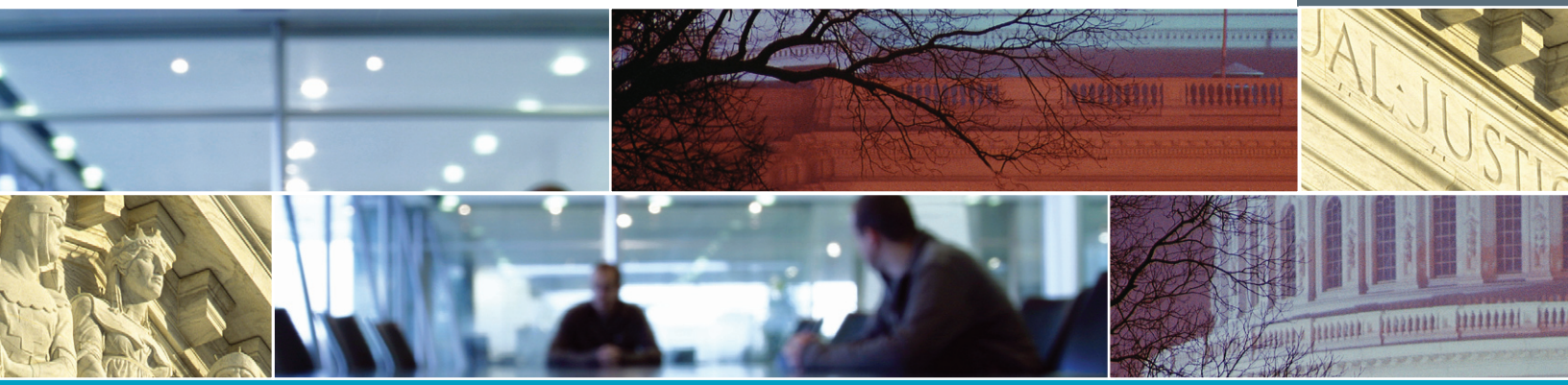
# K&L Gates Global Government Solutions 2010: The Year Ahead



K&L GATES

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# January 2010

2009 brought a further transformation in the relationship between business and government. Regardless of political systems or philosophies, governments around the world became more dynamic and intrusive in response to the financial crisis. This trend of government activism is certain to continue in 2010 and beyond.

K&L Gates' Global Government Solutions initiative brings together our diverse government-related practices around the world. With over 35 policy and regulatory practice disciplines and over 400 alumni of government agencies on three continents, K&L Gates can assist clients in dealing with virtually any legal issue involving government. In the coming years, successful businesses will be those that have a full appreciation of the changing relationship between commerce and government, and can identify the opportunities and avoid the dangers that this presents.

The knowledge and insights of our experienced professionals can be a key resource for companies facing these new challenges. This 2010 Annual Report, prepared by members of the K&L Gates Global Government Solutions initiative, contains concise articles that seek to forecast likely government actions and priorities regarding a broad spectrum of topics. We hope that you will find it valuable and provocative.

If you have questions about any of the articles or wish to obtain further information, you may contact the authors directly or send an e-mail to governmentsolutions@klgates.com.

Best wishes for a successful 2010!
Peter J. Kalis
Chairman and Global Managing Partner

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# Mortgage Banking: Choosing a Regulatory Direction

Federal and state governments may decide in 2010 whether a housing recovery can be predicated solely on aggressive policies against mortgage bankers or, instead, on a mutually beneficial partnership with private enterprise to make, purchase, sell and service residential mortgage loans.

### *Long-Term Implications of Foreclosure Moratoriums*

2009 was the year of trying to prevent home foreclosures. Whether it was President Obama's Home Affordable Mortgage Program, which was designed to promote loan modifications, state legislatures' attempts to enact foreclosure moratoriums, or the efforts of state attorneys general to sue or threaten to sue servicers seeking to enforce loan terms, public policy has stressed home retention. Strong economic and policy arguments support these efforts, but the cumulative effect has been a form of mortgage nullification, where the short-term end is perceived to justify the means, notwithstanding the possible long-term market consequences of knowingly disregarding the terms of loan documents and the rights of mortgage holders.

This debate began in 2007 with the question of whether loan holders should reasonably expect to enforce loan documents evidencing subprime loans that perhaps were unfairly made in the first place. But the story last year morphed into another, whether holders and servicers of properly made prime loans should permanently forgive loan principal for borrowers who lacked the ability or willingness to pay higher loan balances in an uncertain economy and a declining real estate market. Federal, state and local governments, which themselves are strapped for cash, generally chose not to provide taxpayer funds to bail out delinquent borrowers but instead cajoled, threatened and jawboned loan servicers into accelerating loan modifications, or created legislative or administrative road blocks that made it difficult to enforce the loan documents against defaulting borrowers.

### *Balancing the Interests of Loan Servicers/Loan Holders and Borrowers*

Governments appear to be starting to realize that most loan servicers are trying hard to modify mortgage loans of eligible borrowers. The burden of arresting home foreclosures cannot simply be placed on the shoulders of loan servicers and loan holders, particularly where borrowers in alarming numbers continue to refuse to provide documentation to evidence their eligibility for modifications, and often either do not qualify for government-sponsored loan modifications or redefault on restructured loans because of their own deteriorating economic circumstances. Moreover, the moral hazard in allowing able borrowers who default on their loans simply to get a better deal like their distressed neighbors raises material public policy concerns regarding how far the government should go to influence servicers and holders to forgive principal. But the most interesting aspect of this debate in 2010 will be whether governments recognize that their policies have made it increasingly difficult for existing borrowers in distress and for new borrowers who now have the ability to buy houses at materially reduced prices to obtain new mortgage loans.

### *Impact on Loan Availability*

While obviously the bona fide fear of repeating the credit losses of the last few years plays a significant role in the willingness of the real estate finance industry to extend and purchase residential credit, governmental policy has had a material adverse impact on the availability of credit for all but the most pristine borrowers. When coupled with new and prospective laws that would be so difficult to satisfy that they would have the effect of legislating out of existence many state-chartered mortgage brokers and mortgage lenders—such as required risk retention, comprehensive state licensing, and ambiguous and broad statutory duties of care—government policy appears to disfavor fostering a nationwide network of small and medium-size players in the mortgage industry to provide access to credit and competition in prices. As a result, low- and moderate-income borrowers will have an increasingly difficult time qualifying for residential mortgage loans, and, if not in 2010, then in the not too distant future, policy makers will have to grapple with whether the tightening of the residential credit pendulum has swung too far in the opposite direction.

### *Impact on Residential Finance Industry*

2010 could well be another difficult year for the mortgage industry. It appears likely that loan servicers will continue to be punished for job losses by mortgagors. Mortgage brokers will be subjected to punitive legislation. Mortgage lenders will be required to meet restrictive underwriting, net worth and risk retention requirements. Loan purchasers will be saddled with the risk of assignee liability. The result of these policies may be that only the largest federally chartered national banks will find the residential mortgage finance industry to be an inviting place to invest private capital. At some point, federal and state governments will have to deal with the consequences. The hope is that, sooner rather that later, national and state housing policy will go beyond the "never again" mentality of the subprime crisis and instead encourage the mortgage finance industry to participate in the recovery without fearing that every action will be met with accusations, punitive laws, and a potential demand for monetary damages.

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The most interesting aspect of this debate will be whether governments recognize that their policies have made it increasingly difficult for borrowers to obtain new mortgage loans.

# Health Care: Shaping Reforms While Increasing Efficiencies and Enforcement

The Obama Administration's health care initiatives will roll out more fully in 2010, necessitating strategic analysis and planning for all segments of the health care industry. Four areas stand out as particularly significant.

### *Health Care Reform: Assessing the Impacts, Planning for Implementation, and Addressing Unintended Consequences*

While enactment of health care reform is now in question for 2010, legislation could attempt to increase access to health care and to reduce its overall costs. Improving access to health care will pose significant challenges to the industry at a time when health care professional shortages and declining reimbursements are squeezing health care providers. Cost containment measures will take place in the context of an existing health care payment and delivery system that is already beginning to crack.

Whatever the precise parameters of a health care reform law, a critical first step for providers, insurers, businesses and consumers will be to assess the impact of the legislation and develop a strategy to prepare for its implementation. The effects of reform legislation will be particularly difficult to anticipate, as its true impact will become apparent over time, with some consequences intended, and others both unanticipated and unintended. As a result, the agenda for 2010 will ultimately include questions about how to shape solutions to the inevitable imperfections in any new law, as they are exposed.

### *Health Care Quality Reimbursement Initiatives*

Regulatory efforts to advance patient safety and quality are well underway, with the U.S. Centers for Medicare and Medicaid Services ("CMS") aggressively pursuing financial incentive and disincentive programs to improve the quality of the health care services paid for under federal health care programs. These programs will continue and expand in 2010 and include:

- Payment penalties or incentives for various provider types to participate in quality data reporting initiatives, including public reporting of certain quality measures.
- Payment denials for higher complexity diagnosis related groups ("DRGs") (*i.e.*, where the Medicare contractor determines that the level of care is not medically necessary or could be provided more efficiently) and outliers caused by certain hospital acquired conditions (*i.e.*, preventable conditions not present on admission).
- Payment denials for certain National Quality Forum "Never Events" (*e.g.*, surgery on wrong body part).

These efforts are part of CMS's larger, congressionally mandated "Value Based Purchasing Program," which will ultimately result in some portion of every hospital-based DRG being contingent on a hospital's quality rating.

### *Fraud & Abuse Enforcement Initiatives*

Government initiatives to combat fraud and abuse in health care are expected to continue to expand in 2010. The Office of Inspector General ("OIG") for the U.S. Department of Health and Human Services ("HHS") will continue to emphasize the detection and prevention of fraud and abuse, and its 2010 work plan specifies a number of specific areas for review, including but not limited to provider-based status for inpatient and outpatient facilities, Medicare Secondary Payer payments, oversight of compliance with the Emergency Medical Treatment and Labor Act ("EMTALA"), the appropriateness of observation services during outpatient visits, diagnostic x-rays in hospital emergency departments, non-physician outpatient services shortly before or after Part A covered stays, and disproportionate share payments.

The OIG will also continue to focus on investigating noncompliance with federal program billing requirements, requirements under the Stark law relating to physician financial interest in entities to which the physician refers patients, and the federal anti-kickback statute, as well as resolving False Claims Act ("FCA") actions and monitoring Corporate Integrity Agreements.

### *The Push for Electronic Health Records and the Pull of Health Care Privacy & Security Enforcement*

The Obama Administration is providing incentives for development of electronic health record ("EHR") systems, on the theory that in the long run this will enhance efficiencies in providing treatment to individuals across multiple health care providers. Among these incentives are additional Medicare and Medicaid payments to certain eligible professionals and hospitals that adopt and become "meaningful users" of EHR. These financial incentives will begin no sooner than October 2010 for hospitals, and January 2011 for eligible professionals, with decreasing Medicare incentive payments over time for up to a four-year period. Beginning in 2015, however, the tables will turn, and those not using EHR will be penalized by Medicare payment reductions.

At the same time, increased government enforcement of privacy and security provisions under the Health Information Technology for Economic and Clinical Health Act ("HITECH Act") is likely in 2010 and beyond. Service providers will face substantial challenges in taking advantage of EHR incentives while also dealing with increased privacy and security enforcement.

The effects of reform legislation will be particularly difficult to anticipate, as its true impact will become apparent over time, with some consequences both unanticipated and unintended.

The increased emphasis on enforcement in this area results, at least in part, from pressure brought to bear by privacy advocates concerned with the government's inducements for development of EHR systems. Historically, government enforcement efforts have been primarily limited to entities covered under the Health Insurance Portability and Accountability Act ("HIPAA") and driven by complaints of private individuals. This pattern seems likely to change dramatically in 2010, resulting in substantial increases in the number and amount of penalties for HIPAA violations. Among the reasons for this change:

- State Attorneys General now have the ability to bring HIPAA enforcement actions.
- Business associates will have direct liability for violations of certain privacy and security rules.
- HHS is required to conduct periodic compliance audits.

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# Competition/Antitrust Law: Global Priorities

Government enforcement and legislation could make 2010 an interesting year in antitrust and competition law worldwide. In the United States, we can expect action by the Administration, the Supreme Court, and possibly Congress. At the European Commission, a new leader will be taking over the competition-law portfolio. Additional interpretations of the new Chinese competition law, and perhaps the new Indian competition law, can be expected from courts in those jurisdictions.

## *United States*

Many of the initiatives and cases begun last year by the newly appointed heads of the Federal Trade Commission ("FTC") and the Department of Justice ("DOJ") will begin to see the light of day in 2010.

Pursuing monopolists. One important area will be Section 2 of the Sherman Act (illegal monopolization), a statute that the new antitrust chiefs (Federal Trade Commission ("FTC") Chairman Jon Leibowitz and Assistant Attorney General Christine Varney) have vowed to reinvigorate. In the final weeks of 2009, the FTC unveiled its long-anticipated complaint against Intel for illegally preserving its monopoly in the global microprocessor market. This will be an important case to watch because of its size and its potential to change the shape of Section 2 law.

In addition, the Antitrust Division has reportedly begun Section 2 investigations of IBM and Monsanto. These cases will be significant in both their own right, and as potential indicators of the seriousness of Division chief Varney's rhetoric about increased enforcement of Section 2, following her withdrawal, at the end of 2008, of the Section 2 Report issued by the outgoing Bush administration's antitrust chief, which she deemed too lenient.

Expanding the scope of the antitrust laws. We expect that sometime in 2010 the FTC will issue a report on Section 5 of the FTC Act, which gives the agency broad authority to challenge "unfair methods of competition." The report follows hearings held last year on the proper scope of Section 5. Along with the Intel case, which is based in part on a Section 5 theory, the report should give helpful guidance on how far beyond the four corners of the Sherman Act the agency intends to go with Section 5.

Revising the Merger Guidelines. Sometime this year, the two enforcement agencies will likely announce revisions to the 1992 Horizontal Merger Guidelines, updating them to reflect the actual practice of the agencies in the last two decades.

Legislative rescue of the FTC on reverse payments. One of the FTC's highest priorities is to challenge so-called "reverse payments" by branded pharmaceutical companies intended to delay generic entry. The agency has two pending cases in this area. In addition, Congress is actively considering legislation to overturn several appellate decisions that side with the pharmaceutical companies and against the FTC. One such legislative measure has already been passed by the House as part of the health care reform package, and another has been approved by the Senate Judiciary Committee. With the new Administration, the Justice Department has conformed its position on this issue to that of the FTC.

And the potential repeal of the McCarran-Ferguson Act. Congress is also considering legislation to repeal the antitrust exemption for the insurance industry (the McCarran-Ferguson Act), as part of the House version of health care reform. Congress may also focus this year on legislation designed to restore the *per se* rule against resale price maintenance. One state, Maryland, has already enacted such legislation.

The Supreme Court weighing in on joint ventures. Finally, the Supreme Court will issue a decision involving the National Football League that will help shape the law on the proper antitrust treatment of joint ventures. Specifically, the Court's decision could answer a nagging question under U.S. antitrust law: under what circumstances should a joint venture be considered a "single entity" for purposes of Section 1 of the Sherman Act, effectively immunizing decisions made by that joint venture.

## *European Union*

New leaders taking the helm. The biggest development in E.U. competition law this year is the change in leadership in both the No. 1 and No. 2 positions. Spain's Joaquin Almunia will soon be replacing Neelie Kroes as E.U. Commissioner for Competition. Though Almunia is an economist, little is known about his views on antitrust. His first year in the position will offer important clues as to where he plans to focus the Directorate's energies. Also, sometime this year, the No. 2 at the Competition Directorate, Philip Lowe, will retire and be replaced by Alexander Italianer, currently deputy secretary general of the European Commission.

Pursuing Intel. As in the United States, the most important single-firm conduct case to watch is the Intel case, especially now that Microsoft and the E.U. have largely settled their differences. Last year the Commission imposed a fine of over 1 billion euros. Intel is appealing that decision, and the outcome may well determine the E.U.'s ability to challenge single-firm conduct for years to come.

Looking for reverse payments in Europe. The E.U., like the FTC, has begun investigating whether pharmaceutical companies in Europe have been making reverse payments to slow down generic entry. The Commission for Competition issued a report last year and has conducted several "dawn raids" of pharmaceutical companies in search of evidence of illegal agreements. Actions against pharmaceutical companies can be expected to intensify in 2010.

Promoting private causes of action. 2010 could also see important developments in the area of private causes of action. The Commission recently dropped some proposals to permit private actions in the E.U., but the new Commissioner, Almunia, might revisit the subject. In any event, private litigation in the Member States that authorize such actions can be expected to increase as the decade progresses.

We expect the trend of greater government antitrust enforcement to continue in 2010.

**Sending people to jail.** Finally, we expect more activity on the criminal front within Europe, with a growing number of countries adopting criminal provisions to their antitrust laws. While the E.U. as a whole does not pursue cases criminally, some of its Member States (the U.K., Germany) do, and the E.U. actively pursues cartels and levies large fines on corporate offenders. This can be expected to continue in 2010 (its two largest cartel fines were issued in 2008-09).

## *Global Trend*

The last few decades have been marked by an explosion of antitrust activity around the world. Very few significant jurisdictions are still without some form of competition law, and many of them are quite active, as can be seen for example in the various cases against Intel outside the U.S. and the E.U., such as South Korea and Japan.

We expect the trend of greater government antitrust enforcement to continue in 2010, especially with China's recent adoption of an antitrust law, and India's enactment of a revised body of laws and its establishment of a competition commission. Chinese authorities last year issued their first judgment under the new Anti-Monopoly Law dealing with the abuse of dominance provisions, and much more can be expected from China in 2010.


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# Climate Change: U.S. Legislative and Regulatory Proposals

In 2010, there will be increased legislative and regulatory initiatives aimed at controlling emissions of greenhouse gases ("GHGs"), despite the failure of the United Nations conference in Copenhagen to produce any substantial agreement, and despite deep divisions in Congress.

## *Congressional Activity*

To recap, the U.S. House of Representatives has already approved a massive climate change and clean energy bill. Dubbed the Waxman-Markey bill (HR 2454), it passed by a razor-thin margin. It would establish an elaborate cap-and-trade system to reduce GHG emissions over 40 years, and provide mandates and incentives for the production and use of carbon-free energy sources.

The Senate has drafted similar legislation in two parts: a clean energy bill and a cap-and-trade bill. Both bills have been approved by their respective committees. The energy bill is a bi-partisan bill approved by the Energy & Natural Resources Committee, which includes a renewable energy standard and various incentives to promote clean technologies. The cap-and-trade bill was approved by the Environment & Public Works Committee after a highly partisan and contentious process in which the Republicans refused to participate. These bills are now ready for Senate floor consideration. However, most observers agree that there are not the 60 votes necessary in the Senate to approve the cap-and-trade bill. The reasons mirror the core of the climate change politics on display in Copenhagen.

The first concern is that GHG restrictions will impose economic costs in the form of higher prices on carbon-based fuels. Many Senators are reluctant to support any legislation that has economic consequences, especially in the current economy.

The second concern is regional equity. Senators representing states dependent on carbon fuels, such as those that mine or burn coal, worry that their constituents will pay a disproportionate share of the costs stemming from climate change restrictions. They must be persuaded that a cap-and-trade system will not impose an unfair burden on their states.

A third concern relates to the mechanics of cap-and-trade. With the memories of the subprime financial meltdown still fresh, some Senators fear that creating a new and complex market to trade carbon credits is fraught with the potential for gaming and even abuse. If the Senate is to proceed in the elusive effort to cobble together a coalition of 60 votes to pass climate change legislation, a new approach is probably needed. At least two alternative legislative proposals have been presented.

The first alternative proposal is an energy production bill being brokered by Senator Lindsey Graham (R-SC) with help from Senators Kerry (D-MA) and Joe Lieberman (I-CT). Graham's proposal marries GHG reduction targets with a more aggressive campaign to develop domestic energy resources, particularly nuclear power (the largest source of carbon-free energy), clean coal, and offshore oil and gas. Graham is at odds with most in his party by being prepared to accept a modified cap-and-trade program, provided it also features some consumer protections and expanded energy production to reduce dependence on unreliable foreign supplies.

The second alterative is a "cap-and-dividend" proposal advanced by Senators Maria Cantwell (D-WA) and Susan Collins (R-ME). This bi-partisan approach gets credit for its simplicity (it is only 39 pages of legislative text compared to over 1,000 pages for the cap-and-trade bills). It would set up a pure auction to allocate carbon permits, in which producers and importers of fossil fuels, not emitters like utilities, would have their emissions capped and in which only they would participate. Revenues generated by the auction would be split two ways–75% to the public to help defray higher energy costs and 25% to support energy efficiency and developing new clean energy technologies.

It will likely take one of these proposals, or perhaps a combination and other fresh approaches, such as a straightforward carbon tax, to break the impasse in the Senate to allow consideration and passage of climate change legislation. Even then, it will be a slog to win approval in the Senate of any meaningful climate legislation, especially on the heels of the marathon Senate health care debate, and as next year's November elections approach.

