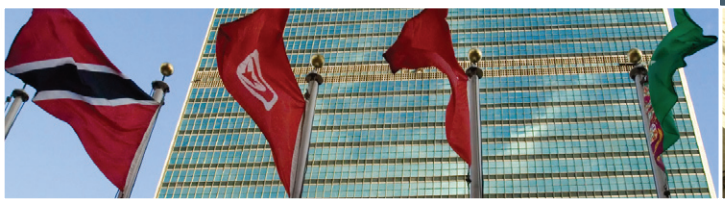
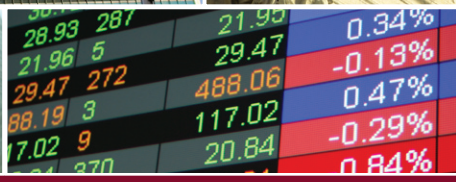
K&L Gates Global Government Solutions℠ 2010: Mid-Year Outlook





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K&L Gates Global Government Solutions℠ 2010 Mid-Year Outlook

Governments around the world continue to take increasingly aggressive and intrusive measures that are fundamentally altering the relationship between business and government.

2010 Mid-Year Outlook

The K&L Gates Global Government Solutions℠ initiative brings together our firm's diverse and extensive government-related practices around the world. In January, members of this initiative published *2010: The Year Ahead*, a report analyzing anticipated government actions and priorities for a broad spectrum of topics. Since the publication of that report, these trends have accelerated, as governments around the world continue to take increasingly aggressive and intrusive measures that are fundamentally altering the relationship between business and government.

This Mid-Year Outlook provides updates on some of the more consequential government developments thus far in 2010, which affect numerous industries and geographic areas. Among the topics covered are global financial regulatory reform and other responses to financial crises, government health care initiatives, environmental and energy policies, major new rules by food, safety and other regulators, aggressive regulatory and law enforcement efforts, and changes in the political landscape in a number of countries.

With over 35 policy and regulatory practice disciplines and more than 400 alumni of government agencies on three continents, K&L Gates can assist clients in dealing with virtually any legal issue involving government. It has become increasingly clear that, in the coming years, successful businesses will be those that have a full appreciation of the changing relationship between the private sector and government, and can identify the opportunities and avoid the dangers that this presents.

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!

Peter J. Kalis

Chairman and Global Managing Partner

The Dodd-Frank Halftime Report

As this Outlook goes to print, U.S. President Barack Obama is expected to sign into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), the most dramatic and wide-reaching financial regulatory reform legislation in the U.S. since the 1930s. However, its enactment marks merely the start of the next stage of the policymaking process, one that will most likely take years. The legislation contains 315 rulemaking requirements and 145 study and reporting provisions, many of them on the most contentious and complex issues. Additionally, Congress will exercise rigorous oversight and will inevitably consider subsequent legislation. K&L Gates has recently published summaries and analyses of key provisions of the legislation. The alerts can be accessed online[1].

The First Half

The Act makes reforms in virtually all aspects of the financial services industry, including:

- Financial and Systemic Stability
- Bank Regulation and Resolution
- Hedge and Private Equity Funds
- Over-the-Counter Derivatives
- Investor Protection
- Credit Rating Agencies
- Securitization
- Executive Compensation and Corporate Governance
- Consumer Financial Protection
- Mortgage Reform and Anti-Predatory Lending
- Insurance

The Act has been in development for well over one year. On June 17, 2009, the Obama Administration unveiled its Financial Regulatory Reform Plan. In the weeks and months that followed, the Obama Administration released several rounds of proposed legislation; House Financial Services Committee Chairman Barney Frank (D-MA) quickly followed with the release of House legislative text, demonstrating a high degree of coordination between the White House and the House. The House passed H.R. 4173, the "Wall Street Reform and Consumer Protection Act of 2009," on December 12, 2009 by a vote of 223 to 209. In contrast, Senate consideration occurred in fits and starts, but after months of development and three weeks of floor consideration, the Senate passed the "Restoring American Financial Stability Act of 2010" on May 20 by a vote of 59 to 39.

In this Outlook, we review and analyze a number of the Act's most important provisions.

Looking Ahead

While financial industry players will certainly have to analyze what happened in the first half of the game, they will also need to consider how the remaining half is likely to play out: enactment marks the beginning of a process that is likely to span years. Congress left many of the most contentious and important policy decisions to rulemaking or study by a number of administrative agencies: on literally hundreds of issues, the Act either directs or authorizes federal agencies to promulgate rules. The Act's numerous study and reporting provisions also signify areas that attracted Congressional interest during the development of the legislation and may be areas of subsequent reform.

Congress retains a vested interest in the outcome of these rulemakings and studies. The ability of Congressional

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committees to engage in oversight is derived from the Constitutional authority of Congress to make laws and for each chamber to establish the rules governing its own procedures. Both chambers have generally delegated to committees the authority to consider legislation within each committee's jurisdiction, to conduct hearings, and to issue subpoenas to compel the production of testimony and documents. Committee oversight responsibilities generally include the analysis, appraisal, and evaluation of the application, administration, execution, and effectiveness of federal laws. Congressional Committees will almost certainly exercise their oversight authority in ways intended to influence the regulators' rulemaking. The legislative and regulatory processes are likely to interact with each other to a level and with a degree of complexity unprecedented in U.S. financial history.

There is also likely to be a series of subsequent legislative measures, including technical corrections, substantive modifications, and issues that were not addressed. Chairman Frank has already indicated that consideration of corrections legislation will begin imminently. Moreover, the Financial Crisis Inquiry Commission that was established by the Fraud Enforcement and Recovery Act of 2009 to examine the causes of the financial crisis will issue its report in December 2010 and will likely recommend further action. The process may be further impacted by international efforts. The G20 continues to coordinate and harmonize policy responses to the financial crisis. Moreover, the Basel Committee on Banking Supervision has started work on consultative proposals to strengthen the banking sector, which may serve as the basis for Basel III.

At end, Congressional oversight of the implementation of the Dodd-Frank Act is expected to be unprecedented in terms of scope and impact.

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[1] http://www.klgates.com/practices/ServiceDetail.aspx?service=139&view=5

Financial Reform Reshapes Depository Institutions Landscape

Far-reaching legislation to reform the U.S. financial system will have a significant impact on depository institutions and their holding companies. With the imminent passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Bill"), it is clear that the banking sector will be different going forward.

One federal bank regulator, the Office of Thrift Supervision ("OTS"), will cease to exist. As of March 31, 2010, 692 institutions were regulated by the OTS. The elimination of the OTS, despite the continuance of the thrift charter at the state level and at the federal level, will likely mean that there will be no long-term viability of the thrift charter. The commercial bank charter will be the dominant charter. Moreover, the mutual form of ownership, which does not exist in the commercial bank industry, will not be significant. For depository institution holding companies, there will be much greater regulation of their capital, leverage, investments, and activities, both at the holding company level and at the subsidiary level.

Thrift Charter Benefits Reduced

The Dodd-Frank Bill abolishes the OTS and transfers all functions relating to the supervision of federal thrifts to the Office of the Comptroller of the Currency ("OCC"). Although the Dodd-Frank Bill requires the appointment of a Deputy Comptroller specifically for thrifts and preserves the thrift charter going forward, the popularity of the thrift charter is likely to decline.

Thrifts have a traditional focus on mortgage lending, and one of their key advantages has been having a regulator specifically focused on the unique circumstances of thrifts and their holding companies. Even though OTS regulations, orders, and interpretations relating to federal thrifts will remain in force over the near term, they will be enforced by the OCC. With time, the OCC's treatment of thrifts and national banks is likely to converge. Moreover, companies that currently own thrifts will no longer have the same regulator at the thrift level and at the holding company level, nor will they have the traditional flexibility afforded thrift holding companies because the Dodd-Frank Bill transfers that responsibility to the Board of Governors of the Federal Reserve System ("Federal Reserve") and generally makes uniform regulatory authority for depository institution holding companies.

As the advantages of the thrift charter fade, the national bank charter will likely appear more attractive. Both charters have virtually identical deposit-taking powers, but a national bank's power is broader on the asset side, notably lacking statutory limits on investments in commercial lending or commercial real estate. As a result, we would expect an increase in the number of thrifts converting to national banks.

The commercial bank charter will solidify its place as the dominant charter for depository institutions.

Mutual Institutions

Since there are no mutual national banks, the OCC is unlikely to be familiar or comfortable with that form of ownership. Further, since mutual institutions have more limited options in raising capital, and since capital will be king following the implementation of the Dodd-Frank Bill, it is likely that the mutual form of ownership will be under stress. One controversial provision of the Dodd-Frank Bill known as the Collins Amendment would eliminate preferential capital treatment for trust preferred securities at the holding company level. This could force a number of mutual banks with trust preferred securities to convert to the stock form in order to remain well capitalized. Moreover, outside of conversions from the credit union industry, all of whose members are organized in mutual form, there is no likely source of growth for the mutual thrifts. While federal credit unions could convert to federal savings banks, the decline of the federal thrift charter may discourage future credit union to mutual thrift conversions.

Holding Company Regulation Increased

In addition to consolidating regulation of depository institution holding companies with the Federal Reserve, the Dodd-Frank Bill repeals what was known as "Fed Lite" adopted under the Gramm-Leach-Bliley Act and generally increases applicable regulatory restrictions.

Under Fed Lite, the Federal Reserve was expected to defer to the primary federal regulator, and in some cases, state regulator, when it came to supervising the activities of bank holding company subsidiaries that were subject to functional regulation. The Dodd-Frank Bill authorizes the Federal Reserve to take its responsibility for supervising bank holding companies and apply it to the non-bank subsidiaries of bank holding companies, with much less regard to whether the subsidiaries are functionally regulated.

The Dodd-Frank Bill directs or authorizes the Federal Reserve to adopt regulations applicable to bank holding companies and systemically significant non-bank financial companies that far exceed the current level of regulation and involve operational constraints not previously imposed. The provisions known as the Volcker Rule generally prohibit banks from engaging in proprietary trading or sponsoring or owning an equity interest in a hedge or private equity fund. Certain of these activities will still be permitted when institutions satisfy additional conditions, such as increased capital requirements. Additional regulations would deal with capital, leverage, liquidity, credit exposure, risk management, enforcement, transactions with affiliates, concentration limits, insider lending, executive compensation, remedial measures for times of distress, liquidation plans, and emergency lending.

In its final form, the Dodd–Frank Bill does not narrow the exceptions to the Bank Holding Company Act, but it may foreshadow such a development. For example, a moratorium will prevent changes in control of industrial loan companies controlled by non-financial companies. During the moratorium, a study will be conducted to determine whether companies owning industrial loan companies should be treated as bank holding companies.

Conclusion

With the imminent passage of financial reform legislation, the advantages and disadvantages associated with operating and investing in depository institutions will change. The commercial bank charter will solidify its place as the dominant charter for depository institutions, popularity of the thrift and mutual charters will further decline, and depository institution holding companies will face significant new restrictions.

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U.S. Consumer Financial Services Industry Gets a New Regulator

Sellers and providers of consumer financial products should be prepared for significant changes to regulatory requirements and the manner in which they are regulated. Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, enacts the Consumer Financial Protection Act of 2010 ("CFPA" or "Title X"). Title X creates a new federal agency that will have extremely broad powers over providers of consumer financial products and services and vast implications for the financial industry. The creation of this new federal agency will fundamentally change how financial products and services are regulated in the United States. The scope and powers granted to it are vast and unprecedented.

The Bureau of Consumer Financial Protection ("Bureau") will regulate the offering and provision of consumer financial products and services, with the main purpose of protecting consumers. Unlike for certain existing regulators, the safety and soundness of the regulated institutions will not be the primary concern of regulators.

The majority of existing federal consumer financial laws will come under the purview of the Bureau, and the Bureau will have the authority to enforce those laws as well as issue its own rules to implement the CFPA. The Bureau will have the authority to make rules requiring registration of non-bank consumer financial products and service providers; prohibiting unfair, deceptive, or abusive acts or practices; and mandating the form and content of disclosures to consumers, among other matters. It also will be able to issue rules under existing consumer financial laws, including the Equal Credit Opportunity Act, Real Estate Settlement Procedures Act, Truth in Lending Act, and numerous others.

The CFPA outlines five primary objectives:

- ensure consumers receive timely and understandable information;
- protect consumers from unfair, deceptive, or abusive acts or practices;
- address outdated, unnecessary, or unduly burdensome regulations;
- enforce federal consumer financial law consistently, without regard to status of a person as a depository institution; and
- ensure the transparent and efficient operation of markets for consumer financial products and services.

The fact that the primary objective of the board is consumer protection may result in different views on existing requirements, and the failure to comply with a particular requirement could have much stronger consequences than in the past.

The potential penalties for violations of the CFPA and federal consumer financial law will be extensive. These penalties will include:

- rescission or reformation of contracts;
- refunds of money or return of real property;
- restitution;
- disgorgement of compensation for unjust enrichment;
- monetary damages;
- limits on activities or functions of the firm or person;
- public notification of the violation, including costs for notification; and
- civil money penalties of up to $5,000 per day, up to $25,000 per day for a reckless violation, or up to $1 million per day for a knowing violation. (The Bureau will be able to reduce this penalty.)

These remedies in large measure are patterned after the rights afforded to federal banking agencies under section 8 of the Federal Deposit Insurance Act. In several respects, however, the Bureau has fewer statutory hurdles it must scale before it can invoke certain of these remedies. Additionally, the CFPA's penalty provisions effectively amend each federal consumer financial law by providing an entirely new set of remedies.

Not everyone will be subject to the Bureau's supervision. For example, there are qualified exemptions from the Act for insurers, auto dealers, and retailers, as well as the scaled-back coverage of community banks. Additionally, smaller depository institutions (total assets of

The creation of this new federal agency will fundamentally change how financial products and services are regulated in the United States.

$10 billion or less) will be subject to the Bureau's rules, but those institutions' prudential regulators will continue to perform their examinations and will retain enforcement authority relating to these rules.

The Bureau will be staffed at first from existing regulators: consumer financial protection functions and personnel from the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision will be transferred to the Bureau.

The Bureau will come into existence as soon as the President signs the Dodd-Frank Act. But the Bureau will not immediately have the authorities and personnel that will be transferred to it from other agencies. That will not happen until a "designated transfer date" to be determined by the Treasury Secretary. Most of the substantive provisions in the CFPA also do not become effective until the designated transfer date.

The Treasury Secretary must decide on a designated transfer date within sixty days of the Dodd-Frank Act becoming law. The designated transfer date cannot be sooner than six months after the bill is enacted (mid- to late-January 2011, assuming a mid- to late-July Presidential signing) and no later than 12 months after enactment. The Treasury Secretary can extend the designated transfer date beyond 12 months if he submits a report to Congress explaining, among other things, why it is not feasible to complete the transition within the statutory timeframe.

The Bureau, with consumer protection as its primary concern and with broad authorization of new rulemaking powers, will be an extraordinarily strong advocate for consumers. The manner in which it exercises those powers and authorities is yet to be seen. Affected parties stay tuned.

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A New Federalism in Bank Regulation

Federal law has long given national banks and federal savings associations (also known as "federal thrifts") broad exemptions from most state laws that regulate consumer financial transactions. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") scales back these exemptions, and thus shifts the balance of power between the federal government and the states in an area where federal law historically has been dominant — the regulation of banks chartered by the federal government. The impact of these changes on any individual bank will depend on a number of factors, but there is no doubt that some national banks and federal thrifts with major consumer operations could soon face the most dramatic regulatorily-mandated restructuring in recent memory.

The Status Quo

The various federal statutes and regulations that preempt (that is, exempt one from having to comply with) state consumer financial laws are too complex and nuanced to receive a full treatment in this article. For present purposes, it is fair to say that federal law exempts national banks and federal thrifts from virtually all state laws that regulate the terms of financial transactions with consumers. It also exempts these banks from having to obtain regulatory approval from a state agency before engaging in business in a state. Federal law also preempts the same range of state laws for state-chartered operating subsidiaries ("op subs") of national banks and federal savings associations.

Changes for Op Subs

Arguably the most dramatic change that will be wrought by the Dodd-Frank Act is to eliminate preemption for op subs. Many national banks and federal thrifts are looking hard at whether it will make sense to provide financial services to consumers through op subs if this provision becomes law (which seems likely). An option for some op subs will be to merge the op subs into their parent banks, although the incremental benefits of this option will depend on the terms of the preemption provisions of the final bill for the banks themselves look like (see below). A merger might not be an option for op subs that banks jointly own with other investors.

Any op sub that remains a separate company from its parent bank would become subject to state licensing requirements. It also will be forced to comply with all of the state laws that apply to other providers of consumer financial services. Complying with these state requirements will certainly result in greater compliance costs. It will also require some of them to fundamentally change how they do business, or even to stop doing business in some states where their business models cannot be reconciled with state requirements.

Changes for the Banks Themselves

The Dodd-Frank Act establishes a new preemption standard for "state consumer financial laws." A state consumer financial law is a state law "that does not directly or indirectly discriminate against national banks and that directly and specifically regulates the manner, content, or terms and conditions of any financial transaction…, or any account related thereto, with respect to a consumer." The Dodd-Frank Act will provide that federal law will preempt a state consumer financial law for a national bank or federal thrift only in three situations: (1) where the state law discriminates

Some national banks and federal thrifts with major consumer operations could face the most dramatic regulatorily-mandated restructuring in recent memory.

against national banks or federal thrifts vis-à-vis banks chartered by the state that enacted the law; (2) "in accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in" *Barnett Bank of Marion County, N.A. v. Nelson*, 517 U.S. 25 (1996), "the State consumer financial law prevents or significantly interferes with the exercise by" a national bank or federal thrift "of its powers;" or (3) where a federal law other than the National Bank Act or Home Owners' Loan Act (the primary two statutes that preempt state laws for national banks and federal thrifts, respectively) preempts the state law.

