IPOs raising more than $37 billion of proceeds, and a large backlog of in-process transactions. Approximately 25 percent of the completed U.S. IPOs were by China-based companies, compared with approximately 19 percent and 11 percent in 2009 and 2008, respectively. Globally, IPOs by Asia-based companies (excluding Japan and Australia) achieved a record-high volume of $159 billion from 760 completed deals, representing a 127 percent increase in volume over 2009 ($70 billion), which itself was a 144 percent increase over 2008 ($29 billion).

Although it always is difficult to extrapolate from these trends, several other developments may be of interest:

- A change related to the regulatory capital treatment of trust preferred securities for U.S. bank holding companies (BHCs) is widely expected to result in a refinancing wave of the more than $148 billion of outstanding trust preferred securities by these BHCs.
- During 2010, a significant number of the going-private transactions used a two-step acquisition structure involving the purchase of shares pursuant to a negotiated tender offer immediately followed by a "short-form merger" without additional action by the target's stockholders. We expect the use of this two-step acquisition structure to increase, with resulting changes in acquisition financing terms.
- Investment managers have focused on the advantages of managed accounts (as compared with sponsored funds), and we expect that investment managers and their clients will continue to focus increasingly on managed accounts in the coming year.
- We anticipate that the Hong Kong Stock Exchange will continue to play an important role in the public equity markets, because it saw record listings in 2009 and 2010, with 85 listings completed in 2010 raising more than $52 billion of proceeds.

Refinancing Trust Preferred Securities in the Wake of Dodd-Frank and Related Regulatory Developments

A provision of the Dodd-Frank Act, widely known as the Collins Amendment (see "Financial Regulation/International Developments"), will harmonize the capital structure requirements of BHCs with those of their insured depositary banks, causing the eventual loss of Tier 1 regulatory capital treatment for capital raised by the BHCs through the issuance of trust preferred and similar hybrid securities (Trust Preferred Capital Securities). BHCs are required to maintain Tier 1 capital ratios in accordance with regulations promulgated by federal banking authorities, and these ratios are widely considered to be an important measure of a BHC's financial strength. The elimination of Tier 1 capital treatment for Trust Preferred Capital Securities will be phased in over a three-year period beginning January 1, 2013.

As of December 31, 2008, approximately 1,400 BHCs had issued more than $148 billion of Trust Preferred Capital Securities (compared to 110 BHCs with $31 billion of Trust Preferred Capital Securities outstanding on December 31, 1999). In order to comply with the eventual loss of Tier 1 capital treatment and the tighter Tier 1 capital requirements applied previously to institutions insured by the Federal Deposit Insurance Corporation, many BHCs are considering alternatives to refinance outstanding Trust Preferred Capital Securities. Most Trust Preferred Capital Securities may be redeemed by the BHC at its option at par after five years from the date of issuance, subject to prior approval by the applicable federal banking regulators. Many Trust Preferred Capital Securities issuances are subject to so-called "capital replacement covenants," which are covenants for the benefit of holders of an unrelated series of senior debt; these capital replacement covenants prohibit the BHC from redeeming, repaying or repurchasing the Trust Preferred Capital Securities, unless the BHC has received specified amounts of net proceeds from the sale of qualifying equity securities within a specified period of time prior to the redemption, repayment or repurchase. Since the passage of Dodd-Frank, several BHCs have conducted consent solicitations to terminate their capital replacement covenants, typically in exchange for a cash payment equal to 0.50 percent of the principal amount of the senior debt.

BHCs that do not have the benefit of a time-based par redemption provision generally have two alternatives to refinance existing Trust Preferred Capital Securities. They may consider either a tender offer or the possibility of effecting a special redemption permitted by the terms of most Trust Preferred Capital Securities if certain regulatory events occur that result in the potential loss of Tier 1 capital treatment (Regulatory Capital Event or RCE). Once a Regulatory Capital Event has occurred, the BHC typically has the right to redeem the outstanding Trust Preferred Capital Securities at par within 90 days, subject to any required regulatory approval.

The permissible windows during which BHCs may effect RCE redemptions have been the subject of lively debate among investors, BHCs and their counsel. The language used to define when an RCE occurs is not precisely the same in all Trust Preferred Capital Securities. Many believe that RCE redemptions would have been permissible during the 90-day period following the enactment of Dodd-Frank, but there is far less consensus on how these provisions should be interpreted with respect to possible future redemptions. Some argue that BHCs may effect RCE redemptions within 90 days following various other events, such as (i) the adoption by the Board of Governors of the Federal Reserve System of regulations implementing the measures of the Collins Amendment, which are required to be issued no later than January 21, 2012; (ii) the loss of Tier 1 capital status by the Trust Preferred Capital Securities, starting in 2013; or (iii) other regulatory milestones related to Dodd-Frank or Basel III.[1]

As a result of the uncertainty in interpreting these provisions, if the Trust Preferred Capital Securities are not otherwise redeemable, BHCs relying on RCE redemption provisions face the possibility of litigation. How significant the risk of litigation may be depends, of course, on the precise wording of the RCE provisions in question and the relation of the RCE redemption price to the then-current trading price of the relevant Trust Preferred Capital Securities. Indenture trustees also may object to RCE redemptions if they are not satisfied that the redemption conditions have been met. Some BHCs may instead consider a tender offer for cash or an offer to exchange securities for the Trust Preferred Capital Securities as an alternative to an RCE redemption. However, because participation in a tender offer is voluntary, it would not provide the same certainty of retiring the Trust Preferred Capital Securities as would an involuntary redemption. If the Trust Preferred Capital Securities are trading substantially below par, a tender offer may be a preferable alternative. Even if the Trust Preferred Capital Securities are trading at or slightly above par, a tender offer may still be attractive because the tender offer disclosure materials could include a

[1] The Basel Committee on Banking Supervision, which includes representatives of most developed countries, periodically issues recommendations on banking laws and regulations designed to establish international standards. The rules are then implemented by the legislatures and regulators of member nations, sometimes in modified form. Basel III, which is a modification to the Basel II rules, was agreed to by the Basel Committee in December 2010 following the endorsement of the Basel III proposal at the meeting of the G-20 nations in November 2010.

factual recitation of the RCE and describe the risk to the Trust Preferred Capital Securities holder if the BHC later elects to pursue, or contain an affirmative statement that it intends to pursue, the RCE redemption alternative should the tender offer be unsuccessful. Faced with this disclosure, a security holder evaluating the adequacy of the tender offer premium also must evaluate the RCE provision and assess the relative merits of the BHC's RCE redemption arguments. In theory, this type of tender offer provides a market-based mechanism to efficiently value the BHC's RCE redemption right in light of litigation risks and uncertainties. A tender offer also would allow a BHC to access the capital markets at times of its own choosing to raise proceeds from the sale of qualifying equity securities to refinance the Trust Preferred Capital Securities, instead of being required to raise capital within 90 days of an RCE.

Six months have elapsed since Dodd-Frank was enacted, and the volume of redemptions and tender offers has been relatively modest. Reasons for this may include, among others:

- the exceptionally long phase-in period for Dodd-Frank, namely, the ability to continue the Tier 1 capital status for the next few years, coupled with the continued relative attractiveness of Trust Preferred Capital Securities as a capital financing vehicle;
- the unavailability of an adequate hybrid substitute that complies with Tier 1 capital requirements;
- the ability of many BHCs to redeem their Trust Preferred Capital Securities at any time without relying on the RCE redemption provisions because the no-call provisions expired or will expire before the Trust Preferred Capital Securities lose their Tier 1 capital status;
- the belief among management of many BHCs that RCE redemptions may be effected later in the chain of regulatory events, providing them the opportunity to defer sales of common equity or other securities receiving favorable regulatory capital treatment;
- the focus of BHCs on more immediate concerns, including troubled loan portfolios, owned real estate, mortgage servicing rights and other matters that have a greater near-term effect on earnings; and
- the difficulties BHCs face in obtaining required regulatory approvals.

Nonetheless, as implementation of the Collins Amendment draws closer, BHCs gradually will increase their focus on refinancing their outstanding Trust Preferred Capital Securities.

Challenges and Approaches in Financing Consensual Tender Offers

In the past two years, we have seen a resurgence of tender offers in M&A transactions. These "two-step" acquisitions can provide buyers with an efficient method of purchasing the outstanding shares of a public target by making a conditional offer to the target's shareholders, followed by a second-step merger. As tender offer structures continue to become more prevalent, clients (both borrowers and lenders) will need to be aware of the particular challenges associated with financing cash bids for two-step acquisitions. (See "Global M&A/U.S. M&A Developments.")

Tender Offer Timing: A Double-Edged Sword

The primary advantage of a tender offer is speed: If a sufficient number of shares is tendered (Delaware requires 90 percent of outstanding shares; other states may vary)[2], the buyer can close the offer and then file a short-form merger immediately thereafter, with the entire process from launch of the tender to closing of the merger lasting as little as 20 business days. This is a much shorter time frame than a

[2] In examination of a tender offer structure, careful attention must be paid to domicile of target company and possible variations of Delaware law.

typical one-step merger, which requires preclearance of a proxy statement by the SEC and a scheduled shareholder meeting and can take three to four months to close after the merger agreement is signed. Moreover, obtaining even 50.1 percent in a tender offer eliminates the risk of third-party competing bidders more quickly than a one-step merger.

Conversely, if the buyer fails to reach the short-form merger threshold, some of the timing benefits of the tender offer structure are lost. The parties still will be able to consummate the acquisition of control, provided the buyer has obtained enough shares in the tender offer. Usually, a simple majority of outstanding shares is enough for the buyer to be able to vote its (controlling) shares in favor of the merger, but the prolonged timing of a "long-form" merger process will prevent the parties from closing the merger on an expedited basis. (However, as noted above, the buyer will have minimized the risk of third-party competition.) From a lender's perspective, the long-form scenario requires attention to a number of unique issues:

- Prior to consummation of the back-end merger, the lenders typically will not have access to the target's cash and other assets due to the lack of 100 percent ownership of the target.
- During the gap period prior to consummation of the merger, the nontendering minority shareholders will be entitled to their pro rata share of any dividends and other distributions from the target (although the merger agreement will typically prohibit or strictly limit such payments).
- The parties also may need to refinance the target's existing debt upon the closing of the tender offer, because the acquisition of a majority of the target's shares likely will trigger change-of-control provisions in the target's existing debt documentation.

Tender Offers and the Federal Margin Regulations

In both the short-form and long-form scenarios, the margin regulations of the Board of Governors of the Federal Reserve System will need to be considered. The federal margin regulations limit a lender's ability to extend credit for the purpose of buying or carrying "margin stock" (which includes publicly traded securities) if the credit is secured, either directly or indirectly, by such stock. Moreover, by defining "indirectly secured" somewhat broadly, the regulations may be applicable to transactions that on their face do not appear to be within the scope of the regulations. The regulations currently require that the maximum loan value to the buyer with respect to margin stock not exceed 50 percent of the current market value of such stock. As a result, to ensure compliance with the regulations, the security package for tender offer financings may exclude some or all of the shares of the target that are acquired.

Tender Offer Financing Strategies

Given the legal impediments and practical risks involved in the long-form scenario, how do lenders get comfortable with financing cash tender offers? There are a number of potential mitigating factors.

- **Top-up options.** In recent years, tender offers increasingly have included a top-up option from the target to the buyer to purchase newly issued target shares after the closing of the tender offer in order to obtain enough shares to reach the required statutory short-form merger threshold (*e.g.*, 90 percent of outstanding shares in Delaware). The size of the top-up option is limited by the amount of authorized but unissued shares of the target, and the significant dilutive effect of the issuance (which increases the number of outstanding shares, thereby increasing the number of shares necessary to achieve short-form merger threshold) will, as a practical matter, require the requisite tender percentage to be relatively close to the statutory short-form merger percentage in many cases. Although shareholders may seek to challenge the dilutive effect of top-up options on the value of the remaining shares, such challenges have been rejected in recent Delaware cases. (See "Global M&A/U.S. M&A – Litigation Issues.")

- **Minimum tender conditions.** Lenders often will require, as a condition to funding a tender offer financing facility, that a minimum percentage of outstanding shares be purchased in the initial stage of the tender offer; usually, this is the same percentage required under the merger agreement (typically 50.1 percent, but may be higher for a particular transaction). Lenders still must wait for the second step to close to obtain security interests in the target's assets to support the financing.
- **Mixed collateral loans.** If the buyer or its parent is a creditworthy entity, the collateral package can include not only the shares of the target (though the margin regulations still must be considered), but also the assets of the buyer or its parent. However, this structure is likely to be available only in the case of a strategic buyer, as the buyer in a private equity deal typically will be a newly created acquisition vehicle without material assets. Consequently, recent tender offer financings structured as true "two-step" financings have involved strategic buyers, rather than private equity sponsors. The high-profile private equity-backed deals occurring in 2010, such as GTCR/Protection One, Bain/Gymboree and 3G Capital/Burger King, required the consummation of the merger as a condition to funding. Generally, true tender offer financing facilities for private equity sponsors (*i.e.*, where consummation of the merger is not a condition to funding) have been rare in recent years, an exception being the acquisition of Biomet by a consortium of private equity sponsors including KKR, Blackstone, TPG and Goldman Sachs Capital Partners.
- **Target financing.** Another option, although not frequently utilized, is for the target itself to provide financing to the buyer. This structure can be particularly useful in tender offers by private equity buyers, provided the target has enough cash on hand or has access to its own financing sources.
- **Joint tender offers.** A joint tender offer conducted simultaneously by buyer and target is another potential alternative. The financing for the self-tender is provided directly to the target, with the lender obtaining security in the target's assets (as opposed to the target's shares). The joint tender structure involves significant participation from the target's incumbent board, which may be difficult to obtain. In addition, because the shares acquired by the target in the self-tender do not vote, the relative portion of the financing provided to the target is limited in amount.

These examples of alternative structures highlight several of the issues that arise in financing cash bids for two-step acquisitions. As tender offer activity continues to increase, we expect these structures to be used more frequently, and new approaches to be formulated, to address the unique issues presented in financing these deals.

Managed Accounts – A Fundraising and Opportunity Trend

In 2010, the use of managed accounts increased in response to stresses on conventional fund structures, continued constraints on fundraising and increasing demand by private fund investors for greater access to tailored terms and flexibility. This trend creates opportunities for investors and managers to customize, and possibly expand, their relationship in terms of both capital commitments and the scope of the investment program.

Managers have, for some time, used managed accounts while simultaneously sponsoring funds with similar investment programs. Moreover, managers and investors regularly agree to some tailored arrangements, as reflected in the expansion of side-letter negotiations. Recently, a number of factors have focused attention on the advantages of managed accounts. These factors include: heightened awareness of potential limits on redemption for investors in hedge funds, increasing disparity of appetites for overage or co-investment deal flow among key investors committing similar base amounts of capital, privacy concerns, investors' requests for preferred terms in exchange for larger commitments, investors' needs to address portfolio disequilibrium through new commitments by tailored allocations to specified

blends of investment strategies, and the effects of most-favored-nations protections and their attendant restrictions on sponsors.

Managers and investors seeking to deploy managed accounts to target opportunities that are within (or associated with) a fund's investment program face issues such as disclosure to investors, process decisions related to building investor consensus, constructive use of existing governance structures (such as investor committees) and economic provisions, such as entitlements to allocations. In some cases, prenegotiated arrangements in the fund documentation or side letters may govern key economic questions such as the allocation of opportunities that are suitable for both the fund and the managed account; the allocation of excess amounts beyond the appetite of the fund; and the terms of investments made by a managed account alongside the fund, such as pricing terms, entry and exiting timing provisions, and governance rights. In other cases, a range of options will be available to a manager to expand the relationship with an investor by negotiating a managed account in view of limited constraints flowing from prenegotiated terms in fund documentation. In such cases, managers also may be able to benefit from the presence of managed accounts in their negotiations on successor funds, particularly with respect to matters of allocation of investment opportunities.

Hong Kong Stock Exchange Leads the World in Listings in 2010 – Key Issues in Hong Kong Listings

Over the course of the past two decades, the Stock Exchange of Hong Kong Limited (SEHK) developed rapidly from a regional exchange to the principal market for companies from the People's Republic of China (PRC or China), and further to a world-scale exchange with listings across a range of industries and countries of origin. The SEHK has grown more rapidly than any other international stock exchange over the past 20 years, and in 2010 achieved the distinction of being the largest exchange in the world for listings, with more than US$52 billion in proceeds from listing transactions.

Nonetheless, the SEHK may face increased competition as foreign investors increasingly establish a presence in China to invest directly in its growing domestic stock markets. In addition, the Shanghai Stock Exchange is implementing a plan to establish an international board on which non-Chinese companies can list their shares in local currency, this being a major step toward achieving the PRC government's stated goal of making Shanghai a global financial center by 2020. However, the SEHK, having established an impressive record of flexibility and innovation while maintaining high listing standards, is well-positioned to continue to take advantage of capital market growth opportunities in Asia and elsewhere.

We would like to outline the internationalization process that the SEHK has gone through and set forth some of the principal differences in the listing process between the SEHK and other major international stock exchanges. Reflecting its origins (the British transferred ownership of Hong Kong to the PRC in the "handover" of sovereignty in 1997), Hong Kong inherited a significant portion of its regulatory structure and principles from the United Kingdom. In addition, due to significant participation by retail public investors in Hong Kong, as well as a generally less litigious culture, the SEHK regulation tends to be more prescriptive than the disclosure-oriented approach of U.S. securities regulation. The SEHK often takes a more paternalistic role than the U.S. regulatory system, scrutinizing transactions among companies within a controlled group, directly assessing the fairness and reasonableness of the terms of listing transactions, and requiring remedial actions of listing applicants to address noncompliance prior to listing. This makes the IPO process and dealing with the SEHK demanding, requiring substantial experience with the SEHK and the Securities and Futures Commission (SFC) — the independent statutory body of the securities and futures market in Hong Kong.

Despite its different regulatory framework and stringent corporate governance requirements, the SEHK is succeeding in attracting a global range of prominent issuers. Historically, almost all of the companies listed in Hong Kong were incorporated in Hong Kong, the PRC, Bermuda or the Cayman Islands. Since the SFC and the SEHK issued the Joint Policy Statement Regarding the Listing of Overseas Companies in 2007, the SEHK has expanded its list of approved foreign jurisdictions of incorporation for companies listing on the SEHK by an additional 14. These include Australia, Brazil, British Virgin Islands, Canada (British Columbia and Ontario), Cyprus, Germany, the Isle of Man, Japan, Jersey, Luxembourg, Singapore, the United Kingdom and the United States (California). Practitioners are confident that additional U.S. jurisdictions, such as Delaware, will be accepted in the future.

Listing Process

Listing and ongoing disclosure requirements for companies listed on the Main Board of the SEHK are governed by the SEHK's Listing Rules as well as various Hong Kong laws, including the Securities and Futures Ordinance and the Companies Law. We summarize below some of the key issues that arise in Hong Kong listings, particularly those that differ materially from what is usually seen in the United States and Europe.

Sponsor(s)

Each listing applicant must appoint at least one "sponsor" — an investment bank with the relevant license — which will serve as the principal channel of communication with the SEHK. Sponsors must perform their duties with impartiality, and at least one sponsor must be independent of the applicant. In the course of the listing process, the SEHK will require the sponsor(s) to express views on a range of issues relating to the applicant and its business.

Financial Qualifications

Generally, and subject to the exceptions discussed below, listing applicants must have conducted business for a period of at least three financial years prior to the date of the listing document and satisfy one of the three financial tests set out below:

Profit Test:

- market capitalization of at least HK$200 million (US$25.6 million)
- profits attributable to shareholders (excluding income or loss generated by activities outside the ordinary and usual course of business):
  - first two years: aggregate of at least HK$30 million (US$3.85 million)
  - third (most recent) year: at least HK$20 million (US$2.56 million)

Market Capitalization/Revenue Test:

- market capitalization of at least HK$4 billion (US$512.8 million) at the time of listing
- revenue of at least HK$500 million (US$64.1 million) for most recent financial year
- at least 1,000 shareholders at time of listing
- a shorter period of doing business may be acceptable if the applicant demonstrates:
  - directors and management have at least three years of experience in the line of business and industry

– management continuity for the most recent financial year

Market Capitalization/Revenue/Cash-Flow Test (Rule 8.05(2)):

- market capitalization of at least HK$2 billion (US$256.4 million) at the time of listing
- revenue of at least HK$500 million (US$64.1 million) for most recent financial year
- positive cash flow from operating activities of at least HK$100 million (US$12.8 million) for the three preceding financial years

Special exemptions are available for mining and infrastructure companies.

Management and Ownership Continuity

New applicants must have a record of doing business under substantially the same management for a minimum of the three preceding financial years (subject to the exceptions previously mentioned). This mandates continuity of executive directors and their equivalents as well as senior management. Ownership continuity and control of the listing applicant by its shareholders also are required for the most recently completed financial year.

Public Float

At least 25 percent of the issuer's total issued share capital must at all times following the IPO be held by the public. For this purpose, public excludes "connected persons," including, but not limited, to directors, the chief executive or substantial shareholders holding or controlling 10 percent or more of any member of the listing applicant's group. The SEHK may, at its discretion, accept a lesser percentage of between 15 and 25 percent in the case of issuers with an expected market capitalization at the time of listing of more than US$1.28 billion.

Accounting Standards

The applicant's accounts must be prepared in accordance with Hong Kong Financial Reporting Standards or International Financial Reporting Standards. Generally accepted accounting principles in the United States also may be acceptable by the SEHK under certain circumstances.

Audited accounts must not be more than six months old as of the date of the Hong Kong prospectus.

Corporate Governance

The applicant must appoint a minimum of three independent nonexecutive directors. At least one of the independent nonexecutive directors must have appropriate professional qualifications or accounting or related financial management expertise. Recommended best practice is to have one-third of the board consist of independent nonexecutive directors.

The applicant must establish an audit committee with clearly defined terms of reference to review and supervise financial reporting processes and internal controls.

Connected Transactions

The SEHK's rules extensively regulate connected (related-party) transactions. These include transactions between a listed issuer and a connected person, including, but not limited to, directors, the chief executive or substantial shareholders holding or controlling 10 percent or more of any member of the listing applicant's group, and certain other transactions in relation to acquisition or disposal of interest in a company, subscription of shares on favorable terms, financial assistance, options and joint ventures.

Prior to listing, the issuer will be required to identify the nature and scope of any connected transactions and ensure that such transactions are conducted on normal commercial terms which are fair and reasonable to the issuer. The requirements are designed to ensure that shareholder interests as a whole are taken into account by the listing applicant and to provide safeguards against "connected persons" (including, but not limited to, directors, the chief executive or substantial shareholders holding or controlling 10 percent or more of any member of the listing applicant's group) taking advantage of their positions.

Future connected transactions require notice and, in certain cases, approval by the independent shareholders.

Independence (Nonreliance) and Noncompetition

An applicant must be capable of carrying on its business independent of any controlling shareholder (holding 30 percent or more) after listing. There is some flexibility in the treatment of indebtedness between the issuer and the controlling shareholder (in either direction), although the generally preferred approach is to have such indebtedness discharged before listing. The same principle applies for guarantees and other financial assistance.

Typically, there is a need to address (through disclosure and, often, noncompetition undertakings) existing or potential competition between the issuer and the controlling shareholder and/or directors.

Property Matters

If the issuer has property interests (interests in land and/or buildings), it is required to engage an appropriately qualified property valuer to conduct a detailed valuation of such interests and prepare a report for inclusion in the prospectus. In support of its valuation report, the property valuer normally requires legal opinions from the issuer's counsel from jurisdictions in which the issuer has property interests. In recent times, the Hong Kong regulators have demonstrated a greater willingness to grant waivers in this regard.

Pre-IPO Investors

The terms of any investments in the listing applicant prior to the IPO will be looked at closely by the SEHK. This is a complex subject, and the SEHK has not always taken a consistent approach. If the issuer contemplates accepting investments prior to the IPO, this must be discussed in the earliest stages of transaction planning.

Corporate Restructuring

Corporate Restructuring

Restructuring activity in 2010 was slower than anticipated, largely due to the ability of many stressed companies to avoid the predicted "wall of debt." As we discuss below, significant debt maturity concerns remain in the near term. Accordingly, stressed entities and other entities seeking to benefit from financial duress should be aware of nontraditional restructuring strategies and techniques being employed by and against stressed entities. These strategies and techniques are being used with increased frequency, both in the U.S. and internationally, and the corporate restructuring world shows no signs of reverting to traditional Chapter 11 filings. This "new normal" for corporate restructuring is characterized by rapidly evolving, cutting-edge legal issues. Both stressed and healthy business entities and their directors and officers should be aware of these issues in their business planning activities.

The Wall of Debt – Reduced but Still Looming

As the stock market climbed throughout 2010 and the economy continued a slow recovery, fears subsided over the nearly trillion-dollar "wall of debt" due to mature in the near and medium term. While uncertainty about the strength of the economic recovery remains, a robust refinancing period, low interest rates and record levels of high-yield bond issuance have reduced debt maturing in the United States over the next four years by close to 34 percent, to $756 billion. While this news may be a sign of relief to Corporate America, the debt-maturity threat is far from over. In fact, much of the recent reduction in debt maturing in the near term is attributable to the willingness of lenders to push back maturity dates until 2015 and beyond.

In what is expected to be the first in a series of steps the market must take to alleviate existing debt pressures, 2010 saw record-breaking levels of high-yield bond issuance. Companies used an overwhelming majority of the proceeds from those high-yield bonds to refinance debt maturing in the short-term, or to repay bank debt in "bond-for-loan" takeout transactions. Yield-hungry investors, a continuing need for liquidity and low interest rates are expected to sustain the booming high-yield bond market this year.

As a result of historically low interest rates, the robust high-yield debt market and the resulting relatively easy access to additional liquidity, the number of traditional Chapter 11 filings fell in 2010. This decrease also can be attributed to several other factors, including the use of exchange offers, the willingness of lenders to forbear from exercising default remedies and the unwillingness of the parties involved to fund a Chapter 11 case (which can be a costly, lengthy and disruptive process).

In particular, lenders continue to be willing to engage borrowers in so-called "amend-to-extend" transactions. In an amend-to-extend transaction, borrowers effectively refinance their revolving credit and/or term loan facilities through loan modification amendments that generally allow a majority of lenders to extend payments by forbearing from the exercise of remedies under the debt instruments or, if all lenders consent, to extend the maturity of the debt. Analysts expect the rapid pace of these transactions to allow the market to redistribute loan maturities to a level more easily absorbed by traditional market sources.

While the high-yield market is booming and amend-to-extend transactions are on the rise, some segments of the financial market may create uncertainty for companies seeking to manage debt maturities. In particular, an important source of funding for the loan market may dry up when the reinvestment periods for a large number of collateralized loan obligations (CLOs) end over the next three years. CLOs, a popular investment vehicle during the market boom, currently represent 50 to 60 percent of all outstanding loans.

Analysts predict low-to-moderate levels, at best, of new CLO creation over the next few years. Without adequate levels of these CLOs as a source of funding for the loan market, companies likely will face a substantial gap in funding.

In the short term, creative refinancings and other out-of-court strategies have enabled companies to defer more comprehensive balance-sheet restructurings. Nevertheless, these measures ultimately may prove inadequate to address the amount of debt that will mature in the coming years. For middle-market companies and companies under stress that may not be able to access the high-yield market, the hundreds of billions of dollars of debt remaining due still poses a formidable hurdle. While the economy has shown signs of life, global financial instability, continued high leverage and a continuing high unemployment rate might cause continued financial stress in the coming years. Refinancing the wall of debt may be untenable in the long term if interest rates rise and the high-yield market begins to close off to riskier credits. For companies weathering these conditions or looking to take advantage of them, an understanding of the strategies and techniques being used by or in conjunction with stressed businesses to address the wall of debt is critical. These strategies and techniques are discussed more fully below.

The Increased Use of Nontraditional Restructuring Strategies

While 2009 was marked by the increased use of "prepackaged" and "prearranged" bankruptcies, 2010 established the use of these strategies as the "new normal" in the move away from traditional Chapter 11 bankruptcies, in which no pre-agreed exit strategy is established at the time of filing. The 2009 increase in prepackaged and prearranged Chapter 11 cases resulted partly from adverse capital market conditions that limited the ability of companies to refinance debt maturities and caused existing debt holders to convert their debt to equity. However, the continued and growing reliance on prepackaged and prearranged bankruptcy strategies in 2010 has been effectuated by choice and suggests a permanent change in the landscape, focused on minimizing time in Chapter 11 and the associated uncertainty, expense and delay.

A "prepackaged" Chapter 11 reorganization case permits a company and its stakeholders to negotiate and obtain requisite creditor acceptances of a fully documented Chapter 11 reorganization plan before the company files its bankruptcy case. A "prepack" strategy:

- significantly reduces to only a month or two, and sometimes even less, the in-court time required to complete a Chapter 11 restructuring;
- minimizes the costs and expenses associated with Chapter 11;
- reduces or eliminates "uncertainty of outcome" because the votes needed to confirm a plan over dissenting stakeholders are obtained before the Chapter 11 case is filed; and
- permits a Chapter 11 restructuring that minimizes the adverse effects upon trade creditors, customers, employees and ordinary-course business operations.