## *Federal Regulatory Activity*

In 2007, the U.S. Supreme Court held that greenhouse gases are air pollutants covered by the Clean Air Act. On December 7, 2009, the EPA issued two findings on greenhouse gases under the Clean Air Act:

- The endangerment finding is that current and projected concentrations of six key well-mixed greenhouse gases (carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons and sulfur hexafluoride) in the atmosphere threaten the public health and welfare of current and future generations.
- The cause finding is that the combined emissions of these gases from new motor vehicles and new motor vehicle engines contribute to the greenhouse gas pollution which threatens public health and welfare.

The findings alone do not impose any requirements on business, but are the next step in finalizing EPA's greenhouse gas emission standards for light-duty vehicles proposed on September 15, 2009. While the findings apply only to these vehicle emissions, even if Congress fails to act, the precedent will almost certainly result in regulation for other sources. EPA has already proposed a so-called "Tailoring Rule", which would result in inclusion of GHGs among the gases regulated through issuance of permits under the federal Clean Air Act.

The EPA actions will pressure Congress to act—either by adopting legislation to regulate GHG emissions, or by blocking the effectiveness of the findings. Observers do not expect that efforts to block the findings will succeed. Although legislation could provide more certainty for business as to source category priorities, timing, minimum emission and other requirements, it could also provide tax incentives and create a revenue opportunity (cap-and-trade). For the reasons described above, it will be challenging to get climate change legislation passed in 2010.


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# Investment Management: Expanding Regulation and Scrutiny

The coming year promises a number of far-reaching legislative, regulatory and judicial developments in the U.S. investment management industry, in reaction to unprecedented market volatility, regulatory lapses, industry scandals, demands for investor protection, renewed focus on retirement savings, and other political and market-driven forces.

## *Hedge Fund Developments*

Registration of Hedge Fund Managers. Proposed legislation would require all hedge fund managers above a certain size (likely to be around $100 million in assets under management) to register with the Securities and Exchange Commission ("SEC") under the Investment Advisers Act of 1940 ("Advisers Act"). In addition, the legislation would, among other matters, authorize the SEC to collect from managers a vast amount of data relating to leverage, trading positions and practices, counterparty exposures and other sensitive information. The SEC would be directed to share this information with a proposed systemic risk regulator in order both to identify managers and funds deemed to present systemic risks and to regulate them, conceivably through restrictions on size, leverage, and counterparty exposure. The Obama Administration has announced its intent that the legislation would significantly restrict relationships between banks—including bank affiliates—and hedge funds. Depending on how this legislation evolves, the investment strategies and business models of many managers could be significantly affected.

SEC Scrutiny of Hedge Fund Operations. The SEC has made clear that it intends to subject hedge funds to heightened scrutiny in examinations and enforcement and is considering new disclosure and compliance practices for managers. Among the many issues the SEC may examine include whether restrictions on redemptions through suspensions, gates, and side pockets during the height of the crisis in late 2008 were fully authorized and disclosed, and whether some investors were unfairly favored over others. In addition, the trend of many institutional investors toward investing in separate accounts may well draw scrutiny, in light of the SEC staff's long-expressed concerns about the potential for conflicts in the "side-by-side" management of hedge funds and institutional accounts.

SEC Rules on Short Sales. The regulatory focus on short selling will make investing more difficult for managers whose strategies have a significant short component. The SEC can be expected to continue to police against "naked" shorting (*i.e.*, the practice of selling short without having pre-located a deliverable security to borrow). Also, the SEC has proposed six different versions of the old uptick rule, which had been rescinded in 2007 as unnecessary in an era of high frequency trading and decimalization. Although rescission of the old rule followed years of careful study by the SEC, pressure from financial institutions, other issuers and Congress in the wake of recent market events has compelled the SEC to consider reinstating a version of the rule.

## *Mutual Fund Developments*

Approval of Mutual Fund Advisory Fees. This year, the Supreme Court is expected to rule on the most important advisory fee case in a generation, *Jones v. Harris Associates*. The Court will decide on the meaning of a fund adviser's fiduciary duty when receiving compensation, as well as the relevance of fees the adviser charges any comparable institutional accounts. It seems unlikely that this Court, which has generally acted to restrain securities litigation, will announce an unworkable standard. However, any suggestion by the Court of a standard that deviates from the current *Gartenberg* standard may become the subject of litigation for years to come.

Money Market Funds. Continuing efforts to prevent another money market fund from "breaking the buck," as the Reserve Primary Fund did after the Lehman Brothers bankruptcy, will generate additional regulatory changes. The SEC seems likely in 2010 to adopt a version of the money market rule reforms proposed last summer that would tighten existing maturity and credit quality requirements and impose strict liquidity requirements. Other, more controversial, reforms under consideration include establishing different liquidity requirements for so-called "institutional" and "retail" money market funds, however that distinction might be defined. A long-delayed study by the President's Working Group regarding the necessity and feasibility of amortized cost valuation could also fuel legislative proposals for bank regulation of money market funds or the SEC's elimination of amortized cost valuation—and constant $1 net asset value—altogether.

Rule 12b-1 Fees. After losing priority during the financial crisis, reform of Rule 12b-1 is back on the SEC's agenda, and SEC Chairman Schapiro and Investment Management Division Director Donohue have stated that the agency is considering potentially dramatic reforms. It is worth noting that Chairman Schapiro's predecessors announced similar intentions but backed away when faced with the difficulty of unwinding and reshaping the complicated network of mutual fund distribution arrangements. The relevance of Rule 12b-1, however, could fade long before the SEC takes any action, as broker-sold share classes that rely on 12b-1 fees continue to be supplanted by wrap-fee advisory programs that do not.

## *Industry-Wide Developments*

Regulation of Fee-Based Brokerage Activities. Sales of securities, including fund shares, made in the context of wrap-fee programs and other fee-based brokerage accounts could be affected by bills pending in the House and the Senate that would require investment advisers and broker-dealers to be held to a comparable "fiduciary duty" in their provision of investment advisory services. These legislative proposals have evolved from the

The SEC has made clear that it intends to subject hedge funds to heightened scrutiny.

debate between investment advisers, on the one hand, and broker-dealers, on the other, generated by the SEC's attempt to regulate fee-based brokerage activity through exemption from Advisers Act registration (which was rejected by the U.S. Court of Appeals for the District of Columbia). The proposals, which are discussed further in the broker-dealer section of this report, would likely impact existing broker-dealer approaches to principal transactions, as well as disclosure of distribution and shareholder servicing fees paid by fund managers to broker-dealers.

SEC Self-Funding and Regulatory Authority. A number of legislative proposals involving regulators' authority over investment advisers are still in play. Congress is likely to provide the SEC with a significantly increased budget to hire enforcement staff and, under the terms of several draft bills, it might even fulfill the agency's desire to be self-funded from industry fees, thereby obviating the need to obtain annual Congressional appropriations (and the resulting oversight and restraint). In addition, although authorization for FINRA to examine the advisory affiliates of broker-dealers was stripped from the House legislation at the last minute, FINRA is still lobbying to be the self-regulatory organization for the advisory industry, and could yet gain this authority in the Senate bill or in conference. Further details of legislative proposals covering the financial services industry appear in a separate section of this report.

Reorganization of Enforcement Division and OCIE. Since his appointment last summer, the Director of the SEC's Enforcement Division has instituted a massive reorganization of the Division and has formed specialized units, including an Asset Management Group with expertise in prosecuting investment managers. This development is discussed further in the securities enforcement section of this report. The newly re-energized Enforcement Division can be expected to continue its recent emphasis on prosecuting insider trading activities: the *Galleon* case foreshadows not only a concentration on fund managers, but also the SEC's continued closer cooperation with criminal prosecutors and the use of wiretaps and other investigative tools not previously associated with financial professionals. The staff also has signaled that it will maintain its longstanding focus on prosecuting market manipulation, conflicts of interest in trade and brokerage allocation, and overvaluation of client and fund assets. The newly-appointed director of the Office of Compliance, Investigations and Examinations ("OCIE") has yet to settle in, but indications are that OCIE is forming multi-disciplinary sweep teams to provide focused examination expertise that would work with and support Enforcement's specialized units.

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# Corporate Governance: Increasing Demands on Corporate Directors

2010 promises to be a challenging year for boards of directors. The recent financial crisis has focused significant attention upon corporate conduct and its role in the worldwide economy. Proposed legislative and regulatory changes threaten to alter the legal landscape in which boards function. Increased concern has been evident over questions of corporate integrity, the quality of corporate governance and compliance programs, and the effect of a supposed "culture of greed" in the worldwide business community, especially in the compensation area. Shareholders, government regulators and the public are looking to boards to reform corporate culture where necessary and also to prevent companies from falling prey to excessive greed and risk. In difficult economic times the risk of fraudulent or improper activity increases. As a result, boards that ignore red flags or rubber stamp ill-advised management schemes will be at an even greater risk of being held accountable when companies do fail.

Boards in 2010 should embark on a proactive course to reassess their role—and management's role—in steering their companies through the economic recovery. In particular, we have identified the following significant issues that many boards will need to confront in the year ahead:

### *The Role of the Board and Its Committees*

Now more than ever, boards must be active and vigilant. Boards should be involved in assessing and shaping the long-term strategic planning for the company and can serve as an important check on excessive short-term performance focus. Boards should remain informed regarding relevant business, legal, accounting, and regulatory developments in order to be well-equipped to assess complex transactions and strategies.

### *Seamless Web of Audit Capability*

Late last year, Robert Khuzami, Director of the SEC's Division of Enforcement, warned that audit committees needed to take careful and proactive steps to ensure that red flags are not missed. To accomplish this objective, the committee must work closely with financial management, internal audit and outside auditors to establish a seamless web of audit capability and promote clear and frequent communication so that together they can identify and address issues even before they become red flags.

### *Risk Management*

The economic crisis showed how excessive risk taking without strong controls can cause even the largest institution to fail. In such cases, both management and company gatekeepers frequently failed to assess risks properly or take effective action to check runaway risk-taking. While a company's board is not responsible for managing day-to-day risk, it is responsible for oversight of risk management functions and for helping to ensure that the company's risk culture is clearly defined. In the coming year, boards will want to reassess their role in overseeing risk management to ensure that the board members with the most appropriate backgrounds are in a position to evaluate management's performance in particular areas. In addition, boards need to be clear as to what the company's risk profile—or risk culture—is and whether it is in line with the company's financial status, the competitive landscape and the broader economic climate.

### *Culture of Compliance*

A well-functioning corporate compliance system is not merely a check-the-box exercise, but requires an enterprise-wide commitment, management accountability and active audit committee oversight. Boards and their audit committees must set the appropriate tone at the top and imbue in company management and employees the importance of compliance. This includes ensuring that management is tasked with designing policies and procedures that are understandable, practical, known, enforced and re-evaluated on a regular basis. Audit committees should also evaluate the efficacy of the company's whistleblower procedures to ensure that they function as intended and remind company counsel of their up-the-ladder reporting obligations to the board in the event of suspicions of serious wrongdoing or fraud.

### *Executive Compensation*

Compensation committees have never before been under such intense scrutiny in setting executive compensation. At a time when the rules of the road are constantly changing, it is critical that committees have the appropriate resources at their disposal—such as compensation consultants, comparative data and advice of counsel as necessary—in order to make timely, well-reasoned and carefully documented decisions regarding compensation. Compensation committees also need to be fully apprised of regulatory developments and appreciate the political climate in which the compensation decisions are made.

### *Crisis Management*

In the current environment, it is important for companies to be prepared to respond to a significant event, such as an insider complaint, a government investigation or a shareholder allegation of fraud. An ill-informed and piecemeal approach to a crisis can lead to disastrous consequences. Depending on the nature of the allegations, it may not be appropriate for management to be involved in handling the crisis. Boards need to have a plan in place to establish leadership, determine a course of action—which may include an independent investigation, coordinate media responses and control leaks. If an independent investigation by outside professionals is warranted, the mandate of the investigation should be clearly identified. See the article later in this report on internal investigations.

Boards need to be clear as to the company's risk profile and whether it is in line with the company's financial status, the competitive landscape and the broader economic climate.

*Managing Conflicts of Interest.*
Concerns regarding related party transactions are not new, but difficult economic times and performance pressures unfortunately often breed motivation to cut corners. To the extent that boards are requested to approve related party transactions, they must ensure that they are adequately—and independently—advised regarding the nature of the conflicts, the risks and benefits to the company and the company's disclosure obligations.

This list is certainly not exhaustive, but it illustrates the complexity of issues facing boards in 2010. An investment in planning and organization will help boards navigate these challenging times and better position their companies for the recovery ahead.

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# E.U.: Consolidation of Reforms

### *Financial Reform*

During 2010, the E.U. hopes to consolidate different strands of its financial markets reform programme, which at the end of 2009 are all in various stages of the legislative process.

Legislation. Legislation agreed in detail by the 27 Member States (the "Council") in a marathon session on 2 December must now be approved by the European Parliament. Spain, which currently holds the rotating presidency of the European Council, is reportedly hoping to have this legislation finally approved before 30 June 2010, when it hands the presidency over to Belgium. The package would create a new European Systemic Risk Board (ESRB), to act as an independent body responsible for macro-level prudential oversight across the E.U. financial system, and a European System of Financial Supervisors (ESFS), to be responsible for the supervision of individual financial institutions. The ESFS would comprise the national financial supervisors of Member States, working together along with three newly-created European Supervisory Authorities (ESAs) covering insurance, banking and securities markets.

Capital adequacy directive. Proposed amendments to the E.U.'s capital adequacy directive were agreed upon in November 2009, which are aimed at strengthening disclosure and capital requirements for the trading book and re-securitisation instruments in the banking sector and at preventing remuneration policies that generate unacceptable levels of risk. The European Parliament will now consider the proposal, but it is unlikely to vote before June 2010.

Directive on Alternative Investment Fund Managers. The proposed directive on Alternative Investment Fund Managers, which seeks to establish a regulatory and supervisory framework for the investment managers of all funds directed at E.U. investors and not currently regulated at the E.U. level, is the subject of substantial, and sometimes irreconcilable, amendments by both the Council and the Parliament, and it is similarly unlikely to be adopted before summer 2010. Accordingly there remains scope for lobbying with regard to these legislative initiatives.

### *REACH Enforcement*

Enforcement of the E.U.'s recent E.U. Regulation on Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH) will increase in 2010. The European Commissioner-Designate for the Environment, Janez Potocnik, indicated in his confirmation hearing before the European Parliament in January 2010 that improved enforcement of environmental legislation, including REACH, was among his three priorities.

Member States were required to have in force by 20 December 2008 effective, proportionate and dissuasive penalties for infringement of its many provisions. Member States agreed that enforcement priorities for 2009 would be pre-registration, registration and safety data sheets, and recent reports indicate increasing levels of checks at borders (leading in some instances to blocked shipments) and on-site inspections. In December 2009, Member States decided to focus next on formulators of mixtures (such as paints, varnishes, detergents, cosmetics and plastics), who as so-called "downstream users" have obligations to communicate information up and down the supply chain, including by way of safety data sheets, and prepare chemical safety reports and to apply prescribed risk management measures. Non-compliance with REACH obligations may have serious consequences, ranging from steep fines and imprisonment to reputational damage (the U.K., for example, has a policy of "naming and shaming" companies in breach by publication of names).

In relation to anticipated regulatory activity under REACH, the European Chemicals Agency will in the course of 2010 be deciding on applications to register numerous substances, and it may be expected that a number of those decisions will be challenged by affected parties.

### *Antitrust Enforcement*

The European Commission will be continuing to apply its recent guidance on its enforcement priorities in applying Article 102 of the Treaty on the Functioning of the European Union (TFEU) (formally Article 82 of the EC Treaty), which prohibits abuse of a dominant position, to abusive exclusionary conduct by dominant firms.

Despite its title, this document does more than reorganise enforcement priorities within the existing judicial framework; in some respects, it expands the Commission's interpretation of conduct that constitutes abuse beyond the parameters laid down by the Court of Justice of the E.U. While these changes may be welcomed as demonstrating a shift from an overly formalistic approach to a more effects-based analysis, the Commission has no power to modify settled case law, and it may be expected that this, together with a number of other problems with the new guidance, will provide fertile ground for appeals against recent and forthcoming decisions.
The Vertical Block Exemption Regulation, which exempts certain vertical agreements from the prohibition of anti-competitive agreements in Article 101 TFEU (formally Article 81 of the EC Treaty), expires at the end of May 2010. The Commission has recently consulted on a draft replacement regulation, which includes three proposed amendments of substance. Certain limitations on internet usage would be defined as "hardcore restrictions," which, if included in an agreement, will automatically take it outside the scope of the exemption.

The Lisbon Treaty will provide a welcome and long awaited opportunity to bring concerns about the validity of E.U. regulations before the General Court.

Under the existing Regulation, the exemption is to apply only where the market share held by the supplier does not exceed 30% of the relevant market. The draft regulation, in contrast, applies only where the market share held by each of the parties to the agreement, thus including buyers as well as suppliers, does not exceed 30% on any of the relevant markets affected by the agreement. Although the draft regulation does not go as far as the U.S. has recently in moving away from a blanket condemnation of minimum resale price maintenance (another hardcore restriction in the existing Regulation), it does open the door to the possibility of raising an efficiency defence in certain circumstances.

## *E.U. Court of Justice*

An area to watch at the Court of Justice is betting and gaming, a sector that resides at the uneasy interface between the private sector's freedom to provide services across borders and the Member States' prerogative to control activities in their territory on public policy grounds. It is clear from recent rulings of the Court that national restrictions on gaming activities are, in principle, contrary to E.U. law, but may be justified on grounds such as consumer protection, the prevention of both fraud and incitement to squander on gaming, and the need to preserve public order. A number of cases are currently pending in which the Court has been asked to flesh out these principles as they apply to various national laws and practices. Among the questions raised are the following:

Can national legislation lawfully restrict or prohibit:

- private actions that conflict with prerogatives granted to Member State monopolies that operate national lotteries?
- the advertising of games of luck and chance?
- online gaming?

Can a Member State lawfully:

- require that the national lottery licence-holder be a national company with no foreign branches?
- require that only national public limited companies operate games of chance in casinos?
- reserve to itself the right to run games of luck or chance and organise pool betting systems?
- use software to make a particular gaming website inaccessible to its residents?
- restrict a gambling licence to "offshore bookmaking"?
- have a national monopoly on the operation of sports betting and lotteries while its semi-autonomous regions permit the private sector to provide other games of chance with more potential risk of addiction?

Where a Member State has a single licence system for games of chance, can it extend the licence of the existing holder without allowing other companies to compete for the licence?

Is the holder of a licence to operate certain gaming companies in a Member State entitled to market its gaming products in other Member States without a licence from those States?

## *Lisbon Treaty*

The Lisbon Treaty, which entered into force on 1 December 2009, significantly expanded the right of individuals to seek judicial review of Community legislation. Under the EC Treaty, a person or company could challenge an E.U. measure before the E.U. courts only if he could show that it was of "direct and individual concern" to him. In most areas, the European Court of Justice interpreted the requirement of individual concern very narrowly, so that legislation of general application (as opposed to a decision with specific addressees) could not be challenged before the E.U. courts by persons or companies. The only course available to a party seeking review was to bring an action before a national court if that was permissible under national law and procedure and hope that the national court referred the matter to the E.U. courts, a process which can take a considerable time.

The Lisbon Treaty enables a person or company to bring a direct challenge before the European General Court (formerly the Court of First Instance) to a regulatory act of direct concern, provided that the act does not require further implementing legislation. This new avenue will provide a welcome and long awaited opportunity for individual applicants to bring their concerns about the validity of an E.U. regulation in any of the numerous areas covered by E.U. law before the General Court.

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# OTC Derivatives Markets: Poised for Profound Changes

## *Past as Prologue*

The explosive events of 2008 crystallized concerns among regulators and derivatives market participants over the extent to which over-the-counter ("OTC") derivatives exacerbated weaknesses in the real asset economy. This issue had been emerging at least since 2005, when the New York Fed acted on its concern that rapid and undocumented credit default swap novations exposed the financial system to unacceptable counterparty risk. The enormous strain of financial markets in the credit crisis focused market participants as never before on the quality of the credit underlying derivatives transactions—specifically the need for adequate collateral and the need to protect against the risk of even the most stable counterparty becoming insolvent.

Regulators, courts and Congress also began to scrutinize the OTC derivatives markets with unprecedented vigor in order to address the role they played in financial instability. For these reasons, the new decade will usher in a profound change of orientation for the OTC derivatives markets in the United States. These developments were spurred by agreement among the G20 states that all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of calendar year 2012 at the latest; that OTC derivative contracts should be reported to trade repositories; and that contracts that are not centrally cleared should be subjected to higher capital requirements. Further impetus came from concerns that regulatory exemptions for security-based swaps had enabled manipulation of securities markets through the use of credit and equity derivatives by short sellers, which became a focus of investigations by state and federal regulators, and the use of equity derivatives by activist investors seeking to avoid reporting of positions, which was a focus of judicial action in the CSX case in 2008.