However, the provisions of the Dodd-Frank Act that limit the authority of the OCC to declare the scope of preemption for national banks and federal thrifts could have more of an impact, at least in the short term, than the substantive preemption standard. (Today, the OTS declares the scope of preemption for federal thrifts, but the legislation will bring federal thrifts under the supervision of the OCC for most purposes.) Both the OTS and OCC have adopted regulations that preempted entire categories of state laws. Under Dodd-Frank, the OCC will be allowed only to declare on a "case-by-case basis" that federal law preempts a state consumer financial law.

Banks often err on the side of complying with a state law when it is not clear whether the state law is preempted. If it is debatable whether federal law preempts a state law, banks are likely to face enforcement actions and lawsuits. Banks also could face substantial liabilities if they failed to comply with a state law that a court later decides was not preempted by federal law. In the past, banks routinely relied on the preemption regulations issued by the OTS and the OCC. Under Dodd-Frank, the OCC will be less able to provide banks with clear-cut guidance about which state laws are preempted.

As a result, some federally-chartered banks might determine that it is simply too risky not to comply with most state laws regulating consumer financial transactions, at least until courts have the chance to interpret the preemption provisions of the law and to define its scope.

Perhaps this is what critics of preemption had in mind all along.

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The Coming Sea Change in the OTC Derivatives Market

While the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") will create a sea change in the OTC derivatives market in the U.S., it certainly will not be the final word. Within one year after the bill is enacted into law, dozens of regulations will be promulgated by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"), and a second "clean-up" bill, which makes largely technical adjustments to Dodd-Frank, will likely follow in early 2011. Taken together, this legislation and regulation will bring about the most comprehensive changes in OTC derivatives trading in the history of the Untied States.

Historical Context

The $615 trillion OTC derivatives market is the largest financial market in the world and has been for some time. While forms of derivatives have existed for thousands of years, government regulation has not. It began when derivatives were blamed for contributing to the financial crisis that led to the Great Depression. In 1936, Congress enacted the Commodity Exchange Act, which created the predecessor to the CFTC, the Commodity Exchange Authority. Nearly forty years later, Congress passed the Commodity Exchange Act in large part to expand the jurisdiction of the CFTC over non-agricultural commodities. Around the time that the first interest rate swap was negotiated between the World Bank and IBM, the CFTC and SEC jointly agreed upon and established the jurisdictional reach of the two regulators over futures and derivatives in the Shad/Johnson Accord.

The development of derivatives frequently outpaces both government regulation and market crises. Even during the most recent market crises, key segments of the OTC derivatives market expanded. The largest category of OTC derivatives is interest rate swaps, and trades within that category doubled in the months following the filing for bankruptcy by Lehman Brothers, according to the Bank for International Settlements ("BIS"). In the second half of 2009, the OTC derivatives market value actually increased. The BIS set the notional value of the OTC derivatives market at $615 trillion.

The derivatives market attracts attention from lawmakers not just due to its size, but also the perceived misuse and opaque nature of the financial instruments. In a June 10, 2010 speech, CFTC Chairman Gensler stated that "[o]ver-the-counter derivatives in particular were at the center of the 2008 financial crisis… taxpayers bailed out AIG with $180 billion when that company's ineffectively regulated $2 trillion derivatives portfolio … nearly brought down the financial system." The enormity of the derivatives market and the role played by one derivative in particular, the credit default swap ("CDS"), have combined to fuel reform of all derivatives within the entire OTC market.

However, the U.S. financial crisis is a story that is not at its root about the vast majority of derivatives; instead, the trillions of dollars in global losses came about from several factors that were driven by a financial tool generally referred to as securitization, and more specifically, collateralized debt obligations ("CDO"), with residential mortgage-backed securities as the underliers. CDSs exacerbated losses during the 2007-2008 market crises.

CDSs and CDOs aside, hundreds of

thousands of derivative trades were entered into for legitimate purposes, functioned properly, and were settled in the OTC market for decades without fanfare. The vast majority of these trades allocated risk in a manner that was efficient, orderly and critical to prudential business practices. The largest category of OTC derivatives, interest rate swaps, are used effectively by many thousands of companies to manage risk. These derivatives, including swaps, caps, floors and collars, frequently accompany traditional financings and are frequently required by banks that provided credit. Other categories of derivatives, such as foreign exchange and equity derivatives, have also performed properly over the years as effective tools for managing a wide range of other risks. Even so, the new law will affect all categories of OTC derivatives that are traded in the United States, and in many ways the impact will be costly and labor-intensive.

Deal-Level and Process Issues Implicated by Reform

Due to the impression held by lawmakers of a vast and entirely unregulated derivatives market, very little in the market will not be regulated, creating an equally prevalent impression that everything will change in the OTC derivatives market.

Central Clearing, the Key Exception, and Margining

Dodd-Frank radically revises the regulatory landscape to bring "swaps," a term that is broadly defined over the course of four pages of the bill to include a wide range of transactions, within the jurisdiction of the CFTC (and security-based swaps within the jurisdiction of the SEC) and subjects all swaps to central clearing unless an important exception applies.

All swaps that regulators require to be cleared must be cleared, except those that are entered into by one party that (i) is not a financial entity, swap dealer or major swap participant; and (ii) uses swaps to hedge or mitigate commercial risk; and (iii) notifies the appropriate regulatory agency how it meets its financial obligations related to non-cleared swaps. As used in this context, the term "financial entity" includes, in addition to swap dealers and major swap (and security-based swap) participants, commodity pools, hedge funds, employee benefit plans, and entities predominantly engaged in banking or financial activities. The CFTC and SEC may exempt smaller depository institutions, farm credit system institutions, and credit unions with total assets of $10 billion or less.

It is presumed by the drafters that non-financial entities are commercial end-users such as utilities, manufacturing and energy companies, but the scope of the definition of major swap participant (and major security-based swap participant) is at this point unclear. A June 30, 2010 letter written to House leadership by Senators Christopher Dodd (D-CT) and Blanche Lincoln (D-AK) further clarified their intent to exclude from the clearing requirement commercial end-users that entered into derivatives for hedging purposes.

Derivative counterparties that are not exempt from the clearing requirements must centrally clear their derivative trades, which must be "margined," or collateralized under central clearing party requirements, according to Section 736 of Dodd-Frank.

Section 736 amends Section 8a(7) of the CEA; Section 8a(7), as written, bars the CFTC from setting the margin of trades covered by the CEA. Dodd-Frank adds a new paragraph in Section 8a(7) that authorizes the CFTC to set margin requirements, provided that such requirements are "limited to protecting the financial integrity of the derivatives clearing organization… [and are] designed for risk management purposes to protect the financial integrity of transactions [but do not] set specific margin amounts."

Cost of Margining

The system-wide cost of margining is expected to be extremely high. In the ISDA Press Release, ISDA reported that U.S. companies may face $1 trillion in additional capital and liquidity requirements as a result of the clearing and margin requirements of Dodd-Frank.[1] According to ISDA:

> The margining requirements for corporate end-users as currently drafted in Dodd-Frank runs [sic] the risk of imposing a significant cost on US companies and could impede their ability to manage their business and financial risks … These provisions would increase rather than decrease risk. They work against Dodd-Frank's main purpose, which ISDA clearly supports, of enhancing financial stability and strengthening our financial system.[2]

Deal-Level and Process Issues Implicated by Reform

The new law will affect virtually every stage within the life cycle of an OTC derivatives transaction (as well as the market for those transactions), including product design, negotiation, documentation, back office functions, clearing (unless the end user exception applies), storing of trade data and post-settlement activities and derivatives trade reconstruction. Under the new law generally, security-based derivatives will

come under the jurisdiction of the SEC, while other derivatives will be regulated by the CFTC. In particular, there are several noteworthy deal-level operational changes that will take place:

- Entering Into and Documenting a Derivative. Most derivatives begin with a phone call between a dealer and an end user. Dodd-Frank imposes comprehensive daily recordkeeping requirements, requiring "major swap participants" and "swap dealers" to maintain daily trading records of trades, along with all recorded communications, electronic mail and instant messages relating to trades.
- Major Swap Participant Requirements. End users will come within the definition of "major swap participant" to the extent that they "maintain" a "substantial position" in swaps or create "substantial counterparty exposure that could have severe adverse effects" on the system (these terms will be subsequently defined in rules promulgated under the statute). Major swap participants will be subject to the most onerous and widest range of statutory and regulatory requirements.
- Collateralizing and Segregating Collateral. Counterparties of swaps and other derivatives will be subject to increased capitalization and margin requirements, unless exemptions apply. Assets pledged to secure positions will generally have to be segregated. Dodd-Frank grants regulators authority to impose margin requirements on any party to a trade.
- Clearing OTC Derivatives. Subject to a limited exemption for commercial end-users discussed above, all OTC derivative trades will be required to be centrally cleared. This requirement is designed to minimize counterparty credit risk, a problem revealed by the failures of AIG and Lehman Brothers. If a swap is not centrally cleared due to the existence of an exemption, counterparties will be required to report the swap details to a registered swap repository or regulators if there is no repository that will accept the swap.
- Exchange Trading. All derivatives that are required to be centrally cleared will also be required to trade on exchanges or swaps execution facilities, a type of alternative trading system. This requirement is designed to bring about an increase in transparency in the pricing of derivatives. Exchange trading will comprehensively change the nature of the markets for derivatives that are currently traded OTC.
- Trade "Storage" and Audit Trails. Complete audit trails for conducting comprehensive trade reconstruction are mandated and trade details are to be "stored."
- A New Duty to Protected End Users. Dodd-Frank also imposes a duty on providers of derivatives to pension plans, certain public entities and others that may possibly discourage dealers from providing derivatives in the first place. If a swap dealer acts as an advisor, it must act in the best interests of the protected entity and have a reasonable basis for determining that any swap recommended to the entity is in its best interests. If the swap dealer (or major swap participant) acts as a counterparty to a protected entity such as a pension plan or municipality, it must have a reasonable basis to believe that the entity has a representative that is independent of the swap dealer or major swap participant that is capable of evaluating the risks of the transaction, is not subject to a statutory disqualification from registration, and will act in the best interests of the pension, municipality or other protected entity.

Conclusion

Approximately one year after the signing into law of Dodd-Frank, much of the OTC derivatives market will begin to dramatically transform, bringing an end in many respects to many thousands of years of trading derivatives over-the-counter.

As we continue to monitor that transformation, two key issues gradually come into sharper focus: first, the global legal regime governing derivatives will likely be regional, spotty, and uneven, creating the distinct possibility that market participants will look for regulatory arbitrage opportunities unless lawmaking is harmonized globally. In addition, because the new law will change so much, OTC market participants should thoughtfully structure derivative trades in anticipation of the law's collateral, clearing, disclosure and recordkeeping requirements, especially if the trades will be entered into after the enactment of the new law.

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[1] Press Release of the International Swaps and Derivatives Association, Inc., dated June 29, 2010.

[2] The ISDA Press Release (quoting Conrad Voldstad, ISDA Chief Executive Officer).

CFTC: Dealing with Technology and New Authority

The hottest topic the CFTC will be addressing during the second half of 2010 is the so-called "flash crash" of May 6, 2010, when prices in financial markets plummeted by about five percent and then promptly bounced back. Since that day, the staffs of the CFTC and the SEC have been reviewing massive amounts of data, with particular focus on so-called "high-frequency" trading that depends on sophisticated technology and algorithms with minimal human intervention. Preliminary staff findings have been discussed at the initial meeting of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues, a body composed of prominent financial industry figures, including several former agency chairs. The CFTC also re-established its Technology Advisory Committee, which plans to hold a meeting on July 14, 2010, to discuss high-frequency trading. So far, no firm conclusions about what roiled the markets have been released.

In the wake of the "flash crash" the national securities exchanges and the Financial Industry Regulatory Authority have proposed a six-month pilot program to temporarily suspend trading in any S&P 500 index security whose price moves up or down by ten percent within a five-minute period. The CFTC and the futures exchanges have not announced any additional rules on the futures markets to supplement existing "circuit breakers" of the Chicago Mercantile Exchange, but issues related to electronic trading will come under increasing scrutiny of the Advisory Committees, referred to above, and Congress. CFTC Chairman Gensler stated, during a Congressional hearing on the "flash crash," that the CFTC plans to re-examine exchange disaster recovery systems. The CFTC has also proposed regulations to govern futures exchanges that provide co-location or proximity services. These proposals would require that such services be available to all traders in an equitable, uniform and non-discriminatory manner, and that exchanges post on their websites the longest, shortest, and average latencies for each connectivity alternative, to assist traders in deciding whether the benefits are worth the cost.

Trading halts have long been part of the regulatory framework at futures exchanges and were instituted on securities markets following the 1987 market break. Some market participants believe that "circuit breakers" distort the markets and may be evaded by trading in international markets or through various alternative mechanisms. In light of the turmoil caused by the "flash crash," the "busting" of certain trades that occurred during that time period, and the delay in sorting out exactly what took place, the tension between the technology of trading and the ability of regulators to monitor it is likely to remain high on the agenda for quite some time.

New Legislation Expanding CFTC Jurisdiction

The Dodd-Frank Act expands the regulatory and enforcement jurisdiction of the CFTC with respect to over-the-counter ("OTC") derivatives by repealing various provisions of the Commodity Exchange Act ("CEA"), enacted in 2000, that had exempted from regulation certain OTC transactions.

The legislation also creates new regulatory frameworks for "swaps" that would require many current OTC transactions to be traded on exchanges and/or cleared through central counterparties, and will also create new categories of CFTC registrants, including "swap dealers" and "major swap participants" ("MSPs"). Commercial end-users of commodities can avoid being classified as swap dealers or MSPs if they limit their swap trading to hedging positions. However, certain institutional traders seeking exposure to swaps are required to register as MSPs with the CFTC (and separately register with the SEC if they also engage in security-based swap transactions) unless they limit their transactions to closely balanced positions or positions reasonably believed to pose no systemic risk to the U.S. banking or financial markets. In any event, even positions that are not required to be executed on exchanges and centrally cleared must be reported to swap repositories or the agencies so that regulators will have more data available to monitor financial markets.

Energy and Metals Markets

The CFTC earlier this year proposed controversial regulations, which have generated thousands of comments, that would establish speculative position limits for four energy-related futures and options contracts traded on the New York Mercantile Exchange and one natural gas contract traded on the Intercontinental Exchange ("ICE"), based in Atlanta. The Commissioners are split in their commitment to the adoption of energy-related position limits. Commissioners Dunn and O'Malia, although agreeing to publish the proposal for comment, have expressed concerns that the proposal could drive business out of the United States to foreign boards of trade, or to unregulated OTC markets, and thus might impair the liquidity and price discovery functions of U.S. futures markets; Commissioner Sommers opposed the proposal because the CFTC does not yet have authority to set limits in the OTC market. Adoption of

energy position limits could further be complicated by the recent public release under the Freedom of Information Act of certain draft CFTC documents, one of which was addressed to Treasury Secretary Geithner, stating that the CFTC finds little evidence to suggest that the imposition of hard, federal position limits would affect price volatility in energy markets.

The CFTC also held a meeting earlier this spring to examine futures and options trading in the metals markets, but it has not issued proposed position limits for those markets. Although the CFTC will likely be given enhanced position limit authority in the final financial regulatory reform legislation, it remains to be seen whether the CFTC will adopt new limits in the energy or metals markets, given the lack of international or academic support for the notion that position limits will decrease market volatility, and the numerous comments filed in opposition to the energy proposals.

The CFTC earlier this spring declared seven natural gas contracts traded at ICE to be "significant price discovery contracts" ("SPDCs"), because the prices of these contracts are commonly used as a key source of price discovery for the cash market and the contracts all exhibit material liquidity. Each of these contracts is what is known as a locational basis contract, which prices natural gas at a specific location other than the main locus of natural gas deliveries in the United States, the Henry (Louisiana) Hub. This was the second time that the CFTC took final action to declare contracts to be SPDCs, pursuant to authority granted to the CFTC when it was reauthorized by Congress in 2008. Following the CFTC determination that the contracts in issue are SPDCs, ICE is required to submit to the CFTC a written demonstration of compliance with nine core principles set

forth in the CEA, including developing an audit trail, adopting speculative position limits or position accountability levels, and making public daily trading information. Exempt Commercial Markets such as ICE will likely be eliminated as a distinctive type of statutory market by passage of financial regulatory reform legislation, despite the fact that they played no role in the crisis in the financial markets in recent years. The concept of SPDCs, however, may remain relevant going forward, because that legislation is also likely to grant the CFTC authority to impose position limits on cleared swaps as well as on uncleared swaps that it determines are SPDCs.

Irrespective of whether the CFTC imposes position limits in energy or metals markets, its Division of Enforcement has continued to investigate trading in those markets, which will remain a top priority. In April and May of 2010, the CFTC brought and settled five cases based upon alleged improper trading in those markets. These included: (1) a case that fined a hedge fund $25 million for allegedly attempting to manipulate the settlement prices of platinum and palladium futures through market-on-close buy orders that were executed in the last ten seconds of the closing period. This practice, which the CFTC refers to as "banging the close," involved allegedly thinly-traded and illiquid markets in commodities where the settlement price was calculated on a volume-weighted basis; (2) wash sale cases against (a) an energy company involving futures and exchange for physical trades in heating oil and gasoline, with a penalty of $130,000, and (b) a utility involving natural gas futures, with a penalty of $80,000; and (3) cases imposing a $14 million fine against a trading firm, and a $200,000 fine against its broker, in connection with an alleged late reporting to the exchange of a Trade at Settlement block trade in crude oil futures.