Similarly, a "prearranged" Chapter 11 case involves the negotiation and documentation of the restructuring terms before entering bankruptcy. Often, immediately upon commencing its Chapter 11 case, or soon thereafter, the company files its Chapter 11 plan and seeks expeditious approval of its disclosure statement. The move is toward confirmation on a 75- to 90-day (or in some instances even shorter) timeline, which reduces the costs, expenses, risks and uncertainties that are otherwise associated with negotiating a plan during in-court proceedings. A recent example of this trend is Skadden's representation of Metro-Goldwyn-Mayer (MGM) in a successful prepackaged bankruptcy filing that restructured and eliminated nearly $5 billion in debt. MGM spent only 29 days in Chapter 11.

This shift toward prepackaged and prearranged bankruptcy strategies does not mean the end of traditional Chapter 11 cases. There still will be circumstances, both macro (*e.g.*, credit market crises, corporate fraud or radical commodity price swings) and micro (*e.g.*, inability to obtain creditor consensus, need for substantial operational changes or limited liquidity) where a putative debtor will not be able to take advantage of accelerated processes and will need the protections (and toolbox) available in a traditional Chapter 11. However, we expect continuing and increased frequency of prepackaged and prearranged Chapter 11 cases in 2011, as companies and their creditors focus on cost-effective restructuring strategies with predictable outcomes. We also expect to see these strategies employed more often by third-party investors who seek to acquire ownership of financially troubled companies or their assets both in the U.S. and internationally.

Cross-Border Issues – Distressed Companies in a Global Environment

Notwithstanding the increased sophistication of restructuring regimes and improved coordination of systems and governments globally, international insolvencies continue to involve new layers of complexity as well as new and nontraditional restructuring strategies.

As companies become increasingly international, the factors establishing their connection with one jurisdiction or another become more complex and potentially increase the choice of forums in which to organize a restructuring. The English law scheme of arrangement is an attractive tool for companies and groups looking to lock a potential dissenting minority into a reorganization plan approved by a majority as specified in the applicable companies' legislation. It is not uncommon for non-U.K. companies and multinational groups to use English law as the governing law of their debt documents, conferring jurisdiction on an English court to hear an application for a scheme of arrangement. *Re La Seda de Barcleona SA* was a notable example of the use of the English scheme of arrangement to give effect to the restructuring of a Spanish company. One of the company's most substantial connections with England was the governing law of the debt documents (the company also had operations and employees in the U.K.). As the English courts' jurisdiction to sanction such arrangements receives greater acceptance through increased use of the process, the English scheme is likely to become an increasingly popular tool for companies and groups with English-law-governed debt.

The High Court in London also recently sanctioned the Scheme of Arrangement in the Orion Cable/Tele Columbus matter. This transaction — in which Skadden represented Orion Cable/Tele Columbus — marks the first time that a German operating company has been schemed in England. The outcome constitutes a considerable enhancement of the jurisdiction for a scheme of arrangement and may pave the way for the restructuring of a wide range of European companies that otherwise would have had trouble being restructured.

The separation of multiple overseas businesses that were formerly linked to a single parent creates significant forum choice complexity. In the Spansion reorganization, the U.S. parent commenced a Chapter 11 case and its Japanese subsidiary commenced a reorganization case in the Tokyo District Court. The filing in Japan caused the appointment of a trustee, which effectively ended the U.S. parent's control over the Japanese restructuring. Litigation ensued, with the Japanese subsidiary suing the U.S. parent for hundreds of millions of dollars in support to facilitate its restructuring. The U.S. parent resisted, hoping to shed operations that were inconsistent with its own restructuring agenda. Ultimately, the litigation was settled, and both companies survived. While a carefully coordinated and cooperative international insolvency is certainly desirable, we expect to see more of these coerced divorces in the future.

There is still no easy fix for the offshore investment structures that foreign investors utilize in China. More and more of this debt is maturing or facing covenant defaults, and — as in the amend-to-extend trans-

actions being used in the U.S. — parties are adopting temporary adjustments of the obligations rather than change-of-control transactions where the debt holders convert their debt into ownership of the issuer. We anticipate that this approach may not last, and that 2011 could see litigation over the enforcement of debt and the corresponding resistance by local equity founders.

Corporate Governance Considerations for 2011 and Beyond[3]

The recent recession has resulted in a changed economic environment that has been characterized by sustained volatility and continuing wide swings in market performance, asset values, consumer confidence and spending, and availability and cost of capital. In this "new normal" it is especially challenging for directors and officers to assess potential liquidity and capital risks while also taking account of new internal and external opportunities to enhance the company's enterprise value. Sometimes, when confronted with unanticipated challenges to their company's business model, liquidity and even survival, directors and officers are forced to operate outside their comfort zones to assess risks and pursue previously uncharted strategic paths.

These challenges have become even more complex as the federal government intercedes in corporate governance matters that have been governed almost exclusively by state law and custom, including, most recently, through passage of the Dodd-Frank Act. These developments require officers and directors to recognize how their fiduciary duties and constituency expectations are affected by economic distress, and accurately assess enterprise risk and anticipate changing economic conditions.

In the recession's wake, stakeholders expect directors and officers to effectively manage their companies in a global marketplace that is experiencing deglobalization, deleveraging and reregulation. In most states, while a corporation is solvent, its directors and officers owe fiduciary duties of care and loyalty exclusively to the corporation and its shareholders. The duty of loyalty requires directors and officers to act solely on the basis of what they honestly believe to be in the best interests of the corporation and its shareholders, without regard to personal or private interests or motivations, financial or otherwise. The duty of care requires directors and officers to act with the care an ordinarily prudent person would exercise under the same or similar circumstances.

More particularly, the duty of care requires directors and officers to be informed of all reasonably available material information prior to making business decisions, including available alternatives, and to act in a deliberative manner. In discharging these duties, directors and officers are entitled to rely on the advice of the corporation's management and outside experts, as long as they are reasonably believed to be knowledgeable/expert in their respective fields and there is no known reason not to rely on the information. Applying these principles, directors and officers are expected to exercise informed, disinterested and good-faith business judgment in connection with affirmatively dealing with material business risks.

In charting their course, directors and officers need to be acutely aware of the consequences of failure to meet the expectations, demands and requirements of their relevant constituencies. For example, allegations of ignoring "red flags" regarding business risks can lead to questions as to the adequacy of a company's disclosure, including with respect to risk factors and compliance with company risk oversight policies. In addition to litigation and regulatory considerations, the spotlight on director conduct as a governance matter and in the media has become increasingly bright; and notoriety, individually or as a member of a board challenged as having failed to monitor risk, is obviously harmful in and of itself. Increased shareholder activism, particularly with respect to the election of directors, also is a practical reminder that the record and reputation of directors is more important than ever.

[3] Portions of this article have appeared in *Navigating Today's Environment: The Directors' and Officers' Guide to Restructuring* (BeardGroup, Globe White Page Ltd, 2010) and the Harvard Law School Forum on Corporate Governance and Financial Regulation.

Especially in times of economic uncertainty, directors and officers are called upon to promptly and accurately gauge the extent of the corporation's troubles and to formulate an appropriate plan of action. More often than not, the emphasis will be on the state of the company's liquidity at the present time and in the near future. In order to respond effectively, directors and senior management should engage in a comprehensive review of the corporation's finances and business plan. In conducting this review, directors and officers should consider cost reduction opportunities and key performance indicators, "stress test" the business plan, review capital expenditures (identifying only those capital expenditures that are absolutely necessary) and keep a close eye on liquidity projections.

As senior management and directors continue to navigate through improving but uncertain economic conditions, they should reaffirm their commitment to responsible corporate oversight in order to regain stakeholder confidence and trust. Directors and officers should pay particular attention to periodic business enterprise risk assessments and identify actions that should be taken in order to implement effective reviews. They need to be cognizant not only of their fiduciary duties and how those duties may come into play in situations where their companies experience financial distress, but also the expectations, demands and requirements of all relevant constituencies focused on the role of directors and officers in identifying, overseeing and managing company risk, particularly in the current economic environment.

While the wisdom of increasing government intervention in the day-to-day affairs of corporations through the Dodd-Frank Act and other legislative initiatives may be open to debate, the imperative for directors and officers to demonstrate vigilant, independent and honest oversight as the driving force of corporate governance is not. Now that the headwinds of the 2007-09 recession are beginning to subside, directors and officers are turning their attention from liquidity risk issues to the assessment of other business risks. Specifically, they are increasing their focus on which enterprise risk management measures should be implemented or enhanced to better serve the interests of their corporations and their stakeholders. One approach to addressing these concerns at the board level is to develop and publicly adopt a set of voluntary principles of conduct.

A voluntary program that would enable directors and officers to demonstrate their commitment to responsible risk management and corporate governance would need to include certain critical elements in order to be successful. First, an agreed-upon set of basic principles of oversight needs to be formulated. These principles would reflect focused and real commitment to comprehensive board oversight of corporate affairs, including self-evaluation of compliance to reinforce quality oversight and support credibility. Next, a program to develop broad and demonstrable support for the guidelines is important. Without widespread support, it will be more difficult for corporate boards to staunch their public detractors and convey their commitment to more stringent, self-imposed oversight guidelines.

By voluntarily subscribing to these principles, a board will publicly commit to overseeing the business and affairs of its company thoughtfully, carefully, comprehensively and proactively. Moreover, the board will be sending a clear message that its business and affairs are to be conducted legally and ethically. Having done so, directors are likely to be highly motivated to act in accordance with their public commitment, even though they are voluntarily accepting a higher standard of conduct than is required as a matter of fiduciary duty under state law.

Sectors to Watch

While the number of traditional Chapter 11 filings fell in 2010, with a significant wall of debt still in place, many business sectors might confront difficult times in 2011. One such sector is retail, where consumer spending, notwithstanding the improvement experienced during the recent holiday period, is expected to grow only modestly in 2011. The lack of improvement in the retail markets can be attributed primarily to persistent unemployment, which continues to rein in consumers' ability and desire to

buy. Because input costs for retail companies remain high, prices may not be as low as shoppers would like them to be, which could dampen demand. As in the past few years, the sluggish economy is likely to continue to shed weaker performers through liquidations or consolidation.

Real estate is another sector that may be at the forefront of restructuring activity in 2011. Analysts predict that the commercial real estate sector will remain a drag on the economy for at least another year. While the sector's fortunes have improved, there is still a long way to go, and many believe that vacancy rates for both offices and industrial property have yet to top out. Additionally, the weakness in the retail sector, described above, will continue to impose pressure on this sector, leading to restructuring events such as those recently undertaken by landlords (*e.g.*, General Growth Properties, Inc.) both in and out of court. Despite low interest rates, the housing market continues to struggle. Anemic job growth is the major obstacle to residential real estate sales. The lack of improvement in this sector suggests that it will continue to experience elevated rates of restructuring activity.

Lastly, restructuring activity surrounding municipalities also is likely to increase in 2011. While municipal bankruptcies are extremely rare, they appear increasingly possible as the finances of many local governments grow more and more distressed. With mounting debt and fears that investors could balk at lending to the weakest municipalities, investing in municipal bonds, historically viewed as a safe investment, has seen a downward trend. If municipalities continue to be unable to fill budget holes with traditional sources of liquidity, there may be an increase in the number of Chapter 9 filings, but there certainly will be an increase in out-of-court restructuring activities among municipalities and their creditors as efforts to avoid bankruptcy filings are undertaken.

Financial Regulation

The Dodd-Frank Act

International Developments

Financial Regulation

In the coming year, the laws enacted in response to the financial crisis will begin to generate extensive new regulations. More than 300 provisions require rulemaking, and a significant part of those regulations will be issued amid continuing stress in the global financial system, deleveraging in developed markets and monetization of debt in the United States. The effects of the new regulations on the global economic recovery — particularly in light of the desire for increased regulatory certainty and predictability as foundations for business investment — have been the subject of speculation and debate.

In 2011 and beyond, we expect our clients to be keenly interested in monitoring, analyzing and adapting to regulations issued under the Dodd-Frank Act,[4] the Basel III accord[5] and related efforts endorsed by the G-20 to coordinate regulation of financial institutions across borders,[6] and the European Union's Alternative Asset Fund Manager Directive.[7] In the following discussion, we explore the current state of these regulations and prospects for their further development.

The Dodd-Frank Act

Critics of Dodd-Frank assert that it will disadvantage U.S. firms competing with foreign firms subject to less burdensome regulatory regimes and will encourage increased regulatory arbitrage. As a result, speculation has centered on the potential for the forthcoming session of Congress to limit or delay the implementation and funding of the new regulations, especially the derivatives regulations and the regulations implementing the Volcker Rule.

In any event, the financial community would benefit from definitive indications regarding how regulators will apply key concepts and interpret key terms of the act. Resolution of ambiguities and unanswered questions in the act would be particularly welcome.

Bank and Systemic Risk Regulation

The United States has been a key participant in global efforts to develop regulatory systems to address the problems that contributed to the financial crisis, including, in particular, tools to deal with any financial institution that is deemed to be a Systemically Important Financial Institution (SIFI).

International Efforts to Address Systemic Risk

At a Washington, D.C. summit in November 2008, the Group of Twenty Finance Ministers and Central Bank Governors (the G-20), together with the leaders of the G-20 nations, initiated a process to develop a global consensus on measures to deal with SIFIs and problems that contributed to the financial crisis.

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[4] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). *See* Skadden memorandum "The Dodd-Frank Act – Commentary and Insights," July 12, 2010.

[5] "Basel III" refers to the set of reform measures developed by the Basel Committee on Banking Supervision. *See* "International Regulatory Framework for Banks (Basel III)," *available at* http://www.bis.org/bcbs/basel3.htm.

[6] *See* Press Release, Financial Stability Board, "G20 Leaders Endorse Financial Stability Board Policy Framework for Addressing Systemically Important Financial Institutions" (Nov. 12, 2010), *available at* http://www.financialstabilityboard.org/press/pr_101111a.pdf.

[7] European Parliament Legislative Resolution of 11 November 2010 on the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/…/EC, COD 2009/0064 (Nov. 11, 2010) *available at* http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2010-0393.

This effort on the part of the global regulators culminated with the endorsement by the G-20, meeting in Seoul, South Korea, on November 11, 2010, of a policy framework developed by the Financial Stability Board (FSB) to reduce the risks and externalities associated with domestic and global SIFIs. The policy framework is based on the FSB's November 2, 2010 report ("Intensity and Effectiveness of SIFI Supervision"), which was prepared in consultation with the International Monetary Fund, containing 32 recommendations based on an internationally coordinated assessment of lessons from the financial crisis on reducing moral hazard risk associated with SIFIs. The goal of the policy framework is to reduce the risks and externalities associated with domestic and global SIFIs by strengthening the intensity and effectiveness of supervision.

The G-20 endorsed FSB's SIFI policy framework, work processes and timelines for addressing the systemic and moral hazard risks associated with SIFIs. The framework consists of five areas:

- a resolution framework and other measures to ensure that all financial institutions can be resolved safely, quickly and without destabilizing the financial system and exposing taxpayers to the risk of loss;
- a requirement that SIFIs and, in particular, global SIFIs (G-SIFIs) have higher loss-absorbency capacity to reflect the greater risks that these institutions pose to the global financial system;
- more intensive supervisory oversight for financial institutions that may pose systemic risk;
- robust core financial market infrastructures to reduce contagion risk from the failure of individual institutions; and
- other supplementary prudential and other requirements as determined by the national authorities.

Additionally, under the framework, home jurisdictions for G-SIFIs should:

- enable a rigorous coordinated assessment of the risks G-SIFIs face through international supervisory colleges;
- make international recovery and resolution planning mandatory for G-SIFIs and negotiate institution-specific crisis cooperation agreements within cross-border crisis management groups; and
- subject their G-SIFI policy measures to review by the proposed Peer Review Council.

As part of this process, global regulators have been considering which companies should be classified as G-SIFIs. According to a report by the *Financial Times*,[8] last year, regulators under the auspices of the FSB identified 30 cross-border financial institutions, most of which are not based in the United States, that were put on a preliminary nonpublic list for "cross-border supervision exercises" in order to check for systematic risk. According to the *Financial Times*, the list of institutions included five U.S. banks: Bank of America, Citigroup, Goldman Sachs, JP Morgan Chase and Morgan Stanley. The list of non-U.S. financial institutions included the Royal Bank of Canada, Barclays, HSBC, Royal Bank of Scotland, Standard Chartered, Credit Suisse, UBS, BNP Paribas, Société Générale, BBVA, Santander, Mitsubishi UFJ, Mizuho, Nomura, Sumitomo Mitsui, Banca Intesa, UniCredit, Deutsche Bank and ING Groep. In addition, the FSB earmarked six insurance firms, including Aegon, Allianz, Aviva, Axa, Swiss Re and Zurich. Recent reports have indicated, however, that Adair Turner, chairman of the U.K. Financial Services Authority and member of the FSB, signaled that individual insurance groups might escape inclusion on the global list of SIFIs. The *Financial Times* reported that Turner told international insurance regulators in Dubai, on October 27, 2010, that the FSB did not believe large individual insurers posed systemic risks in the way that banks did. The FSB and national authorities, in consultation with relevant standard setters, will determine by mid-2011 those institutions to which the FSB G-SIFI recommendations initially will apply.

[8] *See* Patrick Jenkins and Paul J. Davies, "Thirty Financial Groups on Systemic Risk List," *Financial Times*, Nov. 30, 2009.

U.S. Efforts to Address Systemic Risk

The Dodd-Frank Act addresses the concept of SIFIs by imposing heightened prudential requirements on nonbank financial companies, including non-U.S. nonbank financial companies designated by the Financial Stability Oversight Council (FSOC) to be subject to Federal Reserve supervision, and by imposing the same heightened prudential requirements on bank holding companies (BHCs) and non-U.S. banking organizations treated as BHCs with at least $50 billion in total consolidated assets. The term "systemically important financial institution" used by the FSB is not the term found in the Dodd-Frank Act, which, as discussed above, covers BHCs with more than $50 billion in total consolidated assets and certain nonbank financial companies designated by the FSOC. Thus, while the U.S. SIFI standards set forth in the Dodd-Frank Act will be used as the test for determining which companies qualify as SIFIs in the United States, Dodd-Frank's SIFI standards are distinct from the standards being developed by the national bank supervisors in other countries.

The FSOC issued an advance notice of public rulemaking at its inaugural meeting in October 2010 regarding considerations in the designation of SIFIs and another at its November 2010 meeting regarding the designation of systemically important payment, clearing and settlement systems. The FSOC will issue a proposed regulation for comment leading to the adoption of a regulatory framework for making such designations. The FSOC also will make proposed recommendations to the Federal Reserve Board for the implementation of special supervisory requirements for such institutions. This process will roll out over the next two years and presents a significant challenge to the competitiveness of institutions that are selected for designation. (See "Global M&A/U.S. M&A – Recent Developments in Private Equity Transactions.")

The Volcker Rule

In 2011, regulators will begin revealing how they will interpret and enforce the Volcker Rule's restrictions on "proprietary trading" and ownership or "sponsoring" of "hedge funds" and "private equity funds" by "banking entities." The rule's proponents would read it broadly and expansively because it embodies a "clear mandate to end high-risk, conflict-ridden financial activities at our national banks and systemically significant nonbank financial companies."[9] Other commentators have urged a strict, narrow reading of the rule because they regard it as "a solution in search of a problem" that "risks damaging the competitive standing of U.S. financial firms vis-à-vis their European and Asian counterparts."[10] The resolution of those competing perspectives will profoundly impact the future of the financial sector.

Expected Rulemaking

By January 21, 2011, the FSOC is required to conduct a study and make recommendations regarding implementation of the Volcker Rule. In connection with the study, the FSOC solicited public comment regarding the general approach to implementation of the rule and the application of a number of statutory terms and concepts.

Following completion of the study, by October 2011, financial regulators are to issue regulations implementing the Volcker Rule. The rule will become effective at the earlier of 12 months after the issuance of final regulations or July 21, 2012. Given the complexity of the regulations, its effective date is widely expected to be July 21, 2012.

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[9] Letter from Sen. Jeff Merkley (D-OR), *et al.* to Timothy Geithner and Members of the Financial Stability Oversight Council, at 2 (Oct. 28, 2010), *available at* http://www.regulations.gov.

[10] Letter from Rep. Spencer Bachus (R-AL) to Members of the Financial Stability Oversight Council, at 1 (Nov. 3, 2010), *available at* http://www.regulations.gov. (According to Rep. Bachus, the financial crisis was caused not by proprietary trading but by an abandonment of rigor in credit analysis and lending standards.)

The Federal Reserve is required to issue rules implementing the conformance period for the Volcker Rule by January 21, 2011. A two-year conformance period will follow the effective date (expected, as described above, to be July 2012) with up to three one-year extensions on a firm-by-firm basis, bringing the conformance period to as late as July 2017. An additional transition period for illiquid funds may extend the final deadline to as late as July 2022. Although the compliance period may be lengthy in some cases, the breadth of the changes and the degree of uncertainty still remaining in the Dodd-Frank Act have led many banking entities to begin conforming their activities to the new requirements.

Application of the Volcker Rule – 'Banking Entities'

The "banking entities" within the rule's scope include insured depository institutions and bank holding companies and their affiliates and subsidiaries. More clarity and precision regarding the application of this term to non-U.S. banks would be welcome. In addition, the new regulations should confirm that affiliates and subsidiaries for this purpose will not include controlled funds and their portfolio companies, financial subsidiaries and joint venture entities. Finally, the uncertain concept of "control" will drive the determination of whether an entity in which a regulated institution holds or might obtain an interest will be treated as a subsidiary or affiliate.

Proprietary Trading Restrictions

The proprietary trading restrictions of the Volcker Rule[11] will require regulators to monitor, collect and analyze masses of trading data; understand the substance and reality of the activities that those data represent (which may, of course, be complex and elusive); and determine how those activities should be abstracted to fit within the categories articulated by the rule. High stakes are riding on the resolution of the following issues:

- What criteria will determine whether trades are undertaken "as a principal for the trading account" and thus prohibited? As defined by the Dodd-Frank Act, a trading account is used "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)." How will purpose and intention be determined? How will prohibited trades be distinguished from trades undertaken as principal for investment purposes, which would presumably be permitted? Will the treatment of a position as "trading securities," "available-for-sale" or "held-to-maturity" under generally accepted accounting principles inform the determination of whether that position is "for the trading account" for purposes of the Volcker Rule?

- How will regulators distinguish proprietary trading from the permitted activities enumerated by the rule? For example:

  – The Volcker Rule permits underwriting or market-making, to the extent that either does not exceed near-term demands of clients, customers or counterparties. What characteristics of market making and underwriting distinguish those permitted activities from proprietary trading? What import will be assigned to the institution's intent and motivation for entering into a trade? What relevance should be assigned to the holding period? What effect should be given to the language of the statute permitting trading "in connection" with "market-making-related activities"? Is the definition of "market maker" under the Securities Exchange Act of 1934, as amended, relevant to the determination? What types and degrees of principal risk will be permitted in connection with market-making activities? Will the criteria include quantitative metrics?

  – How broad is the scope of permitted "risk-mitigating hedging activities"? Will hedging be limited to specific positions, or will it be permitted on an aggregated basis? How will derivatives hedging activities be treated?

[11] Dodd-Frank Act § 619.

– How will regulators identify trades "on behalf of customers," which are permitted under the rule? Under what circumstances can a trade by an institution as a principal be undertaken on a customer's behalf?

Hedge Fund and Private Equity Fund Restrictions

Definition of "Hedge Fund" and "Private Equity Fund." The Volcker Rule limits the ability of banking entities to own interests in or sponsor a "hedge fund" or "private equity fund." In the absence of any widely accepted definition, Congress defined each of those terms broadly to include any issuer that would be an investment company but for Section 3(c)(1) or Section 3(c)(7) of the 1940 Act and authorized the regulators to expand the definition to include "similar funds."

Section 3(c)(1) and Section 3(c)(7) exempt many business entities other than traditional hedge funds and private equity funds, such as joint ventures, financing vehicles, foreign entities and venture capital funds (which Congress has stated are not intended to be covered by the Volcker Rule). Several industry groups and financial firms asked the council to propose new definitions that would capture only funds that are traditionally considered hedge funds or private equity funds. Others asked the council to utilize the "similar fund" definition only as an anti-evasion tool for traditional hedge funds and private equity funds or to create a bright-line test for its applicability going forward. A major theme of the financial industry's commentary is the need for certainty in the definitions.

Permitted Fund Conditions. The Volcker Rule allows banking entities to organize and offer a hedge fund or private equity fund if they comply with certain conditions.[12] This exception will largely determine the size and scope of banking entities' private fund advisory businesses. Open questions surrounding the conditions are of fundamental concern to banking entities. In particular, we hope that the regulators will provide clarity on the following issues:

- What does it mean to provide bona fide trust, fiduciary or investment advisory services to persons who are "customers of such services" of the banking entity? Do new customers of the bank fit into this definition, or does it mean that permitted funds may be offered only to existing customers of established services? Also, does this purport to create a fiduciary relationship between an investment adviser and ultimate investors, and, if so, how can that be reconciled with the investment adviser's existing fiduciary duty to the permitted fund?

- Which investments are counted toward the *de minimis* investment limitation? Does it include investments by employees or employee pension plans? What about carried interest or other incentive compensation? How does the *de minimis* limitation apply within fund-of-funds structures or master-feeder structures?

- What is the scope of an employee being "directly engaged" in providing "investment advisory or other services" to a permitted fund? Will the definition be based on the existing "knowledgeable employee" definition under the 1940 Act or will it be broader? Does the definition include senior management-level employees who provide oversight? What about employees who provide services other than investment services? Will employee funds be permitted? In the absence of clear guidance from regulators, it will be difficult for banking entities to plan for employee investments, especially in illiquid funds that may not be easily liquidated within the Volcker Rule's transition period.

Private Investment Advisers

The SEC has started to introduce new rules, rule amendments and Form ADV amendments to implement Title IV of the Dodd-Frank Act (the "Registration Act"). The Registration Act repeals the private

[12] Dodd-Frank Act § 619 enumerates eight conditions.

adviser exemption of Section 203(b)(3) of the Investment Advisers Act of 1940, as amended, thus requiring most investment advisers to hedge funds and other private funds to register with the SEC. In its place, the Registration Act adopts several new and more limited exemptions for various types of investment advisers. In October 2010, the SEC proposed a narrow exemption for advisers to single-family offices that would not apply to many single-family office advisers.[13] Industry participants have commented that no policy objectives would be served by requiring these advisers to register with the SEC and have asked the SEC to expand the exemption.

Last November, the SEC proposed a definition for venture capital funds to be used in the new exemption for advisers to such funds and an exemption for investment advisers to private funds with less than $150 million in assets under management in the United States. These "exempt reporting advisers" would, as proposed, be required to file reports with the SEC and to keep such records as the SEC deems necessary to protect investors. They also would be subject to SEC examinations. Exempt reporting advisers may be required to register with one or more state securities authorities as well. Two SEC commissioners expressed concern over elements of the proposed rules relating to exempt reporting advisers and, in particular, the failure to distinguish sufficiently between registered and exempt advisers. These commissioners affirmatively invited public comments on specific issues such as the burdensome reporting, recordkeeping and related compliance obligations of exempt reporting advisers, especially the potential adverse impact on venture capital fund advisers. The SEC also proposed definitions to be used in the new exemption for foreign private advisers[14] and expanded requirements for disclosure about private funds on Form ADV.

Public comments on these proposals are due by January 24, 2011. We expect commentators to criticize — as excessively specific and burdensome — the six elements of the proposed definition of venture capital funds and to echo the concerns expressed by the two SEC commissioners regarding the level of regulation proposed for exempt reporting advisers, especially advisers to venture capital funds. We also expect commentary regarding the proposed exemption for investment advisers to private funds with less than $150 million in assets under management in the United States to address the disparity in treatment of advisers based on whether or not they have a principal office and place of business in the United States. Many other areas are ripe for comment, including:

- the requirement that a non-U.S. fund use U.S. jurisdictional means to offer its securities in order to be considered a "venture capital fund";
- the disparity between the $25 million threshold in assets under management for foreign private advisers and the $150 million threshold in assets under management for other private advisers;
- the continued viability of the SEC's positions relating to non-U.S. affiliates of registered investment advisers in the Unibanco and related no-action letters;[15]
- the requirement for advisers to include assets managed for no compensation and proprietary assets as regulatory assets under management; and
- the level of disclosure required about private funds.

In addition to finalizing the proposed rules described above, future investment adviser rulemaking by the SEC to implement the Dodd-Frank Act will include:

- proposing and adopting rules to implement reporting obligations on investment advisers related to the assessment of systemic risk;

[13] For a discussion of the proposed family office adviser exemption, *see* Skadden memorandum "SEC Proposes Rule Defining 'Family Office' Exclusion From Definition of Investment Adviser," October 27, 2010.