## *The Turn of the Screw*

After twenty years of deregulation, which reached a peak with the Gramm-Leach-Bliley Act of 1999 and the Commodity Futures Modernization Act of 2000, both houses of Congress have now acted to swing the pendulum of regulation far to the other side. In December 2009, the U.S. House of Representatives passed the Over-the-Counter Derivatives Market Act of 2009 ("OTC Derivatives Act") as part of its global financial reform bill. In early 2010, the Senate is expected to vote on a bill that had been approved by the Senate Financial Services Committee. Although different in details, both the House bill and the Senate bill are similar in broad outline as they relate to the reform of the OTC derivatives markets.

## *A New Regulatory Regime*

In place of the current regime, in which OTC derivatives are largely exempt from substantive regulation, the proposed legislation will subject all derivatives to the regulatory jurisdiction of either the CFTC or the SEC, with rulemaking mechanisms that are designed to reduce if not eliminate entirely the jurisdictional turf wars that have bedeviled past efforts to impose uniform regulation on the derivatives markets.

Multilateral Solutions for Bilateral Transactions. In a major challenge to the bilateral nature of OTC derivatives markets, the legislation will mandate central clearing of standardized swaps in an effort to minimize counterparty risk and will provide disclosure of aggregate positions for all swaps through information repositories. The legislators' hope is that those steps, together with robust margin restrictions and collateralization requirements, will minimize the systemic risks to the financial system that were revealed in 2008, when the systemic implications of large counterparty defaults for opaque bilateral markets became painfully apparent. As a corollary to this new transparency, the legislation will impose registration and substantive requirements on designated dealers and participants in swaps and security-based swaps.

Rethinking the Application of Securities Laws to Security-Based Swaps. One of the most far-reaching provisions of the current legislative proposals would amend the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 to include security-based swaps within the definition of "security" under those statutes. While puts, calls, options, straddles and similar rights or privileges relating to securities have always been subject to full SEC jurisdiction, the Gramm-Leach-Bliley Act of 1999 and the Commodity Futures Modernization Act of 2000 deprived the SEC of most jurisdiction to regulate "swaps" that referenced securities. These provisions will be repealed, allowing the SEC to regulate security-based swaps on an equal footing with the securities that they reference. Security-based swaps in some circumstances will have to be registered, thus opening up the possibility of liability under Section 11 and Section 12(a) of the 1933 Act. Certain types of activities involving security-based swaps will be identified as being manipulative. Although broad-based security index swaps will not be considered "security-based swaps," and thus will continue under CFTC jurisdiction, it seems reasonable to expect that the uniform regulatory approach will bring the CFTC's approach for those instruments closer to the SEC's approach for those issues involving mutual funds and other types of collective funds that invest in broad portfolios of securities.

Pressure Points. The scope of central clearing and increased transparency requirements have been key focal points of contention, given that the move towards more central execution is likely to affect the economics of derivatives activities for dealers. Major questions and concerns presented by congressional action include how far Congress will go to exclude classes of transactions from the

Proposed legislation will subject all derivatives to the regulatory jurisdiction of either the CFTC or the SEC.

rules for clearing and exchange-trading of swaps and to exclude end-users from the disclosure and substantive requirements applicable to major swap participants or major security-based swap participants. For example, the House bill would exclude non-U.S. exchange derivatives and balance sheet hedging transactions, which by some estimates may cover approximately a quarter of OTC derivatives transactions. In addition, the legislation would exempt commercial end-users, to some degree, from the clearing requirements and the disclosure and substantive requirements that would apply to major market participants.

Still under consideration is the issue of whether proposed legislation gives regulators too much power to regulate major swap participants, which may, for example, include non-U.S. banks with branches in the United States. It remains to be seen whether non-U.S. banks and industry groups representing their interests will succeed in obtaining exemptions, for example from capital and margining requirements, that will likely be imposed by any legislation. The bills pending in both the House and the Senate authorize regulatory studies that could delay the effectiveness of any new law beyond 2010.

### *Treading a Path Already Worn?*

Even as reform initiatives have been winding their way through the U.S. Congress and governments throughout the world, the pace of change in market practice continues to occur rapidly, reflecting innovation and presenting challenges to practitioners even as they are seeking to adapt to a new regulatory environment. The International Swaps and Derivatives Association, Inc. took a series of steps throughout the credit crisis and later in 2009 to address the issues likely to be addressed in any new law. These include the standardization of cash-settlement and auction valuation methods for credit default swaps and collateral dispute resolution procedures to address the widespread problem of intractable disputes involving trade valuation and collateral issues.

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# Tax Policy: The Search for Revenues

This year the Obama Administration and Congress are facing a nearly unprecedented set of fiscal challenges. The Administration and Congress will be aggressively searching for revenues to lower the budget deficit, which recently hit a staggering $1.42 trillion; by way of context, the previous highest deficit, $459 billion, was set last year. Further, the deficit has become not only an economic but also a political problem, with public displeasure about the economic situation crystallizing around the deficit. This is causing the Administration to consider a much more aggressive approach, and with an increased focus expected on cutting the federal deficit. Given that large spending cuts are unlikely, and that President Obama is expected to honor his promise that he will not increase taxes on families earning less than $250,000 a year, the Administration will have to rely primarily on higher business taxes to raise the needed revenue.

### *Tax Reform*

Complicating matters further is a possible tax reform debate. The 2001 and 2003 tax cuts expire at the end of this year, so Congress must decide which ones to extend. In addition, there have been discussions about comprehensive tax reform, which will include proposals to broaden the tax base by curtailing industry-specific tax incentives and curtailing shelters and perceived abuses. In this regard, the Presidential Advisory Subcommittee on Tax, being led by former Federal Reserve Chairman Paul Volcker, is expected to release its report in the near future. Although the Subcommittee's recommendations are not likely to be groundbreaking, they are likely to set the stage for a broad discussion about tax reform. The recommendations also may serve another function. To the extent that the Commission's tax reform recommendations focus on specific proposals to broaden the tax base or curtail purported tax abuses, they are likely to serve as an additional "menu" of tax increase options for Congress to consider. Thus, there is an increased likelihood that tax proposals that raise revenue and are characterized as "loophole closers" will be given serious consideration this year.

### *Search for Revenues*

Given the confluence of these factors, the Administration and Congress are likely to be engaged in an aggressive search for revenue in 2010, considering tax policy changes that may have previously been considered politically unpopular. Some of the more likely areas where revenue increases will be explored include changes to the rules for private equity and hedge funds, including carried interest; the repeal or limitation of tax provisions benefiting the oil and gas industries; and changes to tax laws affecting international activities. The pace may be unusually fast, particularly if Democrats decide to use the "reconciliation process," which requires only 51 votes in the Senate, because reconciliation unfolds, in part, according to an expeditious schedule set forth in the Congressional Budget Act.

There is, however, a countervailing consideration. Given that this is an election year and that Democrats are concerned that they will lose a significant number of seats in both the House and Senate, some will argue that Democrats should eschew tax increases and "punt" the deficit debate until after the election. This approach certainly will be considered and will be favored by some; however, it is unclear whether it will prevail. The deficits are high, and the President and Congressional Democrats will be under significant pressure to show some progress toward reducing them this year.

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The Administration will have to rely primarily on higher business taxes to raise needed revenue.

# ERISA: Investment of Pension and Other Plan Assets

The U.S. Department of Labor's Employee Benefits Security Administration ("DOL"), which is responsible for almost all federal regulation and enforcement relating to investments by or for private-sector pension and other employee benefit plans, has signaled that it will be active in the coming year. In addition, Congress may pass legislation that would add to the DOL's workload and increase the complexity of regulations.

The following three key areas are likely to see increased DOL or Congressional attention and action.

### *Investment Advice to Participants in 401(k) Plans*

Although there is a general consensus that employees in participant-directed 401(k) plans need access to expert investment advice in order to make appropriate investment decisions, there is no agreement about who should provide the advice, or the conditions under which it may be provided. The Pension Protection Act of 2006 ("PPA") permitted persons who managed investment options in a participant-directed plan (or affiliates of the manager) to provide investment advice to plan participants as long as certain conditions were met. The DOL finalized a regulation in January 2009 that would have implemented this part of the PPA, but withdrew it in November 2009, following strong Congressional criticism.

Current Congressional leaders have made clear that they think the PPA and the withdrawn regulation failed to protect workers from conflicted and self-interested investment advice. The DOL is working on a new regulation that will, presumably, address Congressional concerns. The new regulation is likely to impose far more restrictive conditions regarding advice to employees by a manager (or affiliate) of an investment option in a plan than those contained in the withdrawn regulation.

### *Fee Transparency and Increased Reporting of Fees*

Reporting of Fees and Indirect Compensation to the DOL. The DOL has long been concerned that plan sponsors and participants do not get enough information about fees charged for services to plans. The DOL has been particularly concerned about so-called "indirect" or "hidden" fees. In 2007 the DOL substantially revised Form 5500, a key DOL filing and disclosure document for plan fiduciaries and participants, to require plans to report compensation indirectly received by their service providers. 2010 is the first year in which Form 5500 must be filed under the new rules, and those filings may well prompt DOL examinations of compensation paid to service providers.

Proposed Rule on Disclosure of Fees to Plan Participants. In the summer of 2008, the DOL proposed a regulation that would have required increased and purportedly simplified reporting of fees in 401(k) plans to employees that participate in those plans. The DOL has taken no further action since the proposal, but a key Congressional committee has reported out a bill intended to accomplish the same goal, and the DOL may revive the proposed regulation. The DOL and Congress are likely to continue to push for more disclosure to participants without regard to recent Securities and Exchange Commission ("SEC") activity such as the new short-form prospectus.

Proposed Rule on Disclosure of Fees in Service Contracts. The DOL may return to another proposed but dormant regulation relating to fee disclosures. That 2008 proposal would require service providers to make certain disclosures regarding fees at the time of contract with a plan, and would mandate certain provisions on fee disclosure in service agreements with plans.

### *Investigation and Enforcement Involving Financial Service Providers*

Recent experience suggests that the DOL has substantially increased the number of examinations and investigations relating to plan investments, investment advisers and financial service providers. The DOL may be jump-starting its efforts by communicating with other agencies, including the SEC, which executed a memorandum of understanding ("MOU") with the DOL in mid-2008. The MOU is designed to increase the sharing of information about investigations and possible violations of both ERISA and the federal securities laws. The DOL's efforts are likely to continue and appear to be intended to improve the DOL's understanding of fee, compensation, and disclosure practices that concern the DOL, and to identify areas of potential self-dealing involving investment advisers and others that are or may be fiduciaries responsible for investing plan assets.


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The DOL's efforts appear to be intended to improve its understanding of fee, compensation, and disclosure practices and to identify areas of potential self-dealing.

# SEC Enforcement: Aggressively Assessing Blame

The coming year will likely see a sharp increase in both the number and intensity of investigations by U.S. securities regulators. More actions will be brought, particularly against individuals, and harsher sanctions will be sought. While most actions will continue to be resolved by settlement, potential subjects of enforcement action may be increasingly likely to see litigation as a viable alternative.

This follows a very difficult year for the Securities and Exchange Commission ("SEC"). It was widely agreed that the global financial crisis of late 2008 resulted in part from significant flaws in the existing framework of financial regulation. Some of the remedial proposals under consideration during 2009 would have reallocated large portions of the SEC's jurisdiction, or eliminated the agency altogether, but by late 2009, threats to the SEC's mandate seemed to have faded.

The SEC faced intense pressure to identify and punish those who had engaged in misconduct in connection with the financial crisis. At the same time, however, public confidence in the SEC's ability to perform its core missions was shaken by a series of events, including the agency's performance in connection with the failure of Bear Stearns and its failure to have detected sooner the massive Ponzi scheme directed by Bernard Madoff. Over much of the second half of 2009, the SEC's Enforcement Division undertook a profound self-examination, leading to an internal reorganization of the Division, and a re-evaluation of its strategic and tactical approaches to enforcement.

The impact of these events will be reflected in 2010, with securities enforcement activity likely to reflect a number of key dynamics.

### *Increased resources*

Federal authorities will be able to mount more—and more intensive—investigations than ever before. The SEC's $1.1 budget billion for fiscal 2010 is more than 10 percent larger than last year's, and includes $85 million more than the agency had requested from Congress. Still greater amounts will become available if the Senate's proposal to permit "self-funding" of the agency is enacted, allowing the agency to retain the money it collects in fees, fines and penalties. Congress also increased funding for the Department of Justice to pursue financial fraud cases, with 120 new Assistant U.S. Attorneys and 50 new FBI agents being added.

### *A more aggressive and efficient enforcement process*

The SEC's top leadership is mandating that investigations produce rapid and meaningful results, and with Robert Khuzami, a former federal prosecutor, heading the Enforcement Division, the agency is adopting new approaches, including some drawn from those customarily used in criminal investigations.

**Priority areas.** Some investigative staff has been assigned to specialize in particularly complex areas to increase the level of knowledge and understanding that the agency can bring to bear. The five specialized units are: (i) Asset Management; (ii) Market Abuse; (iii) Structured and New Products; (iv) Foreign Corrupt Practices Act; and (v) Municipal Securities and Public Pensions. These areas, along with insider trading, are the highest priorities for the Enforcement Division in 2010.

**Faster investigations.** The Division has streamlined its internal procedures to provide greater discretion to lower-level personnel so that they can act swiftly and be more strategic in their enforcement efforts.

**Less flexibility.** With the flurry of second-guessing that followed the Madoff scandal, fears of overlooking the next big fraud may lead investigators to be relatively inflexible about negotiating the scope of subpoenas and extending deadlines for response.

**Reassignment of SEC managers to investigative roles.** As part of the Enforcement Division's internal reorganization, one layer of supervisory management has been eliminated, with the majority of former "branch chiefs" reassigned as front-line investigators.

**Incentives for cooperation by potential subjects of enforcement action.** While witnesses who provide incriminating information about others have often been able to avoid or lessen the severity of enforcement action for their own shortcomings, the Enforcement Staff has never been willing to make firm commitments to this effect. Taking a page directly from the Department of Justice's playbook for criminal investigations, the SEC will now enter into agreements to permit individuals and companies to avoid or lessen the severity of any potential enforcement action against them, in return for their cooperation with investigators. Such agreements will take the form of "cooperation" agreements," in which the Enforcement Division agrees to recommend to the Commission that credit be given for assistance provided, and "deferred prosecution" and "non-prosecution" agreements, in which the Commission itself agrees not to bring enforcement action if a party provides full cooperation and complies with express undertakings.

As the SEC's Enforcement Director has noted, these incentives to promote cooperation may result in more instances in which persons under investigation require their own counsel, separate from company counsel or counsel for other similarly-situated employees.

Fears of overlooking the next big fraud may lead investigators to be relatively inflexible about negotiating the scope of subpoenas and extending deadlines for response.

The Commission is also issuing guidance on the ways in which it will evaluate cooperation by individuals, along the lines of its 2001 guidance on factors considered in evaluating cooperation by companies.

**Bounties to whistleblowers.** Pending legislation would permit the SEC to pay "bounties" to whistleblowers for information that uncovers securities law violations. Such payments are currently made only for information regarding insider trading, and any expansion of the program can be expected to result in an increased number of whistleblower allegations.

**More emergency relief.** The Enforcement Division sought emergency relief, such as Temporary Restraining Orders, at record levels in 2009. That trend should continue in 2010 as part of the Enforcement Division's efforts to move quickly and aggressively.

### *More litigation*

In this environment, those who become the subject of enforcement action, particularly individuals facing career-threatening sanctions, may be increasingly likely to litigate rather than settle charges proposed against them.

Proposed sanctions likely will be generally harsher, with relatively more actions against individuals in response to widespread calls to impose responsibility on those who contributed to the global financial crisis. Enforcement officials will be keen to avoid a repeat of the proposed settlement between the SEC and Bank of America, in which Judge Rakoff questioned why individuals were not charged. Enforcement officials may also seek to extend theories of liability beyond existing precedent, as they apply existing laws and regulations to the types of novel financial products and situations involved in the financial crisis.

These circumstances will cause increasing numbers of those charged with wrongdoing to litigate rather than settle such cases. This trend may be further enhanced by a series of recent litigation setbacks for the SEC, as in its high-profile insider trading case against Mark Cuban. The SEC is bolstering its trial unit in anticipation of an increase in court challenges.

### *Continuing competition between federal and state law enforcement*

The prospect of state authorities seeking to take a leading role in high-profile securities enforcement matters remains a real possibility. Over the past decade, state attorneys general acted with great speed and imagination to capture the initiative in areas ordinarily considered to be part of the SEC's jurisdiction, such as research analyst conflicts of interest, and market timing of mutual funds. Given the political ambitions of many state attorneys general, this trend is likely to continue. State securities regulators should also be aggressive in their enforcement efforts, which are discussed in the related article on this subject later in this report.

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# China: Year of the Tiger

As China works to recover from the global economic crisis, we expect to see a number of trends affecting business and investment.

### *Trade disputes between China and its trading partners*

Last year, China overtook Germany as the world's largest exporter. Chinese exports are likely to continue to grow in 2010, particularly given China's determination to maintain the stability of the RMB's exchange rate. Conflicts emerged in 2009 over this policy, and some of China's trading partners took retaliatory action, such as the United States' imposition of special tariffs on Chinese tire products, which led to China's subsequent imposition of tariffs on American auto products and chicken meat. More of these disputes are likely to unfold in 2010.

At the same time, developed nations may take issue with policies that China adopts to protect its domestic industries. For example, many trade associations in the developing countries have raised objection to a joint circular (Notice No. 618) posted on November 15, 2009 that imposes onerous and discriminatory requirements on foreign companies seeking to sell into the Chinese government procurement market.

China's Ministry of Commerce ("MOFCOM") has indicated that it intends to make use of comprehensive measures to resolve trade disputes, including political consultation, legal actions, and the World Trade Organization ("WTO") dispute resolution mechanism. MOFCOM also intends to monitor key industries in China and to pursue legal action and impose trade remedies as appropriate to domestic industry. Further trade disputes seem certain to evolve, with China and its trading partners taking countermeasures and pursuing a variety of avenues, including political ones, to resolve these conflicts

### *Anti-monopoly and concentration regulation*

New regulations regarding the implementation of China's 2008 anti-monopoly and concentration laws became effective January 1, 2010. These measures provide more detailed guidelines on MOFCOM's implementation of the provisions regarding concentration set forth in the Anti-monopoly Law of China and the Provisions of the State Council on Thresholds for Prior Notification of Concentrations of Undertakings.

The Measures on the Notification of Concentration of Undertakings explain the concentration notification criteria relating to concentration activities, and provide a method for calculating turnover that broadens the scope of the merger control regime.

The Measures on the Review of Concentration of Undertakings set out MOFCOM's process for reviewing mergers filed for approval. Under these procedures, MOFCOM may, in its discretion, convene public hearings to review a merger notification. The merger parties will have the opportunity to make written submissions and to satisfy regulatory objections to a merger by proposing restrictive measures to remove or alleviate potential anti-competitive effects.

Foreign companies involved in acquisitions subject to anti-monopoly examination in China will need to understand this process and plan carefully to obtain the necessary approvals.

### *Foreign investment in RMB funds*

Most new investment funds in China, as well as most fund investments, are in RMB rather than foreign currencies. Foreign fund managers have been precluded from establishing RMB funds in China, but have sought permission to do so because RMB funds can invest more easily in Chinese domestic companies and can participate in China's Growth Enterprise Market, which was established in October 2009, as well as in the already-existing A-shares markets. RMB funds also can provide a relatively viable exit strategy for foreign venture capital and private equity investors. The Carlyle Group is reported to have obtained regulatory approval to establish an RMB fund with RMB 5 billion, and additional investment vehicles of this type are sure to follow. The ability of foreign investors to establish RMB funds may also be facilitated by the March 2010 effectiveness of the Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals. This will make it possible, at least in theory, for foreign investors to establish a fund in China by using the form of a Chinese limited partnership.

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Further trade disputes seem certain to evolve, with China and its trading partners taking countermeasures and pursuing a variety of avenues, including political ones, to resolve these conflicts.

# FDA: Swift and Aggressive Enforcement

With regulatory authority over foods, drugs, medical devices, dietary supplements, infant formula, cosmetics, biologics, and veterinary products, the U.S. Food and Drug Administration ("FDA") regulates 25 cents of every dollar spent in the United States. For 2010, FDA-regulated industries face a significantly increased level of enforcement activity by the agency.
According to FDA Commissioner Margaret Hamburg, if the agency's past enforcement program seemed "slow" due to a careful and deliberate approach to enforcement, the new norm will be swift and aggressive, with a "shoot first and ask questions later" approach to enforcement. The FDA's new objectives are to be vigilant, strategic, quick, and visible. Under this new enforcement program, the agency has announced that it will:

### *Establish Post-Inspection Deadlines*

Following a facility inspection resulting in findings of significant noncompliance, a company will have no more than 15 days in which to respond before the FDA will move ahead with a Warning Letter or other enforcement action. While in the past this 15-day response was informal and routinely extended, now the request is formal (published as a Notice in the Federal Register), and the deadline will be enforced.

### *Issue Warning Letters Faster*

A streamlined Warning Letter review policy limits the FDA's internal legal review to only those letters that present significant legal issues.

### *Enhance the FDA's Existing Relationships with its Regulatory Partners*

By enhancing the FDA's existing relationships with local, state, and international partners, the agency hopes to act more quickly when the public health is at risk.