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Investment Management: Assessing the Impact of Financial Regulatory Reform

The passage of the most significant U.S. financial reform legislation since the New Deal raises significant questions about its short-term and long-term impacts on the investment management industry. The long-running debate over hedge fund regulation has been resolved by bringing most hedge fund managers under SEC regulation, but otherwise, little in the 2,000-plus page legislative package is specifically directed at the investment management industry.

Nevertheless, many of the legislation's provisions will necessarily impact industry participants. Given the dozens of provisions requiring studies and further rulemakings, much of the legislation's real impact will take years to unfold, and will turn, in large part, on regulatory interpretations, rulemakings and exercises of discretionary authority. At the same time, the SEC is, on its own initiative, pursuing several regulatory projects that have been on the back burner for years. Among the key issues ahead are the following.

Financial Reform Legislation

Financial Stability Oversight Council. Large investment managers face the uncertainty of potential regulation by the newly-created Financial Stability Oversight Council (FSOC), which will have the authority to deem non-bank financial institutions to be "systemically significant," and to subject them to oversight and regulation by the Federal Reserve. FSOC/Federal Reserve regulation, which would be in addition to SEC requirements, could subject large investment managers and other non-bank financial institutions to capital, liquidity and recordkeeping requirements, as well as regulatory examinations. The FSOC will have significant discretion to determine the levels of assets or types of activities that will trigger substantive regulation, which, at the extreme, includes liquidation authority. Only time will tell whether and how investment managers may be impacted by this authority.

Restrictions on investments in hedge funds and private equity funds. The reform legislation includes a slightly watered-down version of the Volcker Rule, which, in addition to curbing proprietary trading by banks for their own accounts unrelated to customers' needs, will limit the ability of banks to sponsor, manage, and invest in hedge funds and private equity funds. Banks and bank holding companies will now be able to organize and manage these types of funds in the U.S. only in connection with providing trust, fiduciary, and investment advisory services to clients of the bank and will need to make clear the restrictions on its authority to support these funds. Banks and bank holding companies will only be able to invest in hedge and private equity funds in the U.S. in *de minimis* amounts or for a short period in order to seed a fund. These limitations are to be implemented by regulators within a two-year period.

Money Market Funds. Notably, money market funds are not covered by the new legislation, and money market fund reform seems to have taken a breather in the wake of recent SEC rulemaking, which generally tightened credit standards for money fund investments and imposed restrictions on the liquidity and average maturity of fund investments. According to the SEC staff, there could be a second phase of SEC rulemaking involving some of the more controversial reform measures not previously adopted, such as some form of FDIC-type insurance or a floating NAV. In any event, money market funds will feel the indirect impact of the continuing review and increasing regulation of credit rating agencies—the legislation toughens the regulation of credit rating agencies and requires the SEC to establish a new credit rating agency oversight office. Several of the studies required by the legislation relate to credit rating standardization, independence, compensation and development of an industry self-regulatory organization. The legislation encourages regulators to eliminate regulatory reliance on credit ratings, and adoption of this approach by the SEC would have a major impact on money market funds. Elimination of credit rating standards from the money market fund rules would remove objective standards of creditworthiness and require funds to rely more on their internal assessments, with the likelihood of increased liability exposure and expense.

Derivatives. Many investment managers believe that the legislation's requirements regarding over-the-counter derivatives, covered in a related article in this outlook, will favor them by mitigating counterparty risk and enhancing the transparency of pricing. Some observers caution, however, that capital requirements and other regulation may cause dealers to incur additional expenses that will be passed on to customers through wider spreads.

Special Studies. The legislation calls for an unprecedented number of studies, most of which must be completed on one- to two-year deadlines, and some of which must be followed promptly by rulemaking to address the results. In addition to straining the resources of the SEC, these studies will also delay any regulatory changes in these areas until the process is completed.

Much of legislation's real impact will take years to unfold, and will turn, in large part, on regulatory interpretations, rulemakings, and exercises of discretionary authority.

Among the areas of study committed to the SEC is an exploration of the controversial issues surrounding questions of the relative effectiveness of the existing legal and regulatory standards of care owed by broker-dealers and investment advisers to their retail clients in providing personalized investment advice. The legislation specifically authorizes the SEC to impose fiduciary duties upon broker-dealers in providing retail investment advice if it finds in the study that doing so is necessary to protect investors.

Another area committed to SEC study is consideration of the level of financial literacy among retail investors, particularly with regard to the purchase of mutual fund shares. To be completed within two years, the study will include particular focus on the timing, content and format of disclosures, as well as identification of the most useful and understandable relevant information that retail investors need to make informed financial decisions about mutual funds, with particular attention to transparency of expenses and conflicts of interest. In a separate study, the GAO is charged, on a one-year time horizon, with reviewing and recommending improvements to mutual fund advertising, in order to improve investor protection and ensure informed financial decisions by retail investors purchasing mutual fund shares. Separate GAO studies will also review municipal securities markets and disclosures. These studies will likely lead to changes in disclosure requirements.

Other studies that could have a powerful impact on the course of future regulation include the following topics:

- The appropriate financial thresholds or other qualifications relating to accredited investor status and eligibility to invest in private funds;
- The feasibility of forming a self-regulatory organization to oversee private funds;
- The potential conflicts of interest that result from permitting investment banking and equity and fixed income securities analyst functions within the same firm; and
- The need for consumer protection measures relating to those holding themselves out as "financial planners" or similar designations.

SEC Regulation

Rule 12b-1. Chairman Schapiro and the SEC staff have expressed renewed interest in reforming Rule 12b-1 by eliminating the current regulatory structure, which is centered on board approval and special oversight provisions. The staff has suggested that new rules might instead establish a cap on asset-based distribution fees at a level equivalent to front-end loads and remove current restrictions on sales pricing in order to permit distributors to impose their own loads. As this Outlook goes to print, the SEC has scheduled a meeting on July, 21, 2010 to propose changes to Rule 12b-1.

Equity Market Structure. The SEC staff is conducting a wide-ranging review of equity market structure, which includes a study of the May 6, 2010 "flash crash." This review has already resulted in several rulemaking proposals, some of which would affect fund managers, including increasing the transparency of orders and trading at "dark pools"—hindering managers' ability to mask their activity from front-runners—and banning "naked" or unfiltered access to exchanges.

Court Activity

Many elements of the financial reform package that have been fiercely debated may face challenge in the federal courts. The Supreme Court's long-awaited decision in *Jones v. Harris Associates* issued earlier this year decisively supported the status quo ante fund board process for reviewing and approving fund advisory fees as articulated in the seminal *Gartenberg* decision. Although the Court in the *Jones* decision demonstrated sensitivity to the complex dynamics of mutual fund governance, the possibility of future litigation inevitably injects an element of uncertainty into regulatory changes where the affected parties seek to continue their objections in court.

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Investment of Pension and Other Plan Assets: Federal Enforcement

The U.S. Department of Labor's ("DOL") Employee Benefits Security Administration, which is responsible for almost all federal regulation and enforcement of private-sector pension and other employee benefit plans, has been active in the first months of 2010. In addition, Congress is considering legislation that could increase the already complex rules governing plans covered by ERISA, the Employee Retirement Income Security Act of 1974. What follows is a look back on the early months of 2010 and a look forward at possible DOL or Congressional attention and action.

EBSA's 2009 Enforcement Results

In March 2010, the EBSA announced its enforcement results for the fiscal year ending on September 30, 2009. According to the EBSA, 2009 saw over 1,000 cases closed, 910 of which involved violations found by the EBSA and corrected by the target of the investigation. The EBSA claims to have recovered almost $18 million in 2009, down from the record $135 million it recovered in 2003. Ominously, however, 2009 saw twice the number of criminal indictments compared to 2008.

DOL Issues Proposed Investment Advice to Participants in 401(k) Plans

The DOL issued its proposed regulation on investment advice to participants in 401(k) plans in early March 2010. 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. DOL finalized a regulation and a related class exemption in January 2009 that would have implemented this part of the PPA, but withdrew the regulation and class exemption in November 2009 following strong Congressional criticism. Compared to the withdrawn regulation and class exemption, the 2010 proposed regulation imposes more stringent conditions on advice provided to participants in 401(k) plans. The 2010 proposal also requires advice provided to IRA owners to meet the conditions of the proposed regulation. The withdrawn regulation and class exemption would have essentially exempted advice provided to IRA owners from the regulation. The DOL received numerous comments on the 2010 proposed regulation and appears to still be addressing those comments.

Upcoming Issues and Activity

Reporting of Fees and Indirect Compensation to the DOL, Plans, and Plan Participants

The DOL has long been concerned that ERISA 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. The DOL has attempted to address this through revisions to Form 5500 that now require plans to report compensation indirectly received by service providers to plans, and through two regulations proposed in 2008 that would require service providers to make certain disclosures about fees when they contract with a plan, and increased and purportedly simplified reporting of fees in 401(k) plans to participating employees. The Form 5500 revision took effect for plan years beginning in 2009, and many service providers have been providing the required information to plans. However, because the filing deadline for 2009 Form 5500s has not passed, the DOL has not reviewed or reacted to how plans and service providers have tried to comply with the new reporting requirement.

As to the 2008 proposals, the initiative to require service provider disclosures is still under review by OMB. The proposed participant disclosure regulation has been caught in broader Congressional action on reforming the financial services industry. Rep. George Miller (D-Calif.), Chairman of the House Education and Labor Committee, who has been critical of the proposed regulation, has insisted on expansive participant disclosure, and has won a legislative battle to keep 401(k) fee disclosure rules drafted by his committee in the American Jobs and Closing Tax Loopholes Act, which was recently passed by the House. The DOL had sought to have these provisions removed, in order to permit them to deal

DOL has long been concerned that plan sponsors and participants do not get enough information about fees charged for services to plans.

with 401(k) fee disclosure by regulation. The House bill is one of many issues under consideration by a House-Senate Conference Committee, and it is unclear whether the Conference Committee will adopt the Miller approach, reject it and let the DOL issue regulations, or do something else entirely.

Target Date Retirement Funds

On May 6, 2010, the DOL and the SEC issued a joint "Investor Bulletin" on "Target Date Retirement Funds." The bulletin is informational and intended to explain how such funds work and how investors, and plan fiduciaries and participants, can evaluate such funds. However, DOL Assistant Secretary Phyllis Borzi made clear that the DOL will continue to focus on target date retirement funds, and that this focus will involve additional guidance and regulatory amendments, specifically of the DOL's regulations governing "qualified default investment alternatives." However, Assistant Secretary Borzi did not provide details on what may be included in such future guidance or revised regulations.

EBSA Investigation and Enforcement Activity Involving Financial Service Providers

There is continuing evidence that the EBSA is increasingly focusing enforcement resources on investigations relating to plan investments, investment advisers and financial service providers. The EBSA has continued to work with the SEC and other agencies in this regard. The EBSA's efforts are intended to improve the EBSA's understanding of these matters, identify fee, compensation, and disclosure practices that concern the EBSA, and 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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Health Care: A Brave New World of Reform

After a year of heated debate culminating in parliamentary high drama, the comprehensive health care overhaul, known as the Patient Protection and Affordable Care Act ("PPACA"), as immediately amended by the Health Care and Education Reconciliation Act ("Reconciliation Act"), was signed into law in March 2010. The purpose of this legislation is to facilitate, through a complicated structure of tax incentives and penalties and the creation of insurance exchanges, health insurance coverage for the estimated 40-50 million Americans who are currently uninsured. Additionally, the law sets into motion a number of far-reaching reforms and reimbursement changes to the existing Medicare and Medicaid programs. Given its potential scope and likely impact on health care delivery and finance, PPACA may be vone of the most significant pieces of social legislation enacted in recent times.

Legislative Drama

The path to passage of this extraordinary legislation was difficult, requiring a seemingly unusual degree of compromise between the two houses of Congress. The House of Representatives passed initially the Affordable Health Care for America Act in early November of 2009, which included the much debated public option—a proposal in which the federal government would directly offer a low cost health insurance product to consumers. Shortly thereafter, the Senate, focused keenly on developing a 60-vote, filibuster-proof bill, released the Patient Protection and Affordable Care Act. Significantly, it did not include a public option or certain other features contained in the House bill. On Christmas Eve, in climatic fashion, the Senate passed the bill with the minimum 60 votes needed.

However, expectations for a swift conference committee process to negotiate the House and Senate differences were frustrated when Senate Democrats lost their 60-vote majority due to the special election of a Republican to fill the seat vacated by the death of Senator Edward Kennedy of Massachusetts. With agreement on a compromise bill unlikely, the Democratic congressional leadership devised a plan to have the House enact the Senate bill and to use a second reconciliation sidecar bill to resolve major House objections. Under budget reconciliation rules, the Senate would be able to clear all legislative hurdles to approve the Reconciliation Act with a simple 51-vote majority.

As a result, the House passed both PPACA and the Reconciliation Act on March 21, 2010. President Obama signed PPACA into law on March 23, 2010, as the Senate commenced deliberations on the Reconciliation Act. The Senate after considering and defeating multiple amendments passed the Reconciliation Act on March 25, 2010. Due to certain parliamentary issues which were identified and upheld, prior to the Senate vote, the House was required to vote again on the Senate version of the Reconciliation Act. This vote also occurred on March 25, 2010. President Obama thereafter signed the Reconciliation Act into law on March 30, 2010.

Health Care Coverage Expansion

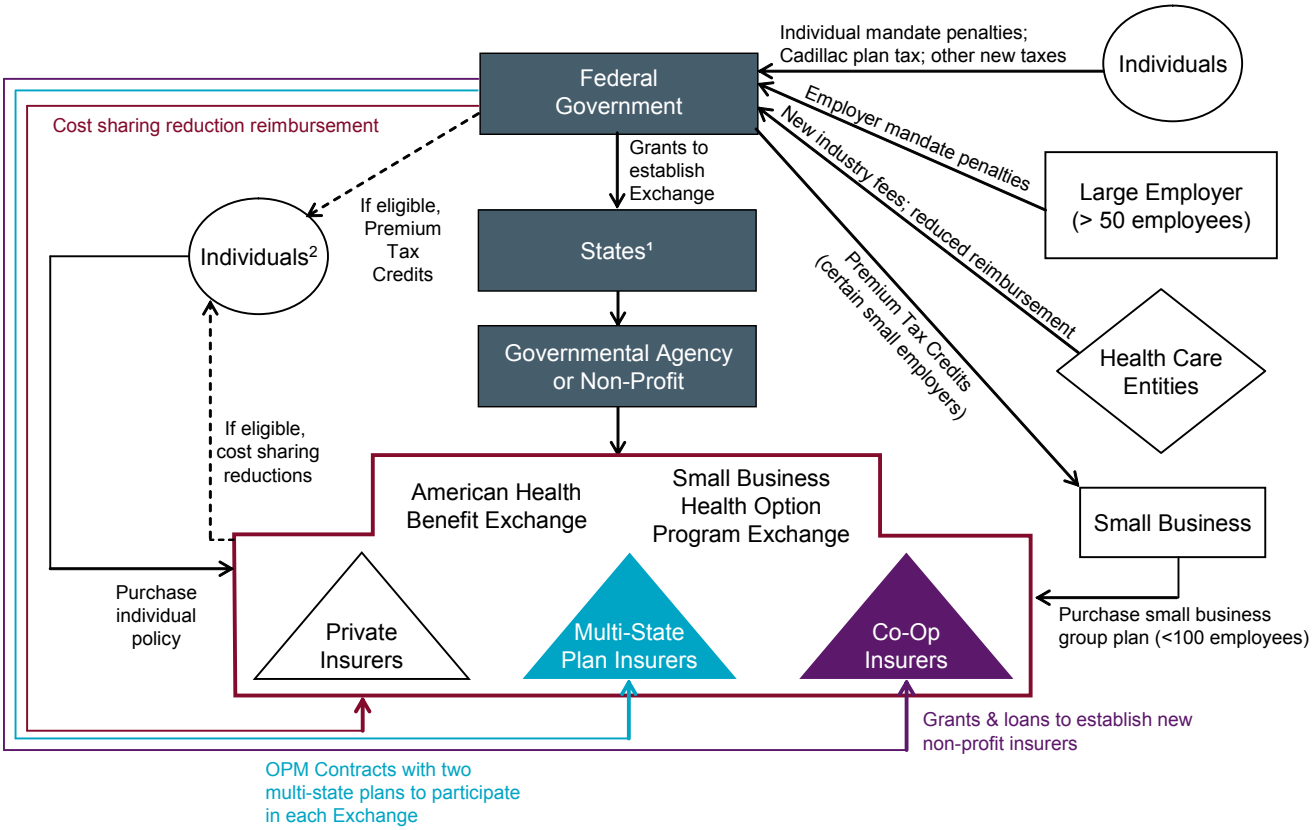
As an alternative to a public option, PPACA creates state-based American Health Benefit Exchanges ("AHBE") and Small Business Health Options Program Exchanges to be administered by a governmental agency or non-profit organization. The exchanges will pool individuals and small businesses in an attempt to obtain more affordable premiums and to facilitate individuals' access to a variety of standardized health insurance plans. Eligibility for coverage through the AHBE will only extend to individuals not currently enrolled in other acceptable coverage. Exchanges will, among other things, certify and rate qualified health plans. PPACA defines a "qualified health plan" as a plan that provides an essential health benefit package, which consists of essential health benefits and is equal to benefits provided by a typical employer plan. The plan must further limit deductibles and out-of-pocket costs, and have a specified actuarial value. There are four different levels of coverage: bronze, silver, gold, and platinum levels. Bronze level coverage must provide benefits that are equivalent to 60 percent of the full actuarial value of benefits, while the silver, gold, and platinum levels are at 70, 80, and 90 percent, respectively.