[14] *See* Skadden memorandum "SEC Proposes Rules Implementing Amendments to the Investment Advisers Act of 1940," December 17, 2010.

[15] Uniao de Bancos de Brasileiros S.A., SEC No-Action Letter, 1992 WL 183054 (July 28, 1992).

- proposing and adopting rules to adjust the threshold for "qualified clients";
- reporting to Congress regarding the need for enhanced resources for investment adviser examinations and enforcement; and
- reporting to Congress regarding the costs and benefits of real-time reporting on short-sale positions.

Investor Protection and SEC Enforcement

New SEC Whistleblower Rules of Questionable Utility Threaten To Undermine Corporate Compliance Programs and Relationships With Corporate Counsel

On November 3, 2010, the SEC released proposed rules to implement Section 922 of the Dodd-Frank Act.[16] The proposed rules allow potential whistleblowers to submit information to the SEC and apply for award payments of between 10 percent and 30 percent of monetary sanctions collected by the SEC and certain other authorities.

The substantial payments offered by the whistleblower proposal for internal compliance information might undermine required corporate compliance programs by discouraging the internal reporting on which such programs depend. To the extent that internal compliance departments compete with the SEC to receive tips about alleged wrongdoing, companies will be hard-pressed to receive cooperation credit for being "first in the door" to report wrongdoing to the government. The proposed rules could more effectively ensure that internal compliance programs continue to play an integral role in responding to potential misconduct by requiring whistleblowers to report concerns internally before approaching the SEC. Alternatively, the SEC should offer only the minimum 10 percent award to whistleblowers who provide tips to the SEC without first reporting them internally.

The proposed rules also would purport to allow the SEC to communicate directly with employees and other personnel of entities represented by legal counsel, notwithstanding established law requiring SEC staff to communicate with represented persons through or with the consent of their attorneys. This radical new approach threatens to undermine companies' confidence in the protections normally afforded by legal representation.

According to the SEC, the most important objective of Section 922 is to encourage high-quality tips. However, the SEC already receives large numbers of tips each year. Payouts under Section 922 will doubtless increase the *quantity* of tips, adding to administrative burdens for an already resource-constrained agency, but may not increase the *quality* of these tips.

Study and Rulemaking Could Transform the Business Model of Broker-Dealer Firms

The Dodd-Frank Act requires the SEC to conduct a study regarding existing standards of care applicable to broker-dealers and investment advisers. The act also provides the SEC with authority to promulgate rules imposing a uniform "fiduciary" duty.[17] Currently, investment advisers are subject to Section 206 of the Investment Advisers Act, which imposes a fiduciary duty. Under such a duty, advisers have ongoing duties to their clients and must always place clients' interests ahead of their own. In contrast, broker-dealers are not fiduciaries (to the extent that they provide investment advice that is solely incidental to

[16] Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Exchange Act Release No. 63,237, 75 Fed. Reg. 70,488 (Nov. 17, 2010) ("Proposing Release"). The act also provided the CFTC with parallel authority to pay whistleblower bounties. Dodd-Frank Act § 748. The CFTC proposed implementing rules on November 10, 2010. Proposed Rules for Implementing Section 23 of the Commodity Exchange Act, RIN Number 3038-AD04, 75 Fed. Reg. 75,728 (Dec. 6, 2010).

[17] Dodd-Frank Act § 913.

brokerage services and do not receive special compensation for that advice), and their recommendations are subject only to a "suitability" requirement, which requires them to have "reasonable grounds for believing that the recommendation is suitable" based on an assessment of a customer's financial status, investment objectives and other factors.

The fiduciary duty study must be completed by January 21, 2011. Until the SEC completes its study and, if it chooses to do so, proposes rules pursuant to its new authority, the impact on brokerage business models is unclear. However, the questions are many, and the impact may be profound. The following issues await resolution in 2011:

- Will the SEC, as expected, impose a fiduciary duty on broker-dealers?
- If a uniform fiduciary duty is imposed, will it permit large, integrated financial services firms to continue offering a wide variety of investment products and services to retail investors?
- Will procedural requirements and costs of compliance effectively limit investor choice and access to products and services?
- Will investment advisers be subject to new, more restrictive regulations?
- Will the fiduciary duty extend to the provision of advice to institutional investors?
- What constitutes "personalized investment advice" that triggers a duty?
- Will the duty apply if a broker merely recommends that a customer hold a security, rather than purchase a security?

Derivatives

Implementation of Title VII will require two agencies with very different regulatory philosophies — the Commodity Futures Trading Commission (CFTC) and the SEC — to agree on new regulations for an existing market in swaps that has never before faced market regulation. The Dodd-Frank Act requires the new regulatory structure to be completed by July 16, 2011, which leaves each resource-constrained agency with little time to deliberate and analyze how best to achieve the regulatory system for the swaps market.

Under Title VII, the CFTC regulates all swaps except "security-based swaps," which are regulated by the SEC. To improve transparency, all swaps must be reported to new centralized data repositories and are subject to real-time public reporting of transaction and pricing data. To further improve transparency and to address systemic risk, most swaps will be required to be exchange-traded and submitted to a clearing system intended to eliminate counterparty credit risk. Other provisions intended to mitigate systemic risk and enhance the integrity of the market (including for categories of swaps permitted to be executed over the counter rather than exchange-traded and cleared) will subject new categories of regulated entities — "Swap Dealers" and "Major Swap Participants" — to comprehensive regulation, including registration, capital, margin and extensive business conduct requirements.

Following months of public roundtables and semiprivate meetings with stakeholders, the CFTC and SEC have begun to unveil their proposals for formal public comment. In many cases, key issues have been deferred to a later date or proposed in the alternative with a request for public input. Commissioners have noted publicly that it is easier to propose rules than to adopt and implement sensible final regulations.

In the coming months and well into 2011, the CFTC and SEC will decide difficult issues posed by Title VII, including:

- What is a swap?
- How should "swap dealers" and "major swap participants" be defined?
- What swaps must be cleared?
- Will agricultural swaps be regulated in the same manner as other swaps?
- What collateral protections, if any, will be imposed for cleared swaps that face "fellow customer" risk (*i.e.*, pooled risk, inherent in the clearinghouse model)?
- What trading platforms will qualify as so-called "Swap Execution Facilities"?
- What commercial end users will qualify for the exemption from mandatory exchange trading and clearing of swaps?
- Should minimum collateral rules be imposed on uncleared swaps for all market participants and to what extent may such new requirements be applied to pre-existing swaps?
- What swap reporting will be required — including real-time price reporting?
- Should position limits be imposed on physical commodity swaps or security-based swaps and, if so, at what level?
- How will manipulation and deception in the swap markets be addressed?
- To what extent should Title VII requirements apply to non-U.S. entities and offshore transactions?

As the rulemaking process continues, regulators will address other issues of concern to derivatives market participants. Regulatory guidance will be particularly welcome regarding the extent to which investment funds and structured finance vehicles may become subject to requirements that could adversely affect their returns or, in some cases (particularly for certain pre-enactment structured finance vehicles), be impossible to satisfy. The CFTC and SEC will adopt governance structures and requirements to mitigate perceived conflicts of interest for exchanges and clearing organizations, while implementing new enforcement authority ranging from expanded powers to monitor deceptive practices to procedures for investigating complaints submitted by whistleblowers. In addition, the Treasury Department will decide whether foreign currency forwards and swaps should be subject to CFTC regulation.

To many observers of the swaps market, it appears that it will be difficult, if not impossible, for the agencies to meet the July 2011 statutory deadline for full implementation. Based on the regulatory proposals to date, the cost of hedging price and rate risks that businesses and financial institutions face every day is likely to increase through regulatory compliance costs and price spreads charged by parties that assume price risks. Whether those higher costs will discourage businesses from continuing to manage price and rate risks using swaps, and the economic implications of the assumption by businesses, without hedging, of more of those risks, will be among the more intriguing issues to play out in the coming years as the swap reforms of the Dodd-Frank Act are implemented.

CFPB Developments

Five months after the enactment of Dodd-Frank, few of the act's consumer or mortgage provisions have taken effect, and the development of the Bureau of Consumer Financial Protection is still in its early phases.

Most notably, President Obama has not yet nominated an individual to serve as director of the bureau. On September 17, 2010, the president appointed Elizabeth Warren as an assistant to the president and

special adviser to Treasury Secretary Timothy Geithner regarding the bureau. Warren, a Harvard Law professor who has been credited with conceiving the idea of a consumer bureau, has been identified as a potential nominee for bureau director. Since her appointment as assistant to President Obama and special adviser to Secretary Geithner, Warren has engaged in a dialogue with representatives from several large banks and other financial institutions, community banks, banking trade groups, consumer advocacy groups, members of Congress, senior White House officials and fellow federal regulators. Warren has emphasized the importance of simplifying loan disclosures and harnessing technology to help the bureau collect and analyze data.

Congress has questioned whether the bureau has the legal authority to engage in substantive rulemaking in the absence of a permanent, confirmed director. In November 2010, the Treasury's general counsel suggested that the bureau may propose rules prior to the confirmation of a permanent director and prior to July 21, 2011 — the designated "transfer date" described below. Since the midterm elections, some Republican lawmakers have questioned whether having the bureau headed by a single director places too much power in the hands of one individual, and some have proposed changing the bureau's leadership to a commission.

While the bureau has been getting up and running, other federal agencies have moved forward aggressively with consumer financial protection enhancements. In November, the Federal Deposit Insurance Corporation (FDIC) issued "supervisory guidance" on automated overdraft payment programs. The guidance sets forth a number of actions that the FDIC expects state nonmember banks to take to reduce compliance risks associated with overdraft programs, including restricting payment posting order in a fashion that maximizes overdraft fee revenue and limiting the number of overdraft fees that a bank can assess. Also, the Federal Reserve finalized rules, effective in April 2011, banning compensation to mortgage loan officers and brokers that varies based on loan terms. Finally, a senior official at the Federal Trade Commission (FTC), which will retain consumer financial protection rulemaking and enforcement authority with respect to auto dealers as an exception to the bureau's authority, has commented that the new streamlined rulemaking authority granted to the FTC with respect to auto dealers extends not only to regulation of consumer financial products and services, but also to all aspects of FTC regulation of auto dealers.

The consumer provisions that have received the most attention since passage of the Dodd-Frank Act relate to the bureau's broad rulemaking authority, particularly the authority to ban "abusive" acts or practices. Much attention and uncertainty surround the "abusive" standard because it is only loosely defined in the Dodd-Frank Act, and, unlike the FTC Act's "unfair" and "deceptive" standards, there is no interpretive judicial precedent. Some Republican lawmakers also have criticized the bureau's broad, loosely defined authority to ban "abusive" acts or practices.

In the coming year, many of the consumer title provisions will take effect, and the bureau likely will become fully staffed and operational. On the "transfer date," most consumer protection functions of the federal banking regulators will be transferred to the bureau, and the bureau will gain new rulemaking authority. Also, several other provisions of the consumer title, including provisions relating to the expanded role of state law and limitations on federal bank preemption, will take effect on that date. Most of the provisions of the mortgage title, however, will take effect after the transfer date.

Resolution Authority

As described in our previous Dodd-Frank compendium, the Dodd-Frank Act created an "orderly liquidation authority" that contemplates appointment of the FDIC as receiver for a troubled financial company for which failure poses a systemic threat to the financial system.[18] Currently, three rulemaking initiatives are under way to implement various aspects of this new liquidation regime:

[18] *See* Skadden memorandum "The Dodd-Frank Act – Commentary and Insights/Orderly Liquidation Authority," July 12, 2010.

First, the United States District Court for the District of Columbia, which is vested with exclusive authority to entertain contested petitions filed by the FDIC to place a financial company into receivership, is to develop rules and procedures for the petition process by January 21, 2011.

Second, the FDIC proposed a relatively small, discrete set of rules for public comment due on November 18, 2010. One of these proposed rules — which provides that collateral securing positions with a financial company which is comprised of direct obligations of the United States will be valued at par — has drawn considerable attention. The ostensible purpose behind this rule is to favor liquid, United States obligations over other, less-liquid forms of collateral, which the FDIC believes exacerbated the recent financial crisis. However, par may not be an accurate indicator of actual value. Many industry participants believe that parties should be allowed to value such collateral in accordance with existing industry norms that are designed to reflect market value.

Finally, the FDIC has raised a much broader series of questions, without any proposed rules, for public comment due by January 18, 2011. A key focus of attention will be on the extent to which rules can be promulgated that afford greater protection to creditors and greater ability by such creditors to provide input into the process by which failed financial companies are liquidated. The liquidation authority, which is modeled in large part on the regime for resolving failed banks under the Federal Deposit Insurance Act, is motivated by a clear policy of protecting taxpayers and the financial system as a whole. Accordingly, it vests the FDIC with vast, and virtually unfettered, authority to make asset dispositions, assign contracts and determine claims, while affording creditors almost no opportunity for input into any of these matters. Under the Bankruptcy Code, by contrast, creditors and other stakeholders are afforded significant rights to weigh in on such matters, with the ultimate aim of enhancing value, and, hence, creditor recovery. The coming weeks will reveal whether institutions and industry groups will take advantage of this open-comment process to press for more protections under the resolution authority, akin to those found under the Bankruptcy Code.

Corporate Governance and Executive Compensation

For a discussion of corporate governance and executive compensation developments under the Dodd-Frank Act, see "Governance/U.S. Corporate Governance at a Crossroads."

International Developments

Basel III, Financial Stability Board and G-20

The G-20 Seoul summit endorsed the so-called "Basel III" bank capital and liquidity proposals of the Group of Governors and Heads of Supervisors of the Basel Committee on Banking Supervision (the Basel Committee) and confirmed a commitment to begin implementing the framework on January 1, 2013, with the phase-in process to be completed by January 1, 2019. On December 16, 2010, the Basel Committee issued the text of the Basel III rules, which presents the details of global regulatory standards on bank capital adequacy and liquidity agreed to by the Basel Committee and endorsed by the G-20 leaders at their November 2010 Seoul summit.

Basel III is the culmination of a banking reform agenda for internationally active banks set out by the G-20 leaders at their Pittsburgh summit in September 2009. Basel III represents the recalibration of the Basel II standards, which are already in place internationally and are in the process of being implemented in the United States. The Basel III framework sets standards for higher and better-quality capital, better risk coverage, the introduction of a leverage ratio as a backstop to the risk-based requirement, measures to promote the build-up of capital that can be drawn down in periods of stress, and the introduction of two global liquidity standards.

Capital. In terms of capital requirements, Basel III will require banks to maintain a minimum common equity capital ratio of 4.5 percent, a minimum Tier 1 capital ratio of 6 percent and a minimum total capital ratio of 8 percent. In addition to the minimum capital requirements, Basel III will require a "capital conservation buffer" of 2.5 percent. Thus, a bank's ability to pay dividends and discretionary bonuses or engage in share repurchases will be limited if it does not have common equity, Tier 1 and total capital ratios of at least 7, 8.5 and 10.5 percent, respectively. Additionally, Basel III gives each national regulator discretion to institute a "countercyclical buffer" if it perceives a greater system-wide risk to the banking system as the result of a build-up of excess credit growth in its jurisdiction. The Basel III basic minimum capital requirements will be phased in first, with a longer period for compliance with the capital conservation buffer and other requirements.

In addition to raising the quality and level of the capital base, Basel III introduces certain reforms to the treatment of counterparty credit risk (CCR) in an effort to ensure that all material risks are captured in the capital framework. Furthermore, in order to constrain the "excessive" on- and off-balance-sheet leverage in the banking sector, Basel III introduces a new leverage ratio requirement. On-balance-sheet items to be included for purposes of the leverage ratio include repurchase agreements, securities financing transactions and derivatives, while off-balance-sheet items will include commitments (including liquidity facilities), unconditionally cancelable commitments, direct credit substitutes, acceptances, standby letters of credit, trade letters of credit, failed transactions and unsettled securities. A supervisory monitoring period began January 1, 2011; a parallel testing run of a minimum Tier 1 leverage ratio of 3 percent will begin January 1, 2013; and any adjustments are contemplated to be made before full implementation of the leverage ratio requirement on January 1, 2018. Basel III also would require banks to disclose their leverage ratios and their components beginning January 1, 2015.

Liquidity. Basel III further strengthens the liquidity framework by implementing two minimum standards for funding liquidity, which were originally proposed by the Basel Committee in December 2009: the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The LCR was established to promote short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high-quality liquid assets to survive a significant stress scenario over a 30-day time horizon. The LCR will require affected banks to maintain sufficient high-quality liquid assets to cover 100 percent of the net cash outflows that could be encountered under acute stress scenarios under certain assumptions, with expected inflows eligible for netting against outflows capped at a maximum of 75 percent of expected outflows.

The NSFR was established to promote resilience over a longer time horizon by establishing a minimum acceptable amount of stable funding based on the liquidity characteristics of an institution's assets and activities over a one-year period. The NSFR aims to limit overreliance on short-term wholesale funding during times of buoyant market liquidity and encourages better assessment of liquidity risk across all on- and off-balance-sheet items. The NSFR ratio measures the amount of available stable funding in relation to the amount of required stable funding, which must be greater than 100 percent.

U.S. Efforts for Revising Capital and Liquidity Requirements. The Basel III directives are not self-effectuating but, rather, must be adopted by legislation or regulation in order to be imposed on any particular country's home banks. Thus, the fact that the Basel Committee has completed its work does not mean that banks now have final rules with which they must immediately comply.

The Dodd-Frank Act requires the establishment of more stringent prudential standards, including higher capital and liquidity requirements for large, interconnected financial institutions. However, significant questions remain as to how the mandates of the Dodd-Frank Act for systemically significant banks to meet enhanced capital, liquidity and other requirements will be integrated with the requirements of Basel III. On September 12, 2010, U.S. bank regulators issued a joint statement specifically stating support for the Basel Committee's efforts "to strengthen the position of large and internationally active banks." However, it remains to be seen whether, like Basel II, the Basel Committee's Basel III capital directives will cover only a subset of the largest U.S. banks or apply to a broader set of U.S. banks.

On November 17, 2010, the Federal Reserve issued new capital guidance in a Temporary Addendum to an existing Federal Reserve supervisory guidance[19] applicable to the 19 BHCs (SCAP BHCs) that took part in the 2009 Supervisory Capital Assessment Program (SCAP). As part of the supervisory assessment of capital adequacy, the new guidance requires each SCAP BHC to submit a "comprehensive capital plan" to the Federal Reserve and its primary federal bank regulator by January 7, 2011, regardless of whether the SCAP BHC proposes to increase dividends or undertake any other capital distributions. In connection with its capital plan, each SCAP BHC is required to conduct a new stress test under a set of detailed requirements and parameters, some to be defined by the SCAP BHC itself and others to be provided by the Federal Reserve. Of note is the requirement that the capital plan reflect management's plans for addressing proposed revisions to the regulatory capital framework under Basel III. The SCAP BHC should provide a transition plan that includes pro forma estimates of regulatory capital ratios consistent with the Basel III regulatory framework over the phase-in period, with supporting detail around actions and assumptions to be taken over the entire period necessary for the SCAP BHC to meet the fully phased-in 7 percent Tier 1 common equity target. Capital plans that include a request to increase common stock dividends, implement common stock repurchase programs, or redeem or repurchase capital instruments ("capital distributions") will be evaluated under a set of special considerations, one of which is that the Federal Reserve expects SCAP BHCs to "demonstrate with great assurance that they could achieve the ratios required by the Basel III framework, inclusive of any proposed dividend increases or other capital distributions, as those ratios come into effect in the United States."

On December 14 and 15, 2010, federal bank regulatory agencies published a joint notice of proposed rulemaking seeking comment on proposed regulations implementing certain provisions of Section 171 of the Dodd-Frank Act, more commonly known as the "Collins Amendment." The proposed regulations would require that the capital requirements and guidelines generally applicable to insured banks (based on Basel I) serve as a floor for those banking organizations that are subject to the internal ratings based and advanced measurement approach minimum risk-based Basel II capital guidelines. The notice states that the agencies may amend the generally applicable capital requirements over time and that such amended requirements would serve as the new floor for banking organizations using the advanced approaches. However, the notice further states that before changing their risk-based capital guidelines, the U.S. federal bank regulatory agencies intend to determine whether proposed amendments thereto (*e.g.*, those implementing the Basel III accords) will result in capital or leverage requirements that are "quantitatively lower" than those generally applicable as of the date of enactment of the Dodd-Frank Act.

European Union Directive for Managers of Alternative Investment Funds

The Alternative Investment Fund Managers Directive (AIFMD), first proposed in April 2009 by the European Union Commission, was adopted by the European Parliament on November 11, 2010. The directive will require national implementation by EU member states by 2013 and will require the European Commission, with assistance from a new Paris-based body, the European Securities and Markets Authority, to promulgate new operating guidelines, exemptions and interpretations.

Much of the directive remains to be negotiated, analyzed and refined by regulatory representatives of the EU member states. However, it is now possible to distill with some certainty the key aspects of the directive expected to affect the global fund management industry:

- The AIFMD will apply to each manager of an "alternative investment fund" (AIF), defined as any collective investment undertaking that raises capital from a number of investors with a view to invest-

[19] SR Letter 09-4: Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies.

ing in accordance with a prescribed investment policy. Existing regulated EU funds aimed mainly at retail investors (UCITS) will be excluded. AIFs will include a wide range of entities not commonly conceived of as "alternative investment funds," such as real estate funds and self-managed corporate entities with a defined investment philosophy.

- A fund manager (AIFM) within the scope of the directive will be the person who performs the functions of portfolio management and risk management in relation to the AIFs.
- The worst "Fortress Europe" protectionist fears of many have not been realized. The directive does not have (as was originally proposed) the intention of preventing EU institutional investors from investing in non-EU funds that are not actively marketed or regulated in Europe.
- An EU-based AIFM will be required to apply for authorization under the AIFMD by (it is expected) January 2014. Depending on national implementation, a passporting regime may apply once the AIFM receives authorization from its "country of reference." A non-EU-based AIFM that markets fund interests to EU-based investors may not be able to apply for this passporting until approximately 2015, at the earliest, but may be able to use national private placement regimes in the meantime. Non-EU funds marketed by such managers to EU investors will have to comply with AIFMD. Private placement regimes will be phased out if and when passporting is permitted.
- Compliance with AIFMD will mean a much greater burden in terms of the use of "depositaries," which will be asked to accept a greater and riskier role in surveilling assets under management.
- AIFMD compliance also will:
  - influence manager compensation structures, in terms of cash release to key persons (moderated through mandatory deferral arrangements and/or use of securities issuances);
  - influence how exits are fashioned in light of the "anti-asset-stripping" objectives of the AIFMD;
  - require monitoring leverage levels and conflicts;
  - impose detailed rules on the conduct of business (already familiar to U.K. Financial Services Authority-regulated firms); and
  - require greater transparency, including requirements for valuation.

AIFMD will be an unavoidable consideration for any investment industry participant with investors in the EU, funds domiciled in the EU or a fund manager presence in the EU. Some private equity funds already have begun consulting with major investors regarding potential impacts on existing and future funds, with commercial choices obviously available to non-EU investors as to whether to suffer (or benefit from) the impact of the regime. Other industry participants are considering whether AIFMD represents a global marketing opportunity similar to that afforded by UCITS, in light of investor concerns about the supervision of collective investment. Given the extra costs and compliance burdens that the AIFMD will engender, however, EU-based submanagers with allocations from non-EU managers and non-EU funds may have cause for concern about their competitiveness against non-EU managers. The implementation of AIFMD will, therefore, present both opportunities and challenges for industry participants.

Global Litigation

Global Litigation

Strategic Thinking in the New Legal Landscape

As events of the past year have demonstrated, the bet-the-company issues and cases that the business community faces are emerging on a radically changed landscape. Continued globalization, the increasingly complex and far-flung operations of large multinational corporations, and the concomitant expansion and diversification of government regulatory bodies have resulted in fewer legal and regulatory issues that fit into neat, familiar categories. Increasingly, corporate litigation and regulatory matters involve multiple areas of the law, touch multiple geographic regions, and are contested before multiple regulatory or judicial bodies. Indeed, in many instances, these complex matters cannot be referred to as "cases"; they are actually clusters of separate but related proceedings spawned by a single public scandal or event.

The paradigmatic examples are international legal disputes involving conduct in several countries, each with its own distinctive laws, regulatory systems and political constituencies. A major oil spill by a foreign company in U.S. coastal waters may generate not only domestic federal and state litigation, but also regulatory inquiries and proceedings in the company's home country and elsewhere. A defect in a product sold internationally can spawn private product liability litigations and simultaneous product safety investigations by regulators in several countries. Increasingly, even purely domestic legal issues involve numerous regulators and legal stakeholders, each with its own unique rights and interests. As recent events amply demonstrate, a scandal in a single domestic financial institution can spawn not only federal class action securities litigation, but also parallel state court proceedings by private litigants and state attorneys general; independent investigations by the Securities and Exchange Commission and the Department of Justice; separate regulatory inquiries and initiatives by the Treasury Department, the FDIC and other federal agencies; and in some cases, hearings before congressional committees.

These cases demand both additional resources, such as larger litigation teams with broader substantive skill sets and dramatic changes in the way companies and outside counsel formulate their strategies. Rather than simply prepare for traditional litigation before a single tribunal, companies and their lawyers now must manage parallel proceedings before different courts or agencies, often in different geographic jurisdictions. Each of the regulatory bodies involved will have its own distinct mandates, adjudicatory procedures and enforcement mechanisms. What's more, each of these simultaneous proceedings can affect the others, continuously redefining the constellation of issues in play. The transition from traditional litigation to this complex multijurisdictional world is akin to moving from a game of checkers to a game of three-dimensional chess. Global strategic thinking along multiple dimensions is required to navigate these matters successfully.

While multijurisdictional matters present novel challenges, they also offer unique opportunities, provided companies and their counsel are prepared to seize them. Even in relatively straightforward situations involving the federal government, companies need not limit their contacts to the prosecuting agency and its lawyers. Opportunities always are available to advance one's case, on the merits, before many audiences and in different forums throughout the federal government. Complex multijurisdictional cases can multiply these opportunities, presenting new avenues for effective advocacy in relevant jurisdictions or before various agencies.

Perhaps most important, given the complexity of such matters, and the speed at which important decisions need to be made, we encourage the development of precrisis strategies and procedures, either on a standalone basis or as part of a company's risk management practice. For companies with high-risk profiles

(*e.g.*, those operating in regions of political instability or high levels of government corruption and companies in industries that have been hit by scandals), such preplanning is essential. Precrisis plans must include clear lines of responsibility and communication among key internal functions (*e.g.*, legal, finance, IT, corporate communications, security), internal coordination and notification procedures, and training of relevant personnel (including senior executives). Such plans also should involve lining up outside resources, including outside counsel with the depth and breadth of experience to handle rapidly evolving crisis situations and a communications firm with expertise in crisis situations.

Cases of Significant Interest to the Business Community During the Current Supreme Court Term

The Supreme Court has continued its recent trend of granting review of cases with significant ramifications for the business community, and decisions in several such cases are expected by July 2011. The positions of the two new justices (Sonia Sotomayor and Elena Kagan) should be of particular interest, both for the specific cases themselves and for their implications regarding the Court's receptiveness to business cases in the future.

- In *Wal-Mart Stores, Inc. v. Dukes*, No. 10-277, the Supreme Court will examine the certification of an extraordinarily large class of plaintiffs. The complaint alleges that during a 10-year period, Wal-Mart discriminated against its female employees — a group as large as 1.5 million women. The district court certified the class, and a closely divided en banc panel of the Ninth Circuit Court of Appeals affirmed. The appellate courts have articulated different standards for determining when a class can be certified, and the decision in *Dukes* could provide much-needed clarification and national uniformity. Because the prospects for class certification have an important effect on the settlement value of many cases, *Dukes* could have important implications for all cases in which plaintiffs seek to use the class action mechanism.

- In *Janus Capital Group Inc. v. First Derivative Traders*, No. 09-525, the Supreme Court will consider whether a company may have primary liability in a private action under the securities laws for statements attributed to another speaker. In this case, the plaintiff alleges that an investment manager is responsible for alleged misstatements made in prospectuses issued by the funds it manages. The United States filed a brief in support of the plaintiff. One issue of particular importance is whether, if there is liability, the theory of liability would include other secondary actors, such as accountants and attorneys. The Supreme Court's decision will help determine the scope of primary liability under the securities laws.

- In *Chamber of Commerce of the United States of America v. Whiting*, No. 09-115, the Supreme Court will explore the limits on states' ability to address immigration issues. The federal government permits employers, on a voluntary basis, to use a database to check the immigration status of their employees. An Arizona law makes use of the database mandatory and revokes the business licenses of employers who hire undocumented workers. The Chamber of Commerce contends that the Arizona law is preempted by federal immigration law. The decision will be of significant relevance to businesses interested in nationwide, uniform immigration regulation, as the decision likely will affect states' efforts to address immigration issues on a local level.