### *Prioritize Enforcement Follow-Up*

After issuing a Warning Letter or initiating a major product recall, the FDA will move faster to assess industry response and compliance.

### *Increase Enforcement Readiness*

This will allow the FDA to act swiftly and aggressively when needed to prevent potential public health risks.

### *Implement a Formal Warning Letter "Close-out" Process*

Following receipt of a Warning Letter and an FDA inspection confirming that the identified problems have been resolved, the FDA will issue a formal "close-out" letter indicating that the identified violations have been successfully addressed.
In the nearly five months since these steps were announced, the FDA has rapidly increased its enforcement activities. In just the last three months, the FDA has:

- filed an action seeking a permanent injunction against a seafood processing company and its executives;
- obtained a consent decree and permanent injunction against a dairy farm and its owner;
- embarked on a coordinated weeklong international effort that resulted in the issuance of 22 Warning Letter to owners of web sites that marketed unapproved or misbranded drugs to U.S. consumers;
- issued Warning Letters to 17 LASIK ambulatory surgical centers for maintaining inadequate adverse event reporting systems; and
- sent Warning Letters concerning two over-the-counter products that combined aspirin with a dietary supplement.

The FDA has also acted to increase its collaboration with local and international regulatory partners. In November 2009, the FDA announced its collaboration with the Food Safety and Inspection Service of the U.S. Department of Agriculture to improve tracing of unsafe food products and ingredients that may cause illness outbreaks or present other risks to the health of consumers. In December 2009, Customs and Border Protection announced, in conjunction with the FDA, the opening of a center "devoted" to ensuring the safety of imported foods. Also in December 2009, the FDA expanded its non-U.S. presence by opening an office in Mexico City, Mexico. The addition of this office brings the FDA's non-U.S. offices to six, with the others being China, India, Costa Rica, Chile, and Belgium.

As the new enforcement program is further implemented in 2010, we expect to see an increasingly aggressive FDA. In particular, we expect more Warning Letters, more inspections, and more aggressive enforcement activity (*e.g.*, more injunctions, subpoenas, civil penalties, seizures, and criminal prosecutions). Consequently, companies should move swiftly to address potential compliance issues, conduct internal audits, and identify areas of concern sooner rather than later. Companies facing FDA enforcement should focus on demonstrating their commitment to public safety and efforts to improve overall compliance.


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The new norm will be swift and aggressive, with a "shoot first and ask questions later" approach to enforcement.

# Telecommunications, Media and Technology: Building Out Broadband and Contesting Net Neutrality

### *The U.S. Market*

No significant telecommunications, media, and technology ("TMT") legislation is expected in 2010, other than the reauthorization of provisions that allow direct broadcast satellite providers to carry local TV stations. The U.S. Federal Communications Commission ("FCC") looks ready to act on multiple, often-overlapping fronts, including the following.

### *Net neutrality*

The FCC's contentious and ongoing rulemaking proceedings to preserve an open Internet and establish new net neutrality rules will continue in 2010. The FCC has proposed to codify six policy principles relating to Internet user freedoms and the treatment of online content in a nondiscriminatory manner. Telecom and cable network operators generally oppose the proposed rules, arguing that they would unduly restrict their ability to manage their increasingly congested networks. Application and content developers and consumer groups largely support net neutrality. Likely areas of contention in 2010 include the proposed extension of the rules to all platforms, including wireless networks, and the definition of "reasonable" network management.

### *Broadband*

The American Recovery and Reinvestment Act of 2009 (the "Recovery Act") requires the FCC to propose a national plan to extend broadband internet services to all Americans. The FCC appears eager to use this mandate as a basis for updating and adopting a wide range of regulations affecting the TMT sectors. At this point, nothing is off the table at the FCC in the name of broadband—even the once sacred cow of local television broadcasting, which is facing calls to repurpose its spectrum for wireless broadband use. We anticipate that interested parties will be actively pursuing opportunities that would be created by the proposals, or seeking to preserve advantages that may be lost, with significant activity at the FCC and before the U.S. Congress and the courts.

We expect the FCC to initiate several rulemaking proceedings to implement the broadband plan on a fast track, which should also include recommendations for new legislation necessary to execute the more novel aspects of the plan. The Recovery Act also set aside more than $7 billion to expand deployment of broadband infrastructure in underserved areas and to spur broadband adoption through grant and grant/loan programs administered by the U.S. Department of Commerce and the U.S. Department of Agriculture. Awards are starting to flow from the first round of funding under the programs, and a final funding round will be announced early in 2010, with final awards being expected in the third quarter of 2010.

The FCC Broadband task force, which has held numerous field hearings on aspects of the broadband plan, has recommended expanding the Universal Service Fund, primarily a rural phone subsidy program, to help fund broadband service in unprofitable parts of the country. This task force also encouraged the FCC to reallocate and find more spectrum to build out wireless broadband services, including a proposal to reallocate portions of spectrum used by local TV stations for wireless broadband services. Facing objections from the traditionally powerful TV industry, the wireless industry argues that it needs the broadcast spectrum to roll out the next generation of advanced wireless services, thereby spurring job growth and innovation.

### *Antitrust*

The U.S. Federal Trade Commission ("FTC") and Department of Justice are expected to get far more active on antitrust matters affecting the TMT sectors, including on consumer protection issues and concerns arising from media consolidation (an issue presented by the proposed Comcast-NBC Universal merger).

In August 2009, the FCC opened two wide-ranging inquiries into promotion, innovation and investment in the wireless industry and into the impact of competitive wireless market conditions on consumers, including mobile broadband competition. In 2010, these inquiries will continue and may result in rulemaking proceedings. Along with these ongoing inquiries, the FCC will expand the scope of its traditional report to Congress on the issue of wireless industry competition to include a wider range of mobile vendors, providers and developers. The FCC may also elect to adopt rules relating to exclusivity arrangements between mobile wireless carriers and handset manufacturers and the industry practice of "locking" handsets to function on only a particular service provider's network.

With an eye towards the declining newspaper and TV industries, the FCC also may lift the rule that restricts the common ownership of a daily newspaper and a television or radio station in the same market, and rules that restrict entities to owning only two TV stations in the same market. This change will only affect a few TV broadcasters, however, and would not address the underlying advertising revenue model and distribution issues troubling the TV and newspaper industries.

### *Privacy*

With the rise of online behavioral advertising technology, the FTC has started to examine whether ad industry self-governing efforts are sufficient to protect the privacy interests of consumers. The FTC is also likely to examine privacy risks associated with the policies of increasingly popular social media websites, like Facebook. These initiatives may lead to new regulations, guidelines or litigation.

The FCC appears eager to use its mandate as a basis for updating and adopting a wide range of regulations affecting the TMT sectors.

### *State actions targeting service providers*

Finally, we expect state attorneys general to continue to aggressively pursue investigations and litigation relating to the consumer practices of wireless service and other TMT service providers in 2010. The issues raised in these disputes could cause the FCC to revise its policies governing the practices of wireless service providers, such as the FCC's "Truth-in-Billing" rules.

### *The European Union and Germany*

E.U. New E.U. Telecoms rules entered into force on December 19, 2009. The reforms in many ways run parallel with efforts in the U.S. market, including measures designed to improve competition, protect consumers, ensure an open Internet, centralize and streamline E.U. authority over spectrum policy and TMT competition issues, and facilitate the implementation of broadband access for all Europeans. The new rules provide, among other things, for the establishment of a new European Telecoms Authority, to be called the Body of European Regulators for Electronic Communications ("BEREC"). The BEREC will be established in spring 2010, with its initial agenda expected to cover international roaming, next generation network access, monitoring, convergence and net neutrality. All 27 E.U. Member States are required to enact this reform as national legislation by June 2011.

Germany. In Germany, the most important TMT issue of 2010 is expected to be the auction of new frequencies, with the German Federal State planning to hold its largest spectrum auction this year. Part of this auction will be the so-called digital dividend, which is a frequency band between MHz 790 and 862, currently used mainly for radio transmission and wireless microphones, but being opened for telecom services aimed at establishing nationwide broadband Internet service in Germany, including its rural areas. Additional frequencies in the range of 1710 to 1725 MHz, 1805 to 1820 MHz and in the range of 1.8 GHz, 2 GHz and 2.6 GHz, will be auctioned for use in any form of wireless telecommunications services. Lawsuits by two mobile operators against the German Federal State, arguing that the auction rules are unfair, could delay the auction. We also expect new efforts to regulate termination fees of mobile operators, an issue also of some controversy in the U.S.


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# CFTC: A Higher Profile and New Initiatives

It seems virtually inevitable that, in 2010, the U.S. Congress will enact major legislation overhauling the framework for the regulation of financial markets. Any such legislation is expected to expand the regulatory and enforcement jurisdiction of the U.S. Commodity Futures Trading Commission ("CFTC") regarding over-the-counter ("OTC") derivatives. A comprehensive bill passed the House on December 11, 2009, H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009, and the Senate is expected to pass its version later this year. The House-passed bill would repeal various provisions of the Commodity Exchange Act ("CEA") enacted in 2000 that exempt certain OTC off-exchange transactions from the CEA.

The current House and Senate bills create new regulatory frameworks for "swaps" that would require many current OTC transactions to be traded on exchanges and/or cleared through central counterparties. The legislation would create new categories of CFTC registrants—including "swap dealers" and "major swap participants"—and would grant the CFTC authority to impose margin and position reporting requirements for certain OTC transactions. It appears that commercial end-users of commodities might avoid being classified as swap dealers or major swap participants if they limit their swap trading to (i) hedging positions, (ii) closely balanced positions (so that there is not a substantial net position outstanding), or (iii) positions reasonably believed to pose no systemic risk to the U.S. Banking or Financial Markets.

Opposition to many features of the House and Senate bills is growing among market users, so it remains to be seen what the final legislation will entail.

### *Imposition of New Futures Contract Position Limits*

In 2010, the CFTC has proposed new limits on the number of speculative futures and options contracts a trader, or an affiliated group of traders, may hold in certain energy contracts (crude oil, gasoline, heating oil and natural gas) and it is possible that limits could be proposed for other commodities, such as for metals, as well. Today, a number of commodity futures contracts have no contract limits, and the existing limits on a number of contracts are not absolute. Proponents of new, hard contract limits believe that they will stem commodity price volatility and inflation by preventing "excess speculation."

CFTC Chairman Gary Gensler has supported the adoption of new limits, and it appears that most of the other CFTC Commissioners would provide varying degrees of support for some form of limits. Many market participants have opposed new position limits out of concern that they will harm markets by reducing liquidity. On December 16, 2009, the U.K. Treasury and Financial Services Authority joined the opposition, stating "we do not believe a case has been made which demonstrates that prices of commodities …can be effectively controlled through the mandatory operation of regulatory tools such as position limits, whether on exchange or OTC."

### *International Regulation*

Since the mid-1990s, the CFTC staff has issued "no-action" letters to more than 20 non-U.S. boards of trade (often referred to by U.S. regulators as "foreign boards of trade" or "FBOTs"), permitting them to provide their members located in the U.S. with direct access to the FBOT's electronic trading and order matching system. Originally, access was provided by trading terminals, but is increasingly made possible through sophisticated software. This permission has been a boon to the FBOTs by eliminating the cost associated with members otherwise needing to route orders through non-U.S. affiliates.

Under financial regulatory reform legislation recently passed by the House, if a contract traded on an FBOT settles against the price of a contract traded on a U.S. exchange, the CFTC would be required to take into account additional issues before direct market access could be permitted, including (1) publication of daily trading information, (2) position limits, (3) authority to prevent manipulation, excessive speculation and disruption of delivery or cash settlement processes, and (4) large trader reporting. The CFTC went even further in its October 16, 2009 Joint Report on harmonization of regulation with the Securities and Exchange Commission ("SEC"), recommending legislation that would empower the CFTC to require FBOTs to register with the CFTC. Various CFTC Commissioners have in the past suggested that the no-action process become more formalized and that the CFTC adopt regulations to govern direct market access to FBOTs, but the difficult jurisdictional issues involved have caused the CFTC to maintain its no-action approach. In this area, as with position limits or increased regulation of derivatives, any CFTC actions could have international consequences. The CFTC will need to coordinate with its counterparts to avoid business being relocated from the U.S. If a provision similar to that in the current House bill were to be enacted, it would be unlikely that the CFTC would receive authority to require registration of FBOTs anytime soon.

### *Enforcement*

CFTC enforcement in 2010 can be described quite simply: more and more intense. New legislation is expected to expand the agency's enforcement authority over OTC transactions, and the expected larger budget for the agency will assuredly translate into increases in enforcement staff. Top targets of investigations will likely continue to be energy trading, solicitation schemes for trading in non-U.S. currency, any futures and OTC trading perceived to be disruptive to commodity pricing, international trading operations affecting U.S. markets and commodity pricing, Ponzi schemes, and fraud in commodity pool operations. The CFTC Enforcement Division's push into investigating trading operations in international venues should lead to greater coordination with the law enforcement bureaus of other countries. The CFTC Enforcement Division has sought to nurture these relationships, with those efforts aided by its eminence within the international enforcement community. Congressional dissatisfaction with perceived excessive speculation and price volatility in commodity markets will increase pressure on the CFTC to ratchet up civil sanctions and to refer more matters for criminal investigation.


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# UAE: Steps to Recovery

Last year was a difficult one for the United Arab Emirates ("UAE"), both because of the restructuring of the Dubai World group and the profoundly negative impact of the global economic crisis on sentiment towards real estate, a cornerstone of the UAE's plans to move away from reliance on oil revenues for economic growth. Looking ahead, we anticipate a number of notable developments at federal and emirate levels in 2010.

### *Development of nuclear power*

The eagerly awaited award of the contract to develop the first nuclear power station on the Arabian peninsula was announced on 28 December 2009. To be located in the Emirate of Abu Dhabi, the project, worth in excess of $20 billion, will lead to further such projects across the Middle East, as well as the development of an entirely new business sector for the region. A number of countries that possess nuclear technology, including the U.S., U.K., France, Japan, South Korea and Russia, have signed agreements with the UAE and other Arab states that will permit the sharing of nuclear know-how for civilian purposes. The biggest challenge for the UAE and similar emerging economies will be to establish and police a comprehensive regulatory framework to ensure that international best practices are adopted in this sensitive sector.

### *Corporate governance*

With corporate governance very much in the limelight due to the many high profile corporate and financial scandals around the world, a new law is to be introduced in 2010 to impose on UAE-listed companies mandatory requirements for greater transparency and more effective levels of governance. The new law, developed by the Emirates Securities and Commodities Authority, will enhance the UAE's reputation as a place for international trade and commerce.

### *Relaxation of restrictions on foreign ownership*

Long-awaited revisions to the UAE Commercial Companies Law are expected to be introduced in 2010. Current law prevents foreigners from owning more than 49% of limited liability companies established in the UAE, other than those in designated free zones. The new law is expected to permit higher levels of foreign ownership, possibly up to 100% in certain industry sectors.

### *Bankruptcy and insolvency reform.*

Events relating to the Dubai World group of companies pointed up significant inadequacies in the UAE insolvency regime, which were addressed in that case by an emergency decree of the Dubai government in December 2009. It is expected that these issues will be addressed by a new Federal law on bankruptcy and insolvency in 2010.

### *Health care and education*

We will also expect to see further developments during the course of 2010 in areas such as health care and education, sectors which have already attracted significant interest in recent years. The insurance industry will benefit from the expansion across the UAE and in other parts of the Gulf countries of mandatory health care insurance for foreign workers. Public-Private Partnership structures are expected to be adopted for new hospital and education facilities.

### *Transport*

A range of transport related projects and initiatives will take a step forward this year. Major projects for 2010 include the opening of Dubai's Al Maktoum International Airport, the development of a $1 billion aerospace cluster at Al Ain International Airport for aerospace manufacturing and services firms, the construction of a freight railway traversing the UAE and the development of light rail and metro systems to serve central Abu Dhabi. It is anticipated that a new airline licensing regime will be introduced in the UAE to regulate the airlines permitted to operate in UAE airspace.

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A new law is to be introduced in 2010 to impose on UAE-listed companies mandatory requirements for greater transparency and more effective levels of governance.

# Broker-Dealers: Bracing For a Legislative and Regulatory Hangover

In the aftermath of the near-collapse of the nation's financial markets, proposed Congressional, SEC and self-regulatory organization initiatives have sought capital markets reforms that would affect the activities of broker-dealers in significant ways.

### *Operation of Dark Pools*

The Securities Exchange Act of 1934 grants the SEC broad rulemaking authority to promote a national market system ("NMS") and, in particular, to encourage "the availability to brokers, dealers and investors of information with respect to quotations for and transactions in securities." Late in 2009, the SEC proposed amendments to Regulation NMS and Regulation ATS to address the trading and reporting activities of so-called "dark pools" of liquidity, which are forms of alternative trading systems ("ATSs") registered with the SEC as broker-dealers. The proposed amendments seek to address concerns regarding market fragmentation, the potential for multi-tier markets and the lack of effective price discovery by requiring public reporting of certain pre- and post-trade information generated by dark pools. At the same time, the SEC sought to preserve the anonymity of block-trading activities of broker-dealers by exempting from each of the proposals specified block-trading and block-crossing activities above a certain size in order to protect institutional orders from front-running.

The SEC has proposed the following measures to bring transparency to dark pool trading:

### *Public Display of Actionable Indications of Interest*

Dark pools are generally not required to publicly display pricing information in NMS securities—essentially listed equity securities—because "dark pool" quotations, which are available only to those participating in the pool, generally take the form of "indications of interests" ("IOIs") sent only to selected traders, rather than "bids" or "offers," which are subject to public reporting under Regulation NMS. The SEC is concerned that this structure could lead to two-tier markets and could inhibit price discovery. In order to make this information broadly available to the market, the SEC proposed to amend the definitions of "bid" and "offer" in Regulation NMS to eliminate the current exemption for IOIs on the basis that certain so-called "actionable" IOIs are the functional equivalent of bids and offers, and thus should be publicly available and widely dispersed.

### *Lowering Volume Thresholds Under Regulation ATS*

An ATS is exempt from regulation as an exchange if it is registered with the SEC as a broker-dealer and publicly displays information on orders exceeding a 5% volume threshold during a specified period. Dark pools typically avoid publicly displaying and providing access to their best-priced orders because their trading volume falls below the current 5% volume threshold of Regulation ATS. Thus, the SEC, in a parallel initiative, proposed amendments to Regulation ATS to lower this volume threshold triggering the public order display and execution access requirements from 5% to 0.25% in order to provide more transparency and access to equity trading through dark pools.

### *Post-Trade Identification of Dark Pool and Other ATS Trading Venues*

The SEC also intends to enhance consolidated market information by requiring the post-trade reporting of the identity of dark pools and other ATSs where trades have been executed; currently these trades are only identified as "OTC" (over-the-counter). Reporting the identity of the dark pool that executed a trade will enhance the ability of market participants to determine where there is liquidity in a particular stock.

### *New Rules on Sponsored Access and Bans on "Naked" Access Arrangements*

Broker-dealers that are exchange members may provide their customers electronic access to the exchange's execution system and allow customers to trade under the broker-dealer's name in so-called "sponsored access" arrangements. In "naked" or "unfiltered" access arrangements, the customer's orders do not pass through the sponsoring broker-dealer's, or even a third-party's, trading/risk-management systems before reaching the exchange.

On January 13, 2010, the SEC approved amendments to Nasdaq Rule 4611 and proposed its own rule, both of which will ban naked access arrangements and will prescribe financial and regulatory controls to address the systemic risks posed by sponsored access arrangements. Sponsored Nasdaq access arrangements, under amended Nasdaq Rule 4611, require customers' orders to pass through systems, whether administered by the sponsoring firm or otherwise, capable of implementing specified pre- and post-trade financial and regulatory controls. In addition, a firm providing sponsored access through systems that it does not administer must enter into contracts with each person sponsored by the firm that must address, among other things, the sponsored person's compliance with applicable laws and recordkeeping requirements. Nasdaq also intends to file a separate proposal to allow for more efficient surveillance by requiring firms to obtain unique market participant identifiers for each person they sponsor.

The SEC's proposed rule is intended to complement and bolster existing self-regulatory organization rules and guidance, including amended Nasdaq Rule 4611. Towards that end, the SEC's proposed Exchange Act Rule 15c3-5 differs from amended Nasdaq Rule 4611 in several key respects: (1) it would not allow broker-dealers to outsource their compliance responsibilities under the rule, whether to a customer or to a third party; (2) it would require broker-dealers to conduct at a minimum an annual review to assure the effectiveness of the controls and procedures mandated by the rule, and to obtain annual CEO certifications of compliance; (3) it would apply to sponsored access arrangements on all exchanges and ATSs; and (4) it would apply to broker-dealers' proprietary trading and agency activities in addition to sponsored access.

Many hedge funds that rely on sponsored access may find themselves compelled to register as broker-dealers.