Individual and Employer Mandates

Significantly, PPACA mandates that individuals maintain minimum essential health insurance coverage or pay a penalty, with certain exceptions. The penalty will be the greater of $95 or one percent of income in 2014, $325 or two percent of income in 2015, and $695 or 2.5 percent of income thereafter, but in no event higher than the national average bronze plan premium. To assist those with financial need in meeting this mandate, individuals and families purchasing insurance through an exchange may also be eligible for tax credits to offset the price of a qualified health plan and cost sharing (i.e. co-pay and deductible) assistance. Individuals participating in an employer-sponsored plan are also eligible for subsidies in certain circumstances.

Employers with 200 or more full-time employees are required to have automatic insurance coverage for new full-time employees and continued coverage of current employees. An employer with 50 or more full-time employees is considered an "applicable large employer" and is required to submit insurance returns to provide proof of coverage availability. If an applicable large employer fails to offer minimum essential coverage for full-time employees and at least one full-time employee has enrolled in a qualified health plan where a premium tax credit or cost-sharing reduction is allowed, the employer will be subject to penalty. The penalty amounts to $2,000 for each full-time employee not covered under a qualified plan, excluding the first 30 full-time employees. Smaller businesses are not required to provide insurance, but there is an immediate tax credit for eligible small businesses to purchase health insurance for employees.

A selected outline of the various flow of funds mentioned above is set forth below.



[1] This chart does not include Medicaid expansion

[2] Some individuals may also receive employer vouchers

Medicaid Enrollment

In addition to coverage expansion through an exchange, Medicaid under PPACA will be expanded to cover individuals with incomes at or below 133 percent of the poverty level. At least for a period of time, states will be compensated for the costs associated with these newly eligible individuals through an increase in the federal stipend for state medical assistance.

Health Insurance Reforms

PPACA also prohibits certain insurance practices that have historically led individuals to be uninsured or underinsured. Among other things, insurance companies are prohibited from:

- Denying benefits based on pre-existing conditions.
- Conducting policy rescissions, except in cases of fraud or misrepresentation.
- Varying insurance premium rates other than due to (a) the type of plan (individual or family), (b) the rating area, (c) age of insured, or (d) tobacco use.
- Establishing lifetime benefit limits or unreasonable annual limits on the dollar value of benefits.

Furthermore, PPACA requires that plans offering dependent coverage extend those benefits through age 26.

Medicare Payment Reforms

PPACA accelerates the ongoing transition to so-called Value-Based Purchasing ("VBP") that is designed to move Medicare from a pay for quantity to a pay for performance model. For example, PPACA ties hospital Medicare reimbursement to overall quality performance scores, hospital acquired conditions rates, excess readmissions rates, and location within a county with low per capita Medicare spending. Similar VBP initiatives are applied to a variety of provider types. PPACA also authorizes various demonstration projects aimed to develop new lower cost, higher quality models that coordinate care across provider types, such as accountable care organizations, medical home models, and bundled payments for episodes of care. In addition, the Center for Medicare and Medicaid Innovation is formed to explore alternative payment models.

Each of these provisions is an attempt to slow the dramatic rise in health care costs that threatens the long-term viability of the Medicare program. Via PPACA, Congress has also tied its own hands by creating an Independent Payment Advisory Board ("IPAB"). The IPAB is required to propose Medicare cuts capable of closing the gap between actual Medicare spending and Medicare growth targets. Medicare must implement these unless Congress intervenes to amend the proposal. However, any congressional proposal must still achieve the cost savings of the original IPAB proposal. In addition, PPACA provides for cuts in Medicare and Medicaid reimbursement generally. Finally, PPACA significantly augments already expansive provisions designed to identify and recoup the costs of health care fraud, waste, and abuse by, for example, significantly tightening enrollment standards in Medicare and Medicaid designed to keep bad actors out of the programs in lieu of a "pay and chase" model.

Conclusion

The passage of PPACA with its many delayed implementation dates is clearly just the beginning of a long process that will be necessary to effect broad based change within the American health care sector. While only time will tell whether the law can achieve its lofty goals, one consequence is sure: there will be an explosion of federal agency rulemaking. Providers in particular must be proactive in reviewing published, proposed regulations and in using the opportunities given to comment on these rules. At a minimum, an investment in monitoring and planning will be imperative for providers, employers, and insurers to navigate this new frontier and to thrive in the time of change ahead.

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The Politics of Climate Change Legislation

With this spring's passage of landmark health care legislation and the enactment this summer of financial reform legislation, the White House is looking for a third legislative victory with the passage of comprehensive climate change and clean energy legislation. Much like horse racing, however, the odds of achieving this legislative trifecta are exceedingly small.

Climate change is a vexing legislative issue that has become increasingly complex and politically problematic. The failure to produce a binding agreement at the Copenhagen conference late last year highlights the intricate politics that permeate the climate change debate. These same politics have largely stymied Congress and the White House in moving forward on "cap and trade" legislation.

Status

To review, the House of Representatives already approved a massive climate change and clean energy bill last summer. The House legislation, dubbed the Waxman-Markey bill (H.R. 2454), passed by a razor-thin and mostly partisan margin of 219-212. It would establish an elaborate cap-and-trade system to reduce greenhouse gas emissions over the next 40 years, and would provide for various 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 sponsored by Senator Jeff Bingaman (D-NM), S 1462, is a bipartisan bill approved last summer by the Energy & Natural Resources Committee, which includes a renewable energy standard and various incentives to promote clean technologies. The cap-and-trade bill sponsored by Senators Barbara Boxer (D-CA) and John Kerry (D-MA), S. 1733, was approved last fall by the Environment & Public Works Committee after a highly partisan and contentious process in which the Republicans refused to participate.

Both bills have been ready for Senate floor consideration for months. Yet, there has been no action on the Boxer-Kerry cap-and-trade bill because most observers (including many Democrats) agree that there are not 60 votes in the Senate, which is usually required to move any meaningful bill. The reasons for this are many and strike at the very core of climate change politics.

The first concern is that restrictions on greenhouse gas emissions 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 with the economy still struggling to recover and a near double-digit jobless rate.

The second concern is regional equity. Senators representing states dependent on carbon fuels, such as those that mine or burn coal, are concerned that their constituents will pay a disproportionate share of the costs stemming from climate change restrictions. These Senators need to be persuaded that a cap-and-trade system will not impose an unfair burden on their states just because of the type of energy they produce or consume.

A third concern relates to the mechanics of cap-and-trade. With the memories of the subprime mortgage financial meltdown still fresh, some Senators fear that a new and complex market to trade

carbon credits would be fraught with potential gaming and even abuse. The House-passed cap-and-trade system has also been roundly criticized for giving away up front too many free credits to utilities and carbon producers to curry political support.

The combination of these concerns, along with a healthy dose of partisan politics as the November midterm elections near, rendered the Boxer-Kerry bill essentially dead on arrival on the Senate floor. So, if the Senate were to proceed in the elusive goal to cobble together a coalition of 60 votes to pass climate change legislation, a new approach was needed. Such an alternative proposal was earnestly pursued for months by a trio of Senators: Kerry, Lindsey Graham (R-SC), and Joe Lieberman (I-CT).

The Kerry-Graham-Lieberman proposal (or "KGL") married the greenhouse gas emission 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 valiantly put himself at odds with most in his party by being prepared to accept a modified cap-and-trade program, provided it also featured some consumer protections, and expanded energy production to reduce dependence on unreliable foreign supplies. KGL was packaged in national and energy security terms, rather than environmental terms, to attract Republican votes.

On the eve of the bill's unveiling in late April, Graham pulled out, leaving the bill without a Republican sponsor. Graham expressed concerns that the political milieu in the Senate had been poisoned by the clumsy efforts to advance controversial immigration reform legislation ahead of climate change. Others speculated that Graham was feeling the political heat as it appeared that no other Senate Republicans were prepared to stand with him in support of KGL.

Undaunted, Kerry and Lieberman pushed ahead without Graham and released their 987-page bill, entitled the American Power Act, in May. The bill was faithful to the production-oriented climate change proposal that Graham helped craft, with a few provisions inserted to respond to the offshore drilling accident in the Gulf of Mexico.

Prospects

In the Senate, the climate change debate for this year now hinges on whether the Kerry-Lieberman bill can muster 60 votes for passage. The Environmental Protection Agency ("EPA") and the Department of Energy ("DOE") released an economic modeling of the bill during June, which means it could be ready for Senate floor action in July.

The continuing oil spill in the Gulf also shines the political spotlight on energy policy, which should provide heightened impetus for Congress to act. In fact, Majority Leader Harry Reid (D-NV) directed the committees of jurisdiction to provide their legislative proposals on oil spill liability and mitigation and response measures by the end of June so that they can proceed with Senate floor consideration after July 4. However, despite the favorable politics, the push to develop oil spill legislation, and the strong personal backing from President Obama involving a series of White House meetings to attract supporters, the Kerry-Lieberman bill still faces the same difficult obstacles as the original Boxer-Kerry bill.

The first obstacle is the compressed calendar. The Senate has many other "must do" priorities, such as spending, tax, and jobs bills, as well as a Supreme Court nomination. With the Senate on recess during most of August and the November election fast approaching, there is not much time to debate climate change.

Second, the Kerry-Lieberman cap-and-trade proposal is complex and has not been fully vetted. In some respects, it is even more complicated than the House-passed bill because it imposes individual caps on three sectors: utilities, industry, and transportation. For this reason, this suggestion to limit the carbon cap just to utilities is gaining support.

Third, the whole climate change debate, and especially the cap-and-trade methodology, has become increasingly controversial. More Americans question the science on global warming, and opponents of cap-and-trade have, for the moment, largely won the public relations battle.

The failure to produce a binding agreement at Copenhagen highlights the intricate politics that permeate the climate change debate.

Fourth, the legislation does not enjoy bipartisan support. Graham's departure is very costly, because without him, there is no visible Republican support in the Senate for the Kerry-Lieberman bill. Given the current party composition of the Senate, a partisan proposal is not going to clear the 60-vote hurdle.

Finally, the timing is wrong. Many members are rightfully fretting their reelection prospects, especially on the heels of tough votes taken to pass health care. The last thing the Senate Democratic leadership and the White House want is to ask moderate Democrats to "walk the plank" again by supporting a climate change bill.

Despite these dismal prospects for passing the Kerry-Lieberman climate change bill, there are some options. For instance, Senators Maria Cantwell (D-WA) and Susan Collins (R-ME) have proposed an alternative "cap and dividend" proposal. This bipartisan approach, which gets credit for its simplicity (it has only 39 pages of legislative text), would set up a pure auction with revenues generated returned mostly to the public. While the cap-and-dividend bill is getting some renewed interest as a bipartisan group of Senators has asked DOE to model its impact, it is simply too late to advance the bill this year, but perhaps the cap-and-dividend concept can become a fresh and viable option to the old cap-and-trade model next year.

Another option is a straightforward carbon tax, which many economists argue is the best way to put a price on carbon to encourage the production and use of clean, non-carbon emitting energy. Yet, given the current political environment, any proposal featuring taxes will likely face entrenched opposition from Republicans and some moderate Democrats.

Another legislative option is to proceed with the Bingaman clean energy bill, with its incentives and mandates to promote renewables and energy efficiency, most of which can probably pass the Senate this year. While the Bingaman bill enjoys bipartisan support, proponents of comprehensive climate change legislation may not support moving it separately for fear that without it being used as a sweetener, passage of cap-and-trade or other stand-alone restrictions on carbon dioxide (CO2) will not be politically viable. Others, however, have advocated using the Bingaman clean energy bill with its renewable electric standard as a legislative vehicle to respond to the Gulf oil spill crisis and permitting it to be amended on the Senate floor with climate change proposals, such as the Kerry-Lieberman bill.

A final option, if Congress is unable to pass climate change legislation, is for the EPA to regulate greenhouse gas emissions. The agency has already started to review proposed rules that impose restrictions on major emitters of CO2, such as coal-fired plants and certain energy-intensive manufacturing. EPA regulation would be extremely controversial and would likely be challenged by the Congress and in the courts. For instance, a privileged resolution offered by Senator Lisa Murkowski (R-AK) disapproving of EPA's regulation of greenhouse gas emissions fell just four votes short of passing the Senate on June 10. In addition, any climate change regulations finalized by EPA will likely trigger lawsuits that may be tied up in the federal courts for years.

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Climate Change Under the New UK Coalition Government

In the run up to the United Kingdom's May general election, all of the principal parties were jostling for the green vote.

Labour wanted to draw attention to its green record whilst in government, and particularly its effectiveness and leadership in implementing energy performance certificates for commercial buildings and in home information packs for residential properties, the CRC energy efficiency scheme and feed in tariffs. However, the failure of the Copenhagen Climate Conference detracted from the UK's efforts to establish credentials as a climate change statesman at an international level.

There was a poor showing for environmental interests at both a local and a national level in the election, with perhaps all the main parties having done just enough to establish their green credentials to not lose voters, and with green issues being overshadowed by the seemingly more pressing economic and budget deficit issues.

The vagaries of the UK polling system have resulted in a change of government with a Conservative/Liberal Democrat coalition taking power, with Conservative prime minister David Cameron firmly at the helm. The coalition's programme for government, published days after the government was formed, contains an amalgam of the policies of the two parties and the compromises reached by them in forming the coalition.

The compromise reached on new nuclear power projects, which Labour (now in opposition) and the Conservatives support, but the Lib Dems oppose, is fascinating in that it has been pre-agreed that a Lib Dem spokesman will speak against the motion to adopt the Nuclear National Policy Statement, but will not vote against it.

Air travel is targeted with the third runway at Heathrow and further expansion at Gatwick and Stansted thwarted, and per-flight duty to be introduced to replace Air Passenger Duty.

There are 24 separate commitments relating to Energy and Climate Change in the coalition's programme for government and an indication in the Queen's Speech that there will be specific new measures focused on improving energy efficiency in homes and businesses, and promoting low carbon energy production.

David Cameron seems keen to pursue a leadership role on international climate change, with express intent to seek effective global collaboration at COP16 in Mexico in November/December.

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David Cameron seems keen to pursue an international climate change leadership role.

Environmental Regulation: Poised for Action

President Obama pledged to take a more aggressive approach to environmental protection this year. While most media attention has focused on the Administration's proposed legislation to establish a cap-and-trade program for greenhouse gases ("GHGs"), U.S. Environmental Protection Agency ("EPA") Director Lisa Jackson has announced several other areas for action.

Reducing Greenhouse Gas Emissions

In December 2009, EPA released findings that concentrations of GHGs threaten both public health and welfare, and that emissions of GHGs from cars contribute to that threat. Although the findings do not themselves impose any requirements on industry or other entities, the findings treat emissions of these GHGs collectively as an "air pollutant" under the Clean Air Act ("CAA") and triggered a requirement that EPA promulgate standards for GHG emissions from new motor vehicles. There is significant debate about whether EPA's endangerment finding has triggered various other provisions under the CAA that require EPA to begin regulating emissions from source categories in other areas, including the Prevention of Significant Deterioration ("PSD") and Title V Permitting Programs, New Source Performance Standards, and National Ambient Air Quality Standards. In essence, EPA's findings amount to an implicit threat that if Congress does not pass legislation to reduce GHG emissions sooner rather than later, the Obama Administration could move unilaterally to regulate GHG emissions under the CAA without congressional input. *See related article, "In the Face of Uncertainty, Large Greenhouse Gas Emitters May Have to Address Their Greenhouse Gas Emissions Preemptively" in this report.*

Improving Air Quality

In addition to reducing GHG emissions, EPA has announced plans to develop a comprehensive strategy for improving air quality that includes, among others, issuing new "Maximum Achievable Control Technology" rules for air emissions from industrial and commercial boilers; new rules for the management of coal combustion ash; the first set of reporting requirements for the capture and geological sequestration of carbon dioxide; and new rules implementing the Renewable Fuels Standard. EPA also plans to improve its monitoring, permitting, and enforcement mechanisms.

Protecting the Nation's Waters

EPA has announced plans to combat a variety of challenges to the nation's waters, including nutrient loadings, storm water runoff, invasive species, and drinking water contaminants, to name a few. As a result, EPA intends to initiate measures to address marine vessel discharges, post-construction runoff, water quality impairment from surface mining, and stronger drinking water protection; expand construction of water infrastructure; develop nutrient limits; and launch an Urban Waters initiative. Additionally, the agency will continue comprehensive watershed protection programs for the Chesapeake Bay and Great Lakes.

The Administration is likely to continue to issue aggressive environmental regulatory proposals.

Assuring Chemical Safety

In 2009, EPA Administrator Jackson announced principles for modernizing the Toxic Substances Control Act, and this year the agency plans to make additional progress in assuring the safety of chemicals that impact our communities by addressing high-concern chemicals and filling data gaps on widely produced chemicals in commerce through peer-reviewed health assessments on substances of concern. EPA has also released the first-ever chemical management plans for five groups of substances, and more plans are underway.

Responding to the Gulf of Mexico Oil Spill

The Deepwater Horizon oil spill in the Gulf of Mexico poses unprecedented environmental challenges, and the Obama Administration has sent a legislative package to Congress that includes proposals to combat the negative impacts of the spill on the environment, protect the nation's natural resources, and rebuild the Gulf region. Among these proposals are new funding to EPA and the National Oceanic and Atmospheric Administration for various environmental studies that would improve the federal response to the spill, as well as provisions that would strengthen and update the oil spill liability system to better address catastrophic events.