- In *American Electric Power Co. v. Connecticut*, No. 10-174, the Court will consider whether federal common law gives states and private parties a federal cause of action to bring a claim for nuisance against utility companies in order to place judicial limits on their carbon emissions. If the Court permits such suits, litigation regarding global warming is likely to expand significantly; and courts, rather than the legislature, will begin to confront issues such as the permissible level of carbon emissions for different types of companies. In addition, courts will have to decide upon appropriate remedies for any determination that a particular level of carbon emissions constitutes a nuisance.

Securities Litigation – Behind the Numbers

When many predicted a decline in securities class filings in 2010, we suggested that, although credit crisis filings would be down, overall filings would be at a level similar to 2008 and 2009. The latest numbers have proven that to be the case. According to NERA Economic Consulting's mid-December projection, securities class action filings were anticipated to reach 239 for 2010, compared to 247 in 2008 and 220 in 2009. As expected, the number of credit crisis filings continued to decline as those from 2008 work their way through the courts. As a result, the Second Circuit's recent dominance in number of filings has leveled off. There also has been a declining trend of restatement- and accounting-based cases. We have seen the decline in credit crisis and accounting filings offset by the more traditional "stock-drop" actions, especially in areas of health care and Asian-based companies listed in the United States. Another observation has been a decrease in the time between the decline in stock price and the filing of a complaint, perhaps suggesting that the resources of plaintiffs' securities firms have become less constrained in light of the decline in credit crisis-related litigation.

We anticipate the trend of plaintiffs' securities firms capitalizing on negative news headlines to continue in 2011. Historically, traditional stock drop cases have been brought primarily on the heels of a company announcing disappointing financial results. This past year, however, we have witnessed a series of significant securities class actions filed in the wake of unexpected nonfinancial crises encountered by companies, such as the Gulf oil spill, the SEC complaint filed against Goldman Sachs, foreclosure paperwork and processing issues, and Toyota's recall issues. It is important to keep this trend in mind when responding to a corporate crisis or announcing unexpected negative news.

Decisions on Motions To Dismiss in Credit Crisis-Related Litigation

- The dismissal of credit crisis/subprime securities class actions has been somewhat mixed. For example, courts have dismissed complaints against CIBC, Fremont and Société Générale, while denying motions to dismiss in cases against E*Trade and AIG.
- The safe harbor for forward-looking statements embodied in the Private Securities Litigation Reform Act of 1995 should continue to play an important role in securities litigation, particularly in light of a recent ruling by the Second Circuit involving American Express. The ruling clarified that statements in the MD&A portion of an SEC filing are eligible for safe harbor coverage and reaffirmed that the safe harbor applies to forward-looking statements, even in the absence of cautionary language, if the plaintiff fails to demonstrate that the statements were made with actual knowledge of falsity.
- We anticipate a number of settlements in cases where motions are denied in 2011, which may increase the median size of securities class actions compared to previous years.
- For those cases that do not settle, loss causation will be a primary defense, as plaintiffs will be required to prove that the losses resulted from the disclosure of allegedly false and misleading information and not from the overall financial crisis.

Mortgage-Backed Securities and Put-Back Litigation

- Mortgage-related and put-back litigation have generated much discussion in the latter half of 2010 and will continue to do so in 2011.
- Generally, investors in mortgage-backed securities (MBS) cases have pursued two avenues: misrepresentation claims and contractual claims. Each has its own hurdles and obstacles that have begun, and will continue, to play out in 2011.
  - Misrepresentation claims often are based on Sections 11 and 12 of the Securities Act of 1933. Some plaintiffs also have asserted state statutory and common law claims. In a series of recent

rulings, courts have limited, for the most part, the proposed class representative's standing to those specific offerings in which he or she actually purchased securities, thereby greatly narrowing the cases. In 2011, class certification will be a major battlefield in mortgage-backed securities litigation, as well as "negative causation" — a defense that the losses suffered were a result of something other than the alleged false and misleading statements in the offering documents, such as general economic conditions or the nationwide decline in housing prices.

– Contractual "put-back" claims face a different set of obstacles. Some holders of MBS have claimed that loans backing the MBS violate contractual representations and warranties made at the time of the offerings and that the party which made the representations and warranties should be required to repurchase the loans. For the most part, the underlying documents require at least 25 percent of the certificate holders to act together in order to enforce such contractual rights. It also can be an extremely time-consuming and expensive process on both sides, as many of the documents require a loan-by-loan analysis.

The Supreme Court Addresses the Extraterritoriality of the U.S. Securities Laws

- The Supreme Court issued its decision in *National Australia Bank v. Morrison*, rejecting the Second Circuit's long-standing "conducts and effects" test and establishing a transaction-based test focusing on the location of the purchase or sale of the securities.
- The transaction test established by the Supreme Court held that Section 10(b) of the Securities Exchange Act of 1934 covers "[o]nly transactions in securities listed on domestic exchanges, and domestic transactions in other securities."
- While the buzz last year was focused on the phrase "F-Cubed" — whether Section 10(b) applies to cases brought by *foreign* investors in *foreign* issuers traded on *foreign* exchanges — the transaction test has limited the application of Section 10(b) even to so-called F-Squared cases. All of the lower courts that have addressed the issue have held that *Morrison* applies even to U.S. investors that purchase or sell shares traded on foreign exchanges.
- Although exchange-traded securities appear to be subject to a bright-line test, continued litigation is expected over what are considered "domestic transactions in other securities" — including derivatives, over-the-counter ADRs and other non-exchange traded securities.
- Some have predicted that foreign companies will retreat from the U.S. capital markets in light of *Morrison*; however, we believe that *Morrison* affords foreign companies the opportunity to tap the U.S. capital markets while limiting their exposure to U.S. securities litigation to the proportion of securities traded in the United States.

Class Action Outlook for 2011

In 2010, federal courts continued to recognize that causation requirements pose substantial hurdles to class certification and other forms of aggregate litigation under most state consumer fraud laws. At the same time, however, plaintiffs did make inroads in the use of issues classes and Rule 23(b)(2) injunctive relief class actions to obtain certification of cases in which common issues do not in fact predominate. In 2011, we expect a continued push by plaintiffs on issues classes and "bellwether" class actions — and, depending on how the U.S. Supreme Court rules in *Dukes v. Wal-Mart*, a continued preference by the plaintiffs' bar for filing class actions in the Ninth Circuit.

- **Causation continued to play a critical role in federal court evaluations of proposed class actions.** Courts continued to recognize in 2010 that causation poses a significant hurdle to certifica-

tion of consumer fraud and other class actions (outside the securities context) because defendants are entitled to challenge the causation prong as to each member of a proposed class or other group. This trend even extended to California, despite concerns in 2009 that courts would apply the California Supreme Court's *In re Tobacco II* ruling to obliterate meaningful review of class actions under California's consumer fraud statutes. Most courts have not done so. *See Pfizer Inc. v. Superior Court*, 182 Cal. App. 4th 622, 631 (Cal. App. 2d Dist. 2010) (reversing certification in case involving mouthwash ads because someone "who was not exposed to the alleged misrepresentations and therefore could not possibly have lost money or property as a result of the unfair competition is not entitled to restitution"). But some courts have interpreted *In re Tobacco II* as defendants feared, including, most notably, a federal court that certified a case involving labeling on soft drinks on the ground that it does not matter what the plaintiffs saw or why they bought the drinks. *See Chavez v. Blue Sky Natural Beverage Co.*, 268 F.R.D. 365, 376 (N.D. Cal. 2010). Courts also have extended some of this causation jurisprudence to "functional" class actions, holding that suits brought by health insurance companies, state attorneys general and other plaintiffs who sought to aggregate what are essentially individual claims into one suit are subject to an "individual proof rule" that bars them from proceeding on an aggregate basis with claims that require individualized fact-finding. This is good news for pharmaceutical defendants, who saw the threat of such "third-party payor" suits diminish substantially in 2010.

- **The Ninth Circuit greatly expanded the scope of Rule 23(b)(2) class actions — but will its ruling stick?** The Ninth Circuit's divided, en banc ruling in *Dukes v. Wal-Mart Stores, Inc.*, 603 F.3d 571, 652 (9th Cir. 2010), upholding certification under Rule 23(b)(2) of a class of female Wal-Mart employees — with "little in common but their sex and this lawsuit" (Alex Kozinski, dissenting) — was probably the low point of 2010 for class action jurisprudence. As Wal-Mart argued to the U.S. Supreme Court in its certiorari petition, the Ninth Circuit's ruling misreads class action law by expanding the scope of Rule 23(b)(2) — intended to apply only to injunctive relief class actions — to include sprawling class actions that seek billions of dollars in potential damages. As expected, the Supreme Court granted certiorari in December 2010, and its ruling could dramatically affect class action standards in federal courts across the country.

- **Plaintiffs made a small but significant inroad on issues classes.** One of the most surprising rulings of the year was *Pella Corp. v. Saltzman*, 606 F.3d 391, 393 (7th Cir. 2010), a per curiam opinion by the usually conservative Seventh Circuit, allowing a class action to proceed in which plaintiffs alleged that the defendant's windows included a defect that caused the wooden portions of the windows to rot. Although the court agreed that individual issues predominated on the questions of causation and injury (did the purchasers' windows rot and why?), it concluded that these admittedly individualized issues need not stand in the way of a limited trial on one "common issue": "whether the windows suffer from a single, inherent design defect leading to wood rot." The Seventh Circuit's ruling departed from the reasoning of several other circuits, which have held that a court may not use "issues classes" to address certain issues in a case where predominance is lacking as to the case as a whole. It also contradicted the Seventh Circuit's own jurisprudence, which had previously recognized that issues trials pose problems under the Seventh Amendment. *See, e.g., In re Rhone-Poulenc Rorer, Inc.*, 51 F.3d 1293, 1303 (7th Cir. 1995). Pella has sought Supreme Court review of the Seventh Circuit's decision, but the speculation is that the Court will not take the case. Until the Seventh Circuit revisits and harmonizes its own rulings on the use of issues classes, we expect a surge in consumer fraud class actions in federal court in Illinois.

- **How far will state supreme courts go before the U.S. Supreme Court establishes fundamental due process requirements for class action litigation in state courts?** As the Class Action Fairness Act (CAFA) nears its sixth anniversary, a small number of class actions are still alive and kicking in state courts — and at least four state supreme courts (Missouri, Arkansas, Louisiana and West Virginia) have made it clear that they do not feel bound to follow federal guidance on application of Rule 23. Several of these courts have issued rulings suggesting that once a class is

certified (under their liberalized Rule 23 standards), a defendant loses any right to assert individual defenses. *See, e.g., Perrine v. DuPont de Nemours & Co.*, 694 S.E.2d 815, 859 (W. Va. Mar. 26, 2010) ("[T]o the extent that this class action was properly certified by the trial court, all of DuPont's individualized defenses have no merit."). Assuming the U.S. Supreme Court does not have class action fatigue, help may be on the way. In *Philip Morris USA, Inc. v. Scott*, 561 U.S. --- (2010), Philip Morris moved the Court for a stay of a $250 million judgment in a tobacco class action, pending resolution of its petition for certiorari. Acting for the Court pursuant to 28 U.S.C. § 2101(f), Justice Antonin Scalia granted the petition, concluding that certiorari was likely in light of the trial court's utter disregard for the defendant's due process rights. According to Justice Scalia, "the court eliminated any need for plaintiffs to prove, and denied any opportunity for applicants to contest, that any particular plaintiff who benefits from the judgment (much less all of them) believed applicants' distortions and continued to smoke as a result." Justice Scalia further noted that "[t]he apparent consequence of the [Louisiana] Court of Appeal's [order upholding the judgment] is that individual plaintiffs who could not recover had they sued separately *can* recover only because their claims were aggregated with others' through the procedural device of the class action." Justice Scalia thus concluded that "[r]efusing a stay may visit an irreversible harm on applicants." Stay tuned.

Intellectual Property and Technology

Patent Issues to Watch in 2011

A number of patent law developments may take place in 2011. The U.S. Supreme Court has granted certiorari in three patent law cases, the resolution of which may have a distinct impact on patent litigation. These cases involve the following issues:

- **Inducement of patent infringement.** Under 35 U.S.C. § 271(b), one can be liable for actively inducing another to infringe. In the pending case *Global-Tech Appliances v. SEB S.A.*, the Supreme Court will determine the "state of mind" element for active inducement. Presently, the test set out by the U.S. Court of Appeals for the Federal Circuit is "deliberate indifference of a known risk," but the petitioner has asked for the standard to be "purposeful, culpable expression and conduct," as set forth in the Supreme Court's copyright decision in *MGM Studios, Inc. v. Grokster, Ltd.*, 545 U.S. 913, 937, 125 S.Ct. 2764, 2780, 162 L. Ed. 2d 781, 801 (2005).

- **Patent ownership for government-funded research.** Under the Bayh-Dole Act, 35 U.S.C. §§ 200-212, a U.S. university, small business or nonprofit entity can retain ownership of inventions created as a result of federally funded research. The question presented in *Board of Trustees of Stanford University v. Roche Molecular Systems* is whether a university's rights to such an invention can be unilaterally terminated because an individual inventor had a separate agreement purporting to assign the inventor's rights to a third party.

- **Burden of proof for patent invalidity.** In *Microsoft v. i4i Limited Partnership*, the Court will consider the level of proof required for a party challenging the validity of an issued patent. By statute, an issued patent is presumed valid and the burden of invalidating the patent is on the challenger. More than two decades ago, the Court of Appeals for the Federal Circuit held that the challenger of a patent must prove invalidity by the heightened standard of "clear and convincing evidence." Microsoft argues, however, that the burden of proof should be the usual "preponderance of the evidence" standard when the patent challenger relies on prior art information that was not considered by the Patent Office when the patent was under review. Microsoft's argument is based on comments made by the Supreme Court in the recent *KSR* decision pertaining to patent invalidity due to obviousness.

In addition to these cases, the Federal Circuit heard two cases en banc in November 2010 that may have a resounding impact on the future of patent law:

- **Inequitable conduct.** Inequitable conduct is a judge-made defense to patent infringement that involves allegations of improper conduct before the Patent Office by the patent applicant. Presently, the law requires a court to determine the materiality of a representation or omission to the Patent Office and evidence (direct or circumstantial) of intent to deceive the Patent Office. The court then balances these two factors and determines whether the entire patent at issue should be rendered unenforceable. However, in *Therasense v. Becton Dickinson & Co.*, the Federal Circuit had asked for briefing on the propriety of its test for inequitable conduct, and the en banc order resulted in the greatest number of amicus briefs the court has received in one matter. Many new tests have been proposed, while some parties advocate maintaining the present test.

- **Contempt proceedings.** When an injunction issues in a patent case and the defendant redesigns its product, what is the test to determine whether the redesigned product should be examined in a contempt proceeding or in a new patent infringement action? That is the question at issue in *TiVo v. Echostar*. The district court had used contempt proceedings to determine that the redesigned product still infringed and issued a penalty of approximately $200 million. While a split panel of the Federal Circuit affirmed, the court has now taken up the issue for reconsideration en banc.

Finally, there are likely to be a number of developments in the area of damages for patent infringement. For example, the district courts and the Federal Circuit have been more critical of the "entire market value rule," in which a plaintiff holding a patent covering a small component in a larger product seeks a royalty on the revenue from the entire product. Legal questions to be resolved include how a patentee can establish that the patented invention is the source of demand for the entire product and what type of evidence can and should be used to prove that demand.

Intellectual Property Litigation and Policy

Several highly controversial cases, with potentially far-reaching implications, especially involving digital media, were decided by lower courts in 2010, and many are on appeal with decisions expected in 2011:

- **Website liability for user-generated infringing works.** *Viacom v. YouTube* (on appeal to the Second Circuit): The district court held that a website that complies with the take-down notices under the DMCA's safe harbor provisions is protected from monetary liability — even if the service intentionally built its value on the availability of user-posted infringing content.

- **Liability for software resellers.** *Vernor v. Autodesk* (petition for re-argument en banc): The Ninth Circuit handed software vendors a significant victory against resellers, holding that properly crafted software license agreements can preclude purchasers from reselling the purchased software to third parties.

- **The "Hot News" doctrine revitalized.** *Barclays Capital Inc. v. Theflyonthewall.com* (on appeal to the Second Circuit): The district court held that redistribution of time-sensitive information, even if not originating from a traditional "news" source, may constitute misappropriation of "hot news" — where resources were expended to generate the information and the use constitutes free-riding by a direct competitor.

- **Does Google's AdWords program constitute trademark infringement?** *Rosetta Stone LTD v. Google, Inc.* (on appeal to the Fourth Circuit): The district court held that Google's AdWords and Sponsored Link service — through which Google sells advertisements triggered by trademark terms entered in its search engine — does not constitute trademark infringement or dilution.

- **Grey market copyright infringement.** *Costco Wholesale Corp. v. Omega:* On December 13, 2010, the Supreme Court affirmed the Ninth Circuit decision by an equally divided court, without a separate opinion. The Ninth Circuit held that the owner of a copyrighted work contained in already manufactured goods can prevent the importation of such goods into the United States.

Litigation and E-Commerce Companies

Litigation by taxing authorities against e-commerce companies will no doubt continue in 2011. For example, dozens of cases have been brought against the online hotel reservation services industry in connection with the potential application of local hotel occupancy tax to compensation earned by these companies for their reservation facilitation business activities, as well as related consumer class actions. These cases are complicated by the myriad jurisdictions and variance in local tax statutes and ordinances at issue. The two federal courts of appeal that have considered the issue on the merits have ruled in favor of the online travel companies. Decisions at the pleading stage have been mixed; however, a number of trial courts have dismissed such actions holding that, like a taxpayer, a taxing authority must exhaust administrative remedies before bringing a judicial action asserting tax claims. And, in several cases that have progressed beyond the pleading stage, the courts have held in favor of the online travel companies. *Louisville/Jefferson County Metro Gov't v. Hotels.com, L.P*, 590 F.3d 381 (6th Cir. 2009); *Pitt County v. Hotels.com, L.P.*, 553 F.3d 308 (4th Cir. 2009); *City of Oakland v. Hotels.com, L.P.*, 572 F.3d 958 (9th Cir. 2009); *Priceline.com, Inc. v. City of Anaheim*, Case No. JCCP-4472 (Cal. Super. Ct. Feb. 1, 2010).

In addition, a number of state taxing authorities are pursuing nonresident e-commerce companies, alleging they are required to collect sales and use taxes from their customers. This effort has generated mixed results. A New York state court denied a facial constitutional challenge to a statute that requires companies with New York "affiliates" (*i.e.*, third parties receiving compensation for certain "click-through" sales) to collect and remit sales tax on transactions with nonresidents. The law continues to be challenged on an "as-applied" basis. *Amazon.com LLC, v. New York State Dep't of Taxation & Fin.*, 2010 NY Slip Op. 07823 (N.Y. App. Div., 1st Dept. Nov. 4, 2010).

Government enforcement and consumer class actions challenging e-commerce marketing practices also are likely to continue. For example, companies marketing consumer discount and service membership programs have faced class actions in federal and state courts nationwide challenging the adequacy of disclosures and related practices under a variety of laws, including state unfair business practice statutes, the federal Unordered Merchandise Statute, the Electronic Fund Transfer Act and the federal Credit Repair Organizations Act. Courts have dismissed many of these actions. Likewise, putative consumer class actions challenging online travel companies' consumer contracts and charges for taxes and service fees generally have not fared well. Several have resulted in wins for the online companies at the summary judgment stage.

Privacy issues also will continue to impact e-commerce companies. For example, North Carolina taxing authorities recently attempted to collect certain product-specific customer data in an effort to tax nonresidents. A federal district court in Washington, however, held that the First Amendment protects this information, which might reveal customers' reading, listening and viewing habits. *Amazon.com, LLC v. Lay*, Case No. C10-664-MJP (W.D. Wash. Oct. 25, 2010).

Antitrust Litigation and Enforcement

Three key antitrust trends for 2011 emerged over the course of 2010. First, the 2008 campaign promises of reinvigorated antitrust enforcement may now be under way as the second full year of the Obama administration draws to a close. Second, the recession did not slow the continued globalization of antitrust enforcement, indicating further convergence in 2011, with nascent attempts at private actions accelerating, particularly in Europe. Third, private case law in the United States will continue to evolve, including with respect to lower court application of *Twombly* and *Iqbal* (Rule 12(b)(6) heightened pleading standard), *Leegin* (minimum resale price maintenance), *American Needle* (joint venture conduct) and *In re Hydrogen Peroxide Antitrust Litigation* (class certification standards). Enforcement action by the EU Commission is likely to focus predominantly on the pharmaceuticals and digital media sectors in 2011.

U.S. Antitrust Enforcement

After a year of "talking the talk," the U.S. Department of Justice's Antitrust Division (DOJ) and the Federal Trade Commission (FTC) may have begun "walking the walk" in terms of increased antitrust nonmerger civil enforcement. In October 2010, the DOJ brought two civil enforcement antitrust actions. In the first action, the DOJ filed a complaint against American Express, challenging certain credit card contract rules with merchants that allegedly thwart competition by prohibiting merchants from offering consumers incentives to use a competitor's credit card. In the same complaint, the DOJ also sued Visa and MasterCard based on the same issues, but simultaneously reached a consent order settlement with both. In the second action, the DOJ challenged the "most-favored-nation" (MFN) clauses allegedly used by Blue Cross Blue Shield of Michigan (BCBSM) in its contracts with Michigan hospitals. The MFN clauses allegedly deter entry and expansion by BCBSM's competitors' costs. The FTC brought a historic case under Section 5 of the FTC Act against Intel in December 2009, which settled in 2010; and it has continued to challenge "pay for delay" patent settlements between branded and generic pharmaceutical companies, although it has not fared well in the courts. Notwithstanding the observation by many commentators that they did not see any increase in enforcement activity in the first year of the Obama administration, it takes time to identify, investigate and bring cases. It may well be that the DOJ and FTC have begun to "fill the pipeline," a harbinger of increased nonmerger civil enforcement activity in 2011.

Continued Globalization of Antitrust — Both Governmental and Private

The continued downturn in the worldwide economy did not slow cartel enforcement and strong interagency cooperation around the globe. For example, investigations and enforcement actions for collusive conduct regarding air cargo and air passenger service, freight forwarding, thin-film transistor liquid crystal display (TFT-LCD) panels, DRAM chips and refrigerant compressors are continuing, or were recently completed, in multiple jurisdictions. Expect to see continued global cartel enforcement in 2011; with the economy still weak, companies need to remain vigilant to ensure that employees do not engage in collusive conduct with competitors.

The push for possible private enforcement actions in Europe also continued in 2010, with the European Commission's ongoing study of the possibility of private actions for damages in the courts of member states (after a public consultation round, a draft directive on antitrust damages actions is expected to be issued in the second half of 2011). Likewise, plaintiffs' lawyers remain eager to transplant U.S.-style litigation abroad. In one closely watched case, an English appeals court affirmed the dismissal of a private action brought against British Airways by the English affiliate of a U.S. plaintiffs' law firm on the basis that it did not meet the very strict procedural requirements for a representative (*i.e.*, "class") proceeding. In 2010, another entity associated with that firm initiated a private "class-type" damages action in the Netherlands with respect to purchases by indirect purchasers of air cargo services. The possibility and form of private "class-type" actions in Europe (and perhaps in other jurisdictions) will be developed further in 2011, although it remains to be seen whether class or mass actions will succeed in these new forums.

U.S. Private Litigation

Private U.S. case law will continue to evolve in 2011, particularly with respect to application by the lower courts, in potentially diverging ways, of *Twombly* and *Iqbal* (Rule 12(b)(6) heightened pleading standard), *Leegin* (minimum resale price maintenance) and *American Needle* (joint venture conduct). First, although the heightened pleading standard of *Bell Atlantic v. Twombly* and *Ashcroft v. Iqbal* has proven enormously helpful to defendants in some cases, there has been a lack of uniformity in lower court application of *Twombly*. Some courts view the *Twombly* "plausibility" standard as significantly heightened over the previous one, while other courts appear inclined to continue to allow at least some

discovery before dismissing a case. Differing approaches by the courts in applying *Twombly* and *Iqbal* almost certainly will continue in 2011.

Second, the future of minimum resale price maintenance litigation remains uncertain. In 2007, the U.S. Supreme Court issued its landmark *Leegin* ruling that minimum resale price maintenance is not a per se antitrust violation. After bouncing around the lower courts — with the plaintiffs faring badly — the same case is now on appeal again to the Supreme Court. Whether or not the Court grants certiorari, the lower courts, and possibly Congress, will continue to grapple with resale price maintenance in the coming year.

And the Supreme Court's decision in *American Needle, Inc. v. National Football League* will have antitrust law ramifications well beyond the sports league. In *American Needle*, the Court reaffirmed the application of the rule of reason to joint venture conduct, and the possibility of a "quick look" analysis to find a joint venture to be legitimate. In the course of its decision, the Court appeared to cast doubt on the extension of precedent by various lower courts of the *Copperweld* doctrine beyond the context of 100 percent-owned subsidiaries. In any event, plaintiffs will continue to be required to meet their burden to plead a nonconclusory, plausible claim under *Twombly*.

Finally, courts are continuing to apply rigor to class certification requests in the wake of the landmark decision in *In re Hydrogen Peroxide*, in which the Third Circuit held that parties seeking class certification must actually establish, by a preponderance of evidence, that the elements of Rule 23 were satisfied. In the antitrust area, the predominance inquiry in particular is forcing plaintiffs to narrow classes in order to be able to show harm to all class members and common methodologies of impact. Amid the general trend toward increased rigor, jurisdictions across the country continue to grapple with how and when to apply the class certification standards appropriately, and further clarity should emerge in 2011.

EU Competition Law Enforcement

On November 30, 2010, the EU Commission announced that it had opened a formal investigation into Google's alleged use of its dominant position in the web search market to lower the ranking of unpaid search results, and it had conducted dawn raids at Astra Zeneca and Nycomed based on allegations of arrangements to restrict generic entry. The commission likely will continue to monitor pharmaceutical patent settlements in 2011 and is expected to bring its first enforcement actions in relation to settlement agreements in 2011, strengthened by the EU General Court's July 1, 2010, judgment largely upholding the EU Commission's fine of €60 million against Astra Zeneca. In relation to the enforcement of Article 102 TFEU that prohibits the abuse of a dominant position, the commission is likely to rely heavily on recent European Court judgments confirming it is not necessary for the EU Commission to show that the conduct in question had an actual impact on the relevant markets, but it is sufficient to demonstrate that the conduct tended to restrict competition, *i.e.,* was capable of having that effect. (*See, e.g., Tomra v. Commission* of September 2010).

International Arbitration

The Continued Dilemma of 'Class Action Arbitration'

Many companies, faced with the ongoing threat of litigation in the U.S. courts, have sought to offset that risk by including arbitration clauses in their standard-form contracts. Ordinarily, the Federal Arbitration Act (FAA) requires that effect be given to such clauses. Some U.S. courts, however, have held that arbitration of claims involving identical or standard-form contracts may proceed on a classwide basis, presenting the specter of large class action arbitration claims against companies in a variety of contexts, including in international arbitration.

- **The impact of the 2010 *Stolt-Nielsen* decision.** In *Stolt-Nielsen S.A. v. Animalfeeds International Corp.* (2010), the Supreme Court dealt a heavy blow to class action arbitration, holding — in a case involving antitrust claims against the shipper of goods — that the right to pursue class action arbitration is *not* generally to be inferred where an arbitration clause is silent on the issue. Arbitration, the Court observed, is a creature of contractual consent, under which "parties may specify with whom they choose to arbitrate their disputes." Class action arbitration "changes the nature of arbitration to such a degree that it cannot be presumed the parties consented to it by simply agreeing to submit their disputes to an arbitrator." To infer that, in the absence of express language, parties had agreed to class arbitration was "fundamentally at war with the foundational FAA principle that arbitration is a matter of consent." This ruling may significantly curtail the number of "class action arbitrations" being pursued in 2011, especially in business-to-business disputes.

- **"Class action arbitration waivers" and standard-form contracts.** In the consumer context, class action arbitration remains a hotly contested issue, even after *Stolt-Nielsen*. Many companies have included in their standard-form contacts an explicit waiver of the right to pursue class action arbitration. Many federal and state courts, however, have held that such waivers have so reduced the "economic" viability of mounting consumer claims that the entire arbitration clause should be regarded as unconscionable under state law. Many of these decisions have emanated from the Ninth Circuit — most applying California law on unconscionability.

- **The *AT&T Mobility* case.** In 2010, the Supreme Court heard an appeal from the Ninth Circuit decision in *AT&T Mobility LLC v. Concepcion*, the latest decision to invalidate a class action arbitration waiver as being unconscionable under California law. The Supreme Court is examining whether the FAA "preempts" state law and prevents courts from "conditioning the enforcement of an arbitration agreement on the availability of particular procedures — here, class-wide arbitration." If the Supreme Court reverses the Ninth Circuit's decision in *AT&T Mobility*, it is possible that class action arbitration waivers will become enforceable on a nationwide basis. This would have a potentially dramatic impact on the ability of companies to preclude consumer class actions by including appropriate language within their standard-form contracts. Conversely, if the Ninth Circuit's decision is affirmed, the enforcement of class action waivers will remain an issue of state law. A decision is expected in early 2011.