### *Concept Release on the Structure of Equity Markets*

Also on January 13, 2010, the SEC voted to publish a concept release requesting comment on matters related to equity market structure. As part of its broad review, the SEC is seeking to ensure, among other things, that the current market structure serves the interests of long-term investors, to understand how all investors are faring in the current market structure and to determine whether that structure promotes capital formation for companies with various levels of market capitalization. To further this review, the concept release requests comments on a wide range of issues, including how small and institutional investors are faring in the current market structure; the impact of globalization on market structure; high frequency trading and related issues, such as co-location services; order routing; market data linkages; and undisplayed, or "dark," liquidity. If past experience is a guide, it may take the SEC several years to digest and act on the knowledge it will gain from this effort.

### *Fiduciary Duty*

Longstanding regulatory issues are likely to be addressed by legislative proposals in the House and the Senate that would subject broker-dealers and investment advisers to a uniform fiduciary standard of conduct when they provide advisory services to investors. The House legislation, the Wall Street Reform and Consumer Protection Act of 2009, would direct the SEC to require broker-dealers and investment advisers providing retail customers personalized advice about securities to "act in the best interest of the customer without regard to [the broker-dealer or adviser's] financial or other interest." It further provides that this standard would have to be at least as stringent as that applicable to investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"), but that broker-dealers would not have a continuing duty of care or loyalty after providing personalized investment advice. The currently available Senate discussion draft would effectively require broker-dealers providing investment advice, incidental or otherwise, to register as investment advisers, but would authorize the SEC to adopt rules providing exceptions to the Advisers Act's principal trading restrictions in recognition of broker-dealers' historical principal trading activities. Both bills would also require additional disclosure concerning conflicts of interest.


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# Public Finance: Reregulating and Rebuilding

Once thought to be generally immune from the volatile nature of the corporate equity and debt markets, the U.S. municipal bond market has suffered its share of tragedies over the course of the global economic crisis. This oft-ignored industry has recently come under microscopic examination by multiple arms of the federal government and by market participants. While 2009 was a year of fact-finding and posturing by various federal regulatory agencies, 2010 appears likely to bring significant changes to the municipal bond market.

## *Regulatory Dynamics*

Regulatory reform legislation that has already cleared the House includes provisions for federal oversight of financial and swap advisors, and changes to the composition of the Municipal Securities Rulemaking Board. The Securities and Exchange Commission ("SEC") has proposed changes to Rule 15c2-12, which regulates disclosure by municipal issuers indirectly through dealers, and expects to adopt the rule changes in final form in 2010. As proposed, the amendments would expand the reporting required by issuers regarding certain listed events relating to their outstanding bonds, apply the rule to variable rate demand obligations, and increase the reporting of tax events. The SEC has also asked for Congress to expand its authority over municipal issuers, and it has expressed interest in the repeal of the Tower Amendment, which exempts municipal issuers from certain disclosure requirements.

Over the last several months of 2009, the tax-exempt bond office of the IRS almost doubled its staff and boosted its fiscal 2010 goals for number of audits to be closed and post-issue compliance checks. Municipal bond issuers should not be surprised to find themselves actively engaged with the IRS in 2010, either as the subject of a random or a targeted audit, or as a target of compliance check.

The Department of Justice will be a major player in the municipal securities market in 2010 as it brings the first indictments stemming from its approximately four-year criminal investigation of alleged anti-competitive activities in the municipal derivatives and investment markets. Market participants anticipate that the number of individuals and firms charged in the case will increase over the course of the year.

## *Economic Dynamics*

Despite its attempt to regulate further the municipal securities market and its participants, the federal government has also recognized the bond market must serve a critical role in stimulating the economy. Access to the capital markets is essential for states and local governments to fund the infrastructure projects that will put people to work.

The American Recovery and Reinvestment Act ("ARRA") created new bonding authority and expanded existing authority. During 2009, many issuers took advantage of these ARRA bond provisions as a way to obtain cheaper funding of their projects. More issuers are expected to do the same in 2010.

As a result of these successful ARRA bond programs, several bills are pending to extend and expand ARRA, including Jobs for Main Street (H.R. 2847), which would change qualified school construction bonds and qualified zone academy bonds from tax credit bonds into direct-pay subsidy bonds in the Build America Bond model. This would permit an issuer, in lieu of issuing traditional tax-exempt bonds, to issue taxable bonds and receive periodic payments from the federal government in an amount equal to 35% of the interest paid to bondholders. In early December, the House passed H.R. 4213, the Tax Extenders Act of 2009, which included a one-year extension of the low-income housing tax credit exchange program created by ARRA, which allows state housing agencies to exchange a portion of the state's allocation of low income housing tax credits for a direct payment.


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Municipal bond issuers should not be surprised to find themselves actively engaged with the IRS in 2010.

# FCPA: Enforcement Growing Globally

In 2010, vigorous enforcement of the Foreign Corrupt Practices Act ("FCPA") is expected to remain a high priority at the U.S. Department of Justice ("DOJ") and Securities and Exchange Commission ("SEC"). Based on recent trends and agency comments, this year we expect to see (1) more proactive SEC enforcement, (2) increased international cooperation, and (3) greater numbers of individual prosecutions. The latter two trends saw tremendous increases throughout 2009, which, according to Lanny Breuer, Assistant Attorney General for the DOJ's Criminal Division, was "the most dynamic single year" in the 30-year history of FCPA enforcement. Recent reports indicate there are currently as many as 130 open investigations. Records were set with nineteen individuals indicted in 2009, and three FCPA cases proceeded to trial in 2009, all three against individuals and all three resulting in convictions. 2008-2009 saw by far the largest settlements ($800 million and $559 million) in the history of the FCPA, and both the DOJ and the SEC have bolstered their commitment to robust enforcement of the FCPA by adding more investigative resources.

## *SEC Forms FCPA Unit; DOJ and FBI Add Resources*

The SEC's Division of Enforcement recently announced that it was forming a specialized FCPA unit, indicating that it intends to take a more proactive role in FCPA investigation and enforcement. Historically, most SEC cases with FCPA implications have been self-reported, while a higher proportion of DOJ cases were reported from other sources, such as whistleblowers, cross-industry investigations, non-U.S. enforcement agencies, embassy contacts, and other non-U.S. sources. According to the SEC, it will no longer primarily react to voluntary disclosures. Rather, as explained by Robert Khuzami, Director of the SEC Enforcement Division, "more needs to be done, including being more proactive in investigations, working more closely with our foreign counterparts, and taking a more global approach to these violations." Accordingly, SEC investigations and related enforcement activity are expected to increase in 2010 and beyond as this new FCPA unit flexes its muscles.

In addition to the SEC's special FCPA unit, DOJ has recently added two dedicated FCPA prosecutors, and the Federal Bureau of Investigation ("FBI") has dedicated ten agents to assist with FCPA investigations, in addition to the dozens who have been deployed intermittently to work on FCPA matters. Robust FCPA enforcement appears to remain an increasingly important priority for each of these agencies.

## *International Cooperation and Parallel Enforcement Proceedings*

As Mr. Khuzami suggested, cross-border cooperation with non-U.S. law enforcement departments is an important objective for U.S. regulators. International cooperation has increased significantly in recent years, with DOJ recently citing assistance from authorities in France, Italy, Switzerland, the Netherlands, Germany, and the United Kingdom, among others, and the SEC acknowledging cooperation from authorities on four continents. That trend is likely to continue. In addition to enhanced international cooperation, parallel enforcement proceedings are also on the rise, which means that companies that uncover potential violations by their personnel abroad may also face investigation, prosecution, and accountability in multiple countries.

## *Individual Prosecutions on the Rise*

The year 2009 also saw an unprecedented number of prosecutions of individuals, and this trend is also expected to continue in 2010, as the enforcement agencies have apparently decided that corporate prosecutions alone have an insufficient deterrent effect. Indeed, Mr. Breuer of the DOJ recently declared that individual prosecutions were the "cornerstone" of DOJ's enforcement strategy and that DOJ's objective is to "hold every corporate executive, every board member, and every sales agent … personally accountable for FCPA violations."
In pursuit of this strategy, the SEC brought an action in 2009 against individual corporate executives who had no knowledge of or involvement in the underlying FCPA violations. This "control person" theory of liability reflects the SEC's interest in pursuing individuals under the FCPA, including top executives who the SEC contends "should have been paying more attention" to potential "red flags" and/or undertaken more stringent compliance measures. It bears watching to see if the SEC makes this "control person" theory of liability a greater focus of its enforcement efforts against individuals in 2010. Regardless, as the agencies pursue cases using increasingly aggressive theories of liability and focus more on individual accountability, including the specter of prison sentences and increased fines, more FCPA cases are expected to proceed to trial.

## *Additional Trends: Continued Focus on Specific Industries and Increasing Size of Settlements*

In addition to these major trends, recent statements by regulators and an analysis of recent enforcement activity indicate that the agencies are likely to continue their industry-specific probes, particularly those relating to the pharmaceutical, medical devices, oil and gas, telecommunications and freight-forwarding industries.

We also expect that settlement amounts will continue their general upward trend, as prosecutors continue to try to push the bar higher. In addition to increasing amounts of fines and disgorgement, DOJ and SEC officials have promised to concentrate on asset forfeiture and recovery actions in all FCPA cases, including working with their non-U.S. counterparts to repatriate any offshore proceeds of corruption where appropriate.

Taken together, these trends underscore how important it is for companies to implement robust compliance measures, such as drafting, updating, and enforcing corporate FCPA policies and guidelines, vetting business partners (including joint venture parties and intermediaries), requiring anticorruption training and certification by employees with foreign government contacts and business partners, conducting regular FCPA audits, and including anticorruption provisions in all relevant contracts.


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# Government Litigation: Takings, Contracts and Experts

In 2010, private parties' litigation with the U.S. federal and state governments is likely to be affected by developing trends relating to "takings claims," the revival of potential contract claims concerning financial regulation, and the continued scrutiny of expert testimony.

### *Constitutional Takings Jurisprudence*

The Takings Clause of the Fifth Amendment to the U.S. Constitution, extended to the states under the Due Process Clause of the Fourteenth Amendment, prohibits the government from taking property for public use without just compensation. Constitutional takings claims typically fall into two general categories: physical takings, where the government physically occupies property without compensation; and regulatory takings, where a government regulation goes too far in limiting the use of property. However, a case currently pending before the Supreme Court raises the possibility of the creation of a separate "judicial takings" doctrine, whereby the Takings Clause of the Fifth Amendment would also apply to actions by state (or possibly even federal) courts, for instance in environmental or land use rulings. The case before the Court involves a holding by a state supreme court that a state beach restoration project created publicly-owned beach rather than property belonging to the adjacent private landowner.

Although the judicial takings doctrine has never been explicitly adopted by the Supreme Court, the petitioner's position appears to have some basis in past Supreme Court precedent, and at oral argument at least some of the Justices seemed to consider the proposal seriously. If adopted, the judicial takings doctrine would have far-reaching implications for future takings claims against the government, as well as for the manner in which courts interpret legislation and apply past precedent when reviewing government actions.

### *Contract Claims Against the Government in Times of Financial Crisis*

The increasing federal regulation of the economy and private industry, resulting from the recent upheaval and uncertainty in the financial markets, may result in increasing litigation against the government on claims that the government breached its contractual obligations. Parties that have contracts with the federal government may see those contracts breached by the passage of new federal regulatory schemes, such as those addressing the financial markets. In particular, claims against the government for breaches of express or implied contracts in particular may increase as Congress alters or overturns the fundamental statutory or regulatory underpinnings of those contracts, particularly where the government accepted the risk of regulatory change in the contracts being altered.

For example, after the savings and loan crisis of the 1980s, federal legislation and regulatory actions imposed tougher capital standards on thrifts. As a result, many institutions that had acquired failed thrifts from the federal government under the prior regulatory regime were immediately thrown out of compliance with regulatory capital requirements and became subject to seizure by regulators.

Many of those institutions subsequently brought suit against the federal government, and in the seminal *Winstar Corporation* case, the Supreme Court held that the federal government had breached its contractual obligations under the purchase agreements and that the institutions were entitled to standard damages and remedies under the law of contracts.

Actions by the federal government in responding to the recent financial crisis may have similar outcomes: parties to contracts with the federal government may be able to successfully litigate claims against the government based on breaches occasioned by regulatory changes promulgated by regulators and Congress. The *Winstar* line of cases will be a valuable roadmap for such litigation.

### *Review of Expert Testimony*

Expert testimony will continue to have a significant, and often conclusive, impact on the ultimate outcome of cases involving the government. In federal courts (and many states) the standard applied to the admissibility of expert witness testimony is known as the *Daubert* standard, after a seminal Supreme Court decision, and is codified in Federal Rule of Evidence 702. This standard establishes a gatekeeper function for the judge, who must determine whether proffered expert testimony is relevant and based on a reliable methodology. *Daubert* issues can arise in both the civil and criminal context, and developments in those areas will continue to have a significant impact on the prosecution of cases involving the federal government.

In 2009, the National Research Council of the National Academy of Sciences published a study that concluded "there is a tremendous need for the forensic science community to improve" its standards in expert testimony. The study advanced thirteen recommendations, including the establishment and funding of a National Institute of Forensic Science, which would establish standard terminology, model lab reports, the funding of peer reviewed research in forensic sciences, and accreditation and individual certification for all forensic science professionals. This study will lead to a continuing focus on the reliability of scientific evidence not only in the criminal context, but also in all disciplines where expert evidence is being submitted in litigation against the government.


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Parties to contracts with the federal government may be able to successfully litigate claims against the government based on breaches occasioned by regulatory changes made by regulators and Congress.

# Consumer Product Safety Commission: Expanding Protections with Greater Resources

Within the archipelago of U.S. government agencies, the Consumer Product Safety Commission ("CPSC") is at best an islet, with a budget of only $118.2 million and a total staff barely exceeding 530. Despite its size, the CPSC has jurisdiction over an estimated 15,000 consumer products, with broad new mandates and regulatory powers under the Consumer Product Safety Improvement Act of 2008 (the "CPSIA"). During the last year, CPSC has implemented many of the new CPSIA requirements, including reducing the amount of lead in children's products, limiting phthalates in children's toys and child care products, implementing new toy regulations, requiring tracking labels on products and packaging, and mandating registration cards for durable nursery products. The agency has also initiated many other rulemakings as well. The CPSC has also been more aggressive in seeking product recalls and providing notice of hazards to the public. Although the sheer number of recalls decreased from 563 in 2008 to 465 in 2009, the number of product units recalled increased from 60.8 million to over 230 million. The CPSC also obtained larger civil penalties in 2009 and increased the number of investigators at ports of entry working with Customs and Border Protection ("CBP").

### *Enforcement*

The CPSC's aggressive enforcement efforts should continue in 2010. The CPSC is expected to hire more investigators, compliance staff, and attorneys and, with the unexpected bonus appropriations, is likely to hire more. In addition, there should be a shift of focus in 2010, from implementing the CPSIA and providing guidance to industry, towards enforcement of the new provisions and recalls of non-complying products. During 2009, the CPSC stayed enforcement of many of CPSIA's testing and certification requirements. The CPSC has announced that this stay will be lifted early in 2010, and many of these requirements will be permitted. These changes will empower the CPSC and CBP to stop uncertified or improperly certified products at ports of entry.

### *Rulemaking*

The CPSC has started the process for issuing extensive rules implementing CPSIA's provisions relating to third party testing and product certification. These rules, which are likely to be implemented in 2010, are expected to impose new financial, recordkeeping, and compliance obligations on many manufacturers.

A great number of lab accreditation rules are also likely to be implemented in 2010. In addition, under the CPSIA, the CPSC must continue to initiate rulemakings on at least two categories of durable infant products every six months. The CPSC has indicated it is also considering rules that would permit the agency to declare that products that violate various voluntary standards present a substantial product hazard, thus permitting the CPSC to more easily stop certain products at the border or to obtain recalls.

### *Public Database*

The CPSC has scheduled hearings early in 2010 regarding the development of CPSIA's public database scheme, which requires the CPSC to place all incident and recall data in a publicly available, searchable database. In 2010, there will be a great deal of discussion regarding ways to make the system accurate and to protect product reputations against those who intentionally or otherwise abuse this system.

### *CPSIA Amendments*

Finally, the CPSC staff and members of Congress have recognized that a number of unintended consequences have flowed from the implementation of the CPSIA. Regulations were inadvertently extended to some products, and CPSIA's priorities may have diverted resources of both the CPSC and industry away from more significant risks. At the end of 2009, Congressman Henry Waxman floated a possible amendment to the lead provision. It is also likely that efforts to correct perceived flaws in the CPSIA will continue in 2010.

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Changes will empower the CPSC and CBP to stop uncertified or improperly certified products at ports of entry.

# The U.K.: Election Impact and Competition Issues

## *General Election*

Events in the United Kingdom in 2010 will be dominated by the General Election, which must take place by early June and will more probably occur in May. The manifestos of the main political parties have yet to be published, although one or two hints are beginning to appear in the press (*e.g.*, the Conservatives are very concerned about the power of the major U.K. grocery chains). Thus far, issues have focused on each party's proposals to deal with the on-going economic crisis and mounting public debt burden. With a close result expected in the General Election, and possibly even a "hung Parliament", there is a prospect of legal challenges to the election process in some constituencies.

## *Regulatory Initiatives*

Government regulatory initiatives for 2010 include:

Bank overdraft charges. The Supreme Court has just published its decision on the levying of bank charges for overdrafts. The decision, which favoured the banks, came as a surprise to many, and a number of companies are reviewing their business practices in the light of that decision.

OFT investigation of retirement homes industry. The Office of Fair Trading ("OFT") has closed its file on the bank overdrafts case but is continuing its investigation of the retirement homes industry.

Actions against cartels. The OFT is expected to continue to prioritize the investigation of cartels in the U.K. 2009 saw the highest cartel fines to date. Further prosecutions are likely to be brought against individuals knowingly engaged in cartel activities, with possible prison sentences of up to five years.

OFT review of the corporate insolvency process. The OFT will continue its ongoing investigation of the corporate insolvency process, following concerns raised both by the government and by industry. Among other matters, the study will examine the structure of the market for the supply of advice and related services to insolvent corporations, and the process for appointing insolvency practitioners and circumstances that may result in harm, such as higher fees or lower recovery rates for certain groups of creditors.

BAA inquiry. The Competition Commission ("CC") is expected to re-open its inquiry into BAA (the owner of all the U.K.'s major airports), following a recent decision by the Competition Appeal Tribunal overturning the CC's decision to require BAA to divest itself of three airports. The Tribunal found that the CC's determination had been tainted by bias, due to the fact that a member of the CC sat on the board of a potential acquirer of one of the airports. The Tribunal agreed that justice not only had to be done, but had to be seen to be done, and accordingly quashed the CC's decision.

Sales practices for payment protection insurance. The CC will be consulting on remedies to improve consumers' interests in the payment protection insurance market. A remedy restricting point of sale insurance marketing, proposed by the CC in 2009, was successfully challenged by Barclays, forcing the CC to consider another approach.

CC inquiry of local bus industry. The CC will undertake a comprehensive inquiry relating to the U.K. local bus industry, including both commercial services and those subsidized by local transport authorities. The CC inquiry follows an OFT market study that found evidence that limited competition between bus operators tends to result in higher prices and lower quality for bus users, and may represent poor value for money for taxpayers. The OFT study also identified a number of features of local bus markets that may prevent, restrict or distort competition.


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Further prosecutions are likely to be brought against individuals knowingly engaged in cartel activities.

# Real Estate: Fostering "Green" Development

Engaging in and supporting "green" practices as a real estate developer or investor is no longer simply a good deed or a matter of image enhancement. It also may be the key to making some projects and investments viable, due to the continued expansion of sustainable development initiatives adopted by federal, state and local governments, as well as by private entities such as electric utilities and non-profit organizations.

These initiatives may take the form of mandatory requirements, such as incorporating green design criteria into new construction regulations. However, a more common approach used by governmental entities to foster green development practices has been the use of financial incentives. While the basic tools used are not new, their application in the sustainable development arena may provide significant opportunities in 2010 and beyond. Below are just a few examples of such incentives:

### *Green Loan Programs*

Green loan programs can provide financing for renewable energy or energy-efficient systems or equipment to a variety of sectors (*e.g.*, residential, commercial, public, etc.) at low-interest or zero-interest rates through utility companies or federal, state or local governments. In Texas, the LoneSTAR Program provides loans of up to $5,000,000 for public buildings to install efficient technologies (such as solar water heat, solar space heat, photovoltaics, wind and geothermal heat pumps) for qualified projects with a payback period of 10 years or less. Similarly, residential developers in Germany (a leader in alternative energy development) whose projects meet certain sustainability criteria may be eligible to receive loans from the federal bank "Kreditanstalt für Wiederaufbau" at below-market rates if the energy efficiency of their buildings exceeds federal law requirements.

### *PACE Financing for Energy-Efficient Retrofits*

Property Assessed Clean Energy ("PACE") financing is a bond financing program under which bond proceeds are lent to property owners (commercial or residential) to finance building retrofits that include the addition of renewable energy systems or energy-efficient improvements on their property. The property owners then repay these loans over a period of years via a special annual assessment on their property tax bills. Enabling legislation for PACE programs has been enacted in 16 U.S. states and is expected to continue to expand.