The spill has also put pressure on lawmakers to address a variety of other environmental issues. For example, a coalition of environmental and public health groups have urged Congress to overhaul the Toxic Substances Control Act, saying dispersants used to break up thick oil in the Gulf of Mexico demonstrate why the law needs to be strengthened. The Gulf Oil spill has also renewed efforts by congressional leaders to push for comprehensive energy and climate change policy this year; however, the spill has not bridged significant gaps between the parties on controversial drilling and cap-and-trade provisions that would yield the 60 votes in the Senate necessary to pass such legislation. *See related article, "The Politics of Climate Change Legislation" in this report.*

The Obama Administration and congressional Democratic leadership have said that they want to produce a bill that addresses problems relating to the Gulf Oil spill. House Speaker Nancy Pelosi and Senate Majority Leader Harry Reid have said that they would like relevant congressional committees to report their recommendations by July 4th, with the expectation that the legislation will go to the House and Senate floors in July.

Other agencies, such as the Fish and Wildlife Service, the Bureau of Land Management, and the Army Corps of Engineers, have undertaken reviews of existing rules and permits for surface mining, marine vessel discharges, and a host of other matters.

Regardless of the outcome of the upcoming Congressional election, and regardless of whether Congress passes cap-and-trade legislation (which, at this point, appears unlikely), the Administration is likely to continue to issue aggressive environmental regulatory proposals over the next two years. These proposals present challenges and opportunities. Many have significant economic implications. For example, the new MACT boiler rule is estimated to impose annual costs of $2.9 billion a year. Further, these initiatives can significantly affect the competitive balance in particular industries, such as renewable fuels. There are a number of strategies for responding, including developing regulatory and technical comments, launching legal challenges, and working with members of Congress and with other stakeholders to highlight critical issues and alternative approaches.

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In the Face of Uncertainty, Large Greenhouse Gas Emitters May Have to Address Their Greenhouse Gas Emissions Preemptively

In April 2010, the U.S. Environmental Protection Agency ("EPA") issued regulations confirming that it will not regulate emissions of greenhouse gases ("GHGs") from stationary sources this year. However, barring court intervention or action from Congress, EPA will regulate GHGs under the Clean Air Act starting in 2011 through the Prevention of Significant Deterioration ("PSD") construction permit program and other sections of the CAA. EPA will focus its initial efforts on the largest emitters, including power plants, who may soon find themselves having to evaluate and implement "best available control technology" ("BACT") for GHG emissions.

EPA Developments

As noted in the previous article, in December 2009, EPA issued its "Endangerment Finding," which is a regulatory determination that GHG emissions are a danger to the public health and welfare under the CAA. If upheld by the courts, the Endangerment Finding will ultimately force new and modified major stationary sources to address GHG emissions through the PSD permitting process. Importantly, EPA's March 2010 "Phase-In Rule" clarified that PSD permitting requirements would not be triggered until January 2, 2011, and that air permit applications pending when the regulations take effect will not be grandfathered and therefore must address BACT for the source's GHG emissions where required. To avoid creating a regulatory scheme that could reach an unmanageable number of GHG sources, EPA promulgated the "Tailoring Rule" to ease initially the regulatory burden on permitting authorities and smaller emitters by setting a high threshold for triggering PSD requirements for GHG sources. EPA plans to set lower thresholds to address smaller emitters in a future rulemaking.

All the moving pieces to EPA's regulation of GHGs under the CAA provide avenues for legal challenges, leaving significant uncertainty as to whether EPA's timeline (and authority) to regulate GHGs will remain intact. The Endangerment Finding is currently being challenged by several industry groups, lawmakers, and three states. Many of these challengers are also attempting to have the Phase-In Rule struck down, and challenges to the Tailoring Rule are almost a certainty. EPA's timeline could be delayed if a court enjoins GHG regulation pending the outcome of the suits. If the Endangerment Finding is invalidated, EPA may find itself with nothing to stand on to regulate GHGs under the CAA.

In the backdrop of these court challenges, efforts are being made in Congress to push through a comprehensive federal climate change bill. Thus, even if EPA is successful in defending its recent rulemakings, a federal climate bill could sidestep the agency's efforts to address GHGs under the CAA—a situation EPA would actually prefer, since it is using the prospect of CAA regulation to prompt congressional action. Since it seems unlikely that Congress will pass climate change legislation, large emitters will have to take seriously the prospect of CAA regulation of GHGs. *For an analysis of the legislative developments in the climate change arena, see the previous article, "The Politics of Climate Change Legislation" in this report.*

EPA's Climate Change Work Group Addressing Emissions Control Technology

Assuming EPA's regulations withstand legal challenge in their current form and Congress does not preempt EPA's actions, the largest GHG emitters, including power plants, are likely to become the first guinea pigs required to address BACT for GHG emissions beginning in 2011. BACT is the type of pollution-control technology required by the PSD permitting program. However, it is a mystery what will constitute BACT for GHGs at this point, since there are no clearly-established GHG emission control technologies to capture GHGs, other than switching from coal to natural gas and increasing operational efficiencies.

To address this situation, EPA established the Climate Change Work Group ("Work Group") in October of 2009 to identify and address major issues for implementing the PSD requirements for GHGs, and BACT analysis in particular. The Work Group's findings will be used by EPA to develop guidance and assist states and regulated entities in implementing and complying with the new GHG regulations.

The Work Group focused the first phase of its work on providing recommendations to help EPA craft BACT guidance for GHGs assuming, at least initially, that the process would occur in the same manner as criteria pollutants. In an interim report released on February 3, 2010, the Work Group largely highlighted the many questions EPA will face in applying the PSD permitting process to GHGs. The Work

The largest emitters may soon find themselves having to evaluate and implement "best available control technology" for GHG emissions.

Group suggested several actions that EPA should take to help address these uncertainties, including:

- Expanding the RACT-BACT-LAER Clearinghouse—a searchable central database of air pollution control technology to aid in selection of emission controls—to include information regarding construction status, controls installed, and compliance test results for projects where GHG controls have been applied;
- Exploring ways to encourage the use of innovative GHG control technologies;
- Providing sector-specific guidance on evaluating energy efficiency in a BACT analysis;
- Developing a periodic GHG control measures newsletter and distributing to permitting authorities and other interested parties;
- Proactively collecting permit decisions with adequate documentation and making them available to stakeholders;
- Developing guidance on appropriate methods or formulas for calculating the costs of GHG controls and other various approaches and technologies for GHG reductions; and
- Providing guidance on how clean fuels should be considered in the BACT analysis.

During its deliberations, the Work Group also reviewed a case study involving a voluntary GHG BACT analysis conducted for a large natural gas-fired power plant in Hayward, California, the first power plant in the country to be subject to GHG emissions limits. The analysis concluded that high-efficiency power generation technology was the only available and feasible control technology for GHGs. Though the Work Group does not cite this case study in its report, it will likely become a model for applying BACT to other power plants and large emitters.

Conclusion

Although future guidance from EPA and findings from the Work Group may eventually provide more direction regarding the obligations permittees will face in applying BACT for GHGs, the most concrete guidance may be provided by permittees who go through the process first. Despite the uncertainties involved, the first permittees will undoubtedly play a critical role in developing the U.S. model to be applied to similar projects in the future. It is likely that at least some early permittees will advocate for more feasible and cost-effective GHG control technologies, such as energy efficiency, as examples of BACT to be applied to their own future modifications. Because EPA has taken the position that PSD will be applied to GHGs for all pending permits when the regulations take effect, voluntary compliance early on could also provide valuable insurance in the event of unforeseen permitting delays.

Preemptively implementing BACT for GHGs could also serve to inoculate projects from potential legal challenges involving their GHG emissions under authorities other than the CAA. For instance, environmental plaintiffs groups may cite the Endangerment Finding and the U.S. Supreme Court's decision that GHGs are "air pollutants" under the CAA in common law nuisance actions or in arguing that a project proponent must address the environmental impacts of GHG emissions under the National Environmental Policy Act or a state law analog. For these reasons, power plants and other large emitters may want to consider evaluating and implementing BACT now, irrespective of the state of GHG legislation or EPA regulation.

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U.S. Regulators Seek to Facilitate Electric Transmission Expansion through Planning Reforms

Over the course of the past twenty years, the U.S. Federal Energy Regulatory Commission ("FERC" or "Commission") has issued a series of orders that have been intended to remedy discrimination in electric transmission service and to create incentives for organized and efficient planning and development of electric transmission facilities.

Nonetheless, in various regions of the United States, continuing constraints on the availability of electric transmission capacity have hampered the development of much-needed new electric generation, including renewable energy generating resources such as wind power projects. On June 17, 2010, FERC issued a notice of proposed rulemaking regarding Transmission Planning and Cost Allocation by Transmission Owning and Operating Public Utilities (the "NOPR") to encourage interregional transmission planning and to resolve one of the biggest barriers to transmission development — disputes regarding the appropriate bases for transmission cost allocation. The central principles of the NOPR are that planning of critical transmission facilities will be required to take place on a coordinated regional and interregional basis, that transmission planning processes will be required to take into account public policy requirements established by state and federal laws and regulations, such as renewable energy standards, and that utility and other incumbent transmission providers will not be permitted to continue to enjoy undue, tariff-based advantages allowing them to block nonincumbent transmission developers, such as merchant transmission companies, from competing to develop transmission projects.

The NOPR would apply to all FERC jurisdictional transmission providers, including Commission-approved regional transmission organizations and independent system operators. Under the NOPR, non-FERC jurisdictional transmission providers would be required to comply with the requirements of the proposed rule in order to maintain the safe harbor afforded to the transmission tariffs of such transmission providers under current FERC reciprocity rules.

The NOPR would build on existing requirements to ensure that transmission expansion is considered on a regional and interregional basis rather than only on the basis of each individual transmission provider's system. The proposal would require each transmission provider to participate in a regional transmission planning process. The proposal would also require each transmission provider through its regional transmission planning process to enter into a transmission planning agreement with each neighboring transmission planning region.

The NOPR asserts that cost allocation processes are not sufficiently aligned with regional transmission planning processes. The proposal would not impose a uniform cost allocation method or dictate how benefits are to be derived or evaluated. Rather, it would give transmission providers discretion to propose solutions. The proposal would establish principles for allocating the cost of new facilities with the stated goal of allocating such costs on a basis at least roughly commensurate with the distribution of benefits from those facilities. FERC would require each grid provider to have a cost allocation method for new facilities in its regional transmission plan and a formula for new projects that result from planning agreements with neighboring regions. The methodology in each case would have to be consistent with FERC's proposed cost allocation principles.

The NOPR would require each local and regional transmission planning process to consider public policy requirements established by state or federal laws or regulations that may affect transmission needs. Each transmission provider would be required to coordinate with its customers and other stakeholders to identify the public policy requirements established by state or federal laws or regulations that are appropriate to include in the local and regional transmission planning processes. The proposal would supplement, rather than replace, existing requirements to consider reliability needs and economic principles in the transmission planning process.

The NOPR proposes to find that existing regional transmission planning processes afford opportunities for undue discrimination against merchant and other nonincumbent transmission developers, by virtue of giving incumbent transmission providers a right of first refusal to develop new transmission projects. FERC asserts that regional transmission planning processes that do not consider and evaluate projects proposed by nonincumbents cannot meet the principle of being "open" and may fail to yield cost-effective solutions to regional transmission needs. FERC's proposed solution is to eliminate from transmission tariffs and agreements subject to the Commission's jurisdiction provisions that establish a federal right of first refusal for an incumbent transmission provider with respect to facilities that are included in a regional transmission plan. FERC proposes that neither incumbent nor nonincumbent transmission developers receive preferential treatment in a regional transmission planning process. However, FERC does not propose to

overturn state or local laws or regulations, that may affect who may construct and own transmission facilities that are selected for inclusion in the regional transmission plan.

FERC proposes to require that each transmission provider revise its transmission tariff to demonstrate that the regional transmission planning process in which it participates has established appropriate qualification criteria for determining an entity's eligibility to propose a project in the regional transmission planning process, whether that entity is an incumbent transmission owner or a nonincumbent transmission developer. In response to concerns that merchant transmission developers pose an increased risk that facilities needed to satisfy reliability criteria may not be completed, or may not be completed on time, transmission providers would be permitted, on a nondiscriminatory basis, to require that each transmission developer demonstrate that it possesses the necessary financial and technical expertise to develop, construct, own, operate, and maintain transmission facilities.

FERC proposes to require that each transmission provider submit, within six months of a final rule, a compliance filing to revise transmission tariffs or other documents as prescribed by the Commission. Interregional transmission planning agreements and interregional cost allocation methods would be required to be filed with FERC one year after issuance of the final rule.

Comments on the NOPR are required to be submitted to the Commission by August 30.

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U.S. Elections: Winds of Change on Capitol Hill

Change may be coming to Capitol Hill. The prevailing political wind is blowing hard in the face of Democrats and at the backs of Republicans. There are certainly crosscurrents, and all incumbents will be attacked for a poor economy and prodigious government spending without clearly visible results. This primary season has already led to the defeat of several senior Members of the House and Senate and electoral challenges have led numerous other incumbents to decide not to seek re-election. Significant changes are surely in the air for the fall Congressional elections.

While neither party has a strong advantage to the generic ballot question "if the election were held today which party's candidate would you vote for, the Republican or the Democrat?" the significant lead of the Democrats in the important race for money is shrinking. Another key factor, voter intensity, may provide a hidden edge for Republicans, as a recent poll showed two-thirds of Republicans are "extremely" or "very" interested in the upcoming elections, while only half of Democrats expressed their interest in those terms.

Historically, the President's party loses seats in the off-year election. That coupled with a poor economy and a grouchy electorate will make it possible for the GOP to win back the House after a four-year hiatus. The Republicans are expected to pick up seats in the Senate as well, although a change of control in the Senate is not expected. Results of the remaining primary elections as well as the performance of the American economy over the next five months will in large part be the determining factors shaping the composition of the next Congress.

Members elected to the incoming Congressional freshman class, both Republicans and Democrats, can be expected to have an aggressive temperament and not be shy at challenging their respective parties' leadership on a host of organizational and policy issues. Several Members will have knocked off powerful incumbents who, in most election cycles, may not have even faced a significant opponent on the ballot.

When Republicans won control of the House in 1994, an off-year election, they adopted a number of internal reforms including establishing term limits for Committee Chairs and ending proxy voting in committees. The House also passed major legislative initiatives for tax cuts, social security and welfare reform. The Appropriations Committee's first priority was passing a rescission bill that recaptured previously appropriated but unexpended funds and made them available for deficit reduction. One can assume that this will again be a Republican priority in the next Congress with billions of stimulus dollars still unspent. There will also be a significant debate within the Republican caucus concerning the future of Member-initiated appropriations, better known as "earmarks," which were the subject of a Republican moratorium this year.

If Republicans take control of the House, they likely will seek to repeal the Obama health care law and to extend the Bush-era tax cuts. Priority also will be given to controlling discretionary spending and real cuts can be expected to be proposed in House Appropriations bills.

If the Republicans win the House but not the Senate, the result will probably be legislative gridlock, which will make unlikely any major policy initiatives on climate change, union voting rules, immigration or taxes. Moreover, the President's budget may be rejected and Appropriations bills likely will be delayed. It is doubtful that either side will be willing to compromise, given the closeness of the majorities and the current tone on Capitol Hill.

Even if Democrats hold both Houses, it is quite likely that their majorities will be much smaller than in recent years, something which will significantly diminish their ability to implement the President's legislative agenda.

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UK Election: The New LibCon Government

The United Kingdom's general election of 6 May 2010 has been seismic. With the electorate unpersuaded by any one political party, the Conservative Party gained a plurality of seats in the House of Commons, but fell short of an absolute majority in the House of Commons. The Labour Party, which had been in Government, lost many MPs, although maybe not as many as they had feared.

The third party, the Liberal Democrats, has been a growing force over the last 20 years, since its creation by merger of the Liberal Party and the Social Democrats. Its influence has not been strong because, in each general election since that time, one or other of the major parties was always able to secure an absolute majority in the House of Commons.

From the start of the campaign, there had been concerns that the election might result in a "hung parliament," and that is what transpired. The televised leaders' debates proved to be very effective for the leader of the Liberal Democrats, Nick Clegg, who managed to secure very considerable personal publicity. Unfortunately, and much to the surprise of all the pollsters, that did not lead to any increase in the number of seats for the Liberal Democrats: indeed, and very ironically, they actually had a net loss of five.

However, the consequence of the electorate's failure to decide between the other two parties was that the Liberal Democrats' 59 seats became pivotal, and in the days following the election result, Nick Clegg was portrayed in the media as a "kingmaker." Having flirted with David Cameron and the Conservative Party, and then Gordon Brown and the Labour Party, Mr. Clegg finally agreed that the Liberal Democrats would form a coalition Government with the Conservative Party.

Observers around the world have watched with fascination. British politics is essentially adversarial, in contrast to European politics, which are much more consensual in nature. Britain had not had a coalition government since Winston Churchill was Prime Minister in the Second World War. There has been much talk of "the national interest," but for many politicians, and for many political observers, we in the UK have entered uncharted territory.

The great worry in the UK is that coalition Government will mean "weak" Government. Elsewhere in Europe, coalitions are much more common and not perceived in this way—indeed, many observers regard coalition as a strength. Initial reactions were that there would be another UK general election inside a year. The Prime Minister, David Cameron, and the Deputy Prime Minister, Nick Clegg, are very keen to say that they will stick together, and that there will be no election again till May 2015.