Emerging Markets Disputes — Investor-State Arbitration and Treaties Under Attack

Throughout 2011, we expect companies with investments in politically volatile countries increasingly will rely on the worldwide network of bilateral investment agreements (BITs) and free trade agreements (FTAs) for protection. Some treaties are multilateral (*e.g.*, NAFTA, the Dominican Republic-Central America Free Trade Agreement and the 1994 Energy Charter Treaty); others are bilateral (*e.g.*, the U.S.-Ecuador BIT, Spain-Venezuela BIT, Germany-Argentina BIT). Typically, these treaties guarantee against expropriation and other unfair or discriminatory measures by the host state and provide for international arbitration of treaty claims before the International Centre for Settlement of Investment Disputes (ICSID).

Recently, however, some sovereign states have intensified their efforts to forestall and/or defeat investor-state arbitration claims:

- **Sovereigns using their own courts to derail investor-state arbitration.** During 2010, the government of Belize, faced with an expropriation claim by a private investor commenced pursuant to the U.K.-Belize BIT, obtained injunctive relief from its own courts to restrain the arbitration — and also enacted new "anti-arbitration" legislation in an attempt to deprive any arbitration award of validity and effect in Belize. The case concerned the expropriation of the assets of Dunkeld International Investments Ltd, a Turks & Caicos Islands company associated with British businessman Michael Ashcroft, which once held a 69 percent stake in Belize Telemedia Limited (BTL).

- **Use of criminal procedures for retaliatory purposes.** In *Quiborax S.A. v. Bolivia*, the government of Bolivia apparently sought to retaliate against a Chilean investor claiming damages for breach of the Chile-Bolivia BIT, following the seizure of a silver mining concession. Bolivian prosecutors had "initiated criminal actions against several persons related directly or indirectly to the [ICSID] arbitration," alleging that company documents had been "forged" to support the claimants' case. In March 2010, an ICSID arbitral tribunal held that the criminal actions had improperly "impair[ed]" the claimants' ability to present their case and to obtain testimony, and therefore ordered the release of the criminal defendants. Bolivia has since boycotted the proceedings.

- **Denunciation of investment protection treaties.** Effective January 7, 2010, Ecuador denounced the ICSID Convention. This does not necessarily alter Ecuador's obligations under the numerous BITs to which it is a party, because arbitration under those BITs often is available in non-ICSID forums. But it comes amidst attempts by Ecuador's president to terminate 13 of these BITs, as well as a ruling by Ecuador's Constitutional Court that parts of Ecuador's BITs with the U.K., Germany, China and Finland are inconsistent with Ecuador's 2008 Constitution.

- **Increased challenges to ICSID or BIT arbitrators.** A recent spate of challenges to the impartiality and independence of ICSID arbitrators has been made, mostly by sovereigns — including Gambia, Bolivia, Ecuador and Venezuela. These challenges usually prolong the arbitral process, with proceedings suspended while they are addressed. Most of these applications have been denied.

- **Use of "annulment" or "revision" procedures.** In 2010, we witnessed an upsurge in the number of final ICSID awards overturned by "annulment committees." Two awards against Argentina, each granting more than $100 million to U.S. investors for the "pesification" of energy tariffs in 2001, were set aside by annulment committees, which held that the original arbitral tribunal had failed to properly analyze whether the "pesification" measures could be justified as "essential" to Argentine national security. Some commentators complained that "annulment" had become a form of full-blown "appeal," rather than the very limited review mechanism originally intended by the ICSID Convention.

- **The "essential security" defense.** The Argentine cases also raise the specter that the latest U.S. BIT text might afford too wide an "essential security" exemption — at worst, a "blank check" permitting states to expropriate at will, so long as they could plausibly "self-judge" their actions as being justified by "security" concerns.

Going forward, however, some recent positive developments suggest that the ICSID system and network of BIT/FTA protection are still fundamentally capable of delivering justice to foreign investors. Bolivia, for example, has agreed to settle BIT claims by ETI Telecom concerning Bolivia's expropriation of telecommunications assets.

Worldwide Enforcement of International Arbitration Awards

The 1958 New York Convention on Recognition and Enforcement of Foreign Arbitral Awards, now ratified by 142 countries worldwide, has played a pivotal role in ensuring the finality of international arbitral awards. It works on two basic principles:

- that the courts of each contracting state shall recognize and enforce contractual agreements by parties to submit disputes to arbitration — and that such courts shall refrain from allowing litigation of such claims; and

- once a final arbitral award is made, it shall be recognized and enforced (*i.e.*, confirmed as a final judgment) in each contracting state, subject only to certain extremely narrow exceptions as set forth in Article V of the New York Convention.

The New York Convention provides that an international arbitration award is immediately enforceable in all contracting states — without the need to seek its confirmation as a final judgment in the courts of the country where it was made. Two cases from 2010 illustrate the potential for multijurisdictional conflict arising from this rule:

- ***Yukos Capital v. Rosneft.*** In 2003, Yukos Capital, a Luxembourg company, made large loans to Yuganskneftegaz, a Russian subsidiary of Yukos Oil Company. The loan agreements provided for arbitration before the Moscow Chamber of Commerce. After the 2004 reorganization of the Yukos Group, Yukos Capital obtained a final arbitration award for more than $400 million from a Moscow tribunal against Rosneft (Yuganskneftegaz's successor). Subsequently, the award was vacated in the Russian courts. Undeterred, Yukos Capital sought and obtained enforcement of the original Moscow award in the courts of the Netherlands. The Amsterdam Court of Appeal held that, under the New York Convention, it had discretion to decline enforcement of the Moscow award (on the grounds it had been vacated in the Russian courts), but the Dutch courts nevertheless retained the power to enforce the award and recognize it as fully binding. In the view of the Amsterdam Court of Appeal, the Russian courts had not acted in an impartial and independent manner and their decision to invalidate the Moscow award could be ignored. After an appeal to the Netherlands Supreme Court was denied, Rosneft reportedly paid Yukos Capital the full amount of the Moscow award, with interest ($431 million), in August 2010. But the case has had an even more recent twist: On December 17, 2010, Rosneft filed an application seeking to reverse this result in the European Court of Human Rights in Strasbourg, claiming that the Dutch courts had denied it a fair hearing.

- ***Dallah Real Estate & Tourism Holding Co. v. Pakistan.*** In 1995, the Pakistan government passed an ordinance establishing the "Awami Hajj Trust," which then entered into a contract with a private company, Dallah Real Estate & Tourism Holding Co. to assist religious pilgrimage to Saudi Arabia. The contract provided for International Chamber of Commerce (ICC) arbitration in Paris. After the fall of the Bhutto government in 1996, the trust ceased to exist when its founding ordinance lapsed, and Dallah brought an arbitration against Pakistan on the basis that it was the legal successor to the trust. In 2006, a Paris ICC arbitral tribunal awarded $20 million in damages against the Pakistan government, which Dallah sought to enforce in England pursuant to the New York Convention. But the U.K.'s highest court, the Supreme Court of the United Kingdom, held that, under French law (the law of the seat of arbitration), there was no valid arbitration agreement between Dallah and Pakistan for purposes of Article V(1)(a) of the New York Convention. The justices of the court held that, under the legal principles applicable within France, Pakistan could not be viewed as a party to the arbitration clause, meaning that the Paris award could not be enforced in England.

Dallah already has generated much controversy within the arbitral community, and, like *Yukos*, probably will not represent the final word on the issue it addressed. Indeed, we expect these kinds of multijurisdictional disputes will continue to proliferate throughout 2011.

Both *Yukos* and *Dallah* serve as useful reminders of fundamental principles in drafting arbitration clauses — the need to be especially careful in selecting arbitral venue, governing law and defining the parties to the arbitration agreement. Venue (or seat) selection for the arbitration has a potentially profound influence on the future enforceability of the award, as does the selection of the governing law. Likewise, when a private party contracts with government-owned or government-sponsored entities (particularly those of the kind encountered in *Dallah*), care always should be taken to maximize the private party's remedies in case the entity in question is liquidated, ceases to exist or loses its principal assets. Careful planning at the drafting and negotiation stage (such as requesting sovereign guarantees or performance bonds) often can mitigate these risks.

Global M&A

Global M&A

The global economic recovery and improving financial and credit market conditions led to increased M&A activity across numerous industry sectors and geographies in 2010, particularly during the second half of the year. However, activity levels have remained below some commentators' expectations due to continued economic uncertainty, market volatility and regulatory reforms. On balance, we believe that improving economic and market conditions bode well for greater M&A activity in 2011.

U.S. M&A Developments

Strategic M&A Continuing to Gain Momentum

Strategic M&A transactions will continue to be the principal source of deal activity in 2011, and, as discussed below, we also expect growth in private equity activity. (See "U.S. M&A – Recent Developments in Private Equity Transactions.") M&A-intensive industries most likely will include, among others, energy, natural resources, financial services, technology and pharmaceuticals/health care. Companies in these and other industries with near-record levels of cash and access to financing on favorable terms will seek out acquisitions to put that cash to work to provide growth, synergies and diversification. Moreover, improving economic conditions and stabilization in the equity markets may encourage boards of directors and CEOs to engage in M&A discussions. However, boards and CEOs of both acquirers and target companies also will need to consider the recent opposition by activists and other shareholders to certain M&A transactions and their preference for such companies to pursue alternative strategies.

Cash likely will remain the preferred form of consideration in acquisitions, though equity will continue to be used in strategically transformative combinations and mergers of equals. Increased use of mixed cash and stock consideration may occur in larger transactions, reflecting a balance between buyers' conservatism in leveraging their balance sheets and their increased willingness to use stock as acquisition currency.

Hostile Transactions on the Rise

Unsolicited transactions (both cash offers and stock exchange offers) likely will continue to be a factor in 2011. Companies in today's market have greater cash reserves and fewer structural takeover defenses, making them more vulnerable to an unsolicited approach than in the past. Further, the recent success that some hostile acquirers have had in pressuring target boards to come to the table and negotiate, albeit in some cases after lengthy public fights, may embolden others considering an unsolicited approach. Potential target companies should be especially vigilant in assessing their takeover vulnerability and monitoring their takeover preparedness. We also may see an increase in "deal jumping," as reflected in the recent bidding wars for Dollar Thrifty and 3Par, where acquirers publicly engaged in battles for control of companies that had signed and announced acquisition agreements with other parties.

Private Equity Firms Return to the M&A Market

Improving conditions in the acquisition financing markets have facilitated acquisitions by private equity firms, which experienced increased M&A activity in 2010 over 2009. A number of private equity funds flush with cash found greater competition from other private equity funds in bidding contests for undervalued target companies, resulting in increased pricing pressure and higher multiples paid in auctions. While financing is once again available for private equity buyers and on favorable terms, private equity acquisitions continue to be funded with higher percentages of equity and less leverage and, on average,

are smaller than they were prior to the credit crisis. On the sell side, private equity firms seeking an exit from their portfolio companies are viewing M&A as an increasingly attractive alternative to capital markets transactions, as valuations of their portfolio companies have risen and acquisition financing has become more readily available. We expect to see a continuation of these trends. (See "U.S. M&A — Recent Developments in Private Equity Transactions.")

Tender Offers as an Attractive Acquisition Structure

An increasing number of acquisition transactions have been structured as tender offers over the past few years to provide speedier closing than traditional one-step mergers, thereby reducing deal execution risk for both parties. The now widespread use of "top-up options" in deals — which allow an acquirer that has completed a tender offer to purchase additional shares from the target company to get to the ownership necessary (90 percent for Delaware corporations) to complete a short-form squeeze-out merger — has provided greater certainty to acquirers and has facilitated obtaining financing on more favorable terms than if less than 100 percent of the target was owned at the closing. The recent Burger King and Gymboree acquisitions show how this structure can be used by private equity buyers while preserving a one-step merger as a fallback option in the event that the minimum tender condition in the tender offer is not satisfied. (See "Capital Markets/Challenges and Approaches in Financing Consensual Tender Offers" and "U.S. M&A — Litigation Issues.")

Continued Focus on Key Deal Terms

Parties to M&A transactions continue to focus on key deal issues relating to closing certainty and remedies for nonperformance, including reverse break-up fees, caps on damages payable by acquirers that fail to close, and the availability of specific performance remedies to compel a party to complete an acquisition. These issues historically have received significant attention in private equity deals and have been discussed with greater frequency in recent years in strategic transactions, as parties seek mutually acceptable sharing of financing and other risks. At the same time, "go-shop" provisions and deal protection mechanisms for acquirers continue as topics of discussion in public company negotiations. In addition, we may see increased use of mechanics such as equity collars and cash-stock election provisions to provide sellers with greater price protection where stock is offered as consideration, as well as earn-outs and contingent value rights to bridge valuation gaps between sellers and buyers.

European Union Developments

Developments in EU Takeover Regulation

As public M&A activity gradually gathers momentum once again in Europe, bidders (whatever their nationality) should expect regulatory changes in 2011. In the aftermath of Kraft's takeover of Cadbury, the U.K., by far the largest European market for public M&A, is considering significant changes to its takeover rules that may influence how bids in other European public M&A markets are regulated.

The Takeover Panel's intervention in June 2010 was designed to correct the perceived tactical imbalance favoring bidders over targets. In most of Europe, takeover conduct is heavily regulated by the relevant member state supervisory authority. While targets are protected from creeping takeovers by the mandatory tender offer rule (requiring an unconditional bid at a specified price upon exceeding 30 percent to 33 percent ownership of a target), target boards are subject to the passivity rule, which generally prevents them from taking defensive ("frustrating") action against a bid, other than by seeking alternative offers, without the consent of target shareholders voting in a general meeting.

Rather than moving closer to the U.S. takeover system where state case law (based on the business judgment rule) allows target boards to take defensive measures within certain limits, the U.K. is proposing to correct the perceived imbalance by, among other things:

- disallowing deal protection mechanisms, including no-shop clauses, matching rights and break-up fees (which were limited to 1 percent), other than with respect to bids following an auction;
- setting a default period, following announcement that a bidder is considering an offer, by which it will have to either announce a fully financed bid or walk away (the so-called "put up or shut up" deadline), which will increase pressure on bidders to raise financing and carry out due diligence as quickly as possible while, at the same time, maintaining confidentiality; and
- implementing other measures to enhance bid-related disclosure.[20]

Because U.K. regulation of takeover bids generally has served as the model for European takeover regulation, and the U.K. Takeover Panel is considered one of the most sophisticated regulators, it will be interesting to see whether, as in the past, European rulemakers move to adopt similar measures. The changes that the U.K. introduces also will attract attention, particularly with respect to defensive measures, control structure and barriers to takeover bids, since the European takeover directive comes up for review in April 2011.

Structuring Takeovers of EU Targets

In previous *Insights* publications, we discussed the positive effect of convergence between European and U.S. securities regulations on cross-border public M&A.[21] In particular, we stated our expectation that such regulatory convergence (coupled with strategic bidders' continuing conservative approach to the use of cash and leverage) would encourage well-positioned M&A players to pursue cross-border transactions using shares as part of the consideration (often mixed with cash).

While the above changes have dealt with the regulatory hurdles to structuring paper bids for European targets (particularly those with large proportions of U.S. shareholders), European bidders continue to hesitate to extend paper bids for European targets into the U.S., fearing exposure to the U.S. plaintiffs' bar and U.S. courts. Although this has not been tested since the regulatory improvements became effective, certain European regulators have purported to continue supporting exclusion of shareholders in paper bids where both bidder and target are European, on the basis that exposure to U.S. securities litigation made extension into the U.S. too burdensome for the bidder.

The U.S. Supreme Court's June 2010 decision in *Morrison v. National Bank of Australia* may change the perspective of European bidders and European regulators regarding the significance of exposure to liability in the U.S. in the context of public M&A transactions. The *Morrison* court established that the private right of action under the anti-fraud provisions of the U.S. Securities Exchange Act of 1934 — Section 10(b) — "reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States." Following the decision, several pending anti-fraud-based actions against non-U.S. companies were either dismissed or the damages to which those companies had been exposed were reduced significantly (because the class of plaintiffs was limited to those who acquired company securities on a U.S. stock exchange or otherwise in the United States).[22]

As the argument regarding the burden of extending bids into the U.S. loses strength, structuring bids for European targets by excluding U.S. shareholders may become more challenging. In addition, regulators trying to correct perceived tactical imbalances favoring bidders may not be as inclined as they were in the past to allow exceptions to the European "equal treatment of target shareholders" rule.

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[20] *See* Skadden memorandum "U.K. Takeover Panel Publishes Response to Consultation of Certain Aspects of the Takeover Code," October 27, 2010.

[21] *See* Skadden memorandum "Europe M&A | UK Bids — How a Scheme of Arrangement May Unlock a Target Board That Repeatedly Says 'No'" in *Insights*, 2010.

[22] *See* "Global Litigation/Cases of Significant Interest to the Business Community During the Current Supreme Court Term."

Emerging Markets M&A Developments

M&A activity in emerging markets increased by more than 70 percent in 2010 over 2009 and comprised more than 25 percent of global M&A activity. China led all emerging nations for both deal volume and deal value, followed by Brazil and Mexico. Dealmaking in these markets was particularly strong in the natural resources, energy and power, consumer goods and pharmaceuticals/health care industries.

According to a survey conducted by Thomson Reuters and Freeman Consulting Services, worldwide M&A is forecasted to grow by more than one-third in 2011, and we believe the year could see a continued trend of emerging markets M&A accounting for a larger share of global M&A activity. Much of the growth will be focused in the BRIC nations, fueled by Brazil's strong consumer market and government-funded infrastructure projects as it ramps up for the World Cup and the Olympics, Russia's anticipated accession to the WTO, Indian corporations with access to cash seeking expansion opportunities and China's hunger for natural resources.

Private equity and sovereign wealth funds, flush with cash, should continue to lead inbound M&A in emerging markets. Private equity in particular has raised new funds focused on emerging markets (with 21 new funds focused on Brazil alone). Growth-stage companies without access to the capital markets will look to these funds for early financing.

In addition, many of the multinationals, with strong cash positions and limited growth opportunities in their main markets (U.S. and Europe), may buy growth and establish or increase their footholds in emerging markets through acquisitions in 2011.

We also expect continuing outbound M&A from emerging markets. With Asia's, particularly China's, insatiable appetite for oil and commodities, 2011 may repeat 2010's sizable outbound deals from Asia in the natural resources sector (*e.g.*, CNOOC's $3.1 billion acquisition of a stake in Bradas Holdings of Argentina and Sinopec Group's $7.1 billion acquisition of deepwater oil assets in Brazil). Companies in emerging markets also need to expand to new markets to fuel their growth, making acquisitions in neighboring countries likely.

U.S. M&A – Litigation Issues

Delaware Cases

Over the past year, several important developments relating to Delaware litigation will have practical implications for both M&A practitioners and companies seeking to engage in M&A transactions.

Top-Up Option Cases Do Not Gain Traction

Delaware courts rejected attacks on top-up option provisions in merger agreements contemplating a tender offer acquisition structure. Three recent Delaware Court of Chancery cases rejected "appraisal dilution" claims, where plaintiffs primarily challenged the top-up options on the theory that the issuance of shares under such provisions (as well as the value of the promissory note) would negatively impact appraisal rights by improperly diluting the company's value:

- In *In re ICX Technologies, Inc. Shareholders Litigation*, C.A. No. 5769-VCL (Del. Ch. Sept. 17, 2010) and *In re Cogent Inc. Shareholder Litigation*, C.A. No. 5780-VCP (Del. Ch. Oct. 5, 2010), the Delaware Court of Chancery noted that the plaintiffs' appraisal dilution claims were not persuasive, given that the merger agreement explicitly provided that the shares issued under the top-up option in question would be excluded from any appraisal calculation.

- In *In re Protection One, Inc. Shareholders Litigation*, C.A. No. 5468-VCS (Del. Ch. Oct. 6, 2010), the Delaware Court of Chancery found that the top-up option included in a merger agreement did not

risk any harm to potential appraisal petitioners and expressed the view that the exercise of the top-up option ought to be viewed merely as part of the accomplishment of the merger, and thus excluded from any appraisal proceeding by operation of Delaware's appraisal statute.

However, the Delaware Supreme Court has not yet spoken on the issue of top-up options, and we expect additional and novel challenges to them in 2011.

Challenges to Poison Pills Lead to Mixed Results

An emergence of challenges to shareholder rights plans ("poison pills") in defending against hostile takeovers has led to mixed results in the Delaware courts. Three recent post-trial Court of Chancery decisions addressed the implementation of shareholder rights plans in the face of perceived threats. The Delaware courts approved the decision to adopt a rights plan in two of the three cases, both involving publicly held companies. *See Selectica, Inc. v. Versata Enterprises, Inc.*, No. 4241-VCN, (Del. Ch. Feb. 26, 2010), *aff'd*, 5 A.2d 586 (Del. 2010) (affirming the Court of Chancery's determination that Selectica Inc.'s board of directors validly adopted a rights plan with a 4.99 percent triggering threshold designed to protect the corporation's net operating losses); and *Yucaipa American Alliance Fund II. v. Riggio*, 1 A.3d 310 (Del. Ch. 2010) (currently on appeal) (upholding a poison pill defense that Barnes & Noble implemented as part of a plan to halt the advances of investor Ronald Burkle's Yucaipa entity). In the third case, involving a closely held private company, the court rescinded a rights plan adopted solely to protect a company's "corporate culture." *See eBay Domestic Holdings, Inc. v. Newmark*, C.A. No. 3705-CC, 2010 WL 351643 (Del. Ch. Sept. 9, 2010).

Court Weighs In on Bylaw Provisions in Contests for Control

The Delaware Supreme Court had the opportunity to address novel issues relating to bylaw proposals that had the potential to impact proxy contests for corporate control. Most notably, in *Airgas, Inc. v. Air Products and Chemicals, Inc.*, No. 649 (Del. Nov. 23, 2010), the Delaware Supreme Court reversed the Court of Chancery's post-trial decision, which upheld a bylaw proposed by Air Products, a hostile acquirer, that was designed to set Airgas' 2011 annual meeting in January 2011, only four months after the 2010 annual meeting. The Delaware Supreme Court found that the bylaw was invalid because it impermissibly truncated the directors' three-year staggered terms as provided by the Airgas charter, and it amounted to a *de facto* removal without cause of those directors without a supermajority vote also required by the Airgas charter.

Court Addresses the Standard of Review in Controlling Shareholder Transactions

In one notable 2010 decision discussed below, the Court of Chancery called upon the Delaware Supreme Court to address certain perceived inconsistencies between the different standards of review that apply depending on whether a deal involving a controlling stockholder is structured as a negotiated merger or a unilateral tender offer. Under Delaware law, negotiated mergers involving a controlling shareholder have long been reviewed under an enhanced entire fairness standard; in contrast, the deferential business judgment rule standard of review has applied to unilateral tender offers by controlling shareholders.

In *In re CNX Gas Corp. Shareholders Litigation*, 4 A.3d 397 (Del. Ch. 2010), the Delaware Court of Chancery denied a request by minority stockholder plaintiffs to enjoin a so-called "squeeze-out tender offer" by a controlling shareholder, but held that the entire fairness standard of review would apply in connection with any claims brought post-merger for damages. In the opinion, the Court of Chancery applied the "unified standard" for reviewing controlling stockholder freeze-outs described in *In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del. Ch. 2005). Defendants sought interlocutory review of the Court of Chancery's decision to apply the unified standard and provide consistency between deals structured as a merger and those proceeding as a tender offer. In certifying the question to the Delaware Supreme Court, the Court of Chancery opined that "the time has come"

for specific guidance on this issue from the state's highest court. The Delaware Supreme Court, however, refused to hear the appeal on an interlocutory basis. Although the Delaware Supreme Court denied the interlocutory appeal, the question of the appropriate standard of review that will apply to merger transactions and tender offers involving controlling stockholders is likely to be addressed by the Delaware Supreme Court in the near future.

Increase in Deal Litigation, Including in Non-Delaware Forums

As M&A activity has gained steam, there has been a corresponding increase in deal litigation, which we anticipate will continue; however, it is unlikely that such litigation activity will be confined exclusively to the Delaware courts. An increasingly popular tactic among members of the plaintiffs' bar is to file deal litigation (raising issues of Delaware law) not only in Delaware, but also in a non-Delaware forum (usually where the company's principal place of business is located). As a result, multiple sets of plaintiffs will file multiple lawsuits in multiple states related to the same deal.

One likely reason for this "multiple jurisdiction" approach is to avoid what may otherwise be a routine corporation law dispute heard by the judges of the Delaware Court of Chancery, who have significant experience handling complex deal litigation matters. In addition, unlike most other state courts, the Court of Chancery does not pose the risk of a jury trial or punitive damages if the case proceeds past a preliminary injunction phase. The net result of the "multiple forum" tactic is to increase the costs of litigation and elevate the risk of an adverse decision for corporate defendants.

One way that companies are fighting back is to include "choice of forum" provisions in charters and bylaws. These provisions address typical state law deal litigation claims — such as breach of fiduciary duty and other stockholder-related claims — and require them to be filed in a more manageable single forum (usually the state of incorporation, which is typically Delaware). A number of prominent companies already have adopted such provisions. In a recent decision, the Court of Chancery suggested that such provisions would be upheld under Delaware law. *See In re Revlon, Inc. S'holders Litig.,* 990 A.2d 940, 960 (Del. Ch. 2010). However, a federal district court recently indicated that a choice-of-law bylaw provision adopted unilaterally by a board of directors may not pass muster. *See Galaviz v. Berg*, C.A. No. 10-3392 (N.D. Cal. Jan. 3, 2011) and *Prince v. Berg*, C.A. No. 10-4233 (N.D. Cal. Jan. 3, 2011). It would not be surprising to see additional stockholder challenges testing the validity of such "choice of forum" provisions in Delaware and other courts in 2011.

Antitrust Enforcement in M&A Transactions

U.S. Enforcement

The Federal Trade Commission (FTC) and U.S. Department of Justice's Antitrust Division (DOJ) have continued to pledge vigorous merger enforcement, echoing a message that President Obama carried from the 2008 campaign trail to the Oval Office. Given the relatively low levels of merger activity in 2009 and 2010, it is difficult to determine whether the agencies will follow through on their assertions, except perhaps with regard to the Antitrust Division's renewed interest in vertical merger enforcement. The agencies have dedicated significant resources to updating the merger review process, issuing new Merger Guidelines and updating Hart-Scott-Rodino Act (HSR Act) notification rules, which will impact merger review in 2011 and beyond.

In spring 2010, the agencies unveiled new Horizontal Merger Guidelines, which went into effect in August 2010. The "new" guidelines do not reflect a significant shift from recent agency practice. Nevertheless, they suggest a preference by the agencies to minimize the need to define relevant markets as a necessary part of merger analysis and to rely more on sophisticated economic calculations of potential competitive effects. Recent court decisions highlight the uphill battle the agencies face in this

regard, noting the fundamental role of market definition in merger cases.[23] Whether the agencies can convince the courts to change course remains to be seen.

The antitrust agencies also proposed changes to their premerger notification form. Although they introduced the proposed changes as burden-reducing, several of the proposals threaten to substantially increase burdens in preparing the HSR notification; broaden the circle of people with pre-announcement knowledge of the proposed transaction; and materially increase the risk that, well into the second-request review process, the FTC will conclude that the original notification was defective. Consequently, Skadden submitted comments to the FTC explaining the shortcomings of certain of the proposed changes.[24] We will continue to monitor the proposed HSR Act rule changes and will alert clients to the final rules when they are issued, which is expected to occur in March 2011.

For its part, the Antitrust Division has stepped up enforcement in the past year in connection with vertical mergers, which historically have received less scrutiny than combinations between competitors. For example, the Ticketmaster and Live Nation merger had significant vertical dimensions in the live entertainment business. After a lengthy DOJ review, the parties agreed to several conditions in order to avoid a challenge to the transaction. Similarly, the Antitrust Division demanded concessions from GrafTech in connection with its acquisition of a significant supplier, requiring GrafTech to modify an existing agreement with another supplier.[25] The Antitrust Division will have another opportunity to express its views regarding vertical mergers once it completes its investigation of Comcast's proposed acquisition of a controlling interest in NBC Universal.

European Union

2010 marked Joaquín Almunia's first year at the helm of the EU Commission's Directorate General for Competition (DG COMP). Significant changes in terms of merger enforcement did not take place. In Almunia's words, merger control is now a "mature area of enforcement," with the commission generally following the analytical framework set forth in the EU's Horizontal Merger Guidelines (2004) and Non-Horizontal Merger Guidelines (2008). The current trend is a greater emphasis on empirical data and increased use of economics and economists.

Despite criticism that the EU Commission received for lack of due process, it maintained the position that its existing administrative process already offers appropriate safeguards. Nonetheless, the commission has signaled that it continues to look at areas for improvement in light of the feedback.