### *Subsidies for Renewable Energy Technology*

In Germany, the new Renewable Energy Act has established subsidies to be paid by grid system operators to energy providers who generate and supply renewable energy to the grid. To promote investments and improvements in renewable energy technology, newer and developing production technologies (*e.g.*, solar) are more heavily subsidized than more well-established technologies (*e.g.*, wind).

### *Permitting Priority Programs*

To provide for the priority handling of projects meeting sustainability goals and to maximize the financial incentives available for such projects, the City of Seattle, Washington has established a "Priority Green" permitting process for innovative projects that are intended to serve as "visible models of high performance and sustainability" in the City. To qualify, applicants must, among other requirements, either complete the City's "Priority Green Building Matrix" or submit a proposal that achieves a Platinum rating in the U.S. Green Building Council's Leadership in Energy and Environmental Design (LEED) program or a five-star rating in the Seattle Area "Built Green" program.

### *Federal Tax Credits*

Certain products and materials used in building construction may be eligible for U.S. federal tax credits. For example, taxpayers may be eligible to receive a federal tax credit equal to 30% (up to a total credit of $1,500) of the cost of biomass stoves, HVAC, insulation, roofing (metal and asphalt), water heaters (non-solar) and certain windows and doors that are "placed in service" between January 1, 2009 and December 31, 2010, and a federal tax credit equal to 30% (with no upper limit) of the cost of geothermal heat pumps, solar energy systems, small wind energy systems and fuel cells through 2016.

### *Property Tax Incentives*

Property tax incentives relating to green improvements or systems also may be available in the form of exemptions, exclusions or credits. A typical property tax incentive provides for the exclusion of the value of a renewable energy system or improvement from the total appraised value of the property containing such system or improvement.


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"Green" practices may be the key to making some projects and investments viable.

# Depository Institutions: Banking on Change

The structure of bank regulation in the United States is likely to be rewritten in 2010. The Obama Administration, the House of Representatives and the Senate have all proposed major changes to the banking laws. These legislative proposals, if enacted, will profoundly affect financial institutions and the holding companies that control them. The legislation is also likely to limit the activities in which financial institutions can engage. In particular, the Administration has proposed that banking regulators be authorized to break up financial institutions that had grown too large (in the view of the regulator) and to prohibit commercial banks from engaging in proprietary trading or being affiliated with firms that do, such as hedge funds and private equity funds.

An important element of the legislative debate over reforming the banking system will involve the size and nature of the carve-outs and exemptions granted to financial institutions and their holding companies in two key areas—holding company regulation and charter choice.

## *Holding Companies*

Many of the most important provisions in the pending legislative proposals relate to the regulation of holding companies.

Parents of Savings and Loans or Thrifts. The Administration's proposal would eliminate all savings and loan holding companies ("SLHCs") by reclassifying them as bank holding companies ("BHCs"), which are subject to tougher rules and regulations. While the House reform proposal would similarly reclassify most SLHCs as BHCs, it also would allow insurance companies and fraternal benefit societies owning thrifts to continue to be treated as SLHCs, not BHCs. The advantages of SLHC status for these entities would be that there are no capital requirements, activity restrictions are less onerous than those under the BHC Act, and the SLHC Act, as essentially a "dead letter," may no longer be rigorously enforced.

Parents of Credit Card Banks and Trust Companies. The Administration's proposal would subject to regulation as BHCs all entities controlling credit card banks, as well as trust companies with FDIC-insured deposits. In contrast, the House proposal would preserve existing exceptions to the BHC Act for these entities, meaning that credit card banks and trust companies with FDIC-insured deposits would not be treated as "banks," and their parent companies would be exempted from registration as BHCs and regulation by the Federal Reserve. The House proposal may in fact expand the credit card bank exception because it would expand the definition of credit cards to include "virtual or intangible devices" that "function as credit cards."

Parents of Industrial Loan Companies. The Administration's proposal would also subject firms that control industrial loan companies ("ILCs") to regulation as BHCs. Given the current activity restrictions applicable to BHCs, many commercial companies would effectively be required to divest their commercial businesses or their subsidiary ILCs. The House proposal would avoid this dilemma by creating a tier of intermediate holding companies that, while themselves generally subject to BHC restrictions on non-financial activities, would be permitted to conduct such activities through subsidiaries.

## *Charter Choice—Mutual National Bank*

The Administration originally proposed abolishing the thrift charter, while the House proposal would preserve the thrift charter and add another charter to the menu—the mutual national bank. Any insured depository institution, state mutual bank, or credit union would be able to convert to this new charter, and a mutual national bank would, in turn, be able to convert to stock form.

Impact on Credit Unions. Significantly, the mutual national bank charter would give credit unions, which are all organized as mutual organizations, another federal charter into which to convert. Under existing law, credit unions seeking to convert to a more full-service depository institution are able to do so only by converting to a federal or state mutual thrift. The mutual national bank charter may be more agreeable to credit unions than the present federal mutual thrift charter because credit union lending often lacks the predominant focus on mortgage finance characteristic of the thrift industry.


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The Administration's proposal would eliminate savings and loan holding companies by reclassifying them as bank holding companies subject to tougher rules and regulations.

# White Collar Prosecutions: Financial Fraud, Health Care and Individual Liability

White collar criminal enforcement in 2010 is expected to grow even faster and become more aggressive in tone than was the case in 2009. As a result of the global financial meltdown, mortgage fraud has become a focus for all prosecutors. Securities fraud has also become a higher priority. The discovery in December 2008 that Bernard Madoff was running a long-standing Ponzi scheme that had evaded detection for more than a decade was emblematic of these frauds. The U.S. Department of Justice ("DOJ") has pledged to aggressively pursue fraud investigations with renewed focus and has redirected resources to combating such fraud.

## *Pooling Resources to Combat Financial Fraud*

For 2010, DOJ has listed "Combating Financial Fraud and Protecting the Federal Fisc" as one of its top priorities, and has sought $62.6 million in 2010 for additional prosecutors, civil lawyers, bankruptcy attorneys and 50 new FBI agents to investigate mortgage fraud and financial crime, as well as to "address the problems that contributed to, and that are caused by, the current financial crisis." Moreover, in November 2009, the Obama Administration replaced the Corporate Fraud Task Force, established in 2002 in the wake of Enron and other high-profile corporate frauds, with the Financial Fraud Enforcement Task Force ("FFETF"), a collection of senior-level officials from DOJ, the Treasury Department, the Securities and Exchange Commission and more than 20 other federal agencies and offices. The new Task Force will use traditional methods as well as the enhanced investigative and prosecutorial tools provided in the Fraud Enforcement and Recovery Act of 2009 to aggressively prosecute both companies and individuals (such as corporate officers and employees) responsible for corporate crime.

## *Pursuing Individual Fraudsters*

The government's approach in pursuing individuals, and not just companies, in white collar cases carries with it some risk for the government. In general, cases against individual corporate employees are often hard for the government to win before juries, which appear wary of laying blame at the feet of individuals. For instance, in November 2009, the government lost a high-profile case against two former Bear Stearns hedge fund portfolio managers who had been accused of concealing the imminent collapse of hedge funds that were invested in the subprime mortgage market. Nonetheless, this and other recent prosecutorial failures do not mean the government will stop bringing these types of cases. Attorney General Holder's announcement of the new FFETF, with its aim to prosecute companies and individuals, came after the Bear Stearns acquittals, confirming the government's commitment to these cases. Indeed, when DOJ pursues individuals in the future, one should anticipate that DOJ will be sure to be even better prepared to prevail.

## *Health Care Fraud*

Federal and state governments in the United States have brought a reinvigorated emphasis on criminal, civil, and administrative enforcement in the health care area, as significant new enforcement techniques and policies have been put in place. Robust civil and criminal enforcement in the health care sector is expected to proliferate at all levels of the industry in 2010 and beyond. Traditional enforcement in this area is also expected to continue. DOJ's record-setting $2.3 billion criminal and civil settlement against Pfizer in 2009 for alleged off-label marketing of pharmaceuticals sets the tone in this area. DOJ is also supporting programs that have traditionally provided "high rates of return," such as tax law enforcement.

## *State Attorneys General*

State attorneys general can be expected to continue to focus on health care fraud and to work in conjunction with the federal government in combating financial crime, in part through coordination with the FFETF. In addition, state attorneys general are bringing a new focus to intellectual property (IP) theft, out of concern that fake branded products such as prescription drugs, brake pads and contact lenses pose a significant consumer threat. IP theft at universities through peer-to-peer file sharing and piracy is also a focus.

## *National Security*

Lastly, it bears noting that DOJ's top priority remains national security, and DOJ can be expected to pursue these cases, including the enforcement of laws that restrict financial transactions with designated countries or individuals. DOJ's December 2009 settlement of criminal and civil charges against Credit Suisse AG is illustrative. The Swiss company agreed to forfeit $536 million in connection with violations of restrictions against doing business on behalf of prohibited persons and customers from Iran, Sudan and other prohibited countries. DOJ's targeting of overseas activity is nothing new. In recent years, DOJ has been aggressively pursuing cases involving alleged bribery of foreign government officials in violation of the Foreign Corrupt Practices Act and other federal statutes, and will continue to do so.

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Cases against individual corporate employees are often hard for the government to win before juries.

# International Trade Rules: Broader U.S. Sanctions and Agreements

While unanticipated global economic and political events dictate many international trade regulatory and policy developments, some current trend lines suggest the likelihood of certain developments relating to trade sanctions, U.S. Customs, and trade agreements during 2010.

### *Likelihood of Enhanced Sanctions Relating to Trade with Iran*

As Iran continues to defy international demands to curb its nuclear weapons program, the new year brings with it the threat of stiffer sanctions and increased enforcement for companies that do business with Iran—particularly in the energy and finance sectors.

While the Obama Administration continues to pursue diplomatic efforts to design a multinational sanctions program, new unilateral U.S. sanctions also are possible. In 2009, the House overwhelmingly approved a bill, H.R. 2194, that authorizes the President to sanction non-U.S. companies that supply gasoline to Iran, as well as firms that provide support for Iran's petrochemical industry, including through the supply of equipment or services. The U.S. Senate also is expected to vote early in 2010 on a measure that would greatly expand the current U.S. sanctions on Iran. It is probable that any final Congressional action will give the President discretion to waive some or all of the new sanctions. However, at least some of the new sanctions could be used by the President if the diplomatic impasse with Iran continues.

These legislative efforts will play out as federal agencies step up enforcement of the existing U.S. sanctions programs. Late in 2009, for example, Credit Suisse AG paid $536 million to settle accusations that the bank had allowed its clients to access the U.S. banking system in connection with transactions involving Iran and other sanctioned countries, and Lloyds TSB Bank PLC agreed to a $217 million fine and other penalties for manipulating money transfers to avoid U.S. sanction restrictions.

As 2010 begins, firms that do business with Iran—or have subsidiaries, clients, or account-holders that do business there—should be aware of these evolving risks.

### *Growing focus by Customs and Border Protection on Commercial Enforcement Issues*

Since 9/11, many of the regulatory initiatives of U.S. Customs and Border Protection ("CBP") have focused on border and cargo security. These initiatives have included the Customs-Trade Partnership Against Terrorism, the Secure Freight Initiative, and the Container Security Initiative. Some observers believe that CBP may soon begin to devote greater attention to commercial enforcement issues.

One possible area of focus involves rules regarding country of origin. Traditionally, the core standard for determining country of origin under U.S. Customs laws, for both duty assessment and marking purposes, has been "substantial transformation." The last country where a commodity undergoes a substantial transformation is generally considered the country of origin for U.S. Customs laws purposes.

With the advent of bilateral and multilateral trade agreements that confer special tariff rates on goods originating in certain countries, however, an array of more specialized rules of origin have evolved. For example, under NAFTA, there are two sets of highly specialized tariff-schedule-number rules, based on tariff shift and/or value added considerations, for determining the country of origin and whether goods are NAFTA-originating. CBP recently proposed the consideration of a tariff-schedule-number specific approach for origin determinations, such as used under NAFTA, for all imports.

### *A Greater Emphasis on Regional Trade Agreement Initiatives in Lieu of Bilateral Arrangements*

The Bush Administration was the era of the bilateral trade agreement. More than a dozen bilateral trade agreements were implemented during the Bush years, and three other agreements—with Colombia, Panama, and South Korea—still await Congressional approval. The Obama Administration, including specifically United States Trade Representative Ron Kirk, does not appear motivated to continue this bilateral approach, which may signal delay for any action on the pending agreements. Indeed, the Administration's first venture into the trade agreement arena was the announcement in December of the proposed negotiation of a Trans-Pacific Partnership. The current negotiating partners include Australia, Brunei Darussalam, Chile, New Zealand, Peru, Singapore, and Vietnam. This effort may presage a more multilateral approach to future trade agreements.

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The announcement of the proposed Trans-Pacific Partnership may presage a more multilateral approach to future trade agreements.

# Financial Services Legislation: Sweeping Changes on the Way

## *Financial Services Reform Legislation*

On June 17, 2009, President Obama unveiled the most significant financial regulatory reform proposal in U.S. history since the Great Depression. Drafted by the U.S. Department of the Treasury ("Treasury"), with significant input from the Federal Reserve Board, the reforms are so sweeping, and the legislation so massive, that many unsuspecting participants in financial markets will be impacted. A modified version of the proposal passed the House in December 2009. Senate consideration is expected to begin in the first quarter of 2010. While it is unclear at this time what the final legislation will include, it is highly likely that a bill will be passed that includes sweeping changes to the U.S. financial regulatory scheme. Some of the most significant provisions being debated include the following:

Risk Regulator. A new regulator would be created to monitor systemic risk, meaning it would have the authority to identify systemically significant financial companies and subject them to stricter prudential standards relating to capital adequacy, leverage, and other regulatory matters. Once identified as being in danger of default, a new subsidiary of the FDIC would be empowered to dissolve or break up a systemically risky financial company. Other large financial companies would bear the cost associated with dissolving such a company.

Under the House bill, the regulation of all bank, savings and loan, and financial holding companies would be consolidated with the Federal Reserve, and applicable prudential standards would be tightened. Regulation of national banks and federal savings associations would be consolidated with the Office of the Comptroller of the Currency. In the Senate, even more thorough streamlining of banking regulation is proposed.

Financial Products Agency. Under the Administration proposal as passed by the House, consumer protection regulation concerning financial products would be taken from banking regulators and given to a new regulator, the Consumer Financial Protection Agency ("CFPA"). The CFPA would have authority over nearly any company offering a financial product to consumers, which will undoubtedly increase compliance costs.

While the creation of the CFPA is currently facing significant obstacles in the Senate, financial products will be covered in some fashion.

Derivatives. The over-the-counter derivatives market would be fundamentally changed, requiring anyone with a substantial net position in swaps to register as a major swap participant. This includes many unsuspecting investors that happen to own large amounts of certain commodities. Swap dealers and major swap participants would have to conduct transactions in clearable swaps on transparent exchanges and have them cleared by central counterparties.

Executive Compensation. All publicly traded companies would be required to submit executive compensation packages to a shareholder vote and establish independent executive compensation committees at the board level. Substantive prohibitions on certain executive compensation practices are also under consideration, although the legislation passed by the House would only apply such prohibitions to regulated financial companies. The European Union is considering applying similar substantive prohibitions more broadly and implementing special taxes on bank bonuses.

Additional Provisions. Advisers to most private investment funds would be required to register with the Securities and Exchange Commission. Broker-dealers would be subjected to new fiduciary duties comparable to those of investment advisers. Credit ratings agencies would be required to disclose payments received from issuers, the factors considered in issuing ratings, and any conflicts of interest.

## *Global Response*

To an unprecedented degree, the changes to the U.S. financial system are being coordinated with non-U.S. governments. As stated succinctly in a G20 communique, "a global crisis requires a global solution." As a result, a similar pattern of policy responses to the credit crisis has occurred in London and other international money centers. As the emphasis shifts from stabilization of the financial markets to preventing future crises, the breadth and depth of financial regulation will expand greatly and impact market participants around the world.


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The reforms are so sweeping, and the legislation so massive, that many unsuspecting participants in financial markets will be impacted.

# Taiwan: Increasing Cooperation with China

Over the past year-and-a-half, significant progress has been made in talks regarding trade and economic development between Taiwan and China. By the end of 2009, several broad agreements had been signed, with topics including economic relations and trade, air and ship transport, culture and education, food safety protection, media, and tourist visas.

Taiwan has lifted, to a certain extent, legal restrictions on investment by Chinese investors, and it has opened the way for Taiwan funds to invest in Chinese shares. Policies have been implemented to encourage companies run by Taiwanese in China to be listed on the Taiwan Stock Exchange or the Taiwan Over-the-Counter Market.

## *Financial MOU's*

In 2010, focus will be on the implementation and impact of the Financial Memoranda of Understanding ("Financial MOUs") signed by the financial regulators of Taiwan and China in November 2009 and on the signing of the Economic Cooperation Framework Agreement ("ECFA"). The Financial MOUs, which were signed in November 2009, and become effective in January 2010, relate to the supervision of banks, securities and futures brokers, and insurance companies. They provide a framework for Chinese and Taiwanese regulators to work together in supervising cross-border business and offshore branches or entities of financial institutions based in their respective jurisdictions. Among the issues covered are the following:

Information Sharing. Taiwanese and Chinese regulators will share information deemed necessary for them to conduct consolidated supervision of financial institutions. The agreement does not provide for the sharing of customer account data.

Confidentiality. Shared information will be used for supervisory purposes only, and shall remain confidential.

Inspections of Financial Institutions. Regulators may conduct on-site inspections of the branch offices of financial institutions in their respective jurisdictions.

Ongoing Coordination and Communication. Regulators from each side will hold regular talks or meetings, promote cooperation and encourage visits to each other. When financial institutions operating on both jurisdictions become financially troubled, both regulators will work together to resolve the problem.

## *ECFA*

The Financial MOUs do not address issues in connection with entering the financial services markets, such as potential advantages that may be offered to Taiwan investors entering into the financial services industry in China. It is anticipated that these issues will be dealt with in negotiation of a broader ECFA.

It is expected that the ECFA will differ substantially from the CEPA agreement between China and Hong Kong and from typical free trade agreements. Although Taiwan and China are both members of the WTO, they have differing commitments to the establishment of open markets for trade in goods and services. In addition, as a result of the history of political confrontation between China and Taiwan, Taiwan restricts investment by and imports from China more strictly than those from other nations. Service trade is a particularly critical issue.

Taiwanese regulators hope to reach agreement that existing thresholds on foreign investments in China will not apply to Taiwan investors. By way of example, Taiwan has expressed the hope that Chinese branches of Taiwanese banks will be allowed to engage in RMB business without being restricted by China's current restrictions on branch offices of foreign banks.

Discussions by the ECFA's task force will start in January 2010 on issues including the protection of intellectual property, trade in services, "Early Harvest", safeguards measures, investment protection, and dispute settlement mechanisms. Semi-annual reviews of the implementation of current cooperation agreements will be conducted. The hope is that these talks will continue to promote trade and investment between China and Taiwan for the benefit of both parties.

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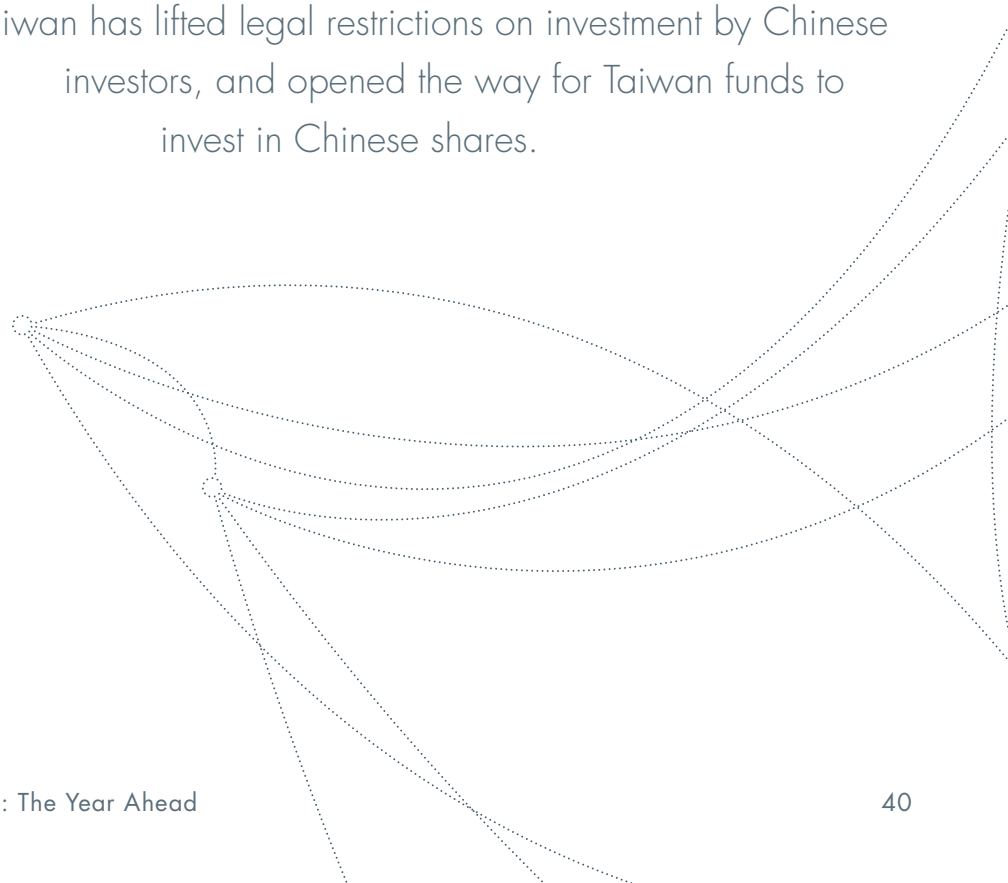
Taiwan has lifted legal restrictions on investment by Chinese investors, and opened the way for Taiwan funds to invest in Chinese shares.