To buttress that, there are proposed measures to bind the House of Commons (an interesting principle because it is widely accepted that no Parliament can bind its successors) to a system of five-year fixed term Parliaments, with the next general election to be held in May 2015. Under the proposal, which has outraged some constitutionalists, dissolution of the House of Commons would only occur on more than 55 percent voting in favour. This contrasts with the House's current ability to pass, by a simple majority vote, a motion of "no confidence" which, if successful, brings down a Government (this last occurred in 1979).

Constitutionalists worry how this can possibly work: if 55 percent are required in order to secure a general election, but only 50 percent are required to stop legislation from being passed, the House of Commons could become paralysed and therefore the 55 percent threshold virtually pointless: current indications are that the Government is already rowing back, and we are waiting to see where this challenging proposal will finally end. It is too early to say whether the coalition Government (described already by the media as a LibCon Government) will be strong or not. It is certain to face huge stresses, both from the right wing of the Conservative Party and the left wing of the Liberal Democrats, and from a sceptical press.

One of the key proposals of the new Government is political and constitutional reform. That will include, because it was a key bargaining chip for the Liberal Democrats' agreement to join the Government, electoral reform. A referendum on a new, supposedly more 'proportional' system of voting in a general election is likely to occur in early 2011. The new Government's proposals are only just being formulated, but were they to succeed, the planned reforms would be more radical than any undertaken in about 180 years. That presents a huge challenge, particularly for a Government of two partners new to each other, and one that also faces the imperative to address the huge deficit left by the departing Labour Government.

Politics in the United Kingdom is likely to be more exciting than it has been for many years.

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Tax Policy Outlook for 2011: Congress Likely to Face a Crowded Agenda

Congress will likely face a crowded tax policy agenda in 2011, primarily because much of what was expected to be resolved this year has not been addressed. Although Congress may still act on some of these issues before the end of this year, given the short time that Congress will remain in session prior to the midterm elections, resolution of most of these issues seems certain to be deferred until 2011.

From small business tax issues, to modifications, to international tax laws, the upcoming tax agenda will present both enormous economic risks and opportunities. Key issues remaining on the tax policy agenda include the following:

2009 Tax Extenders. Dozens of tax provisions were allowed to expire on December 31, 2009, and legislation to extend those provisions is still working its way through Congress. This long-awaited package, known as the American Jobs and Closing Tax Loopholes Act of 2010, contains many much desired tax extensions, infrastructure incentives, pension relief and revenue offsets but the overall cost of the bill has proven to be controversial. Nonetheless, Congress will likely resolve action on the measure this year.

2010 Tax Extenders. In addition to the tax provisions that expired last year, several dozen other provisions will expire at the end of 2010, including the Alternative Minimum Tax (AMT) and the 2001/2003 tax cuts. Earlier this year, Congress reinstituted the PAYGO rules requiring any bill that reduces taxes or increases spending to be offset by an equal amount of spending cuts or tax increases. There are certain exceptions to these rules, including making permanent the 2001/2003 tax cuts for middle- and lower-income taxpayers. Nonetheless, there remains a struggle to find offsets for the balance of the tax extenders.

AMT Relief. The AMT was designed to insure that high income taxpayers would pay a minimum amount of federal income tax. However, the tax's exemption levels are not indexed to reflect inflation, so every year the AMT regime threatens to include millions of Americans that were never its intended targets. Unless Congress passes the AMT patch, which raises the tax's exemption level, 23 million Americans will face an average additional $3,900 in tax liability.

2001/2003 Tax Cuts. President Obama supports a permanent extension of the 2001/2003 tax cuts for individuals making less than $200,000, and for families making less than $250,000. Those making above those amounts will see their taxes increase. Congress may permanently extend the 2001/2003 tax cuts currently in place for individuals making less than $200,000 without having to offset the cost. Giving the fragile state of the economy, and with Democrats facing a competitive election year, both Republicans and some moderate Democrats have called for a temporary extension of the tax cuts for high income brackets as well.

Estate Tax. The 2001 tax cuts liberalized the estate tax from an exclusion threshold of $1 million and top rate of 55 percent in 2001, to an exclusion threshold of $3.5 million and top rate of 45 percent in 2009. Since Congress did not address the issue in 2009, the estate tax was repealed, as scheduled, on January 1, 2010. In 2011, it will revert to its pre-2001 levels. President Obama favors permanently extending the 2009 tax rate of 45 percent and $3.5 million exemption, but there is no consensus among Republicans and Democrats on the matter.

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State Budget Crises: A Growing Threat to Business

It is well accepted that the current international economic turmoil has created unprecedented fiscal instability around the globe. Once a problem seemingly limited to struggling third world countries, financial ruin and bankruptcy now threaten industrialized nations, as evidenced by Greece's current debt crisis. The United States is not immune, as debt continues to rise and deficit spending threatens to negatively impact the country's bond rating. Adding to America's concerns are the fiscal crises facing individual states, with budget gaps that could cripple the nation's economy much like Greece is affecting the European Union.

According to a 2009 survey by the National Governors Association and National Association of State Budget Officers, between 2009 and 2011 states will face a cumulative budget gap of $256 billion. As state governments grapple with their respective deficits, businesses struggling to rebound from the recession are now being forced to shoulder both cuts in economic programs and crippling tax increases.

Pennsylvania's budget situation offers a snapshot of the challenges facing businesses in states across the country. Last year, Pennsylvania budget negotiators struggled to close a budget gap of nearly $2 billion, leading to a 101-day impasse beyond the June 30th deadline established by the state constitution. While such a stalemate is unlikely this year, due to the summer's proximity to a general election (in which all of the House and half of the Senate seats will be selected), the fiscal situation continues to present enormous challenges, as revenue collections fall more than $1.3 billion short of estimate, and other revenue assumptions made by the Governor and the General Assembly prove to have been significantly optimistic.

Earlier this year, with the shortfall already at $375 million, Governor Rendell proposed his fiscal 2010-2011 budget. His plan included $26.27 billion in state revenues, combined with $2.76 billion in federal American Recovery and Reinvestment Act funds, for total proposed state expenditures of $29.03 billion. This represented a 4.14 percent increase over 2009-2010 total expenditures, of which $1.134 billion relied on assumptions dependent on approval by entities outside the state government.

The Governor's proposal included a number of tax changes that met with resistance from a business community struggling to recover from the recession. The proposed tax provisions that concerned business included the following:

- Imposition of a severance tax on natural gas extraction.
- Imposition of a tax on cigars and smokeless tobacco.
- Elimination of the sales tax vendor's discount, which has historically been provided to retailers to help them offset the cost of collection and remittance to the state.
- Lowering the sales tax rate to four percent (from six percent), but expanding the base by eliminating 74 current sales tax exemptions. Some of the key exemptions to be eliminated include engineering, accounting, legal, consulting, and advertising services, and would fall primarily on the business community.
- Adoption of mandatory unitary combined reporting in conjunction with several changes to the corporate net income tax (CNIT) structure.

None of these proposals were enacted this year, although there was agreement to enact a severance tax on natural gas extraction, with details to be worked out over the summer. These and similar proposals will be made in future years, as Pennsylvania's budget situation becomes more challenging.

These financial pressures are multiplied further by the looming state public pension crisis. Due in part to the economic instability and overestimates of anticipated rates of return on investments, Pennsylvania's two public pension systems, the Public School Employees' Retirement System and State Employees' Retirement System, face a shortfall estimated at $6 billion by 2012. This dire situation, combined with the volatile economy, is sure to result in dramatically increased business taxes in future periods.

This scenario is repeating itself all around the nation, as the public pension problem reaches a crisis of national proportion. States will continue to turn to business to help fill their expanding revenue gaps. Existing taxes will be raised and new ones will be enacted as state legislatures exhaust all avenues to stay afloat.

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Global Trade: Current Initiatives Bring Together Strange Bedfellows

The global trend towards economic integration has been accompanied by the signing of approximately 250 trade agreements by countries around the world. Despite the formation of the World Trade Organization ("WTO") in 1995 and the evolution of WTO agreements covering virtually every facet of trade and investment, bilateral and regional trade agreements remain popular national tools for pursuing trade, and even strategic, interests and, as a result, continue to serve an important role in the liberalization of international trade.

Bilateral and regional trade agreements vary considerably in terms of their breadth and the levels of cooperation committed to by the parties. Some agreements merely establish a non-binding framework for cooperation on trade and/or the negotiation of future, more specific trade agreements. Other agreements, while more concrete, may be limited in scope, covering things like (i) the reduction or elimination of duties on imports of merchandise from signatory countries, (ii) trade in specified types of goods and/or services, (iii) government procurement, and/or (iv) investment activities. Broadest of all are "free trade agreements" ("FTAs"), which ordinarily address the entire spectrum of trade and investment issues, and routinely provide for the immediate or graduated withdrawal and/or reduction of tariffs and the elimination of other trade and investment restrictions among the parties. FTAs optimally seek to provide equal treatment in each signatory country for nationals of the host country and all other signatory countries with respect to their trade and investment activities, and can result in substantial economic integration among the participating countries. Of course, as a result, the negotiation of FTAs can be more controversial on the national level, and the process of adoption more politically charged.

The earliest trade agreements usually involved the most obvious partners—neighbors. For example, the U.S. entered into its first comprehensive FTA with Canada and Mexico (NAFTA); some of the earliest ventures into free trade agreements by the EU (at a time when it was still the European Economic Community) were the bilateral agreements it entered into in 1972 with Austria, Portugal, Sweden, Norway, Iceland, and Switzerland, respectively, members at that time of the European Free Trade Association; and one of China's first trade agreements was with the Association of Southeast Asian Nations (ASEAN), comprising Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Burma (Myanmar), Cambodia, Laos, and Vietnam). A number of current trade agreement initiatives, however, which include both frameworks for regional agreements and proposed FTAs, have been undertaken among somewhat less obvious candidates for trade partnerships—the United States and Libya; the EU and Latin American countries; and China and Taiwan. These arrangements reflect new economic and political realities that may not have been anticipated even as recently as five years ago.

The United States and Libya

In May 2010, about 18 months after resuming full diplomatic relations, trade officials from the United States and Libya signed a Trade and Investment Framework Agreement. According to the U.S. Department of Commerce, in 2009, Libya was the 69th-largest partner of the United States for trade in goods, with $2.6 billion in two-way trade. This trade consists primarily of vehicles, machinery, agricultural products, medical instruments, and iron and steel products exported by the United States, and oil exported by Libya.

Current trade agreement initiatives reflect new economic and political realities that may not have been anticipated even as recently as five years ago.

Although the United States has similar agreements with a number of countries, the agreement with Libya, coming less than six years after the United States lifted trade embargo sanctions that had been in place since the early 1980s, is significant. The agreement calls for the establishment of a joint U.S.–Libya Council on Trade and Investment to discuss bilateral trade and investment relations between the two nations. In addition to addressing a range of trade topics, including market access, intellectual property, labor and environmental issues, the Council will attempt to identify and eliminate obstructions to trade and investment between the two countries. Discussions between the United States and Libya are scheduled to continue throughout 2010.

The European Union and Latin America.

Although the European Union is Latin America's second-largest trading partner, trade relations between these regions have been blemished in recent years by trade disputes, such as the prolonged dispute over access to the European market for Latin American bananas. Nonetheless, motivated in part by growing competition in the region from China, the European Union recently agreed to an initiative to strengthen trade ties with Latin America. The European Union, Latin America, and the Caribbean Summit, which took place in Madrid in May 2010, resulted in (i) a determination to resume negotiations relating to an FTA between the European Union and Mercosur, a regional trade agreement among Argentina, Brazil, Paraguay and Uruguay, (ii) approval to complete a comprehensive trade agreement between the European Union and the Andean Countries (Peru and Colombia), (iii) authorization to finalize negotiations between the European Union and Central America countries (Costa Rica, Guatemala, Honduras, Nicaragua, Panama, and El Salvador) on an agreement targeting development, stability and integration of the economies of the Central American countries, and (iv) the possibility of further liberalizing trade relations with Mexico and Chile through already existing FTAs between the European Union and these countries.

Of course, given the issues to be resolved, the successful conclusion of the negotiations relating to these initiatives is not certain. Although there appears to be a consensus on resuming negotiations on the trade agreements, which supporters believe will lead to increased jobs and economic growth for both the European Union and Latin American countries, among other issues, France and several other EU member-states are concerned that a Mercosur FTA, in particular, could result in increased agricultural imports that would be harmful to European farmers. Negotiations relating to the proposed European Union/Latin America trade agreements are scheduled to continue throughout 2010.

China and Taiwan

China and Taiwan are scheduled to sign, in mid-2010, a trade agreement called the Economic Cooperation Framework Agreement ("ECFA") which, despite the ongoing disagreement regarding Taiwan's political status, is intended to normalize ties between mainland China and Taiwan, and promote greater integration of their economies.

While some in Taiwan believe that the ECFA is merely part of efforts by China to seek unification with Taiwan, supporters argue that the agreement will expand economic growth for Taiwan by more than 1.5 percent, create between more than a quarter-million jobs, and facilitate Taiwan's integration into the global trading system by offering incentives for multinational companies to use Taiwan as a point of access to the East Asia markets. In China, concerns remain as to how the agreement might impact the ability of Taiwan to enter into formal trade agreements with other countries, given China's view that Taiwan should not be permitted to enter into such agreements, and Taiwan's belief that the ECFA could facilitate such other agreements. Nevertheless, China appears optimistic that other issues of concern can be successfully negotiated, including those regarding rules of origin and agricultural imports. Although it appears that the ECFA may be signed in the near future, Taiwan may do so subject to the right to terminate if a referendum is subsequently held and the agreement fails to win popular approval.

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U.S. Makes "Down Payment" on High-Speed Rail, but Questions About Long-Term Commitment Remain

In an effort to spend the $8 billion of time-sensitive funds allotted by the American Recovery and Reinvestment Act ("ARRA" or the "Recovery Act") for the establishment of high-speed intercity passenger rail service, the U.S. Department of Transportation and the Federal Railroad Administration ("FRA") announced on January 28, 2010 a slew of grants to state transportation departments through the FRA's hastily-established High-Speed Intercity Passenger Rail Program. With the ARRA funds awarded, however, large political and financial challenges loom, including identifying continuing stable sources of federal and state funding.

The Obama Administration's branding of "high-speed rail" as one of the public faces of its Recovery Act conjured images of iconic Japanese bullet trains. The grant program, however, seems determined to spread support among a variety of incremental "higher speed" upgrades to existing intercity passenger rail systems, with limited investment in stand-alone, "true" high-speed rail projects.

Recovery Act winners included two states with plans to construct dedicated high-speed passenger rail lines: California ($2.25 billion for its ambitious San Francisco—Anaheim line) and Florida ($1.25 billion for the Tampa—Orlando segment of a Tampa—Orlando—Miami line). The FRA distributed the remaining $4.5 billion to a variety of states that touted less transformative, more sequential upgrades to existing track in order to improve passenger train speeds. Among others, these grants included:

- $1.1 billion to Illinois for improvements to the Chicago–St. Louis line;
- $824 million to Wisconsin for service between Madison, WI and Chicago;
- $590 million to Washington for upgrades to the Seattle–Portland line;
- $545 million to North Carolina for improvements to the Raleigh–Charlotte and Raleigh–Richmond lines; and
- $400 million to Ohio to restart passenger service along the "3C Corridor" connecting Cleveland, Columbus, and Cincinnati.

Conspicuously absent from this list of awardees is the Northeast Corridor (Washington, D.C.–New York–Boston), the nation's only current high-speed rail line, with Amtrak's Acela Express service reaching 150 mph. The Northeast Corridor received only $112 million in ARRA high-speed rail grants for limited improvements along the route.

Federal legislation authorizing the grant program defines "high-speed rail" as intercity passenger rail service that is "reasonably expected" to reach speeds of at least 110 mph. The California project promises maximum speeds of up to 220 mph, and the Florida corridor targets 168 mph as its top speed. Many of the other funded projects, however, simply hope to reduce travel times by taking steps such as the elimination of grade crossings, laying the groundwork for future improvements that could achieve "true" high-speed rail.

In order to take these next steps, however, federal and state governments must identify stable sources of future funding. Full funding of these and other high-speed rail projects will require exponentially more money. For example, the California project, which received $2.25 billion in federal funds this round, is expected to cost at least $45 billion. Amtrak has targeted nearly $52 billion in infrastructure capital needs for the Northeast Corridor over the next twenty years.

While the Obama Administration characterized the $8 billion in ARRA funds as a "down payment" for future funds, it has proposed appropriating only $5 billion more for these programs over the next five years. Passenger rail proponents in Congress have pushed back, and authorized $2.5 billion in

funding for FY2010. Drafts of the next federal transportation bill have proposed an "infrastructure bank" and other dedicated funding sources for high-speed rail, but progress on this critical reauthorization bill has been bogged down for more than a year with partisan debates and other legislative priorities.

Similarly, individual states must identify up-front funds to match federal grants and develop sustainable operating budgets for their rail services. Politicians and activists in certain states, such as Wisconsin and Ohio, have bristled at accepting the ARRA funds, arguing that their state governments cannot afford the additional capital costs necessary to improve rail lines or the subsidies that operating budgets will require in the future. Ideological debates about the propriety of accepting federal monies funded by deficit spending also threaten to derail acceptance of the grants by certain states and keep other states from even applying for these federal funds.

Public-private partnerships may provide a partial solution to the twin dilemmas of capital and operating costs. International rail carriers with decades of high-speed rail experience—such as Japan's JR Central and JR East, and France's SNCF—and international rail suppliers from China, France, Spain and Japan have expressed an interest in partnering with state sponsors of high-speed rail service. However, strict "Buy America" rules on federal funds will require any foreign contractors to open U.S. manufacturing facilities to construct rolling stock and other rail supplies.