Similar to the U.S., the number of 2010 merger notifications remained at levels comparable to 2009, about two-thirds of the 2007 levels (which was the commission's busiest year in terms of merger notifications). In 2010, the EU Commission opened only four Phase II investigations, all of which led to clearance decisions (in some cases, subject to conditions), with the exception of the Olympic Air/Aegean case, which would combine the two leading carriers in Greece, and where the Phase II investigation will conclude this month.

DG COMP and its Chief Economist team are carefully following the U.S.-led debate regarding the desirability of minimizing the need to define markets surrounding the new U.S. Horizontal Merger Guidelines, even though there are no official indications at this stage that DG COMP will reassess the need to define relevant markets.

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[23] *FTC v. Lundbeck, Inc.*, 2010-2 Trade Cases ¶ 77,160 (CCH) (D. Minn. 2010); *City of New York v. Group Health, Inc.*, No. 06 Civ. 13122 (RJS), 2010 WL 2132246 (S.D.N.Y. May 11, 2010).

[24] *See* http://www.skadden.com/newsletters/Comments_Letter.pdf.

[25] Among other changes, GrafTech was required to remove a MFNs pricing provision from the agreement. This highlights a DOJ focus on MFNs, even in the merger context. Earlier this year, the DOJ filed a complaint alleging that Blue Cross Blue Shield of Michigan's MFN provisions in its contracts with doctors and hospitals violate Section 1 of the Sherman Act. That suit was brought several months after Blue Cross Blue Shield of Michigan abandoned its proposed acquisition of another Michigan health plan in the face of DOJ opposition. (See "Global Litigation/Antitrust Litigation and Enforcement.")

Another trend in recent DG COMP merger decisions is increased reliance on the counterfactual analysis to address the question of whether a merger gives rise to a significant impediment to effective competition. The counterfactual analysis compares the potential effect of the merger with the most competitive situation that realistically would exist in the absence of the merger. This can be particularly relevant in the case of failing firms or of competing bids. The EU Commission relied heavily on the counterfactual analysis in the recent Microsoft/Yahoo! search business case as well as its analysis of the Olympic Airways/Aegean case. The increased importance of counterfactual analysis also is reflected in the new Merger Assessment Guidelines issued by the U.K. Competition Commission and the Office of Fair Trading in September 2010 (MAGs), which cover not only horizontal, but also nonhorizontal, mergers. Similar to the new U.S. Horizontal Merger Guidelines, the MAGs put less weight on market definition and more emphasis on the assessment of unilateral effects.

Brazil, China and India

The Brazilian Administrative Council for Economic Defense (CADE) has improved significantly in terms of administrative efficiency and sophistication. On the procedural front, mergers raising no significant merit issues are now cleared faster (within approximately three to four months) than the seven- to nine-month period that it usually took to obtain clearance in Brazil, even in noncomplex transactions. On the substantive front, the CADE now relies on increasingly sophisticated theories of harm, which, to date, only had been encountered in dealings with the U.S., the EU and other Western competition authorities. For example, in TIM/Telefonica, the CADE took enforcement action against Telefonica's acquisition of 10.9 percent of Telecom Italia, despite the fact that this was the acquisition of a noncontrolling minority stake, on the basis that the transaction would reduce competition between the wireline/wireless operators controlled by Telefonica and TIM in Brazil. The CADE eventually cleared the case subject to firewall commitments preventing Telefonica from discussing or accessing information relating to Telecom Italia's activities in the Brazilian telecommunications market. Against this background, the CADE has been pushing for the enactment of new legislation (Bill No. 6) that would, among other things, include a bar on closing that would prevent the parties from closing the transaction before a clearance is issued. This change would have significant timing implications and would put Brazil on the map as one of the gateway jurisdictions that could hold up global M&A deal closings.

China's Ministry of Commerce (MOFCOM) continued to aggressively enforce the 2008 Chinese Antimonopoly Law (AML) in 2010. MOFCOM's sophistication and expertise are increasing; as of December 2010, MOFCOM had reviewed approximately 150 notifications since the adoption of the AML. China has emerged as one of the major gateway jurisdictions (along with the U.S. and the EU) that could have significant timing implications for a global deal. However, the merger review process in China continues to be more burdensome and time-consuming than U.S. and EU merger review procedures. As a result, the effective time required for MOFCOM clearance is much lengthier than the statutory Phase I review period of 30 calendar days, even for cases raising no significant antitrust issues.

The newly created Competition Commission of India (which replaced the Monopolies and Restrictive Trade Practices Commission) has been active in the antitrust (nonmerger) enforcement front and has launched a number of cartel and abuse of dominance proceedings. However, the implementing regulations relating to the merger control regime under the Competition Act 2002 have yet to enter into force. The draft implementing regulations provide for a mandatory preclosing merger control regime that could require the parties to hold up the global deal until clearance in India is received.

U.S. M&A – Recent Developments in Private Equity Transactions

As expected, given the increased availability of leveraged financing and greater perceived stability in valuations, 2010 showed a marked resurgence in private equity M&A activity relative to 2009. Completed

acquisitions for the year totaled approximately $76 billion, as compared to approximately $57 billion in 2009, a 25 percent increase.[26] Although many private equity sponsors accessed the capital markets in 2010 to fund leveraged recapitalizations and reduce their level of equity investment in companies acquired at the height of the credit crisis, sale transactions became an increasingly attractive exit alternative. In addition, sponsor activity in the acquisition environment has resulted in more active auctions and levels of competition for attractive assets that are somewhat reminiscent of the pre-credit crisis period.

The credit crisis has contributed to a number of factors that should continue to drive private equity dealmaking through 2011:

- First, older vintage funds at or near the end of their investment periods are hungry for realization events. The average holding period for portfolio companies has steadily increased, and now averages 4.9 years as compared to 4.1 years in 2007.[27] Some of these "end of life" issues facing private equity dealmakers are discussed in greater detail below.
- Second, funds raised just prior to the credit crisis are anxious to deploy capital, having been sidelined to an extent by the lack of leveraged financing and uncertainty in valuations. By some estimates, the private equity industry has approximately $450 billion to $485 billion of undeployed capital waiting to be invested.[28]
- Finally, a significant reduction in private equity fundraising has resulted from the credit crisis and its aftermath. Although fundraising has been increasing over the past few quarters, levels are extremely depressed relative to the pre-credit crisis period. Fundraising for the third quarter of 2010 was approximately $20 billion, compared to approximately $103 billion in the first quarter of 2008.[29] Pressure on fundraising activities, coupled with the paucity of exit opportunities and increased performance pressure on certain funds, has led to a number of wind-down situations, and has exacerbated the lack of "dry powder" concerns discussed below.

These issues — along with the increased use of tender offers in leveraged transactions, the continuing effect of the Dodd-Frank legislation and a focus on dealmaking in the emerging markets — promise to shape private equity developments in 2011.

'End of Life' Issues

Portfolio company dispositions at or near the end of a private equity fund's traditional 10-year lifecycle present unique challenges for both the purchaser and the private equity fund seller as the fund's desire to wind down competes with a buyer's desire for traditional rights and recourse. These issues are arising more frequently as the private equity industry matures and more funds are reaching their contractually mandated duration. Navigating them effectively will greatly enhance a private equity fund seller's ability to make final distributions to its investors and close the fund. To achieve this result, buyers must be convinced to eliminate or curtail future obligations of sellers, including indemnification and post-closing covenants such as retention of books and records, and sellers must determine the best way to dissolve "orphan" entities resulting from asset sales. Buyers in these situations can expect private equity sellers to suggest that the offer price reflect the lack of these obligations or that the buyer accept alternative structures such as exclusive remedy escrows or, if available, representation and warranty insurance. Purchasers also need to consider the practical effects of the lack of continuity of the seller entity, especially potential issues associated with managing ongoing litigation.

[26] pitchbook.com 4Q 2010 PE & VC Presentation Deck.

[27] *Id.*

[28] *The Wall Street Journal* and pitchbook.com "The Private Equity Breakdown 4Q 2010."

[29] "Preqin Investor Outlook: Private Equity — The Opinions of 100 Leading Private Equity LPs on the Market and Their Plans in 2011."

Lack of 'Dry Powder' Issues

Given the limited investment period applicable to most funds and the finite amount of capital committed by a fund's limited partners, issues frequently arise regarding how to provide for the continuing capital needs of portfolio companies held by older vintage private equity funds. Even if "end of life" issues are not implicated, the lack of exit opportunities and general expansion of portfolio company holding periods increasingly have left funds searching for ways to infuse capital into portfolio companies at a time when the fund's investment period is over or nearly over and little or no "dry powder" (available, committed capital) exists. Many funds have needed to provide liquidity bridges to their portfolio companies in order to avoid covenant issues under debt financing arrangements or, in more severe cases, to avoid insolvency. In roll-up situations or platform builds, in particular, funds have needed to provide equity capital for add-on acquisitions to enable the portfolio company to achieve the scale necessary to complete an exit transaction at an attractive multiple. In these situations, lack of available capital commitments and restrictions on further investments or investment concentration under a fund's limited partnership agreement can be problematic.

Going forward, these issues are likely to continue to figure prominently. Dealmakers can expect funds to attempt to address these issues through increased co-investments with affiliated funds or third parties, each of which may give rise to significant conflict-of-interest and valuation concerns. Portfolio companies also may employ complex borrowing strategies to address these capital needs.

Other Areas of Interest

Use of Tender Offers in Private Equity Transactions

In recent years — particularly after SEC rulemaking that addressed certain "all holders rule" concerns — the use of tender offers in two-step merger transactions has been on the rise. However, the mechanism has been used less frequently in leveraged transactions, in large part due to financing issues resulting from the acquirer's inability to use the target's assets as collateral at the time the tender offer closes. Notably, two deals last year — leveraged buyouts of Burger King and Gymboree — were accomplished through the use of tender offers coupled with "top-up" options and some level of target shareholder support designed to provide the buyer with the ability to consummate a short-form merger at the time of the tender offer closing, thus allowing use of the target's assets as collateral. As leveraged buyout professionals become more knowledgeable about the tender offer mechanism and its potential timing advantages, the use of tender offers is likely to become even more prevalent, potentially leading to a willingness by private equity funds to address margin rule concerns and borrow funds at the close of a tender offer, even when the ability to immediately consummate a merger with the target is not assured.

Effect of Dodd-Frank on Private Equity

The Dodd-Frank Act contains several amendments to the registration provisions of the Advisers Act applicable to private equity fund advisers. The relevant changes include: (i) repealing the "private adviser exemption" relied upon by many private equity fund advisers, thus requiring most advisers to register with the SEC, (ii) introducing new and more limited exemptions for "foreign private advisers" and "mid-sized private fund advisers," (iii) generally increasing the statutory threshold for registration by investment advisers with the SEC rather than the states (from $25 million to $100 million), and (iv) enhancing mandated reporting under the Advisers Act by registered advisers and advisers exempt under the new "mid-sized private fund adviser" exemption. The amendments to the Advisers Act will come into effect in July 2011, and the SEC is currently in the process of promulgating rules and amendments to Form ADV to give effect to these changes. For further discussion of the Advisers Act amendments, see "Financial Regulation/Private Investment Advisers."

Additionally, the Dodd-Frank Act provides that "banking entities" (as defined in the Dodd-Frank Act) will be subject to the provisions of the Volcker Rule, including the limitations on the sponsorship of private

equity funds and hedge funds. Generally, banking entities will have to modify their private equity fund and hedge fund activities to comply with the "permitted activity" conditions of the Volcker Rule, which provide eight conditions that banking entities must follow in order to organize and offer a permitted private equity fund or hedge fund. The various financial regulators are in the process of conducting a study and proposing rules to implement the Volcker Rule, but there are still a number of unanswered questions. For further discussion, see "Financial Regulation/The Volcker Rule."

Private Equity in Emerging Markets

Emerging markets saw robust private equity investment activity during 2010, led by a surge in Latin America and strong levels in China, India and Russia. According to Thomson Reuters data, private equity investments in emerging markets totaled $18.3 billion as of December 2010, up 10 percent from the same period in 2009. The BRIC economies (Brazil, Russia, India and China) experienced especially strong private equity activity in 2010. According to a recent survey by the private equity firm Coller Capital and the Emerging Markets Private Equity Association, approximately 57 percent of private equity investors surveyed expect to increase allocations to emerging markets, including China, India and Brazil, over the next two years.

Private equity investment in Brazil reached remarkably high levels in 2010, with well-known international fund managers joining established local firms in the bid to maximize opportunities in Brazil's rapidly growing economy. A prominent example of this trend is The Blackstone Group L.P.'s recent purchase of a 40 percent stake in Brazilian asset management company Patria Investimentos. In China, one clear trend is that international private equity funds are increasingly setting up Renminbi, or RMB, funds in joint ventures with Chinese partners onshore in China as opposed to the traditional U.S. dollar funds offshore. The Carlyle Group and The Blackstone Group L.P. recently closed RMB funds in joint ventures with entities owned by the city governments of Beijing and Shanghai, respectively. According to Ernst & Young, private equity investments in India totaled approximately $6.5 billion in 2010, up from $3.5 billion in 2009, as continuing robust economic growth has made the country an attractive market. One recent example is the pending offer for Patni Computer Systems, which is valued at nearly $1 billion, from a consortium led by Apax Partners. Although macroeconomic volatility remains an obstacle for private equity investment in Russia, investors have been encouraged by a rebound in Russian economic growth in 2010. Recent examples include Baring Vostok Capital Partners' purchase of a 30 percent stake in Orient Express Bank, a midsized Russian lender, and Nafta Moskva's multibillion-dollar acquisition of a significant stake in OJSC Uralkali, a major global producer of potash based in Russia.

We expect the pace of private equity investments in emerging markets to maintain its momentum through 2011, buoyed by greater stability and better governance, particularly in China, India and Brazil. We also expect that private equity investment in emerging markets will result in sophisticated joint ventures and other state and private partnerships that will present increasingly complex regulatory, structuring and tax issues.

National Security and Other Regulatory Review of Cross-Border Transactions

We expect that the continued weakness in certain sectors of the global economy in 2011 will provide companies with a number of attractive M&A and investment opportunities in the U.S. and internationally. Countries such as Russia, faced with lower oil revenues and a pressing need to increase government revenues, have announced tentative plans to reduce barriers to foreign investment and recently have approved major foreign investments.

At the same time, growing consolidation in the natural resources, telecommunications and critical technologies industries, coupled with increased concerns over the security of the industrial supply

chain and defense industrial base, have led a number of countries, including the United States, to rigorously scrutinize the national security implications of cross-border transactions in these areas. In the United States, the interagency Committee on Foreign Investment in the United States (CFIUS), which reviews the national security implications of foreign acquisitions of, mergers with, or investments in U.S. businesses, forced the withdrawal of two transactions in 2010 after indicating they would otherwise be blocked. In January 2010, CFIUS prevented a Chinese corporation from investing in U.S. miner Firstgold, and, in June, CFIUS forced another Chinese company to withdraw its bid for 60 percent of U.S. company Emcore's fiber optics business.

This past year, other countries also used similar review processes to block several major transactions. Canada, for instance, blocked an Australian company's proposed acquisition of Potash Corporation by invoking the Investment Canada Act for only the second time in the act's 25-year history. The EU also is considering the creation of a Europe-wide body similar to CFIUS to prevent foreign takeovers of strategic European businesses, a move prompted in part by a Chinese company's audacious but ultimately unsuccessful takeover bid for a Dutch cable company.

Underlying Concerns

Several underlying trends have driven countries' determinations that certain transactions implicate strategically essential domestic companies:

- **Perceived security risks associated with foreign control of telecommunications and other aspects of critical infrastructure.** Military operations and other sensitive government activities increasingly depend upon telecommunications networks. As a result, countries have become increasingly sensitive to the perceived cybersecurity risks associated with foreign telecommunications providers. Political scrutiny of cross-border transactions in the telecommunications sector continues to grow, as does monitoring of each link of the supply chain.

- **Maintaining control over critical technologies.** The U.S., like other countries, has long been concerned with maintaining control over critical technologies with military or national security applications. Many producers of these technologies face pressures to increase scope and scale in order to effectively compete in a global platform. This has created incentives for consolidation within industries but also has led to growing efforts to prevent foreign acquisitions of domestic producers of these technologies.

- **The global competition for natural resources.** Spurred by China's voracious appetite for natural resources, countries have raced to amass controlling positions in the world's supply of various natural resources. China, for instance, currently mines 95 percent of the world's rare earth metals crucial to manufacturing a number of advanced commercial and military technologies. This consolidation of control has raised fears regarding the security of the supply of these resources and the potential for disruptions to the supply chain.

Trends in the CFIUS Review Process

2010 was the second full year under the regulations the Treasury Department adopted to implement the Foreign Investment and National Security Act of 2007 (FINSA). CFIUS' caseload remained light for much of the year, reflecting the relatively low levels of global M&A activity, but then increased substantially in the fourth quarter. While the number of cross-border transactions subject to CFIUS review in 2010 was still lower than the peak year of 2008, the number of filings in 2010 exceeded 2009 by a considerable margin. Trends in the CFIUS review process included:

- **The number of transactions that went to investigation continued to increase.** The CFIUS process consists of a mandatory 30-day review and a discretionary 45-day investigation period, which

CFIUS can impose if, in its discretion, it determines that the transaction may "impair national security," for instance because the transaction would result in "foreign government control" or in foreign control of "critical infrastructure." We expect this trend to continue in 2011.

- **Fewer transactions were subject to mitigation agreements.** In the past, CFIUS has entered into mitigation agreements with parties to transactions to address national security concerns identified during the review process. The number of such agreements declined in 2010, a development largely attributable to FINSA's requirement that mitigation agreements must be approved unanimously by all CFIUS member agencies. Because those agreements often reflect the concerns of one particular CFIUS member agency but not others, the unanimity requirement has had a pronounced effect and likely will continue to do so in the future.

- **Industrial supply chain and defense industrial base concerns have crept into CFIUS review.** The Department of Defense, as a CFIUS member agency, has increasingly pushed assessments of a transaction's effect on the industrial supply chain and on the defense industrial base during CFIUS review. This reflects a growing concern on DOD's part that it maintain trusted suppliers for telecommunications and other critical technologies and equipment used in DOD activities.

- **Cybersecurity issues are increasingly important.** Fears of cyber-espionage, the vulnerability of companies with sensitive information to cyberattack, and concerns that reliance on foreign telecommunications providers may expose U.S. government agencies and companies to risks all play a growing role in the CFIUS review process. These issues are especially acute in transactions involving the telecommunications sector, but FINSA now requires all U.S. companies involved in transactions subject to CFIUS review to provide their cybersecurity plans.

Although CFIUS blocked two transactions (Firstgold and Emcore) involving Chinese acquirers, those transactions reflected broader concerns beyond the nationality of the foreign acquirer. Indeed, CFIUS approved a number of transactions involving Chinese acquirers, including Meadville Holdings Limited's sale of its printed circuit board business to TTM Technologies.

The Firstgold and Emcore transactions were distinguished instead by two key issues:

- **Co-location of classified facilities.** Emcore's facilities reportedly were in close proximity to classified U.S. government facilities, which likely heightened CFIUS' perception that foreign ownership of Emcore would pose a risk to U.S. national security. Similarly, Firstgold's Nevada mine leases were on federal government property, and all four of its facilities were in close proximity to military installations and/or classified U.S. government facilities, limiting mitigation options.

- **Access to export-controlled technologies and/or resources with military applications.** Emcore's fiber optics business also produced and/or used a number of export-controlled technologies with significant military applications, raising additional concerns about whether the proposed investment would give a foreign company access to such technologies. Likewise, CFIUS expressed concerns as to whether Firstgold's mining operations might give China greater access to tungsten, a key component in missiles that is subject to U.S. export control restrictions.

In 2010, the United States and other countries became increasingly active in their scrutiny of foreign investments in companies deemed strategically essential to national security. It remains to be seen whether this trend will remain limited to businesses involved in telecommunications, critical technologies and access to raw materials, or whether it will broaden to encompass a wider range of industries in 2011.

Governance

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U.S. Corporate Governance at a Crossroads

It would be understandable if, as 2010 drew to a close, some directors of U.S. public companies reflected on the year and thought, "That wasn't so bad." Most importantly, the economic turmoil experienced by many companies in recent years began to abate. On the corporate governance front, predictions that large numbers of directors would incur high negative votes due to the elimination of broker discretionary voting in uncontested director elections did not come to pass. In fact, the level of dissent in director elections decreased in the 2010 proxy season compared to 2009. Moreover, the number of contested director elections decreased, as did the level of success for competing slates of director nominees. Also, for the second year in a row, most companies that provided their shareholders with an advisory vote on executive compensation found shareholders to be very supportive of their compensation programs.

Although the Dodd-Frank Act includes corporate governance and executive compensation provisions that will impact all public companies (more on that later), legislative proposals mandating majority voting in director elections, prohibiting classified boards of directors, requiring board-level risk committees for all public companies and requiring independent board chairs were not included in the final legislation. And finally, even though the SEC adopted proxy access rules, the three-year and 3 percent holding requirements for shareholders to use proxy access were a relief for public companies. Additional relief came when the SEC stayed the effectiveness of proxy access pending the resolution of a court challenge brought by the Business Roundtable and the Chamber of Commerce.

All of this "good news" notwithstanding, 2011 brings the state of corporate governance and many of its key players (public companies, institutional and activist investors, proxy advisory firms and, especially, the SEC) to a crossroads. Many courses of action will be decided in 2011. Whether those decisions foster an environment that allows corporate directors to continue to provide meaningful strategic guidance with a view toward long-term value creation, or whether they place undue burdens on public companies and their directors that may impede growth and provide opportunities for those with short-term agendas to distract public companies from their long-term goals, hangs in the balance. Accordingly, it is incumbent on public companies to remain diligent and to be proactive and engaged participants as events unfold.

This note explores the corporate governance themes that we expect will play a critical role in 2011 and beyond: (i) the first year of mandatory shareholder advisory votes on executive compensation and the potential fallout from those votes, (ii) the continuing evolution in the board-shareholder relationship, and (iii) the implementation of certain provisions of the Dodd-Frank Act that are applicable to many or all U.S. public companies.

Say-on-Pay Votes

Pursuant to the Dodd-Frank Act (see "Financial Regulation/The Dodd-Frank Act"), most U.S. public companies will provide their shareholders with an advisory vote to approve the compensation of executive officers as disclosed in the proxy statement (referred to as a "say-on-pay" vote) at their 2011 annual meetings. In addition, shareholders will have an advisory vote on whether future say-on-pay votes should occur every one, two or three years (referred to as a "frequency vote").

2010 Experience. According to ISS, as of July 1, 2010, say-on-pay votes at companies voluntarily providing the vote and at companies with remaining obligations under the TARP program (requiring them to provide say-on-pay votes) resulted in an average of 89.6 percent of votes cast in favor of executive compensation. Perhaps it is more instructive, however, to look at two of the companies

where executive compensation failed to receive majority support — Occidental Petroleum and KeyCorp (Motorola was the other company that failed to receive majority support for its executive compensation). In October 2010, Occidental Petroleum announced "significant changes" to its executive compensation program and that its CEO would step down from this position as of the 2011 annual meeting (continuing to serve as an executive chairman). This was followed, in November 2010, by KeyCorp's announcement that its chairman and CEO would retire effective May 1, 2011. Although various factors may have contributed to the outcome in each case, these events underscore the significant ramifications that may result from a negative say-on-pay vote.

Preparation for 2011 Annual Meetings. As an initial matter, companies should continue to analyze whether their executive compensation programs are consistent with the guidelines of their major institutional shareholders and proxy advisory firms such as ISS. To the extent that there are areas of divergence, companies may want to consider the extent to which they have articulated the reasons behind their compensation decisions and why those decisions are consistent with paying for performance. In the event that these divergences have not been fully explained, companies may find it advisable to engage in a dialogue with their major shareholders about any potential concerns. Also, in light of the upcoming say-on-pay votes, companies should take a fresh look at their proxy statement compensation disclosure (particularly CD&A) to ensure they are clearly and effectively communicating to shareholders why their executive compensation programs are appropriate given the company's particular circumstances, performance and competitive landscape.

In addition, companies will need to consider what recommendation, if any, they will make regarding the frequency vote. Although ISS and other institutional investors have indicated that they favor annual say-on-pay votes, some companies have recommended that say-on-pay votes be held every two or three years.

Institutional shareholders and proxy advisory firms also will have to make decisions regarding 2011 annual meetings. They have promoted say-on-pay votes as a better means of communicating displeasure with a company's executive compensation than by voting against (or recommending votes against) directors who serve on compensation committees. Having obtained say-on-pay votes, will they follow through on this at 2011 annual meetings? If so, we should see fewer directors receiving large negative votes in 2011. Another open question is whether institutional investors and proxy advisory firms actually will review and analyze a company's articulation of why its compensation decisions made sense for the company in light of its particular situation, or engage in a "one-size-fits-all" review to determine whether to vote for or against a company's executive compensation.

After the Meeting — Responding to the Vote. The real impact of say-on-pay votes will be felt after the 2011 proxy season. Companies, and compensation committees in particular, will need to consider the message behind the vote — for example, a 60 percent favorable vote may "win," but is it a "passing grade"? Also, compensation committees may not know with any degree of certainty which aspects of the executive compensation program resulted in shareholder dissatisfaction. Accordingly, companies and major shareholders will have to engage in a meaningful dialogue. Perhaps the company's rationale for certain decisions could have been communicated more clearly. Perhaps shareholders did not fully appreciate the situation that resulted in a compensation committee's particular decision. Without question, however, a company's response, or failure to respond, to a negative say-on-pay vote — in terms of shareholder engagement, improved disclosure and, possibly, changes to executive compensation programs — is likely to have consequences. As evidenced by recent events, the consequences may be significant and may come relatively soon after the vote. Alternatively, if a board is viewed as being unresponsive to shareholder concerns, these consequences may become evident in the next election of directors.

The Board-Shareholder Relationship: Activism, Access and Engagement

Say-on-pay votes can be viewed as part of a broader change in the board-shareholder relationship. For a variety of reasons, some long-term institutional investors have come to view boards of directors with

greater skepticism and have sought tools they believe necessary to hold boards of directors more accountable, including the ability to have their own director nominees included in the company's proxy materials.

At the same time, hedge funds and other activist investors focused on short-term returns often attempt to exploit corporate governance issues as part of an investment strategy in which companies are pressured to engage in transactions that maximize short-term returns at the expense of long-term growth. Under the guise of advocating for improved corporate governance and shareholder rights, these short-term-focused investors often win the support of more passive, longer-term investors.

Facing a landscape of shareholder proposals, increased activism and proxy access, public companies must continue to be proactive in their outreach to major shareholders. Increasingly, these engagement efforts include making certain directors (*e.g.*, the lead independent director or compensation committee chair) available to meet with major shareholders under appropriate circumstances.

Shareholder Proposals. Shareholder proposals submitted under Exchange Act Rule 14a-8 continue to be a favorite tool for some institutional investors — particularly labor unions and public pension funds. According to ISS, approximately 31 percent of governance proposals going to a vote in the 2010 proxy season received majority support (down from 37 percent in the 2009 proxy season, but comparable to the 30 percent success rate in the 2008 proxy season). Governance proposals receiving the most majority votes in the 2010 proxy season were those seeking board declassification, elimination or reduction of supermajority voting requirements, majority voting in uncontested director elections, the right for shareholders to call a special meeting, and the right for shareholders to act by written consent. The challenge for boards of directors arises when a proposal obtains majority support from shareholders. The board may not believe that implementing the proposal is in the best interests of all shareholders. On the other hand, disregarding the majority-supported proposal can earn the board the label of being unresponsive. This again is an area where an open dialogue between companies and major shareholders may be necessary to attempt to bridge the divide.

For example, shareholder ability to call special meetings and to act by written consent are complex topics. Even ISS, in its 2011 policy updates, acknowledges the risk that action by written consent can be abused, especially in hostile situations, and can be detrimental to shareholders. ISS updated its policy so that, in certain situations, it will review proposals seeking shareholder ability to act by written consent on a case-by-case basis. One of ISS' requirements, however, is that holders of 10 percent of a company's shares have the "unfettered" right to call a special meeting. Yet a number of companies, in consultation with their major shareholders, have determined that 10 percent is too low a threshold at which to call a special meeting — an expensive and time-consuming endeavor — and have instead adopted bylaws that require shareholders to have a higher level of ownership (*e.g.*, 25 percent) in order to call special meetings.

Activists and Reporting Beneficial Ownership. For a number of years, public companies and their advisers have voiced concerns over the ability of hedge funds and other activist investors to use derivatives and other forms of synthetic ownership to accumulate significant economic or voting positions prior to making those positions public. This phenomenon, in part, drives company concerns over some of the shareholder proposals described above, such as granting holders of 10 percent of a company's shares the right to call a special meeting.