# Energy and Utilities: Grappling with Higher Costs and Environmental Concerns

The energy and utilities sector promises to be active, challenging and unpredictable in 2010.

## *Federal Legislation on Climate Change and Renewable Energy Standards*

The U.S. Congress seems poised to enact federal energy legislation during 2010, although significant uncertainty remains as to the form such legislation will take. The House and the Senate moved on separate, similar bills during 2009. The House's Waxman-Markey bill would establish an elaborate cap-and-trade system to reduce greenhouse gas ("GHG") emissions over the next 40 years, and would provide for national renewable energy standards and other mandates and incentives for the production and use of renewable energy resources. The Senate's Boxer-Kerry bill is similar, but it is generally agreed that the bill currently lacks sufficient support in the Senate for passage. If GHG regulation fails to garner sufficient support, however, the Senate may instead proceed separately with a clean energy bill containing incentives and mandates to promote renewables and energy efficiency. For a further discussion of this legislation, see the article on Climate Change earlier in this report.

## *Federal Regulatory Developments*

Aside from legislation, federal regulatory changes affecting the electric power industry are pending on several fronts.

EPA: Potential Action on GHG Regulation. During 2009, the U.S. Environmental Protection Agency (the "EPA") adopted final rules requiring GHG reporting by large emitters beginning in 2010, proposed rules to require permits stipulating the best available control technologies for new facilities (or existing facilities undergoing major modifications) that emit over 25,000 tons of GHGs annually, and issued an "endangerment finding" under the Federal Clean Air Act (the "CAA") that GHG emissions endanger public health and welfare. These measures signal that the EPA is prepared to regulate GHG emissions under the framework of the CAA if Congress does not act first.

CFTC Regulation of OTC Derivatives. As a result of concerns regarding the role of credit default swaps and other derivatives in precipitating the global financial crisis, Congress and the U.S. Commodity Futures Trading Commission ("CFTC") appear anxious to impose additional regulatory requirements on over-the-counter derivatives. Those regulations could have a significant effect on the hedging activities of utilities and electric generators and on the trading of financial products within regional transmission organizations.

FERC: Electric Power Transmission Policy. Among the top priorities of the U.S. Federal Energy Regulatory Commission ("FERC") for 2010 is to clarify and enhance its requirements for transmission planning, in order to facilitate the construction of transmission projects to transport energy from renewable resource generating facilities (such as wind and solar facilities), which are often located at a considerable distance from load centers. Several proceedings currently pending before FERC could significantly shape its approach to these polices. FERC has, among other things, requested public comment on the allocation of the costs of regional transmission facilities and the appropriate roles of various interested parties in the development, construction, ownership and operation of transmission assets. Any FERC rulemaking on these highly contentious issues would extend well into 2010 and perhaps beyond.

## *Natural Gas Development: Regulation of Fracking Activities*

Natural gas development is on the rise across the U. S., with a primary focus of attention being unconventional development from shale formations, utilizing the relatively recent technologies of horizontal drilling and hydraulic fracture treatment ("fracking") to open fractures in the shale rock and release the natural gas trapped within. While these shale formations offer huge reserves of gas to power the nation's needs for decades to come, concerns have been expressed regarding the water resources and water quality impacts of such development—leading to new and evolving regulatory proposals at both the federal and state level.

Proposed federal legislation. Bills have been introduced in the House and Senate to bring all fracking activities under EPA's underground injection control regulatory program—a move that threatens to seriously delay and hinder the development of literally thousands of gas wells per year. The industry is sufficiently concerned that, in one widely-reported recent transaction (the proposed Exxon-XTO Energy merger), a deal condition would reportedly allow Exxon-Mobil to back out if anti-fracking legislation were to be adopted.

Proposed state legislation. At the state level, legislative and regulatory proposals are active in several states, including New York and Pennsylvania. Proposals include more stringent water and wastewater regulations, forced pooling arrangements, landowner bills of rights, and severance taxes.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Additional regulatory requirements on over-the-counter derivatives could have a significant effect on the hedging activities of utilities and electric generators.

# State Securities Regulators: Asserting a National Role

## *Federal Legislative Agenda of NASAA*

The North American Securities Administrators' Association ("NASAA"), the Washington, DC-based association representing U.S. state securities regulators, recognizes that 2010 presents a rare opportunity for the states to reassert their securities regulatory authority through federal legislation. This is in stark contrast to 1996, when the National Securities Market Improvement Act ("NSMIA") reduced state regulatory authority in several significant areas, such as oversight of investment advisers and Rule 506 private offerings. Given the recent financial crisis and widely acknowledged failures by the Securities and Exchange Commission ("SEC"), NASAA's well-publicized policy in favor of more vibrant state jurisdiction and against preemption of state laws has gained the attention of the Obama Administration and Congress.

In general, NASAA's federal legislative agenda reflects its members' focus on consumer protection, which is consistent with many of the Administration's initiatives. NASAA also supports several key changes that would increase state securities regulators' authority:

Investment Adviser Registration. NASAA claims that, since the SEC cannot effectively examine all of the investment advisory firms currently under its jurisdiction, the best solution is to put them under state jurisdiction by raising the threshold for SEC registration from $25 million to $100 million in assets under management. Legislation passed by the House of Representatives would adopt this approach and in fact raise the threshold for SEC registration to $150 million. Because of concerns about overextension of the SEC's resources, the Senate is likely to adopt a similar approach.

Private Offerings. Citing a dramatic rise in fraudulent activity in this area, NASAA seeks to restore state registration jurisdiction over Rule 506 offerings preempted by NSMIA, as well as an increase in the income and net worth thresholds to qualify as an "accredited investor." Removing Rule 506 offerings from "covered security" status for federal preemption would allow states to reassert their authority in an area with little current federal or state oversight.

Federal-State Cooperation. NASAA seeks enhanced federal-state-self-regulatory organization information sharing and the formation of a federal-state systemic risk council to establish crisis management protocols.

## *Regulatory*

Investment Adviser Oversight. Whether or not federal legislation provides state securities regulators with greater investment adviser regulatory responsibility, NASAA will continue its current emphasis on assisting states in providing more effective oversight of state registered advisers.

Broker-Dealer Oversight. The broker-dealer community will be impacted by NASAA's continuing efforts to streamline registration requirements among the states, while also emphasizing compliance with state agent registration requirements.

Private Placements. If Congress restores Rule 506 registration jurisdiction to the states, many states are likely to require, as they did historically, private issuers to provide presale notice filings for state regulatory review. In any case, NASAA is actively seeking ways to assist states in policing this sector by utilizing existing fraud authority under state laws.

## *Enforcement*

In recent years, NASAA multi-state task forces, as well as individual states such as New York and Massachusetts, have taken a leading role in policing industry-wide problems that first appeared as local issues, such as those involving auction-rate securities. By sharing local information with each other, the states try to determine whether such problems are so common as to warrant the formation of a multi-state investigative task force. We anticipate that the states, by and through NASAA, will continue to increase their active securities enforcement efforts. States also likely will continue the trend of bringing more criminal charges for securities and investment-related fraud.

## *Overcoming State Budget Limitations*

Although some states have recently increased their securities agency staffing, budget limitations resulting from the current economy may continue to hinder regulatory and enforcement activity. NASAA is trying to combat this problem by coordinating and pooling regulatory and enforcement resources among the states.


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The trend towards more criminal charges for securities and investment-related fraud will continue.

# Government Contracts: Mounting Audits and Investigations

Last year's upsurge in audits, investigations and litigation will continue in 2010, with a number of areas warranting the attention of responsible federal contractors to ensure that they have adequate compliance and internal control protocols in place.

In 2009, the activities of the GSA Office of Inspector General ("GSA IG"), DOD Office of Inspector General ("DOD IG") and the Department of Justice ("DOJ") were vigorous and produced noteworthy results. In FY 2009 alone, the GSA IG was responsible for investigations that resulted in over $1.128 billion of government recoveries. DOD IG oversight activities resulted in over $2 billion of such recoveries, and DOJ reported that it recovered over $2.428 billion under the FCA in just the first nine months of 2009 alone. Last year also demonstrated a continuing and disturbing trend by the United States and *qui tam* plaintiffs to initiate litigation against contractors under the Civil False Claims Act ("FCA"), charging that certain contracting practices—and the submission of invoices under related contracts—constituted fraud.

These activities will continue. Here are some predictions for just a few focus areas of enforcement and exposure in 2010. These are a few of the many areas that warrant attention by responsible federal contractors to ensure that they have adequate compliance and internal control protocols in place.

### *Foreign Sourcing*

The sourcing provisions of the Buy American Act ("BAA") and Trade Agreements Act ("TAA")—as well as similar provisions in the American Recovery and Reinvestment Act of 2009—will continue to engender investigatory action and civil False Claims Act ("FCA") litigation. These laws and their implementing regulations generally require that products provided to the United States in a federal contract be domestic end products and/or products that were manufactured or "substantially transformed" in a "designated country." Additional restrictive foreign sourcing legislation likely will be considered by Congress this year.

During the past three years, there have been numerous General Services Administration Office of Inspector General ("GSA IG") and Department of Justice ("DOJ") investigations concerning BAA and TAA compliance, focusing on products as disparate as tools, office supplies, hardware, and software; many of these are ongoing. In addition, there are a number of pending FCA cases alleging that government contractors violated the FCA by knowingly submitting claims for payment for BAA- or TAA-noncompliant products under federal contracts. We expect that investigations and litigation of this nature will continue to develop in 2010. Contractors would do well to ensure that they have adequate systems in place to monitor the sourcing of products that they sell to the federal government, including an ongoing system to ensure that they are aware when sources change, or the sources of products are added to contracts via modifications.

### *GSA Contract Audits and Investigations*

GSA contracts for commercial items (known as "multiple award schedule" or "Federal Supply Schedule" contracts) contain onerous disclosure and pricing requirements that require contractors to disclose their commercial pricing/discounting information to GSA during negotiations, and to reduce GSA pricing after contract award when the contractor reduces its prices to certain "triggering" commercial customers identified in the contract. Numerous GSA contractors—particularly in the information technology industry—are the subject of ongoing audits, investigations and even FCA actions claiming that contractors have violated these disclosure and pricing obligations. Last year, in a landmark settlement, one such contractor, NetApp Inc., paid the United States $128 million to resolve such allegations in an FCA matter. We expect that here, too, the GSA IG, DOJ and *qui tam* plaintiffs will continue their aggressive attacks on contractors' compliance—or lack of compliance—with these obligations through contract audits, investigations and, ultimately, FCA lawsuits.

### *Organizational Conflict of Interest ("OCI") Issues*

Federal regulations and often contract clauses require the government and contractors to ensure that contractors do not engage in and must disclose any potential OCIs—financial or organizational relationships or contractual arrangements that might give a federal contractor unfair competitive or other advantages in future procurements. Increasingly, GSA IG and DOJ are investigating OCI allegations with an eye towards charging that they constitute violations of the FCA. Late last year, one jury awarded the United States over $6.5 million in damages and costs in a case involving OCI and FCA allegations against a prominent defense contractor. Other such cases are pending, and we believe that this is just the beginning of an increased investigatory and litigative focus on this issue.

### *Qui Tam and Other Actions Under State and Local False Claims Acts*

The federal arena is not the only procurement realm in which government contractors face increased risk. State and local contracts also will be a subject of potential scrutiny. Congress authorized changes to the Deficit Reduction Act in February 2006 that provide incentives to state and local governments to enact or modify false claims laws that would be "at least as effective" as the FCA. Now, just four years later, thirty states have some form of false claims law, and eight others are considering such laws. The impact of these laws will be to encourage *qui tam* plaintiffs and state and local governments to file lawsuits against government contractors challenging routine government contracting activities as violations of pertinent state (or local) false claims acts. In light of these developments, contractors would be well served to ensure that their compliance and oversight activities cover not only federal contracts, but state and local contracts as well.

2010 will present continuing opportunities for technology and defense companies in all public sector markets. These opportunities are accompanied by potential risks and the prospects of financial exposure. Careful attention to the details of contracting and the institution and use of appropriate internal controls will help to minimize these risks and potential liabilities.

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The GSA IG, DOJ and *qui tam* plaintiffs will continue aggressive attacks on contractors' compliance.

# Transportation: Boosting High-Speed Rail

After more than thirty years of talk about high-speed intercity passenger rail and a financially starved national passenger railroad, the Obama Administration and the U.S. Congress have taken real steps to boost high-speed intercity passenger rail and provide adequate long-term funding for Amtrak. Although there are no guarantees, the establishment of high-speed intercity passenger rail service would transform the U.S. transportation network, provide economic stimulus through infrastructure projects and equipment manufacturing and indirectly advance urban renewal, energy conservation and carbon reduction initiatives Legislation enacted in the wake of the global financial crisis has made available approximately $18 billion of federal funding for Amtrak, the improvement of existing intercity passenger rail routes and new high-speed intercity passenger rail projects.

In early 2009, the American Recovery & Reinvestment Act ("ARRA") provided $8 billion in funding for competitive grant programs for high-speed intercity passenger rail service. These programs were authorized by the Passenger Rail Investment & Improvement Act ("PRIIA"), enacted in late-2008. State transportation departments and other state transportation-related agencies, as well as Amtrak, may apply for these funds, which will be administered by the U.S. Department of Transportation and the Federal Railroad Administration ("FRA"). PRIIA also authorized nearly $10 billion for Amtrak capital and operating expenses through FY 2013.

Submitted applications for the ARRA funds total nearly seven times more than the $8 billion available. More than 200 applicants in 34 states have requested a total of $7 billion for "ready-to-go" projects (largely improvements to existing passenger rail routes). Another 45 applicants from 24 states are seeking $50 billion for new corridor programs consisting of interrelated high-speed intercity passenger rail projects.

The task now is to decide which projects should be funded. The FRA anticipates awarding the $8 billion in ARRA funds during the first quarter of 2010. According to the statute and the Administration's stated policy, the best projects are to be funded, taking into account regional balance, the promotion of immediate job creation (through the funding of shovel-ready projects), and the establishment of true high-speed intercity passenger rail service.

If the ARRA funds are spread too broadly, they may have little long-term impact on the development of effective intercity passenger rail networks. Yet if the bulk of the money is directed toward one or two projects (*e.g.*, California's ambitious, but costly, corridor system), many good incremental projects (*e.g.*, improvements to existing Amtrak in the Midwest or on the Northeast Corridor) will be left wanting.

Subsequent rounds of applications and awards under the PRIIA competitive grant programs will be dictated by the pace of annual appropriations and any future one-time funding mechanisms, such as a potential second federal stimulus bill. The Obama Administration has characterized the $8 billion of ARRA money as a "down payment" for future federal funding, and Congress answered the Obama Administration's call by approving $2.5 billion for these PRIIA high-speed rail grant programs in 2010 appropriations funding. FRA anticipates that it will set deadlines to apply for these funds later this year.

A variety of private interests are poised to benefit from the federal government's commitment to high-speed rail. Construction, engineering, and manufacturing firms, among many others, are preparing to pitch their expertise to high-speed rail project sponsors with ARRA funds in hand. We anticipate that many states will seek public-private partnerships and other forms of innovative procurement to develop these projects. We also anticipate Asian and European companies will open U.S. manufacturing facilities for rolling stock, in order to comply with Buy American restrictions on the PRIIA grant programs.


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High-speed intercity passenger rail service would transform the U.S. transportation network.

# Employment Law: Changing Priorities

In both the E.U. and the U.S., employment law tends to move in step with political change. With a new administration in the U.S., and potentially a new administration coming to the U.K. in May 2010, the following are some key issues to watch in the coming year.

## *United States*

The Obama administration came into office promising sweeping statutory changes in labor and employment law and enhanced government enforcement of existing laws. Legislative and enforcement actions in key areas of the administration's labor and employment law agenda remain on the near horizon, despite delays caused by the economic crisis, health-care reform and international concerns.

Independent Contractors. The use and asserted misuse of independent contractors has become a target issue for federal and state regulators. It has also been the basis of innumerable class actions by independent contractors claiming a right to benefits and wages that would be due to employees. Recent sessions of Congress have seen the introduction of several bills aimed at curbing or effectively eliminating the widespread use of independent contractors. These have included the Independent Contractor Proper Classification Act, which was co-sponsored by then-Senator Obama, and the Employee Misclassification Prevention Act. Most recently, the Taxpayer Responsibility, Accountability and Consistency Act of 2009 was introduced in December by Senator Kerry. This bill would significantly gut Section 530 of the Revenue Act of 1978 by eliminating the safe harbor for classifications based upon a long-standing recognized practice of a significant segment of the industry in which the individual was engaged.

Compensation Discrimination—Lilly Ledbetter Fair Pay Act. Last year's Lilly Ledbetter Fair Pay Act ("Ledbetter Act") radically extended the time within which claims for discrimination in pay may be brought. Under the Ledbetter Act, the limitations period on pay discrimination claims begins again each time the employee is "affected" by the disputed practice—for example, each time the employee receives a paycheck reflecting the allegedly discriminatory wage. Thus, if a decision were made in 1960 to pay a woman a lower salary than a man, and both the man and the woman were given equal raises since that time, the 1960 decision would still be actionable today in 2010. As broad as that change is, it could be made even broader in application. Some have argued that it applies to non-compensation decisions like promotions and transfers that may have an impact on compensation. While most courts have not adopted that position, a recent amendment to the Equal Employment Opportunity Commission's ("EEOC") Compliance Manual suggests that the agency will be taking the expansive view.

Compensation Discrimination—Paycheck Fairness Act. The proposed Paycheck Fairness Act is still pending. If passed in its present form, it would dramatically alter the "factor other than sex" defense in the Equal Pay Act (which prohibits pay disparities based on sex for work of equal skill, effort and responsibility performed under similar working conditions, unless the disparity is based on (1) a bona fide seniority or merit system, (2) a system of earnings based on productivity, or (3) a factor other than sex). The Paycheck Fairness Act would require an employer relying on a "factor other than sex" defense to prove not only that the disparity was not based on sex but also that it was based on a "bona fide factor consistent with business necessity." Even then, the employee could prevail by proving that the employer had other options for meeting its business purpose, without the same impact on women, that it chose not to take. The Paycheck Fairness Act would also allow uncapped compensatory and punitive damages, even for unintentional violations.

Caregivers. While recognizing that "caregivers" as such are not a statutorily protected class, the EEOC is continuing its focus on what it perceives to be widespread discrimination against employees with caregiving responsibilities. The EEOC's 2007 Guidance on the subject stretched to find protections for these employees. Its recent publication, Employer Best Practices for Workers With Caregiving Responsibilities, goes even further, providing "examples of best practices that go beyond federal nondiscrimination requirements and that are designed to remove barriers to equal employment opportunity." Enforcement efforts are to be expected.

## *European Union*

Government action within the E.U. for 2010 is focused on the financial sector, with various governments of E.U. countries determined to implement the principles agreed to at the Pittsburgh G20 Summit.

France. The French Government is leading the way, in conjunction with the French Banking Federation, with legislation brought into effect in November 2009, to dictate how employee compensation is calculated and paid.

This legislation applies to compensation payable in 2010 in respect of 2009 performance. It applies to credit institutions, investment firms and similar bodies that are either established in France or that have a branch in France, where the entity is headquartered outside of the E.U.

All businesses subject to this legislation must adhere to strict rules relating to the establishment of compensation committees and designed to increase the level of transparency and control relating to compensation decision making.

In addition, variable compensation is required to be determined on the basis of achievement of financial and non-financial objectives, with at least 50% of that compensation to be deferred and payable in stock and subject to the achievement of yet further criteria relating to company and individual performance.

The misuse of independent contractors has become a target issue.

United Kingdom. In the U.K., the Government has introduced the Financial Services Bill, which, if passed, would give greater power to the U.K.'s Financial Services Authority (the "FSA") to regulate compensation in the financial sector to promote effective risk management, and compliance with international standards, and to provide a greater link between risk and reward. Even though there is an election set for June 2010 at the latest, the current Government has pledged to ensure that the Bill becomes law prior to the election.

The FSA will be able to make rules to prohibit certain types of compensation and to claw back compensation paid pursuant to contractual terms that have been outlawed. In particular, the Government wants to end multi-year guaranteed bonuses where financial sector employees receive a share of profits with no adjustment to account for the risk taken.