For the remainder of 2010, the California and Florida rail projects will likely continue to make progress, while the possibility of additional federal appropriations to state sponsors of high-speed rail projects and continued interest by international rail firms promise to fill the headlines.

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EU: Financial Reform and Political Developments

The European Union's financial reform initiatives summarized in the Annual Report are still being negotiated between the two arms of the EU legislature, the European Parliament and the Council of Ministers (the 27 Member States).

The package of financial markets reform legislation, agreed by the Council in December 2009, has been the subject of extensive proposed amendments by the Parliament. The Council's draft would create a new European Systemic Risk Board (ESRB), to act as an independent body responsible for macro-level prudential oversight across the EU 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. The Parliament proposes to confer significantly greater powers on the ESAs, enabling them to draw up draft regulatory financial standards, issue binding decisions to national supervisory authorities, directly supervise systemically important cross-border financial institutions, ban certain "high risk" financial products on a temporary basis, and carry out "stress tests" on financial institutions. The Parliament and Council are currently negotiating, with the Council hoping to persuade the Parliament to rein back some of its proposals. It is expected that the bodies will be established in 2011.

In separate votes on 17 and 18 May, the Parliament and the Council adopted their respective positions on the infamous Alternative Investment Fund Managers (AIFM) Directive. The versions approved, however, differ significantly from each other, and the discussions will now move on to the so-called "Trialogue" procedure, involving the Parliament, the Council, and the European Commission, in an attempt to arrive at a final, definitive text acceptable to all three institutions. Although the Commission is not strictly part of the legislature, the new Internal Market Commissioner, Michel Barnier, is likely to have a significant influence in negotiating the final text given the differences between the two versions. It is hoped to have the Directive agreed in July, but this is widely regarded as over-ambitious. Although the Council and the Parliament have generally agreed a number of points (including authorisation, minimum capital, disclosure to investors and other standards of conduct, regulatory oversight of total leverage, remuneration, valuation of assets and depositary banks), there remains significant divergence, including on the so-called "third country rules," one part of which deals with access by non-EU AIFMs to EU markets. The Council approach would permit non-EU AIFMs to market funds established in a third country to professional investors in any Member State that chose to allow such marketing, subject to certain requirements regarding disclosure of information to investors and to EU regulatory authorities, and subject to appropriate cooperation arrangements between the authorities in the EU and those of the non-EU AIFM for the purpose of systemic risk oversight. By contrast, the Parliament's plan would require non-EU AIFMs to agree to be subject to requirements of the AIFM, with compliance to be monitored by an appropriate regulatory body in the AIFM's country of domicile, by agreement between that body and ESMA (a proposed new centralised European regulatory agency, the European

Securities and Markets Authority). Both the AIFM's country and the country of domicile of the AIF would also need to satisfy the EU concerning protection against money laundering and terrorist financing, reciprocal access to marketing of EU funds on its territory, exchange of information relating to taxation and monitoring matters.

The United States (where a significant proportion of EU-based funds raise capital) and the United Kingdom (where a significant proportion of EU-based funds are managed) share concerns about the likely effect of the Directive, particularly in relation to the third-country rules. In a letter to the Commission in March, U.S. Treasury Secretary Timothy Geithner warned that the proposals could cause a rift between the United States and the EU by discriminating against U.S. groups in preventing them from getting a "passport" to market to EU investors. The new government of the United Kingdom, for its part, seems to have decided not to fight what would inevitably have been a losing battle against the Directive, settling instead for a statement in the communiqué issued after approval by the Council of Ministers on 18 May, noting that future negotiations should take into account concerns expressed by some Member States about the rules for non-EU managers.

Council President and Foreign Representative

The Treaty of Lisbon, adopted in December 2009, created the new posts of President of the European Council and High Representative for Foreign Affairs and Security Policy.

Herman Van Rompuy, the President, has been understandably preoccupied with the Eurozone's financial crisis. At the end of May, an EU special economic governance task force began discussions for better fiscal policy coordination and crisis management among the 27 EU nations. The Task Force is chaired by Van Rompuy and includes as its members Jean-Claude Trichet, the European Central Bank president, Jean-Claude Juncker, President of the Eurogroup, and Olli Rehn, the EU monetary affairs commissioner, and most of the EU's 27 finance ministers. At its first meeting, the task force reportedly agreed on the four objectives of achieving greater budgetary discipline, reducing the divergences in competitiveness between the Member States, setting up an effective crisis mechanism and strengthening economic governance.

As High Representative, Catherine Ashton chairs the Foreign Affairs Council. She is also a Vice-President of the European Commission, ensuring the consistency and coordination of the EU's external action. The impact of EU foreign policy will be enhanced by the creation of the European External Action Service (EEAS), which will work for the High Representative. EEAS staff will come from the European Commission, the Council of the EU and the Diplomatic Services of EU Member States. The High Representative has submitted her proposal on the structure of the EEAS, which is currently being discussed by Council, Parliament and Commission.

The UK's New Government and the EU

Another area to watch is the approach of the UK's new coalition government to the EU, and to the UK's role in it. The Conservative party has traditionally been unenthusiastic about the EU, with certain elements in the party being positively hostile. The Liberal Democrats, in contrast, have historically been positive about the benefits of EU membership and keen for the United Kingdom to play a more positive and constructive role. The Coalition Programme states that the Government will ensure that there is no further transfer of sovereignty or powers to the EU without a referendum, work to limit the application of the Working Time Directive (which limits the maximum length of a working week to 48 hours in seven days with a minimum rest period of 11 hours in each 24 hours and a minimum number of annual paid leave days) in the United Kingdom, press for the European Parliament to have only one seat, in Brussels (while it is currently based in Brussels, its official seat is in Strasbourg, France, where monthly sittings are held necessitating costly travel between the two, while its secretariat is in Luxembourg) and approach forthcoming legislation in the area of criminal justice on a case-by-case basis. This is a significant watering down of proposals in the Conservative Manifesto for wholesale "repatriation" of the areas of criminal justice, fundamental rights and social and employment legislation generally.

A more tempered, pragmatic and engaged approach was illustrated by the appointment of a moderate Conservative as Europe Minister, by the Prime Minister's prompt visits to France and Germany, and by the Chancellor George Osborne's attendance at meetings of the EU Council of Ministers only days after the Government had taken office.

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EU Developments: Financial Support Package

Following the financial crisis in Greece, there has been deep concern that a loss of confidence might spread to the economies of other EU Member States and, potentially, to the Euro itself as a currency. In addition to direct support for Greece, the Council and the Member States of the European Union have decided to establish a European stabilization mechanism and a strong commitment to accelerate fiscal regulation and control. For at least the remainder of 2010, we can expect continued nervousness as to whether the measures taken by the EU will prove sufficient to meet the great challenges they appear to face.

On 10 May 2010, the Council and the Member States introduced a package of measures aimed at preserving financial stability within Europe, and specifically establishing a European Financial Stabilization mechanism backed by up to €500 billion of additional funds and guarantees.

Approval was given for a support package for Greece, following the meeting of the Heads of State for the Euro nations. The Commission signed a loan agreement with Greece on 10 May, with the first sums being paid out on 19 May. The Council gave its strong support to an ambitious financial reform program of the Greek government, which has already led to considerable civil unrest within Greece.

More broadly, the Council confirmed its commitment to ensuring fiscal sustainability and economic growth in all Member States, and agreed that plans for fiscal consolidation and structural reforms would be accelerated. The Council gave its support to commitments by Portugal and Spain to take significant additional consolidation measures in 2010 and 2011. On 30 June 2010, the Commission set out a package of measures to strengthen the economic governance of the EU and the euro area. The key measures include the implementation of enhanced surveillance of fiscal policies, macroeconomic policies and structural reforms. Enhanced surveillance will be based on a "European semester" and will include an array of sanctions to prevent or correct budgetary excesses that could jeopardize the financial stability of the EU and the euro area. The Commission intends to present formal legislative proposals by end- September. Such measures could bring about a profound change in the budget setting freedoms of the Member States. Also in June, other EU Member States introduced austerity measures, for example Italy and the United Kingdom have both sought to cut public spending by many billions of euros/pounds in the coming year. Further cuts are viewed as inevitable.

Finally, the Council decided to establish a European stabilization mechanism to make available up to €60 billion to Member States in financial difficulties. The mechanism will only apply in exceptional circumstances, and on terms and conditions similar to those that have been imposed elsewhere by the IMF. The mechanism will remain in place as long as needed to safeguard financial stability. Up to €60 billion is to be made available to Member States in financial difficulties.

In addition, euro area Member States have committed to supplement such resources through a Special Purpose Vehicle that is guaranteed on a pro rata basis by participating Member States up to a sum of €440 billion. The IMF will also participate in similar financing arrangements, and is expected to provide at least half as much as the EU contribution through its usual facilities, in line with the recent European programs. Accordingly, the total support package available should exceed €600 billion.

Separately, the Council has repeated its commitment to progress financial market regulation and supervision, in particular with regard to derivative markets and the role of rating agencies. Other ideas being developed include a "stability fee", which would be aimed at ensuring that, in the future, the financial sector bears its share of financial risk in the event of a crisis. The current plan is for the stability fee to be funded by a tax on banks.

Immediate reaction to the Council's announcements was positive, with stock markets rising across the EU. Since then, however, renewed doubts as to the weakness of the Greek economy along with those of Spain, Italy and to a lesser extent the UK, have resulted in what, by July 2010, were significant falls in stock markets as well as in the value of the euro as against the dollar. While ironically this may benefit exporting nations, notably Germany, the weak euro and the fall in external investment in the EU as a whole will mean, at best, a sluggish recovery for the European economy through 2010, and at worst a need for a more fundamental restructuring of the Eurozone. Few will wish to predict the exact shape of the European economy a year from now. All that seems certain is that volatility in stock and currency markets will continue for some time.

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Russia: Making the Economy More Competitive

As the Russian economy begins to emerge from the global financial crisis, its government has taken a number of measures aimed at revitalizing the economy, including an ambitious modernization package. In addition to new legislation aimed at attracting foreign capital, two initiatives are particularly noteworthy. Both seek to make Russia more competitive in the development of technology and expertise.

Innograd

Part of the modernization package declared by Russian President Dmitry Medvedev includes plans to create a "Russian Silicon Valley" in the Moscow region, in a town called Skolkovo (which also hosts a recently opened business school, modeled on Western standards).

This new innovation center, which has been dubbed by some as "Innograd" or "Nanotown," will be run by a nonprofit foundation headed by Viktor Vekselberg, one of Russia's preeminent businessmen, and President of the Renova Group. The foundation's management will also include a former CEO and Chairman of the Board of Intel, Craig Barrett, and two Nobel Laureates, Roger Kornberg and Zhores Alferov.

The project provides for the establishment of scientific research and higher educational facilities, along with housing, offices, schools, hospitals and related infrastructure, with the eventual goal of creating a community of up to 40,000 people. The first residents are expected to relocate to Skolkovo within three to four years.

Special legislation is being considered for Innograd that would provide for a separate legal regime to facilitate the community's ability to focus its activities on science and research, without being hampered by various bureaucratic inefficiencies. Grants, tax incentives, and subsidies would also be available to companies who are selected as participants. Participant status will be given for up to ten years, and cannot be revoked.

A preferential customs regime will allow participants to either import equipment without tariffs, or otherwise receive subsidies to compensate for tariffs. Tax incentives will be given directly to the foundation, its subsidiaries and participants, either for a period of ten years or until their consolidated yearly revenues reach three billion rubles. Currently applicable profit, property, land, transport and value-added taxes will all be repealed.

A proposal is also being considered to apply this special regime to other projects in addition to Innograd.

Recent Amendments to the Migration Law

On May 19, 2010, President Medvedev signed into law various new amendments to the current federal law "On the Legal Status of Foreign Citizens in the Russian Federation." Among the issues addressed by the amendments is the employment of what are termed "highly qualified foreign employees" (HQFE). Under the amendments, a foreign employee is considered to be "highly qualified" if that person has recognizable experience, skills or achievements in a particular field of activity, and his or her current annual salary is not less than two million rubles (approximately $65,000). The amendments did not set forth any formal procedure for the recognition/certification of an HQFE, allowing the employer to evaluate whether the foreigner has the necessary qualifications and skills.

Previously, Russian employers were required to obtain official permission to hire any foreign employee, but from July 1, 2010, certain types of employers can hire HQFEs, and no approvals will be required, other than visa invitations and individual work permits (although quotas that would otherwise limit these will not apply). Work permits for HQFEs may have a term of up to three years, and may be extended for an unlimited number of subsequent terms of up to three years each.

HQFEs may be hired by the following Russian employers:

- Russian commercial organizations;
- Russian scientific, professional training, public health, and other organizations engaged in scientific, technical and innovative activities; and
- duly accredited branch offices of foreign legal entities.

The amendments introduce certain other significant changes for HQFEs, including the ability of an HQFE to immediately apply to the local migration office for permanent residency for the term of his or her labor contract.

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"Open Source Planning" Under the New UK Coalition Government

Prior to the United Kingdom's general election in May, the UK land development industry had been looking carefully at each of the major parties' statements about planning and development. Developers were hoping for signs of a helping hand from government to lead the industry out of recession.

The Conservative Party drew much attention with the pre-election policy document "Open Source Planning." "Open source" was a reference to the concept, more commonly used in the information technology sphere, of a system where reference sources and operating systems are open and accessible to all. The policy document contained many radical ideas, asserting that the planning system needed to be "re-booted," notwithstanding the myriad of changes pushed through by the Labour government during its years in power.

Now that the Conservatives are in government (albeit in a coalition with the Liberal Democrats) and the principal political force behind Open Source Planning, Bob Neill, is Junior Planning Minister under Greg Clark (both Conservative), the development industry is focused on understanding which Open Source Planning aspirations will become reality. The Liberal Democrats said relatively little about planning in the run-up to the election, so it seems likely that the planning agenda will be Conservative-led.

Some pre-election promises will be implemented immediately. The regional planning tier will be abolished, leaving just central government policy and local plans at the District Council level (although County-level mineral and waste plans are likely to remain). Also scheduled for abolition is the newly-formed Infrastructure Planning Commission (IPC), which had been created to make decisions about new nuclear and renewable power projects, ports, airports, high-speed rail and other nationally significant infrastructure projects. The IPC is to be replaced, before it has even rendered its first decision, by a new decision-making approach that will retain the fast-track characteristics of the IPC but will be more democratically accountable.

Whilst we can expect more changes in the future, the more radical reforms proposed in Open Source Planning are now likely to be deferred for a substantial period of time, perhaps reflecting some of the adverse comments the document received in the pre-election period. In particular, members of the planning profession were harsh critics of Open Source Planning, expressing concerns about the workability of the proposals and also about the quality of the planning decisions that might follow.

However, Prime Minister David Cameron's much-vaunted "localism" agenda looks set to be carried through into a planning system that works from the bottom up, not from the top down as was the case with the previous centralist approach. This bottom-up approach may be of concern to developers, as it can be read as a charter for NIMBY (not in my back yard) objectors to stifle development, but it also is likely to feature balancing mechanisms to create "volunteerism," whereby communities are rewarded for embracing development, such as new housing, in their localities.

A notable omission from the coalition programme for government is a commitment to the previous Labour government's Community Infrastructure Levy ("CIL"), which was a tariff chargeable on development that had been enabled by legislation but not yet placed into operation. In addition, there is no clear commitment by the new government to implement U.S.-style tax-increment financing in the UK, under which a portion of the tax revenues generated by a public project is dedicated to paying off the debt raised to invest in the project. The previous government was experimenting with tax-increment financing in a couple of pilot projects, and it is supported by London Mayor Boris Johnson; but, as yet, there does not appear to be any enthusiasm for the concept from the new government.

Notwithstanding the change in government, we can expect a rolling programme of modified and updated guidance to streamline and improve the working of the planning and contaminated land regimes. The lead civil servants implementing the changes will not change, notwithstanding the change in line-up of their political masters. It is expected that the current culture of civil servants consulting widely and engaging with the legal profession to understand industry issues will continue, and may increase, as the new coalition government seeks to promote its ambitious agenda and balance the interests of the electorate and industry and meet the current economic challenges.

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New UK Bribery Act Expands Jurisdiction, Encourages Preventative Measures

The United Kingdom is emerging as a significant new force in the global effort against corruption. Although corrupt payments made abroad have been illegal under English law since 2002, anticorruption efforts will take on vastly greater importance as new legislation, the Bribery Act 2010, comes into force later this year. The new law makes it easier to convict companies of corruption-related offences, and significantly expands both the range of prohibited conduct and the jurisdiction of UK authorities, bringing more people and businesses within the scope of UK criminal law.

The primary UK enforcement authority in this area is the Serious Fraud Office ("SFO"), which has been increasingly active. Since 2008, it has obtained millions of pounds of settlements and fines in foreign corruption cases. International cooperation, especially between the SFO and U.S. authorities, has become an important element of some major cases, and will continue to grow. Like U.S. authorities, the SFO has exerted substantial effort towards convincing companies to self-report corruption violations, which are notoriously difficult to uncover and to prove in court. Recent developments, however, raise questions as to the results of self-reporting, and may cast doubt on its ultimate viability as an approach to law enforcement by the SFO.

The Bribery Act

The Bribery Act expands and clarifies UK law relating to corrupt payments. Among the key elements of the new law are the following.