These concerns were reinforced in October 2010 when Bill Ackman's hedge fund, Pershing Square, and Vornado Realty Trust disclosed a combined ownership of more than 26 percent of J.C. Penney Company. They accomplished this accumulation of shares through a combination of methods, including the use of derivatives, call options and an aggressive buying spree during the 10-day window between the time a Schedule 13D filing was triggered and the date the filing was due.

Although Dodd-Frank permits the SEC to shorten this 10-day window, and the SEC could take other steps relating to beneficial ownership reporting and derivatives, these matters do not appear to be on

the SEC's near-term agenda. Accordingly, public companies will need to be more vocal and proactive in delivering a message that these stealth accumulations of significant amounts of shares are not in the long-term best interests of investors and should be promptly and publicly disclosed. Until the SEC catches up with the techniques often employed by activist investors, companies need to remain prepared to address this type of activity, including by regularly reviewing their takeover preparedness, having internal and external teams at the ready, and being prepared to adopt a shareholder rights plan to preserve the board's ability to engage in a thoughtful evaluation of options that are in the company's and shareholders' best interests.

Proxy Access and Even More Access. In August 2010, the SEC adopted rules that would allow a shareholder or group of shareholders holding at least 3 percent of a company's shares for three years, and nominating candidates for up to one quarter of the total number of board members, to have its nominees included in the company's proxy materials. In addition, Rule 14a-8 was amended so that shareholders could submit proposals calling for additional access to company proxy materials (*e.g.*, 1 percent and one-year holding requirements). As a result of a court challenge to the proxy access rules, the SEC stayed the effectiveness of proxy access as well as the amendment to Rule 14a-8. The stay effectively takes proxy access off the field of play for the 2011 proxy season.

It remains to be seen whether the SEC's proxy access rule will survive the legal challenge unscathed and become effective for the 2012 proxy season or whether the court will find a defect that further delays the effectiveness of mandatory proxy access. Even if proxy access is delayed, companies should expect the debate to continue. In the course of the SEC rulemaking process, public companies and others embraced the concept that proxy access should be the subject of "private ordering" — that companies and their shareholders should decide whether, and on what terms, proxy access should be adopted at a particular company. As a result, future proxy access shareholder proposals under Rule 14a-8 may be inevitable (once the stay on the effectiveness of the amendment to Rule 14a-8, which is not part of the litigation, is lifted).

Separately, it has been reported that the United Brotherhood of Carpenters (the institutional investor that played a leading role in the movement to adopt majority voting in director elections) has been conducting a letter-writing campaign, focused on larger companies, proposing that these companies provide shareholders or shareholder groups holding 1 percent of the company's securities for one year with access to the company's nominating and corporate governance committee to discuss a range of board-related issues, including possible alternative nominees for election to the board. Although the concept of requiring the nominating and corporate governance committee to meet with a potentially large number of shareholders appears extreme and unrealistic, it may represent the next battle in the fight for increased shareholder access to directors.

Dodd-Frank Act Implementation

As is now widely understood, the Dodd-Frank Act significantly impacts all public companies. In addition, the act requires a significant amount of rulemaking by the SEC and other regulators. Three particular aspects of the act should be of interest to public companies: (i) executive compensation matters, (ii) the SEC whistleblower bounty and (iii) the conflict minerals provision.

Executive Compensation. Over the course of 2011, the SEC will engage in rulemaking on the following compensation-related topics:

- shareholder advisory votes on merger-related compensation arrangements;
- enhanced independence for compensation committee members and a requirement that the committee take into consideration independence factors when selecting consultants, counsel and other advisers;

- additional executive compensation disclosure concerning pay for performance and the ratio of the CEO's total compensation to the median of total annual compensation paid to all employees other than the CEO;
- "clawback policies" for companies to recoup executive compensation from current and former executive officers in the event of a financial restatement due to noncompliance with the securities laws, regardless of whether the executive was at fault or engaged in misconduct; and
- disclosure of whether directors and employees are permitted to hedge against decreases in the value of company equity securities.

A number of issues may be presented in the course of these rulemakings. For example, the SEC has proposed rules to implement the advisory vote on merger-related compensation arrangements that could result in up to four new compensation tables being included in proxy statements to approve mergers and similar business combination transactions. In the case of the new disclosure requirement concerning median compensation for all employees other than the CEO, companies with many employees or employees in various countries could be faced with an enormous, complex and expensive data collection and analysis task that results in disclosure of information that many believe will be meaningless to investors. And, in the case of required clawback policies, depending on the SEC's approach, compensation committees may lack the discretion often afforded them by voluntarily adopted clawback policies to weigh all of the relevant considerations and make a business judgment as to whether to seek to recoup executive compensation.

Public companies must emphasize the need for the SEC to implement these legislative mandates in a manner that does not result in more voluminous but less useful disclosures; does not place undue burdens on public companies to collect and analyze data; and does not make it more difficult for public companies to attract, retain, incentivize and reward executives who are supposed to take risks (within the parameters of board-approved strategic plans) in order to create long-term reward for all of the company's stakeholders.

Whistleblower Bounty. Pursuant to the Dodd-Frank Act, the SEC is required to pay awards to individuals who provide the SEC with original information about a potential violation of the federal securities laws that leads to a successful SEC enforcement action resulting in monetary sanctions exceeding $1 million. This whistleblower bounty must be at least 10 percent, and up to 30 percent, of the monetary sanctions assessed by the SEC and certain other regulatory agencies in related actions. (See "Financial Regulation/Investor Protection and SEC Enforcement.")

Although the bounty is effective for information provided to the SEC at any time after the enactment of the Dodd-Frank Act on July 21, 2010, the SEC proposed rules in November 2010 to implement the whistleblower bounty program and must adopt final rules by April 21, 2011.

Among the many criticisms of this statutory provision and the SEC's proposed rules is that the whistleblower bounty will undermine corporate compliance programs. Rather than utilizing company hotlines or other mechanisms developed to facilitate employee reporting of accounting or compliance concerns, company employees will have a substantial personal financial incentive (and the encouragement of plaintiffs' lawyers advertising their services to help whistleblowers maximize the size of an award) to go directly to the SEC to voice their concerns.

Accordingly, the SEC will need to give further consideration to balancing the competing interests of encouraging whistleblowers without undermining the effectiveness of corporate compliance programs. At the same time, companies will need to consider ways to bolster the effectiveness of internal compliance programs and to incentivize employees to report concerns internally, in the first instance, rather than outside the company.

Conflict Minerals. The Dodd-Frank Act requires the SEC to adopt rules by April 15, 2011, requiring annual disclosure of whether any "conflict minerals" necessary to the functionality or production of a company's products originated in the Democratic Republic of Congo or any neighboring country. Under rules proposed by the SEC to implement this provision, if conflict minerals did originate in any such country, or the company is unable to determine that conflict minerals did not originate in any such country, companies will be required to disclose, in an independently audited report, additional information relating to the conflict minerals, including supply chain due diligence measures and a description of the relevant products and facilities. Affected companies will be required to publish the reports on their websites and furnish them as exhibits to their annual reports on Form 10-K, 20-F or 40-F, as applicable.

This provision of the Dodd-Frank Act could be applicable to a large number of companies that use gold, tin, tantalum or tungsten in their products or in the production of their products. As described in a comment letter submitted by the National Association of Manufacturers, this rulemaking could impact companies in a broad range of industries, including the automobile, medical device, consumer product, defense and aerospace industries. The SEC will need to implement this provision in a way that accounts for the real-world complexities of supply chain management and avoids imposing unrealistic burdens and immense costs on U.S. companies engaged in manufacturing.

Conclusions

Public companies continue to operate in an environment that requires diligence and engagement on several fronts. Many of the challenges faced by public companies in 2011 arise from the cumulative effect of actions taken, or failures to act, over many years and across a broad spectrum of companies. Decisions made in 2011 by companies, boards of directors, investors and the SEC may very well have consequences that are felt by public companies in 2012 and for many years thereafter.

Regulatory

Regulatory

Clearly, one of the responses to the economic and financial turmoil of the past several years has been a significant increase in legislative and regulatory oversight of business. The following offers guidance in key areas where business and regulation intersect with respect to transactions, risk prevention/avoidance, and the defense of conduct challenged by the government or private parties. We also discuss the increasing need to integrate litigation and regulatory strategies into many of the complex and highly publicized situations that businesses are facing more frequently. (See "Global Litigation.")

Communications: FCC Approves Controversial 'Network Neutrality' Rules

After a contentious, year-long proceeding that split the agency along political and ideological fault lines, the Federal Communications Commission (FCC) voted 3-2 on December 21, 2010, to adopt so-called "network neutrality" rules to regulate the provision of broadband Internet access to consumers. The party-line vote, over strenuous dissents from the FCC's two Republican commissioners, will for the first time implement binding rules to preclude Internet service providers (ISPs) from blocking consumers' access to lawful websites or applications and prevent ISPs from discriminating against disfavored content.

The new rules specifically will (i) restrict ISPs from blocking consumers' access to lawful content, applications and services on the Internet; (ii) bar fixed (wired) broadband providers from engaging in unreasonable discrimination in transmitting lawful network traffic; and (iii) require that ISPs provide consumers with clear and transparent information about the way that they manage broadband networks. Wireless broadband providers must abide by the no-blocking and transparency rules, but will have additional flexibility to prioritize traffic on their networks (except that they cannot favor co-owned traffic). All ISPs will be permitted to engage in "reasonable network management" — practices that are "appropriate and tailored to achiev[e] a legitimate network management purpose, taking into account the particular network architecture and technology" of the broadband service.

In response to the concerns of content creators and intellectual property owners about the large and growing threat of online piracy, the FCC indicated in its order that its rules would not prevent ISPs from making "reasonable efforts" to "address copyright infringement or other unlawful activity."

While the new rules will apply to the public Internet, the FCC also recognized that businesses are experimenting with new and innovative delivery models that distribute content parallel to the public Internet using the same network architecture. These so-called "specialized services," including types of voice-over-Internet Protocol (VOIP) and IP-video offerings, are too nascent to warrant regulation at this time. The FCC cautioned, however, that it will closely monitor the development of these services and will consider future regulation if "specialized services" threaten to impede the development of the public Internet.

The FCC's order was an attempt at compromise, with the agency taking a measured approach to its authority to exercise jurisdiction over the Internet. Proponents of the rules had urged the FCC to rely on its more expansive statutory powers to regulate telecommunications companies, but in anticipation of legal challenges, the FCC chose a narrower approach in an attempt to draw broader support. Ironically, this decision has led to criticism even from those quarters where support for network neutrality regulations was strongest — including those who feel that the new rules do not go far enough — while at

the same time has done little to decrease the likelihood of legal challenges. Indeed, the two Republican commissioners' dissents contain lengthy and detailed analyses of what they perceive to be the legal infirmities of the FCC's chosen approach. Various members of Congress also have threatened to introduce legislation in 2011 to unwind the new rules, or to at least preclude the agency from expending any funds to enforce them.

Congressional Investigations: Increased Investigatory Activity Anticipated in the 112th Congress

As expected, the Republican Caucus in the House of Representatives designated Darrell Issa (R-CA) as chairman of the Oversight and Government Reform Committee for the 112th Congress. Rep. Issa already has made several statements concerning his plans for the committee, telling *Politico* magazine on November 8, 2010, "I want seven hearings a week, times 40 weeks." As many as 80 investigative staff are expected to be on board once the Republican-controlled committee is operating at full force.

Rep. Issa has stated that he expects at least one of his seven subcommittees will hold a hearing every week, a plan that appears to be fully endorsed by his party's leadership. After the election, Majority Leader-elect Eric Cantor (R-VA) issued a report to his Republican colleagues entitled "Delivering on Our Commitment," which advises the new majority party "to highlight one major oversight hearing each week that plays into our overall focus on job creation and reducing spending."

Among the topics long on Rep. Issa's stated agenda are health care reform legislation, the TARP program, stimulus grants, Fannie Mae and Freddie Mac, Medicare and the U.S. Postal Service. Recently, he added airport security and WikiLeaks to the list. Private companies can anticipate becoming enmeshed in these investigations, especially those focused on alleged misfeasance by the Obama administration. These include companies affected by the new health care act; businesses impacted by the Dodd-Frank reforms; financial institutions involved in all aspects of the housing market, mortgages and foreclosures; companies that received or administered TARP funds or assets; businesses that benefited from federal stimulus funds; and defense and IT firms that contract with the government. Regarding how his committee and subcommittees will proceed, Rep. Issa told "Fox News Sunday's" Chris Wallace on November 7, 2010, "We're going to look for the person most knowledgeable of our problem and have them before our committee. And in many cases we're going to do it outside the public glare through depositions, with Republicans and Democrats both sitting there."

Other House committees appear less motivated to launch major corporate investigations. Indeed, at least one member of the House, Rep. Fred Upton (R-MI), indicated he had the opposite in mind. When selected as chairman of the House Energy and Commerce Committee, Rep. Upton announced that the "two-year assault on the health, energy and telecommunications sectors is now over." While such oversight activities may not target companies or industry sectors directly (as did House Democrats examining the financial crisis or Gulf oil spill), companies may become entangled in matters in which congressional panels are seeking to highlight deficiencies in agency, regulatory or enforcement action.

At the same time, Democrats remain in charge of the Senate's investigatory apparatus. Senate leadership has been preoccupied with attempting to get legislative initiatives passed in the lame-duck session, and leaders of the key Senate investigating committees have said little about their plans in the new Congress. If past is prologue, however, areas of focus are likely to include the housing foreclosure process, WikiLeaks and other Internet security and privacy issues, the operations of investment banks, consumer fraud and possibly even the safety of NFL football.

Companies can be caught off guard when a congressional investigation arises with little warning. If not properly handled, these inquiries can do substantial damage to a business's reputation and stock price and to the credibility of its top executives, as was demonstrated in myriad hearings involving the Gulf oil

spill in 2010. Once Congress begins such an investigation, the legal grounds to prevent it from proceeding are few. As the Supreme Court has stated, "[t]he scope of [Congress'] power of inquiry … is as penetrating and far-reaching as the potential power to enact and appropriate under the Constitution."[30] It extends to any subject that is, has been or might be the subject of legislation.[31] Short of a situation in which Congress has violated an individual's constitutional rights, courts rarely intervene in congressional inquiries. A company that becomes the focus of a congressional inquiry is therefore well advised to retain counsel with extensive experience in handling crisis situations and dealing with the media, and who is knowledgeable about the impact such investigations can have on any parallel criminal and civil proceedings.[32]

Energy: Regulations Affecting the Electric Power Industry

As prospects dim for significant new legislation affecting the energy industry, attention in 2011 will turn to new policies proposed by executive branch agencies, the impact of which is expected to be significant. What follows is a summary of key reforms likely to be proposed or adopted by the Federal Energy Regulatory Commission (FERC), the Commodity Futures Trading Commission (CFTC) and the Environmental Protection Agency (EPA).

FERC Policy Initiatives

Transmission Cost Allocation. The steady increase in renewable resources being connected to the grid has created sharp debates over who should pay for the associated transmission facilities necessary to deliver it to load. In June 2010, FERC proposed to require each region to conform its allocation policies to a set of new principles articulated by FERC. These principles appear to envision a broader allocation of costs than occurs in certain regions today, by proposing to eliminate the so-called "participant funding" approach to cost allocation. The comment period is now complete on FERC's proposal and a final rule is expected in mid-2011. Equally important, FERC is likely to rule in 2011 on a controversial cost allocation method for the PJM region (which stretches from New Jersey to Illinois) that was struck down by the U.S. Court of Appeals for the Seventh Circuit. In that case, FERC will reconsider its earlier decision to spread the cost of new, extra-high voltage 500kV facilities across the entire region. FERC collected new evidence on whether such facilities produce benefits to the entire region or, alternatively, mostly for customers in the eastern portion of PJM.

Variable Energy Resources. In addition to transmission cost allocation issues, renewable resources also have created operational challenges for grid operators. In November 2010, FERC proposed a new rule to address certain of these challenges and their cost implications. The proposed rule would (i) require utilities to offer intra-hour scheduling to allow for more accurate scheduling of variable resources, (ii) require variable resources to provide better meteorological and operational data to improve the forecasting capability of system operators, and (iii) allow public utilities to charge for generation regulation and frequency response service. FERC will be receiving comments on these proposals in the next few months and is expected to issue a final rule sometime in 2011.

Demand Response. Another challenging policy issue is the appropriate pricing for demand response offered into organized electricity markets. In March 2010, FERC proposed that demand responders (*i.e.*, energy consumers who have agreed to decrease their consumption when power is scarce) be compensated at the same wholesale price as power plants receive for the energy they generate. This proposal

[30] *Eastland v. U.S. Servicemen's Fund*, 421 U.S. 491, 504 n.15 (1975) (citation and internal quotation marks omitted).

[31] *Shelton v. United States*, 404 F.2d 1292, 1297 (D.C. Cir. 1969).

[32] *See* Skadden memorandum "How to Survive a Congressional Investigation," November 11, 2010.

has proven controversial, with economists and industry groups arguing that it would be efficient only if demand responders were first required to buy the power from their local utility at the retail price before selling it back at wholesale or, alternatively, if they received only the excess of the higher wholesale price over the lower retail price. Other groups contend that the proposal could be modified (*e.g.*, through a "net benefits" test) to address these concerns. In total, more than 200 comments were filed in response to the proposed rule. A final rule is expected in 2011.

Smart Grid. The "smart grid" encompasses a variety of technological advances, supported by policy reforms, that allow grid operators to increase the reliability and efficiency of the electric grid. One element of this reform agenda involves FERC. The Energy Independence and Security Act of 2007 required the National Institute of Standards and Technology to (i) coordinate efforts to achieve interoperability of Smart Grid devices and systems and (ii) then feed recommendations to FERC. The statute then directed that FERC adopt standards and protocols "necessary to insure smart-grid functionality and interoperability" in electric transmission and wholesale markets. In a Policy Statement issued in July 2009, FERC said it would adopt standards applicable to all power facilities and devices with Smart Grid features — explicitly including facilities/devices at the local distribution level and those directly used by retail customers if necessary to ensure interstate functionality and interoperability. FERC added that it may make compliance with its Smart Grid standards and protocols a *mandatory* condition for rate recovery of FERC-jurisdictional Smart Grid costs. After a long review process, on October 6, 2010, NIST sent five groups of new Smart Grids standards to FERC. The next day, FERC created a new rulemaking docket (RM11-2-000) and stated that it would issue a notice of proposed rulemaking "in the near future."

CFTC Proposals To Implement Dodd-Frank

In Title VII of Dodd-Frank, Congress defines the term "swap" very broadly and directs the CFTC to refine the scope of which agreements, contracts or transactions are to be considered swaps (see "Financial Regulation/Derivatives"). At least until the CFTC provides further clarity through interpretation or rule, we will not know the full breadth of energy agreements, contracts or transactions that will be regulated as swaps. Examples of energy contracts, transactions or agreements that could be swaps include:

- Financial Transmission Rights contracts;
- Contracts for Differences in energy or ancillary products (*e.g.*, capacity); and
- any transactions in an organized market's day-ahead market that are not intended to be settled physically.

The Dodd-Frank regulatory consequences for swaps are serious and comprehensive. Generally speaking, Dodd-Frank creates two categories of persons whose extensive use of swaps requires regulation: swap dealers and major swap participants, both of which will be subject to extensive regulatory requirements for capital, margin, business conduct, recordkeeping and daily reporting.

Dodd-Frank also divides swaps into two categories: swaps the CFTC determines must be exchange-traded and cleared ("cleared swaps") and swaps that are not required to be cleared ("uncleared swaps"). Swap dealers and major swap participants will be required to trade cleared swaps on exchanges and submit them for clearing. The only exception to this requirement will be for swaps entered into with qualified "commercial end-users," who will be allowed to elect whether to clear or exchange-trade those swaps held to hedge or mitigate "commercial risk." Uncleared swaps will be subject to capital, margin, recordkeeping, reporting and business conduct requirements (see below).

Swap Dealers

The CFTC is establishing rules to determine who must be regulated as a swap dealer or major swap participant. Under the CFTC's proposal, a person would generally be a swap dealer if that person:

- holds oneself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties as an ordinary course of business for one's own account; or
- engages in activity causing oneself to be commonly known in the trade as a dealer or market maker in swaps.

Major Swap Participants

A nonswap dealer would be a major swap participant if that person's swap positions equal or exceed the CFTC's proposed thresholds:

- $3 billion of current exposure in rate swaps (swaps based primarily on reference rates);
- $6 billion of combined current exposure and potential future exposure in rate swaps;
- $1 billion of current exposure or $2 billion of combined current exposure and potential future exposure in:
  - credit swaps (swaps based primarily on indebtedness);
  - equity swaps (swaps based primarily on equity securities); or
  - other commodity swaps (swaps that are not rate swaps, credit swaps or equity swaps — this would likely include most, and maybe all, energy swaps); or
- $5 billion of current exposure or $8 billion of combined current exposure and potential future exposure in all swaps collectively.

Commercial End-User Exemptions

Businesses that use swaps may be exempt from (i) the major swap participant definition and (ii) the exchange-trading and clearing mandate for "cleared swaps" to the extent the business enters into swaps to hedge or mitigate commercial risk. The CFTC's recent proposals would define when a swap would be considered to hedge or mitigate commercial risk as when a swap:

- is economically appropriate to the reduction of certain risk in the conduct and management of a commercial enterprise;
- would qualify as bona fide hedging for position-limit purposes; or
- would qualify for hedging treatment under certain accounting principles.

A swap would **not** be considered to hedge or mitigate commercial risk if that swap is used:

- to speculate, invest or trade; or
- to hedge or mitigate the risk of another swap (unless that other swap is used to hedge or mitigate commercial risk).

Regulating Uncleared Swaps

Uncleared swaps also will become subject to extensive new regulation, including comprehensive reporting and recordkeeping. Dodd-Frank requires the CFTC to adopt initial and variation margin

requirements on uncleared swaps for swap dealers and major swap participants. In a Senate floor colloquy, Sen. Chris Dodd (D-CT and chairman of Senate Banking Committee) and former Sen. Blanche Lincoln (D-AR and chairman of Senate Agricultural Committee) stated that Congress intended the regulators to impose margin requirements only on swap dealers and major swap participants, not on end-users who qualify for the exemption from mandatory clearing.[33] However, some members of the CFTC have questioned whether these margin requirements should be applied to end-users too.

Position Limits

If the CFTC determines position limits are necessary or appropriate for energy swaps and futures, Dodd-Frank requires the CFTC to establish position limits: (i) by instrument (*i.e.*, on energy futures, options and swaps separately) and (ii) by commodity *(i.e.*, on the aggregate number of futures, options and swaps per energy commodity). While many believed Dodd-Frank mandates that the CFTC adopt these limits by January 17, 2011, it is very unlikely limits will be imposed by that date as the CFTC has yet to publish proposed rules in this area.

Whistleblowers

Dodd-Frank encourages whistleblowers to provide information about potential violations of commodities law to the CFTC by offering protection against retaliation and substantial monetary incentives (up to 30 percent of monetary sanctions imposed in the resulting action). The CFTC has proposed and will adopt rules governing the procedures through which potential whistleblowers may submit information and apply for award payments.

EPA Regulatory Developments

The electric power industry is facing a plethora of air, water and solid waste regulations that will impose significant retrofit requirements on existing generating units. These regulatory developments include the following:

Clean Air Act

Hazardous Air Pollutants. In accordance with a consent decree entered in April 2010, the EPA is committed to proposing regulations limiting emissions of hazardous air pollutants (HAPs) from coal- and oil-fired electrical generating units that are major sources of HAPs by March 16, 2011, and finalizing such regulations by November 16, 2011. The emissions standards must be designed to achieve the maximum degree of emission reduction that the EPA determines is achievable for the affected units, taking into account costs and non-air quality environmental and health benefits (MACT). Unlike the Clean Air Mercury Rule that was vacated in 2008, the EPA must regulate all of the hazardous air pollutants emitted by these generating units. Based on the proposed industrial boiler MACT rule, it is anticipated that the EPA will propose MACT limitations for mercury, particulate matter (as a surrogate for nonmercury metallic HAPs), hydrogen chloride (surrogate for acid gas HAPs), carbon monoxide (surrogate for nondioxin organic HAPs) and dioxin/furans. Compliance with the MACT standards will be required three years after the effective date of the final regulation.

Clean Air Transport Rule. In July 2010, the EPA proposed the Clean Air Transport Rule (CATR) as a replacement for the Clean Air Interstate Rule, which was vacated in 2008 but later remanded to the EPA. The EPA anticipates finalizing this regulation in mid-2011. The purpose of CATR is to limit the interstate transport of sulfur dioxide and nitrogen oxide emissions that interfere with attainment or maintenance of the 1997 ozone national ambient air quality standard (NAAQS) and the 1997 annual and 2006 24-hour fine particulate matter NAAQS in downwind states. Thirty-one states in the East, South and Midwest

[33]Congressional Record — Senate, July 15, 2010, S5904.

will be required to comply with state budgets for sulfur dioxide and annual nitrogen oxide emissions (to address interference with the fine particulate matter standards) and/or ozone season nitrogen oxide emissions (to address interference with the ozone standard). The EPA has proposed three alternative rules: (i) the preferred alternative, which would allow intrastate emissions trading and limited interstate emissions trading; (ii) a second alternative that would allow only intrastate emissions trading; and (iii) an alternative that would not allow emissions trading, but would allow system averaging for commonly owned or operated emission units located within a state. Phase I of CATR goes into effect in 2012, and Phase II of CATR (reducing sulfur dioxide emission budgets in 15 states) becomes effective in 2014.

On a related note, the EPA has proposed a revision to the eight-hour primary ozone NAAQS and also will promulgate a secondary ozone standard to protect sensitive vegetation and ecosystems. The EPA had intended to finalize the revision to the eight-hour ozone NAAQS by December 2010, but on December 8, the EPA filed a motion requesting an extension until July 2011. It is expected that once the EPA finalizes the revised ozone NAAQS, it will propose a second Clean Air Transport Rule that may further impact electric power generating units. The EPA also intends to propose revised fine particulate matter NAAQS in 2011, which could result in further emission reduction requirements in future years.

Clean Water Act

Cooling Water Intake Structures. Section 316(b) of the Clean Water Act requires the EPA to ensure that the location, design, construction and capacity of cooling water intake structures (CWIS) reflect the best technology available (BTA) for minimizing adverse environmental impacts. Although the EPA recently stated that it intended to propose a Section 316(b) regulation covering all existing electrical generation units and manufacturing facilities in 2011 and to finalize this regulation by July 2012, there have been reports that it intends to enter into a consent order with environmental groups that may extend those deadlines. Significant issues in this rulemaking will include the extent to which facilities will be required to replace once-through cooling water systems with closed-loop cooling systems and the extent to which the EPA will authorize site-specific variances based on cost/benefit analysis.

Effluent Limitations Guidelines. The EPA also has begun work on revising its technology-based limitations for pollutant discharges from steam electrical generating units, last revised in 1982. The updated regulations are expected to address, among other things, wastewater pollutants arising from the operation of ash ponds and flue gas desulfurization air pollution controls, the use of which are expected to expand as a result of the air pollution control regulations discussed above. In November 2010, the EPA entered into a consent decree with the Sierra Club and Defenders of Wildlife that requires the EPA to propose regulations by July 2012 and complete action on the regulations by January 2014.

Resource Conservation and Recovery Act

Coal Combustion Residuals. In May 2010, the EPA issued a proposal to regulate coal combustion residuals (CCR) generated by the combustion of coal at electrical generating facilities. We anticipate that the EPA will issue final regulations in 2011. The EPA proposed two alternatives. Under either proposal, most beneficial reuse of CCR would continue to be exempt from regulation, although the use of CCR as fill in operations such as sand and gravel pits and quarries would not be considered beneficial reuse.

Under one alternative, CCR would be regulated as "special wastes" that would, with certain modifications, subject the storage, transport, treatment and disposal of such wastes to hazardous waste regulation. Such regulations generally would subject existing treatment and disposal units, such as landfills and surface impoundments, to the applicable hazardous waste technical standards for such units, including liner, leachate collection and location requirements. It is likely that surface impoundments handling "wet" CCR would not be retrofitted and would therefore need to be closed no later than five years after the effective date of the regulation.

Under the other alternative, CCR would continue to be exempt from hazardous waste regulation but would be subject to minimum criteria governing its disposal. The technical standards under this alternative (the "Subtitle D" option) would be similar to the first alternative (the "Subtitle C" alternative), but there would be a few significant differences, including that existing landfills would not be required to be retrofitted to meet the liner/leachate collection standards (although groundwater monitoring would be required). Existing surface impoundments would need to be retrofitted to meet the standards, although the EPA also requested comment on an alternative that would allow existing surface impoundments to operate for the remainder of their useful life.