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# Executive Compensation: A Drive Toward Greater Transparency

In 2009, the Securities and Exchange Commission ("SEC") adopted significant amendments to the proxy rules and to its executive compensation and corporate governance disclosure requirements. As a result, many U.S. public companies now face a number of significant new disclosure requirements for the 2010 proxy season:

### *Compensation Policies and Risk*

Companies must disclose the effect of their overall compensation policies and practices on their risk and management of risk. This disclosure goes beyond a company's "named executive officers" to all employees if the risks arising from such policies and practices "are reasonably likely to have a material adverse effect on the company." This disclosure will vary from company to company, but issues that may need to be addressed include:

- the general design and implementation of compensation policies and how such policies relate to or affect risk-taking by employees;
- the impact of risk assessment and risk-taking incentives on compensation policies and pay; and
- how compensation policies account for longer-term risk, such as through clawbacks or required holding periods.

### *Reporting of Equity Awards.*

Companies must disclose equity awards in the summary compensation table using the aggregate grant date fair value rather than the equity award expense recognized in the applicable year.

### *Director and Nominee Qualifications.*

Companies must disclose new information about directors and nominees including:

- the "particular experience, qualifications, attributes or skills" that led the board to conclude that the person should serve as a director;
- a list of all public company directorships held during the preceding five years; and
- a greatly expanded list of legal proceedings, including violations of any securities, commodities, insurance or banking laws, involving directors, executive officers or nominees occurring within the last ten years rather than five years.

In addition, companies must disclose the extent to which diversity (including any formal diversity policy) is considered in identifying director nominees.

### *Board Leadership Structure and Role in Risk Oversight*

Companies must disclose their leadership structure and why that structure is the most appropriate. In particular, a public company must disclose whether and why it has combined or separated the functions of chief executive officer and chairman of the board, whether and why it has a lead independent director, and the specific role played by a lead independent director in the leadership of the company. It must also describe the board's role in risk oversight, how the board administers its oversight function, and the effect this has on the company's leadership structure.

### *Impacts of the new proxy rules*

The disclosure of any material relationship between risk and compensation policies will likely require a comprehensive risk analysis of the company's compensation structure throughout its entire organization, a significant undertaking. The SEC's design is that these risk analyses will lead public companies to rethink their approaches to risk management.

The new reporting rules for equity awards also extend to the amounts reported for prior year awards for the applicable named executives. These recomputed amounts, however, are for informational purposes only and do not require a change in the individuals reported as named executive officers for any preceding year or an amendment to any earlier filing.

Finally, director and officer questionnaires will need to be updated or supplemented to request this new information and companies should consider implementing, or reviewing their existing, diversity policies regarding director nominations in light of the new requirements.


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The disclosure will likely require a comprehensive risk analysis of the company's compensation structure.

# Internal Investigations: Restoring Investor Confidence

In the wake of the recent economic crisis, there is great pressure on organizations and corporations to detect and prevent fraud or other wrongdoing. Federal, state and local governments have increased their resources to pursue fraud cases. Prosecutors in 2009 warned that boards of directors, audit committees and management will be pursued along with perpetrators if they recklessly ignore red flags or credible allegations of wrongdoing.

In these circumstances, an internal investigation can be an effective tool to restore investor confidence and minimize exposure to government enforcement. Even if an internal investigation does not prevent a government enforcement action, it can shorten the length of the investigation and provide a company with greater ability to negotiate sanctions.

Successful internal investigations should be timely, thorough, accurate, fair and objective. A number of recent judicial and regulatory developments have altered the considerations for effective internal investigations, and companies should now consider the following when conducting and structuring internal investigations:

### *Consider potential conflicts and experience when choosing the investigation team*

Recent litigation has sparked a renewed focus on conflicts of interest in internal investigations. While some matters can be handled by regular outside counsel or internal audit departments, high-profile or sensitive investigations should be handled by outside professionals whose business relationships are not intertwined or closely aligned with the people who may be investigated.

### *Consider early on whether key individuals need separate representation*

For many of the same reasons, it is important for companies and their investigation teams to consider whether certain employees or officers should be provided separate representation.

### *Maximize privilege and work product protections by ensuring that the client, scope and purpose of the investigation are clear at the outset.*

A recent First Circuit decision, *United States v. Textron Inc.*, *577* F.3d 21 (1st Cir. 2009), sparked a debate as to what types of activities should be afforded work product protection. The ensuing debate served as an important reminder that companies and their professionals should be clear at the outset regarding: (a) who the client is; (b) what is triggering the investigation; (c) what legal advice is being sought; and (d) whether litigation is threatened, pending or likely to result.

### *Choose someone within the company (or on the board or audit committee if appropriate) as the company's point person for the investigation team*

An investigation without a tether to the company can be as problematic as an investigation without a purpose. An appropriate liaison can make the investigation more cost efficient and less intrusive.

### *Preserve and collect relevant records and data quickly and often*

Determine what data needs to be preserved and collected and execute the plan early in the investigation. In addition, the company and investigation team should continue to revisit the plan throughout the investigation to ensure compliance with preservation requirements and identification of all relevant data.

### *Determine whether any local data protection laws will impact the investigation team's ability to access or copy such information*

In a typical U.S.-style investigation, forensic IT specialists come on the scene early to image hard drives and copy server data. This approach may run afoul of local data protection laws in non-U.S. jurisdictions, particularly in the E.U., and such laws need to be considered at the outset of any investigation.

### *Determine whether insurance coverage is available*

E&O insurance policies often cover certain expenses associated with internal investigations. Evaluate the potential for coverage early in order to meet notice and other requirements.

### *Involve internal communications personnel promptly when a crisis hits*

An informed communications department is critical in dealing with a crisis. Develop a coordinated plan that is consistent with keeping the investigation independent and credible.

### *Do not prejudge the need for a full written report*

The decision whether or not to prepare a written report is important and difficult. In particular, sharing a report or its contents with a third party, such as the government or an auditor, may lead a court to find that the company has waived applicable privileges and order the production of the report. As a result, it is generally best not to prepare a written report unless there is a specific need to do so, and the need outweighs any potentially adverse consequences that might arise if the report is later required to be disclosed.

Boards of directors, audit committees and management will be pursued along with perpetrators if they recklessly ignore red flags or credible allegations of wrongdoing.

### *When interviewing, "Mirandize" witnesses*

Recent cases have underscored the importance of proper *Upjohn* warnings. Among other matters, it must be made clear to employees being interviewed that the investigator does not represent the employee personally and that any privilege belongs to the company. It is good practice, particularly in large cases, to prepare a script for all interviewers, and, in every case, it is important to document the fact that the warning was given.


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# Federal Appropriations: Election Year Influences

The Congressional Appropriations process for FY 2011 has begun in earnest as House and Senate offices issue forms and set deadlines for appropriations requests. The FY 2011 Appropriations process is expected to be largely similar to that for FY 2010, though recent trends toward increased accountability, public-private partnerships, and a smaller share of overall funds being directed to discretionary funding are expected to continue this year. The 2010 elections will likely prompt some additional partisanship on funding priorities and slow the end-game on the Appropriations process, but not significantly more than what developed in 2009, with health care legislation dominating Congress the latter part of the year.

## *Timeline*

The general timeline for consideration of the FY 2011 Appropriations bills is expected to be similar to the FY 2010 process. Offices will likely submit requests to the Appropriations committees in April and May, followed by committee consideration of their bills through the summer. Both chambers, particularly the House, are likely to consider and pass some of the bills on the floor in the fall, but the ongoing procedural dysfunction in the Senate and the looming 2010 midterm elections will likely limit such action. This will probably lead to the passage of a large omnibus Appropriations bill or several small ones, similar to actions taken by Congress in recent years.

## *Funding Levels*

Recent year trends on Appropriations funding levels are expected to continue in the FY 2011 bills. While overall funding for Appropriations bills is likely to increase over the previous year, the percentage of the funds directed to discretionary funding will probably continue to trend downward. The overall increase in the discretionary budget is likely to be about five percent, based on recent trends. This should include a smaller discretionary increase for defense-related funding, with a larger increase in non-defense discretionary programs. This reflects the Administration's and Congress' efforts to shift funds toward their domestic priorities.

The distribution of funds for earmarks is expected to be similar to what was seen in the FY 2010 process. The number of earmarks in the Appropriations bills has trended slightly upwards in the past few years, but the dollar value of the awards has grown smaller. As for the distribution of earmarks, both parties should continue to receive funds for projects in the bills, with the Democratic Members receiving a larger funding amount than the Republican Members. Partisan politics will play a role in the distribution of project funding in the House, particularly because of tension between Appropriations Chairman Obey and Ranking Member Lewis, but both sides will receive funds for their project priorities. Senate appropriators should be more cordial, with much of the pressure on earmarks coming from anti-earmark Senators such as McCain, DeMint and Coburn.

## *Funding Priorities*

Congress will continue its recent trend of increasingly directing discretionary appropriations funds toward public and non-profit entities and away from private company recipients. For the most part, private companies wishing to secure earmark funding in the Appropriations process will need to partner with a public or non-profit entity to be considered for funds. The exception to this rule will continue to be the Defense and (to the extent that funds are available) Military Construction Appropriations bills, where private companies will continue to face fewer constraints to being considered for funds. However, an increasing number of Members, particularly House Republicans, are limiting any consideration of requests from solely private groups, including for defense-related projects. Additionally, it is expected that Department of Defense earmarks will be subject to a competitive bidding process once approved by Congress. This is not likely to have a significant impact on Congressional earmarks, given the typically very specific nature of the earmarked projects and the vetting processes already in place at the that Department.

In terms of specific issues, Congress will continue to be particularly focused on issues highlighted in the past stimulus bill, including job promotion, environmental sustainability (*e.g.*, clean tech, energy efficiency, clean industry job training), and federal infrastructure. Members up for re-election in 2010 will also be especially focused on funding projects and programs that provide clear, immediate benefit to their constituents and which will assist in their re-election campaigns.

## *Accountability*

Congress has taken several steps in recent years to increase accountability and transparency in the Appropriations process. While no significant new reforms are expected to be enacted for the FY 2011 process, forms already released by Member offices indicate a continuing effort to more thoroughly vet appropriations requests to ensure their legitimacy and viability. Requesters should anticipate additional questions from offices about their projects and be prepared to provide more detailed analyses of project plans, stakeholders and funding sources for the project.


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Congress will continue to be particularly focused on job promotion, environmental sustainability and federal infrastructure.

# Washington Politics: Grappling with Divisive Issues

"Volatile," "Charged," "Challenging," and "Partisan" are words that best describe the likely political climate in Washington in 2010 as the White House and the U.S. Congress wrestle with some big and critical issues in the New Year. Four of the biggest are the economy, health care, taxes and fiscal policy and national defense/homeland security—with the overlay of Congressional elections looming in the fall.

### *The Economy*

First and foremost, the health of the U.S. economy will be center stage. In political terms this means addressing unemployment and stimulating job creation—particularly for those Senators and all of the House members seeking re-election in November. The issue is volatile because of the angst and pessimism of an electorate experiencing a relatively jobless recovery so far. Fixing the economy is also politically sensitive because, while many Americans understand the importance of stabilizing the U.S. market, at the same time they feel that they have not enjoyed or felt the benefits. In response, there will be new spending in 2010 on infrastructure projects, assistance to state and local governments, and similar targeted initiatives all aimed at moving unemployment numbers downward. It is also expected that there will be a great deal of attention to regulatory issues and oversight hearings designed to address issues of concern to families and consumers. Many of those issues are covered elsewhere in this report.

### *Health Care*

The President and Congressional Democrats will find a way to enact health care reform legislation. From a policy and political perspective, the President and his Congressional allies have invested so much that failure, while possible, is almost inconceivable. Expect House Democrats to move closer to the Senate-passed health care bill. For additional information on health care legislation, see the related article earlier in this report.

### *Taxes and Fiscal Policy*

Adding to the challenge of stimulating the economy and jobs is the tremendous overhang of the federal deficit. Fiscal conservatism, deficit reduction and federal tax policy will be important cross-cutting themes within key wings of both the Democratic and Republican Parties. Expect the Administration and Congressional Democrats to try to find consensus on new business tax measures that will raise revenue without affecting middle income and blue collar workers. For additional information on tax policy, see the article entitled "Tax Policy: The Search for Revenues" earlier in this report.

### *National Defense and Homeland Security*

The President's decision to commit additional troops to the conflict in Afghanistan will be an issue of considerable debate in 2010. However, that discussion may not break down along traditional party lines. Even as Congressional Republicans will look for openings to distinguish themselves from the Administration, President Obama is likely to feel strong pressure against his policy from the more progressive wing of the Democratic Party. Expect difficult votes in the Congress regarding funding for the war effort, particularly in the House. The foiled Christmas Day terrorist attack on a Northwest Airlines plane has also rekindled concerns for homeland security. Politically both parties will pursue initiatives to reassure the American public on this score. Congressional Republicans believe they may have an opening to assert that the nation is less safe under the current Administration. Congressional Democrats and the President will strongly counter any such arguments.

### *Congressional Elections*

One-third of the Senate and all Members of the House will stand for re-election in November. Historically, the political party that occupies the White House tends to lose congressional seats in mid-presidential term elections. Republicans hope that this trend holds true in 2010. They believe that the Democratic majorities in the Congress are fragile and short-term, and sense an opportunity. Mindful of this, Democrats will likely attempt to strengthen their connections with the voting blocks that gave them larger majorities in the last election through a series of targeted legislative initiatives ranging from completion of financial services reform to jobs, education and energy. The President's approval ratings and the jobless numbers toward the end of the summer are bellwethers that each party will monitor closely. Complicating matters for both parties are announced retirements of both key Republican and Democratic legislators. In many cases, this may put what might have been regarded as a relatively safe House or seat for a party "in play." Moreover, planned retirements may affect the votes of Members of Congress who are no longer concerned about facing voters.


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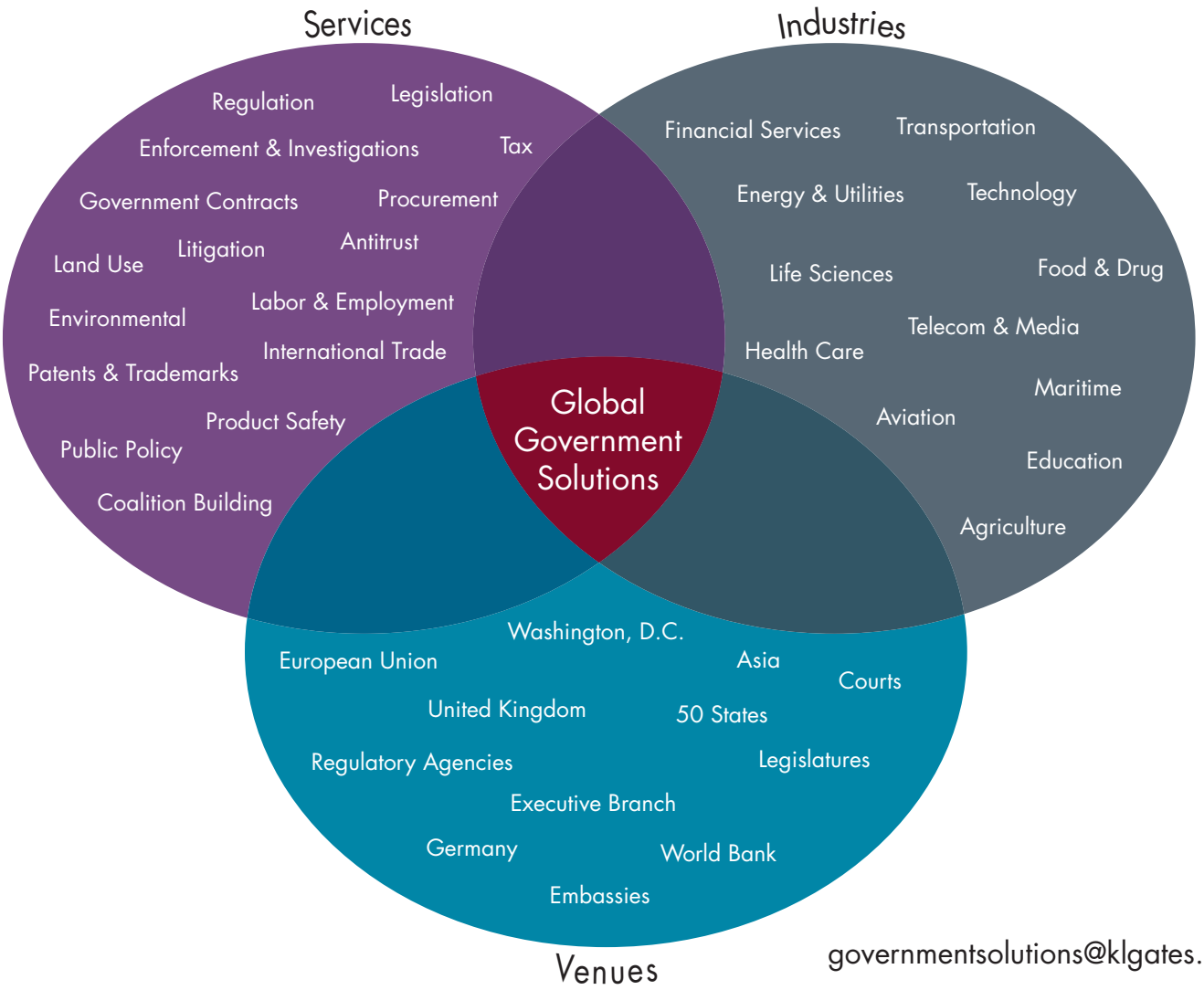


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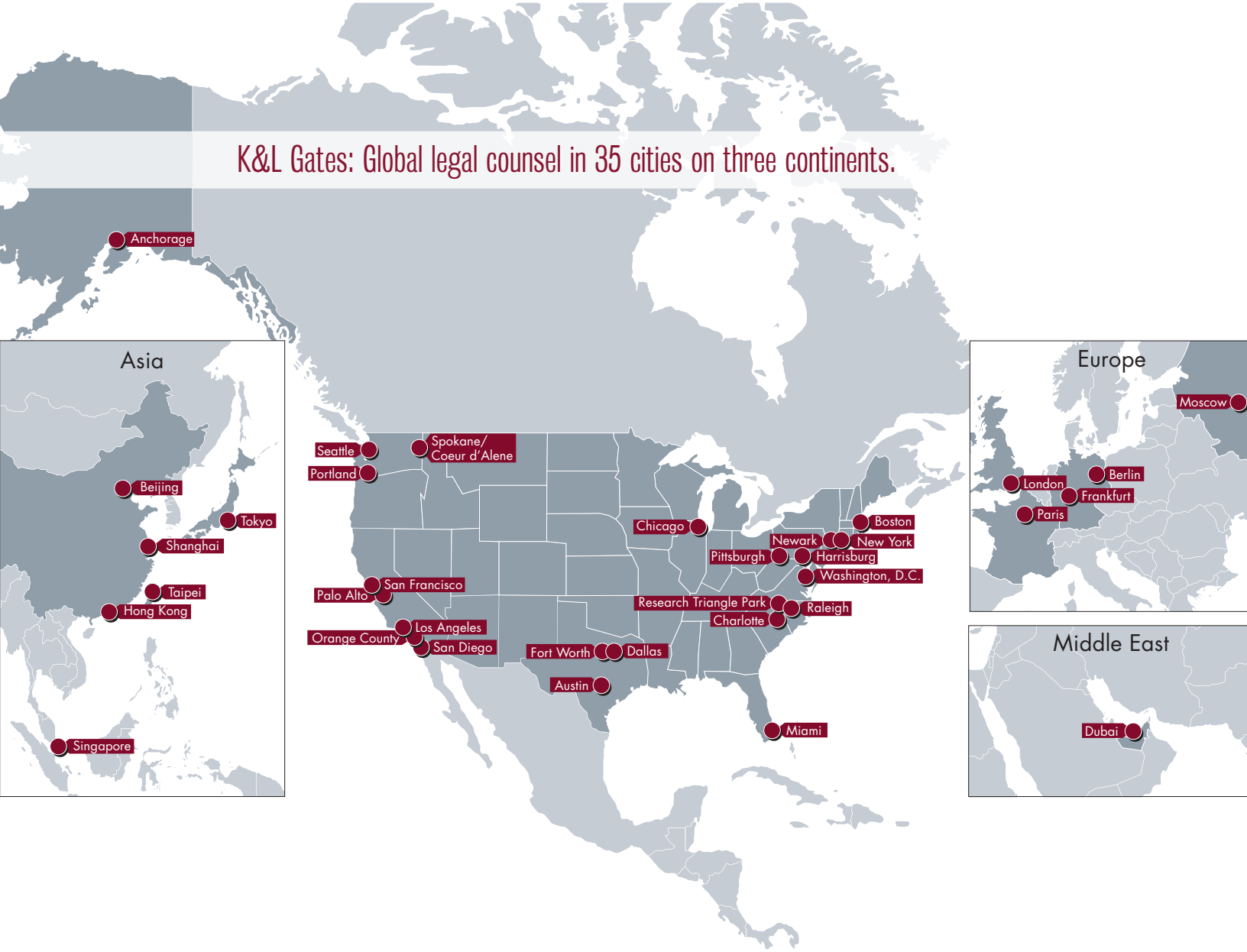
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