Health Care: Politics Will Dominate Media Coverage but Is Unlikely To Alter Near-Term Business Trends

The Debate Over Health Care Reform

The contentiousness of 2010's health care reform effort appears headed for an encore in 2011. Although the Patient Protection and Affordable Care Act (PPACA) is officially in the books and various provisions are slated to come into effect in 2011, debates about the legislation's sustainability, fairness and even legality show no signs of slowing. Two potentially conflicting efforts will play out in the coming year: As the administration attempts to push through rulemaking to implement PPACA, some members of Congress and state attorneys general will continue efforts to block portions of the legislation from taking effect. In many ways, 2011 will be the year in which the business community finds out whether reform floats or sinks.

Some PPACA provisions will go into effect in 2011 for the first time. For example:

- The market-share-based fees on pharmaceutical manufacturers will begin, with the sector paying $2.5 billion in 2011.
- Manufacturers of brand-name drugs will begin providing a discount for drugs in the Part D coverage gap. The federal government will begin providing a discount for generic drugs in the gap.
- The biggest single year for federal anti-fraud funding under PPACA will be 2011, with the $10 million annual allocation being supplemented with a one-time-only $95 million.
- When the medical-loss ratio for plans in the large group market reaches 85 percent (or 80 percent for plans in the small group and individual markets), these plans must provide rebates. This obligation extends to plans that are otherwise granted "grandfathering" protection from some other requirements; however, self-insurance plans are not affected by this requirement.
- Employers will be required to include the value of employee insurance benefits on W-2s, though the administration has indicated it would work with Congress to repeal or modify this requirement.
- Taxes on personal savings accounts will increase. The tax on health savings account and Archer medical savings account distributions not used for qualified medical expenses will rise to 20 percent. Over-the-counter drug purchases from health reimbursement arrangements and health flexible savings accounts will not be allowed, and such purchases from health savings accounts and Archer medical savings accounts will be taxed.
- Several cost-cutting reforms will begin. The Centers for Medicare and Medicaid Services and Center for Medicare and Medicaid Innovation will be established to test payment reforms to Medicare, Medicaid and the Children's Health Insurance Program that reduce costs and preserve quality. Medicare Advantage payments will freeze. Also, the Department of Health and Human Services

(HHS) will report to Congress on how to move home health and nursing home providers into a value-based purchasing payment system, and a five-year grant program designed to encourage states to implement medical malpractice litigation alternatives will begin.

- Medicare beneficiaries will be entitled to a free annual wellness visit and will not be asked to participate in cost-sharing for preventive services.
- The federal government will provide $11 billion over five years, starting this year, for community health centers.

While outright repeal of PPACA is highly unlikely, repeal or modification of certain provisions may be more realistic. The list of targets includes the mandate for individuals to purchase insurance, the Independent Payment Advisory Board that will attempt to control Medicare spending and the tax on high-end insurance. One provision likely to change is the requirement that employers issue 1099 statements to anyone with whom they do more than $600 in business. The president has said this provision is too burdensome and that he is open to changing it.

- PPACA foes have other options to use against the legislation. They could vote to withhold funding for various provisions (as was done successfully during the lame-duck session of the 111th Congress during consideration of the continuing resolution), an option that may gain traction in a deficit-wary political climate but which may risk a government shutdown. The House also is likely to use its oversight authority to slow down or block the promulgation of regulations.

Finally, state attorneys general will continue their efforts to challenge the legality of some of the law's provisions. With early district court successes in Virginia and Florida, and the administration vowing aggressive appeals, the issue is all but certain to end at the Supreme Court.

Reform or Not — Enforcement Will Take Center Stage

While the political parties disagree on many health policy matters, one area has broad bipartisan support: tougher enforcement of laws combating health care fraud and abuse. Within the past two years, Congress has passed two major packages of tougher health care fraud laws, with increased penalties, new compliance and overpayment requirements, and increased resources for prosecutors and investigative agencies.

More troubling than the overall increase in enforcement scrutiny is the government's more aggressive targeting of individuals — particularly executives — for prosecution and enforcement action. Within the past 12 months, prosecutors have charged several senior business executives and an in-house lawyer with health care fraud-related offenses, reflecting a policy decision within the federal law enforcement community to hold individuals accountable for corporate malfeasance. Prosecution, however, is not the only area of increased enforcement activity. The HHS Office of Inspector General has followed through on its threat to use its exclusion authorities more aggressively, forcing a foreign-based medical device company to divest its U.S. operating company (with more than 100 employees) following a guilty plea and, in a separate case, excluding a former pharmaceutical company CEO following the company's guilty plea to manufacturing-related violations of the Food, Drug and Cosmetic Act. Every indication is that the recent uptick in the prosecution and exclusion of individuals is not an aberration but rather a policy decision that is not likely to be reversed in the near term.

Politics Won't Alter Near-Term Trends for Health Care Companies

Last year, we predicted that health care reform would create winners and losers through (i) changes in health care business models, (ii) new taxes and fees, and (iii) changes in how hundreds of billions of dollars are spent by federal and state governments. We also predicted that one of the basic policy tradeoffs in the health care reform law — expanded coverage for tens of millions of Americans which

would increase overall health care expenditures but compress margins by reduced reimbursement rates and increased costs — would lead to sector consolidation as companies seek profitability through economies of scale. For the most part, these predictions have come true.

Merger activity in the health care sector has been relatively strong, with more than 10 deals exceeding $1 billion in 2010. Sectors with comparatively robust M&A activity include hospitals and health systems, pharmaceutical manufacturers, medical device makers and health insurance companies (see "Global M&A"). We believe the drivers of this activity — particularly the legislative changes in the health care reform legislation and the continued low cost of debt and financing options — will persist through 2011.

In addition to M&A activity across the health care sector generally, we believe large pharmaceutical and medical device manufacturers will seek to bolster product pipelines and offset patent expirations through aggressive pursuit of in-licensing activities in the U.S. markets and expanded operations in foreign markets, where sales growth can exceed 20 percent or more in some major markets. Companies with specialty products that address serious health conditions (*e.g.*, oncology, HIV/AIDS, asthma) and have superior clinical effectiveness data will be highly valued, particularly those without near-term generic competition (*e.g.*, biotechnology products), while primary care products with lower-cost competitors will continue to face serious pricing pressures. Companies with significant exposure to Medicaid may experience headwinds, as significant new Medicaid spending by the federal government called for in PPACA may be offset by belt-tightening and budget cuts by cash-strapped state governments.

Health care providers will face many of the same pressures as pharmaceutical and device manufacturers. Consolidation will continue as companies seek profitability by expanding volume to offset reductions in reimbursement rates. Also, larger companies are in a better position to address the health care reform law's new requirements relating to health IT, patient safety, and quality monitoring and reporting. As with manufacturers, providers with significant exposure to Medicaid will encounter challenges due to government budget pressures.

Privacy: On the Road to Comprehensive Privacy Legislation?

Over the past decade, there has been considerable debate over whether the United States ever would enact the type of omnibus data privacy legislation that exists in the EU member states and certain other countries. While data privacy laws have been enacted in the U.S. to protect certain types of personal information — such as health information or data held by financial services companies — most felt that omnibus federal data privacy legislation would result only if there was a significant new technological development that reshaped the manner in which Americans viewed their personal information. While such legislation still has not been enacted, the U.S. appears to be closer than ever to adopting such an approach.

Interestingly, the catalyst for this legislative activity has not been any single new technology or any new approach to collecting and mining data. Rather, over the past 24 months a steady drumbeat of new developments and disclosures of existing data practices has caused Americans to question how they want their personal information being used and their online activities being tracked. A consensus also is emerging that technology developments have far outpaced existing privacy protections, exposing Americans to unwanted uses of their personal information. As an example, traditional distinctions between personally identifiable information (such as name and address) and "anonymous" information are eroded when companies can use techniques such as browser "fingerprinting" or a mobile device's Unique Device Identifier to build robust data profiles about an individual without actually learning the individual's name.

The difficulty faced by many consumers, as well as U.S. legislators and regulators, is that expansive uses of personal information offer certain benefits (such as targeted advertising or personalized content) that consumers appreciate in certain circumstances but find overly invasive in other situations. Moreover,

through services like Facebook, Twitter and Foursquare, an unprecedented number of people are voluntarily disclosing their personal information, suggesting to some that individuals are becoming less concerned about how their information might be used. Others feel, however, that most people do not fully appreciate how their information and Internet activity is being collected, tracked and stored.

There is a similar tension with respect to whether increased data privacy regulation will impede or fuel the burgeoning online advertising industry. Some argue that any new laws or regulations could have a detrimental impact on this multibillion-dollar business, a result that no lawmaker wants to be associated with in a weakened economy. Others argue that increased regulation is actually necessary to grow the online sector, because consumers need a better sense of security when they transact online or adopt new technologies.

Despite these inherent tensions, momentum appears to be building slowly on a number of fronts toward enactment of broad-based data privacy legislation in the United States. At present, five main legislative or regulatory initiatives, each described below, are under way in the U.S.: a Federal Trade Commission preliminary staff report, a Department of Commerce green paper on privacy, two House bills on privacy and a newly created executive branch task force on privacy. Additionally, new privacy initiatives are not limited to the United States. In November 2010, the European Commission outlined its proposed strategy to strengthen data protection in the EU, which includes improving the transparency of privacy policies and giving consumers greater rights to have the information deleted when it is no longer required.

Proposed House Legislation

In May 2010, Reps. Rick Boucher (D-VA) and Cliff Stearns (R-FL) released a discussion draft of an omnibus privacy bill.[34] The bill would apply to any entity that collects personal information from more than 5,000 individuals in a 12-month period, either offline or online; such information would include "preference profiles" (*i.e.*, a list of information or preferences associated with a specific individual or a computer/device). Before collecting, using or storing any personal information, a company must provide a clear and conspicuous privacy notice that includes, among other items, a description of the information collected, the purpose for which it is collected, and how individuals can exercise choice and access rights.

While opt-out consent would be permitted for many data uses, the bill would require opt-in consent for a number of common online practices including: (i) selling, sharing or otherwise disclosing personal information to unaffiliated parties; (ii) collecting or disclosing sensitive information (such as health information); (iii) collecting or disclosing personal information about all or substantially all of an individual's online activity, including across websites; (iv) using information for a purpose different than that for which it was disclosed; and (v) using location-based information.

The FTC would be responsible for implementing and enforcing the legislation, and states also would have the right to enforce the FTC's rules through state attorneys general or consumer protection agencies.

In July 2010, Rep. Bobby Rush (D-IL) introduced the Building Effective Strategies to Promote Responsibility Accountability Choice Transparency Innovation Consumer Expectations and Safeguards ("Best Practices") Act. The Best Practices Act includes many of the same concepts as the Boucher/Stearns discussion draft, with the following key differences. The Best Practices Act:

- provides the FTC with considerably more discretion to craft appropriate privacy regulations;
- covers a broader range of "fair information practice principles" than the Boucher/Stearns draft;
- permits individuals to bring certain civil actions, while the Boucher/Stearns draft contains no such right; and

[34]Rep. Boucher lost his reelection bid in November.

- provides that companies participating in FTC-approved self-regulatory programs are in a "safe harbor" and are not subject to the act's opt-in consent requirements, access requirements or private right of action provisions.

As a general matter, the Best Practices Act has received greater support than the Boucher-Stearns draft from both privacy advocates and businesses. Privacy advocates have been pleased with the proposed act's greater protection of personal information, while businesses are supportive of the "safe harbor" approach. Although other federal privacy legislation has been proposed in the past, the Best Practices Act addresses many of the concerns of the privacy community and comes at a time when there is an increased focus on privacy legislation. In addition, given that privacy protection is enjoying broad bipartisan support, there is an increased likelihood of such legislation being enacted.

The FTC Preliminary Staff Report — Protecting Consumer Privacy in an Era of Rapid Change

On December 1, 2010, the FTC issued its long-awaited preliminary staff report on Protecting Consumer Privacy in an Era of Rapid Change. The report first describes the FTC's long history of regulating privacy in the United States. (Indeed, the accompanying press release notes that the FTC has been "the nation's chief privacy policy and enforcement agency for 40 years.") The report then proposes a framework "to inform policymakers as they develop solutions, policies, and potential laws governing privacy, and to guide and motivate industry as it develops and refines best practices and self-regulatory guidelines."

As part of this proposed framework, the FTC first notes the limitations of the "notice-and-choice" model, in which consumers are informed about a company's privacy policies through a privacy notice and then have the choice either not to provide their data or, in some cases, to "opt out" of their data being used. According to the FTC staff report, privacy policies have become increasingly complex and fail to spell out the choices for consumers. Significantly, the FTC also recognizes that the harm to consumers from misuse of their personal information extends beyond traditional physical or economic injury. Rather, given today's technology, the potential harm includes reputational harm, fear of being monitored and simply "having private information 'out there.'"

The FTC framework includes four basic principles:

- **Scope.** The framework applies to all commercial entities collecting or using consumer data that can be reasonably linked to a specific consumer, computer or other device. The key to this principle is the FTC's inclusion of computers and devices, thereby addressing the fact that "anonymous" information linked to a device also can invade an individual's privacy.

- **Privacy by design.** The "privacy by design" concept states that companies should promote consumer privacy and incorporate privacy protection into their product and service development cycles. In addition, companies should limit the data they collect to what is necessary to provide the products or services being offered and delete data when it no longer is required.

- **Simplified choice.** The FTC is concerned that consumers do not realize the choice they have regarding how their data is used because: (i) They typically are informed of this choice only once, and (ii) such notice often is relegated to a dense privacy policy that few people read. The FTC therefore recommends that consumers be offered the choice "at a time and in a context" when their data is going to be used. So that such choice options do not become overly intrusive, the FTC also suggests that choice not be required for commonly accepted practices, such as product fulfillment.

  The most important FTC pronouncement with respect to choice relates to behavioral advertising (*i.e.*, the display of ads based on a consumer's browsing habits). The FTC notes that while some companies participate in self-regulatory systems that allow consumers to opt out of behavioral advertising, industry efforts have, in the view of the FTC, fallen short. The FTC therefore has supported the implementation of a "Do Not Track" mechanism; namely, a cookie or other technology that would

signal to companies that the user does not want to be tracked. This mechanism could be put in place by legislation or possibly by "robust, enforceable self-regulation."

- **Greater transparency.** The transparency principle is the core of the FTC staff report and includes four subprinciples:
  - The FTC advocates the use of clearer, shorter and more standardized privacy policies so a consumer can more easily compare the privacy practices of different entities. It should be noted that while such standardization may seem reasonable, many financial institutions have been frustrated with the form model privacy notices that were introduced this year under Gramm-Leach Bliley (GLB). The experience under GLB suggests that a "one-size-fits-all" approach may not work for privacy protection.
  - Companies should provide consumers with reasonable access to their data, a principle that already exists in the EU and is required today of companies participating in the U.S.-EU Safe Harbor framework.
  - Companies must provide prominent disclosures and obtain affirmative (*i.e.*, "opt-in") consent before using personal data in a "materially different manner" than was claimed when the data was collected.
  - All "stakeholders" should expand their efforts to educate consumers about commercial data privacy practices.

Perhaps most importantly for companies, the FTC indicates that until comprehensive privacy legislation is enacted, it will "continue its vigorous law enforcement of the privacy area" under Section 5 of the FTC Act and other privacy laws it enforces. While some privacy advocates question whether the FTC has truly engaged in "vigorous enforcement" over the past few years, the issuance of the staff report and the FTC's activities in certain privacy cases suggest that the FTC may indeed be adopting a more proactive role in the privacy sphere.

The report is replete with questions for the industry regarding how different matters should be addressed, and public comments on the report are being accepted until January 31, 2011. Any company that uses or processes personal information, or that builds profiles from anonymous data, should take advantage of this public comment period.

The Department of Commerce Green Paper

On December 16, 2010, just two weeks after the FTC staff report was released, the Department of Commerce (DOC) Internet Policy Task Force released its own green paper, setting forth the department's views on data privacy. The green paper does not advocate any specific policy proposal. Rather, it sets forth possible approaches and invites further discussion in the domestic and global policy communities. Overall, the DOC advocates a self-regulatory framework, but with regulatory authorities stepping in if self-regulation falls short.

The centerpiece of the green paper is a "Dynamic Privacy Framework," which consists of policy recommendations in four categories:

- **Revitalized Fair Information Practice Principles.** The DOC notes that many Internet users misunderstand commercial data privacy protections, and therefore recommends that the U.S. government recognize Fair Information Practice Principles. These principles should emphasize substantive privacy protection "rather than simply creating procedural hurdles," and they should include the promotion of clear and simple privacy notices and commitments to limit data to fulfill stated purposes. Significantly, the DOC notes that possible approaches include "voluntary, enforceable codes of conduct"; safe harbors against FTC enforcement for complying with these codes; and disfavoring "prescriptive rules."

- **Voluntary privacy codes and the creation of a Privacy Policy Office.** The DOC advocates multistakeholder bodies in which commercial and noncommercial actors voluntarily participate to create voluntary codes of conduct that promote informed consent and safeguard personal information. Regulatory authorities would step in if these bodies did not create meaningful data practices. In order for the government to coordinate these efforts, the DOC recommends the creation of a Privacy Policy Office (within the DOC).

- **Global interoperability.** The DOC notes that disparate global privacy laws have an adverse impact on global competition and recommends that the U.S. take a leadership role in the global privacy policy debate. This includes establishing that the U.S. has a strong privacy framework that it is committed to strengthening. The DOC also acknowledges the burden that many companies face in satisfying EU requirements for transborder data flow to the United States. However, the DOC appears to advocate an acceptance by the EU of a self-regulatory framework in the U.S., rather than the enactment of omnibus data privacy legislation.

- **National security breach notification rules.** Today, almost every state requires notification to affected consumers in the event a company suffers a data security breach. Any company that has provided such notice is well aware of the many differences that exist in these laws from state to state. The DOC therefore recommends the creation of a unified breach notification rule that would harmonize these various state requirements and would be enforced by state authorities and the FTC.

The green paper marks just the first step in the DOC's analysis of these issues. The DOC has invited comments and input as it works toward the creation of its final white paper on this topic.

Obama Administration Task Force on Privacy

In October 2010, a new White House Subcommittee on Privacy and Internet Policy was formed with the mandate of working with the DOC and FTC on Internet policy and privacy issues. The subcommittee, which is part of the White House's National Science and Technology Council's Committee on Technology, is being co-chaired by Cameron Kerry, general counsel at the DOC, and Christopher Schroeder, assistant attorney general at the U.S. Department of Justice. Other agencies represented on the subcommittee include the departments of Education, Energy, Health and Human Services, Homeland Security, State, Transportation and Treasury.

The subcommittee's charter states that its mission is to "develop strategic direction on information privacy policy that can guide legislative, regulatory and international policy consensus." Currently, the subcommittee is focused on three main deliverables:

- an "Administration White Paper on Information Privacy in the Internet Age" that builds on the work of the FTC and DOC and examines the development of new privacy protection tools as well as cloud-computing issues;

- development of Internet policy principles that will focus on a variety of issues, including cybersecurity and intellectual property enforcement; and

- coordination of the administration's statements on privacy and Internet policy.

* * *

At present, no major operational changes are required by companies to respond to the flurry of activity surrounding the privacy debate. However, companies should be cognizant that privacy, and particularly online data privacy, is receiving an unprecedented amount of attention and, potentially, regulatory enforcement. Companies are well advised to audit their privacy practices to ensure that they are consistent with their stated privacy policies. In addition, companies should carefully consider whether any data use or

mining they are conducting, while technically permissible, might create public relations or reputational issues if disclosed. Finally, companies should closely monitor legislative and regulatory developments in this area in 2011.

Tax: Recent International Tax Law Changes Impact U.S. Multinationals' Ability To Claim Foreign Tax Credits; Present Challenges and Opportunities

On August 10, 2010, President Obama signed into law the Education Jobs and Medicaid Assistance Act of 2010, which contains several provisions (two of which are discussed here) that will impose higher taxes when U.S.-based multinationals access their foreign earnings. Because the United States taxes a U.S. corporation's worldwide income, a taxpayer may credit foreign taxes against its U.S. tax liability to ensure that the same income is not taxed twice, once by the non-U.S. jurisdiction where it is earned and again by the United States. The new provisions, generally effective beginning in 2011, defer or permanently disallow foreign tax credits that otherwise would be available to the U.S. multinational, either when it earns the income directly through a branch or when it brings back foreign earnings from a subsidiary through a dividend or loan.

The increased tax costs on foreign earnings will further exacerbate the competitive disadvantage U.S. corporations face. As a result, these changes may cause some U.S. corporations to reassess the carrying costs of noncore operations. Because many non-U.S. entities are subject to a significantly lower tax burden, they may bring extra tax efficiencies to bear once they acquire a U.S. corporation's non-U.S. business. For example, many non-U.S. entities would not be subject to tax in their home jurisdiction when they withdraw earnings from another country, thus allowing them to move earnings more easily within their tax structure.

'Hopscotch Loans'

When a U.S. taxpayer borrows from a foreign subsidiary, it generally is deemed to have received a taxable dividend directly from the lending subsidiary, and the U.S. borrower is able to credit a portion of the foreign taxes paid by the foreign lending subsidiary against its U.S. tax liability for the deemed dividend. These deemed dividends and foreign tax credits are said to "hopscotch" over any subsidiaries between the lending foreign subsidiary and the ultimate U.S. shareholder. Under prior law, where the foreign lending subsidiary paid a high tax rate in its local jurisdiction, there may have been little or no residual U.S. tax due upon the loan, notwithstanding that the high-taxed foreign subsidiary was owned indirectly through a low-taxed foreign subsidiary (for example, a holding company in a low-tax jurisdiction).

New Anti-Hopscotch Provision

New Section 960(c), effective for loans (and certain other acquisitions of "United States property" by foreign subsidiaries) made after December 31, 2010, limits the amount of foreign tax credit that is available when a foreign subsidiary lends earnings to its indirect U.S. shareholder. The new provision will limit the amount of foreign tax credits available to the lesser of the amount determined under prior law or the amount that would be available if the foreign subsidiary instead actually had distributed a dividend through the chain of ownership to its indirect U.S. shareholder; generally this will dilute the amount of foreign tax credits available when a high-taxed foreign subsidiary is owned by a low-taxed subsidiary (a common tax structure).

Basis Step-Up Transactions

U.S. taxpayers may achieve a "step up" in the basis of non-U.S. assets for U.S. tax purposes by making a special election in connection with certain acquisitions of stock of a corporation or of a partnership interest, or by acquiring equity in an entity that is disregarded for U.S. tax purposes (which is viewed as a direct asset purchase for such purposes). Amortization or depreciation deductions with respect to the increased tax basis result in a difference between the foreign income upon which foreign tax is levied and the U.S. income upon which U.S. tax is levied and with respect to which a foreign tax credit may be allowed. In other words, a U.S. taxpayer may include an amount of foreign income that has been reduced by depreciation deductions for U.S. tax purposes while it credits an amount of foreign taxes that have been imposed on a comparatively greater amount of income for non-U.S. tax purposes.

Foreign Tax Credits Attributable to Basis Differences Disallowed

New Section 901(m) disallows a portion of foreign tax credits attributable to a "covered asset acquisition" occurring after December 31, 2010. For this purpose, "covered asset acquisition" corresponds to the type of basis step-up transaction described above. A portion of foreign tax credits will be disallowed based on a ratio of (i) the aggregate basis differences under U.S. and foreign tax law, and (ii) the income on which foreign tax is levied (determined under local law).

Going Forward

U.S. multinationals should revisit their existing organizational structures and tax-planning strategies in light of these (and other) new changes to determine whether structural or operational changes are warranted. In addition, these higher tax costs may lead U.S. multinationals to reconsider the "carrying cost" of noncore operations abroad. A strategic non-U.S. buyer, operating in a lower-tax jurisdiction, may value a U.S. corporation's non-U.S. operations more than the U.S. corporation does and may be willing to pay a premium for such operations.

White Collar Crime

As 2010 came to a close, Lanny Breuer addressed what every white collar lawyer wanted to know heading into a new year — "emerging enforcement trends" from the DOJ's perspective. Breuer, who serves as assistant attorney general for the Criminal Division, underscored "the reinvigoration of the DOJ's criminal enforcement program" by highlighting the addition of more than 30 new prosecutors in the DOJ's Fraud Section, increased reliance on "undercover investigative techniques," and enhanced and "on the rise" Foreign Corrupt Practices Act (FCPA) enforcement. The message was clear: the DOJ has "stepped up [its] white collar investigations and prosecutions in the last year and a half," and that trend will continue in 2011.[35]

The DOJ's message for the new year, which undoubtedly is responsive to calls for a more proactive approach to investigating and prosecuting financial crime, paints this picture of the 2011 white collar law enforcement agenda:

- **Insider trading.** Federal prosecutors will continue their aggressive pursuit of insider trading. U.S. Attorney for the Southern District of New York Preet Bharara, who brought the pending and highly visible case against Galleon Group founder Raj Rajaratnam, recently stated that "insider trading is rampant and may even be on the rise," and thus is his "top criminal priority."[36] The Galleon investigation alone reportedly has resulted in 23 arrests and 14 guilty pleas, in addition to sparking vibrant

[35]Remarks of Assistant Attorney General Lanny A. Breuer at the Practising Law Institute (Nov. 4, 2010).

[36]Remarks of United States Attorney Preet Bharara at the New York City Bar Association (Oct. 20, 2010).

debate about the DOJ's use of wiretaps in white collar cases. The end of the year saw new headlines of insider trading arrests, and we anticipate no reversal of the trend in 2011.

- **Investment and mortgage fraud.** In December 2010, Attorney General Eric Holder minced no words in stating that "financial fraud crimes have reached crisis proportions," and that the DOJ, as a member of President Obama's Financial Fraud Enforcement Task Force, will remain focused on the full gamut of financial fraud, especially investment and mortgage schemes.[37] The icon from last year is the DOJ's prosecution of former Taylor, Bean & Whitaker Mortgage Corporation Chairman Lee Bentley Farkas for bank and mortgage fraud that allegedly resulted in losses of more than $1.9 billion. The Farkas prosecution entails allegations of TARP fraud, demonstrating continued law enforcement focus on cases connected to the credit crisis. Indeed, in his most recent report to Congress, the special inspector general for the Troubled Asset Relief Program revealed its participation in "130 ongoing criminal and civil investigations," ranging from TARP fraud to false statement and obstruction of justice cases.[38] We expect the past to be prologue in these areas.

- **Foreign corrupt practices.** The DOJ is coming off a record year in FCPA enforcement, having collected "well over $1 billion" in penalties and marking what Lanny Breuer recently called "a new era of FCPA enforcement" that is "here to stay."[39] This news comes against the backdrop of the U.K. Parliament's enactment earlier in 2010 of a landmark anti-bribery law with broad extraterritorial reach and strong provisions for corporate criminal liability. The new U.K. law becomes effective in April 2011, and in its wake, we expect to see even more investigative activity added to an already-busy anti-bribery law enforcement agenda.

- **Health care fraud.** We fully expect health care fraud to remain an area of priority focus for the DOJ in 2011, including prosecutions and civil enforcement actions against corporate defendants and individual executives and managers (see "Health Care: Politics Will Dominate Media Coverage but Is Unlikely To Alter Near-Term Business Trends"). Since 2007, the DOJ has charged more than 825 individuals with criminal health care fraud.[40] On the civil enforcement side, the DOJ recovered more than $2.5 billion under the False Claims Act in health care cases, a 60 percent increase over the 2009 level.[41] Last year alone, the DOJ opened more than 2,000 new criminal and civil cases.[42] We see the trend toward more criminal and civil enforcement, including cases against companies and individuals, continuing into 2011.

With the DOJ's agenda in clear view, two equally clear messages emerge for corporations and their officers and directors:

- **Review corporate policies.** The beginning of the new year presents a good opportunity for companies to review carefully their insider trading policies and anti-corruption compliance programs. Our experience indicates that companies benefit from establishing top-shelf policies and programs, enforcing those measures through regular training, and otherwise promoting cultures of compliance — points emphasized in the DOJ's *Principles of Federal Prosecution of Business Organizations* and strongly reinforced by the November 1, 2010, amendments to Federal Sentencing Guidelines for organizations.

[37] Remarks of Attorney General Eric Holder at the Western Regional Financial Fraud Enforcement Task Force Summit (Dec. 10, 2010).

[38] Quarterly Report to Congress of Special Inspector General for the Troubled Asset Relief Program, at 32 (Oct. 26, 2010).

[39] Remarks of Assistant Attorney General Lanny A. Breuer at the 24th National Conference on the Foreign Corrupt Practices Act (Nov. 16, 2010).

[40] Remarks of Attorney General Eric Holder at the Regional HEAT Summit (Dec. 16, 2010).

[41] *Id.*

[42] *Id.*

- **Commit to swift investigations and complete remediation.** The seemingly ubiquitous message from the DOJ is to encourage companies, upon learning of potential criminal conduct, to commit promptly to a thorough investigation and plan of remediation. The DOJ also places great emphasis on the self-reporting of criminal conduct — an issue not without great complexity in certain circumstances. The overarching point is to recognize the urgency of time when discovering potential criminal conduct and the immediate need for experienced counsel to help define and navigate a path forward, including with law enforcement — with whom the initial communications often prove the most important in an investigation.