Strict Corporate Liability, Absent "Adequate" Compliance Procedures. The Act makes companies strictly liable for bribes given or offered by anyone on their behalf anywhere in the world. No knowledge of the bribery by any manager is necessary. The only defence available to a company will be to prove that it had in place "adequate procedures" to prevent the bribery occurring. The Act contains no definition of "adequate procedures." The Act requires the Minister of Justice to publish guidance on this issue, and the "failure to prevent" offence will not come into effect until after such guidance is available.

Extraterritorial Jurisdiction. The Act will mean that more people will come under the UK criminal bribery regime. UK companies are subject to the Act and individuals may be prosecuted under the Act even where the offence occurs wholly outside the UK if they are ordinarily resident in any part of the UK. Foreign companies may be guilty of failing to prevent bribery if they carry on any part of their business in the UK. Further, it does not matter if the function or activity sought to be influenced has no connection with the UK and/or is performed entirely outside the UK.

Prohibition of Commercial as well as Official Bribery. The Bribery Act applies to commercial bribery as well as to payments involving foreign government officials, making its scope significantly broader than the U.S. Foreign Corrupt Practices Act ("FCPA").

Questions About Corporate Gifts and Entertainment. Although the Act appears to prohibit the conferring of any benefit on a foreign government official, without regard to any intent to corrupt, the UK Government has said that it does not intend to penalise "legitimate and proportionate use of corporate hospitality to establish or maintain good relations with prospective customers." A spokesman for the Ministry of Justice said in this regard that it would be "sufficient to rely on prosecutors to differentiate between legitimate and illegitimate corporate hospitality and to

decide whether or not it would be in the public interest to bring a prosecution." Although more guidance may be issued, businesses must be sure to have a gifts/entertainment/hospitality policy that guards against what the Ministry calls "lavish corporate hospitality [being] used as a bribe to secure advantages."

Facilitation Payments Outlawed. "Facilitation payments" while legal under the U.S. FCPA, are criminal under the Bribery Act.

The Bribery Act makes it more vital than ever for companies to assess their risk of bribery, and to have—and implement—robust and effective anti-bribery procedures. To have the "adequate procedures" defence a company will have to show the effectiveness of its policy and a real compliance culture. Lip service alone will be of no help. Anticorruption compliance programmes based upon the U.S. FCPA will need some adjustment to accommodate the broader scope of the Bribery Act.

All roads lead to the same conclusion. If a corrupt payment is made by or on behalf of a company, even in spite of its best intentions, that company risks prosecution if it has not already developed and implemented well-designed and effective anticorruption compliance procedures. The guidance to be issued by the UK Government on what constitutes "adequate procedures" will need to be considered when available, but the time is now for businesses to review their bribery risks and their current compliance programmes with an eye to the Bribery Act.

Questions as to the Viability of "Self-Reporting"

As noted, in seeking to bolster its anticorruption enforcement efforts, the UK's SFO has invested considerable effort towards convincing businesses to "self-report" instances in which they have made corrupt payments. The SFO will then review the matter and the remedial actions taken to address the situation and to prevent a recurrence. The SFO has indicated that, by doing so, companies may avoid prosecution, or at least face reduced sanctions. In this regard, the SFO published guidance to companies on self-reporting last July, "Approach of the Serious Fraud Office to Dealing with Overseas Corruption" (21 July 2009)[1].

Although the SFO has sought to encourage self-reporting, these efforts appear to have hit difficult waters, for a number of reasons, each of which points up the risks that may remain for reporting companies.

Civil v. Criminal Charges. The SFO's written guidelines indicate that, where a self-reporting company is committed to change and is fully cooperative, the SFO will seek to deal with the matter "civilly wherever possible." In 2009 the SFO concluded three settlements with companies that self-reported overseas corruption concerns. Although two involved civil charges, the third resulted in a criminal conviction despite the company's "constructive engagement."

Two companies, Balfour Beatty and AMEC, reached settlements with the SFO, without admitting any corrupt activity but based on accounting "irregularities." Both companies agreed to pay civil recoveries of property obtained by unlawful conduct (£2.25 million by Balfour Beatty, and nearly £5 million by AMEC), and consented to an independent review of their compliance systems. A third company, Mabey & Johnson, agreed to plead guilty to criminal charges of corruption in connection with public contracts in Jamaica and Ghana. The court assessed financial penalties of £6.36 million, and the company also agreed to submit its compliance programme to independent monitoring.

Debarment From Public Contracts. The Public Contracts Regulations 2006 permanently debar a company convicted of corruption from EU public sector contracts. An operator convicted of a corruption offence is automatically (and permanently) debarred from public contracts within the European Union, and there is very limited discretion to make exceptions. Government guidance states that exceptions will be granted only "in the most serious of circumstances, for example in the case of a national emergency." The SFO's guidance[2] referred to above suggests that such a collateral effect will not be a significant factor in its charging decisions, because a "decision not to prosecute because the

The new law makes it easier to convict companies. The only defense will be to prove that "adequate procedures" were in place to prevent the bribery.

[Regulations are] engaged will tend to undermine [their] deterrent effect.'"

Questions have arisen as to the even-handedness of this policy. In early 2010, the SFO settled civil charges with BAE Systems of improper accounting for certain payments made in Tanzania. BAE simultaneously settled with U.S. authorities charges of conspiring to make false statements to the U.S. Government. The BAE settlements have been much criticized by observers, some of whom have suggested that BAE was permitted to resolve these matters for less serious charges than might have been justified, so as not to jeopardize its ability to obtain public sector contracts.

Court Review of SFO Settlements. If charges are brought in such a case, this would ordinarily follow a settlement between the SFO and the reporting company, involving an agreement to enter a guilty plea to a criminal charge or to submit to an order for civil recovery. In criminal cases the court makes the final determination as to the sentence to be imposed, although it "may take into account" the defendant's assistance to the SFO. Recent developments indicate that such approval is hardly a mere formality; indeed, the rigor of such court review threatens to undercut the SFO's efforts to encourage self-reporting.

In March, Innospec Limited pleaded guilty to "conspiracy to corrupt" in connection with dealings with officials in Indonesia. Like the BAE matter, the company settled charges both with the SFO and U.S. authorities.

The court reviewing the proposed settlement commended the SFO director for "vigorous[ly]" pursuing corruption cases and encouraging self-reporting, but his praise of the SFO's approach in that case ended there. In a far-reaching judgment[3], the court found that the SFO "had no power to enter into the arrangements made and no such arrangements should be made again."

The court also stressed that penalties must be proportionate to the offence, and criticized the size of the fine in light of the fact that corruption of foreign officials is a very serious corporate offence. The court reluctantly approved the fine, but cautioned that, in the future, courts should not be expected to uphold deals simply because they are recommended by the SFO, noting that "…the court will not consider itself in any way restricted in its powers by such agreement."

A subsequent decision further affirms this stance. In *R v. Dougall*, an employee charged with corruption in connection with sales to the Greek public health care system provided substantial cooperation to the SFO in its investigation of the employee's company. The employee, agreed to plead guilty to the offence of conspiracy to corrupt, with the SFO recommending to the court that the employee's prison sentence be suspended in light of his cooperation (recorded in a formal statutory agreement). The court refused to go along, noting that, in its view, a suspended sentence was inappropriate for such a serious offence, even under the circumstances.

The employee appealed, and although the Court of Appeal found that the suspended sentence was appropriate, it noted the independence of the judiciary in sentencing matters, and its view that a deal agreeing sentence or presenting an agreed package to the court "is contrary to principle," citing the Attorney General's "Guidelines on Plea Discussions,"[4] ("where a plea agreement is reached, it remains entirely a matter for the court to decide how to deal with the case.").

Both of these decisions reflect the reluctance of the courts to be a rubber stamp for deals made by the SFO, notwithstanding the important policy objectives of encouraging self-reporting of corruption offences, which are notoriously difficult to detect and prove without significant cooperation. The decisions raise doubts as to the SFO's ability to deliver on its agreements, and threaten to vitiate the effort to convince companies that they should self-report.

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[1] http://www.klgates.com/newsstand/detail.aspx?publication=6274

[2] http://www.ogc.gov.uk/documents/Article_45_Guidance_Mandatory_Exclusion_update_Feb_2009.pdf

[3] http://www.judiciary.gov.uk/docs/judgments_guidance/sentencing-remarks-thomas-lj-innospec.pdf

[4] http://www.attorneygeneral.gov.uk/Publications/Documents/AG's%20Guidelines%20on%20Plea%20Discussions%20in%20Cases%20of%20Serious%20or%20Complex%20Fraud.pdf

China and Hong Kong: Building Low Carbon Economies

Since the return of Hong Kong to China in 1997, "one country, two systems" has been the guiding principle for constitutional and policy issues. Under this principle, the common law legal system of Hong Kong was guaranteed for 50 years within the Chinese civil law system, through 2047.

Today, more than a decade later, it is increasingly clear that the economies and communities of Hong Kong and Mainland China have integrated and converged. While "one country, two systems" broadly holds true, and Hong Kong remains a distinct legal jurisdiction, over the years, each legal system has exerted increasing influence on the other. An understanding of these policy and regulatory dynamics is crucial to businesses seeking to navigate business opportunities and risks that straddle both jurisdictions.

2010 is a watershed year in this continuing convergence, and there is no single policy and development issue more pressing than the transition of the Mainland Chinese and Hong Kong economies to a low carbon basis.

Supporting the Transition: Low Carbon Policies and Law

China

China's National Climate Change Programme of 2007 was the first comprehensive policy document to address climate change. However, it is only in the last year that senior Chinese government policymakers have started to seriously evaluate specific policies to transform the economy to a low carbon basis. The key catalyst for this development was the November 2009 announcement that China would target a 40-45 percent reduction in carbon intensity by 2020 (adopting a 2005 baseline).

No national low carbon economy policy has yet emerged, but the State Council and key government ministries, such as the National Development and Reform Commission (NDRC), the Ministry of Finance, and the Ministry of Housing and Urban-Rural Development, along with researchers at Tsinghua University and the Chinese Academy of Social Sciences, are doing a great deal of work to formulate such policies for inclusion in China's 12th Five Year Plan (FYP) (2011-2015). The 12th FYP is expected to mandate new laws and regulations to support the development of a low carbon economy. As this national policy evolves, provincial and municipal governments, along with those of special economic regions, are proceeding with the development of their own low carbon plans.

In marked contrast to the United States, the low carbon economy drive has reignited the interest of senior policymakers in introducing domestic carbon trading. If domestic carbon trading adopts a baseline and credit model, rather than a cap and trade model, or a hybrid of the two, there would be substantial potential to develop emission reduction projects to generate domestic Chinese carbon credits. Carbon market commentators indicate a domestic Chinese carbon credit market value between US$500 million and US$2 billion is realistic and achievable.

Plans for domestic carbon trading pilots are expected in the 12th FYP. Such plans will be only one part of a much broader array of economy wide and sector based initiatives to encourage action and investment in clean and low emissions technology, alternative energy and energy efficiency. Estimates of the scale of investment needs for China vary considerably, and must be treated cautiously, but credible estimates suggest a range of US$35 billion to US$250 billion for 2010-2030.

Foreign investors can establish or acquire operations in Hong Kong while also taking advantage of the preferred access afforded to Hong Kong based companies and investors in Mainland China.

Hong Kong

The Hong Kong Government has been pursuing a low carbon economy policy since 2008, although it does not have any separate overarching climate change policy. To date, these efforts have been led by the Hong Kong Environment Bureau and Environmental Protection Department.

In May 2010, Edward Yau, the Hong Kong Secretary for Environment, said that Hong Kong would seek to meet or exceed the China national carbon intensity reduction target of 40-45 percent by 2020. This marked a substantial shift from the previous policy commitment of a 25 percent reduction in energy intensity from 2005 levels by 2030. A recent study conducted by the Energy Research Institute of the NDRC suggests additional investment and energy expenditure up to 2020 of around US$1 billion to over US$5 billion.

Preparations are now underway in Hong Kong to develop a low carbon strategy and action plan that will both align with the China national carbon intensity reduction target, and co-ordinate action with Guangdong Province to create a low carbon and green Pearl River Delta. Ideally, this low carbon strategy and plan will be formally incorporated into the Hong Kong Chief Executive's Policy Address and Agenda in October this year. In any event, Hong Kong's commitment to the China national carbon intensity reduction target, and the impending inclusion of Hong Kong in the 12th FYP, will provide strong impetus for low carbon investment and action in Hong Kong.

Recent developments under The Closer Economic Partnership Arrangement between Mainland China and Hong Kong have extended the ability of Hong Kong businesses to set up wholly-owned enterprises to provide environmental protection services in Mainland China and, since 1 December 2009, Hong Kong companies have been able to fully own and control Clean Development Mechanism projects in China. These measures provide Hong Kong based investors, which can be foreign-owned, with preferred access to China's low carbon and green market. Significantly, policymakers in Mainland China and Hong Kong are firmly committed to providing further preferred market access for Hong Kong based companies and investors.

What it Means to Foreign Investors

The high level of co-operation between Mainland China and Hong Kong in low carbon and green economic development means that foreign investors can establish or acquire operations in Hong Kong, benefiting from the strength of Hong Kong's legal system and courts, while also taking advantage of the preferred access afforded to Hong Kong based companies and investors in Mainland China across a range of industries. Further policy and legal incentives are likely to emerge to encourage foreign investment in clean technology and alternative energy in both Mainland China and Hong Kong. Careful attention will need to be paid to the scope, interaction and implementation of these policies and initiatives to ensure that an investor gains maximum benefit while keeping risks to a minimum.

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UAE: Awaiting Legal Changes to Retain its Competitive Edge

In our report for 2010: The Year Ahead, we anticipated a number of new industry initiatives and legal changes, including the relaxation of foreign business ownership restrictions, and the introduction of more robust bankruptcy and insolvency laws. Over the first half of the year, speculation has increased about the nature and timing of these changes. Sultan Saeed Al Mansouri, the UAE Minister of Economy, was recently quoted as saying that "the UAE is revamping its legal system to reflect the changes in the global economic landscape and maintain its competitive edge as a centre of business. It is a thorough process that will fulfil specific conditions and requires a lot of time, research and consensus among all parties concerned."

New and updated laws and regulations are still expected in a number of key areas over the second half of 2010 and throughout 2011. Given the lack of a forum for public consultation on such matters, however, limited information is available, and our best understanding of the pending reforms is as follows.

Financial Services

The recent global financial crisis highlighted deficiencies in the manner in which the financial services sector is regulated, and we anticipate a number of reforms in this area.

With the exception of the DIFC (Dubai's semi-autonomous financial free zone), the UAE's banking and financial services laws and regulations have been in need of review for some time. Deficiencies in existing regulations have been blamed, in part, for the rise in fraud and the mis-selling of financial products over the past decade, and it is anticipated that any reforms will seek to address these matters in some fashion.

At the same time the Government is likely to seek to create the environment for a broader mix of financial products. For instance, it is widely reported that the Emirates Securities and Commodities Authority, which regulates the Abu Dhabi and Dubai stock exchanges, is developing rules to allow short selling activities and the development of a market for derivative contracts (already a feature of the NASDAQ Dubai exchange in the DIFC). The settlement systems of the Abu Dhabi and Dubai stock exchanges are also likely to be improved; both have been subjected to criticism by market participants, particularly with regard to excessive delays between payment and the delivery of certificates for traded securities.

We may also see steps to introduce regulation in areas that are already subject to supervision and control in more established jurisdictions (including the DIFC), including rules regarding business conduct, takeover activity, and the establishment and operation of collective investments.

Commercial Law

Changes are expected in a range of areas relating to the broader UAE economy, including:

- Competition. The Ministry of Economy has finalised the draft of a new competition law aimed at encouraging competition and reducing anticompetitive practices. These changes will reflect recommendations made by the World Trade Organisation during its last UAE trade policy review.
- Arbitration. A new and much-needed arbitration law is being prepared to replace, for the most part, the vague and poorly drafted provisions of the UAE Civil Procedures Law of 1992 that currently governs arbitrations in the UAE.

New and updated laws and regulations are still expected in a number of key areas.

- **Auditors.** Recent corporate scandals have highlighted the need for the auditing profession to play a more prominent role in achieving greater transparency and disclosure among UAE institutions. It has been proposed that the auditors' profession be regulated to a higher standard than has hitherto been the case under the existing outdated UAE Auditors Law of 1995.
- **Intellectual Property.** Amendments have been proposed to the current UAE Patents, Industrial Drawings and Copyright Law of 2006 that would:
  - introduce mechanisms for protecting confidential information through the UAE court system;
  - improve the way in which patent and design protection is assessed, and extend the term of protection for registered designs; and
  - introduce specific protection for the design and layout of integrated circuits.
- **Fraud.** Amendments have been proposed to expand existing law, principally the UAE Law on Suppression of Fraud and Deceit in Commercial Transactions of 1979, to cover a broader range of commercial fraud.
- **Industry.** The Ministry of Economy is framing a new law aimed at enhancing the performance of the industrial sector. Key objectives of the law will include encouraging the development of small- to medium-sized enterprises, and improving the quality of goods produced in the UAE. A further aim will be to offer protection to local businesses against harmful international trade practices, in line with World Trade Organisation guidelines.

Conclusion

The legislative reforms in process are ambitious in their scope, given the historically slow pace of lawmaking in the UAE. The anticipated new companies law, promised some years ago, is still awaited. The revised bankruptcy and insolvency law, which was to be drawn up as a matter of priority, has yet to see the light of day. As Sultan Saeed Al Mansouri says, the process of introducing new law in the UAE "… requires a lot of time, research and consensus among all parties concerned." We must wait to see whether the UAE Government can deliver its wider law reform package in a timely fashion, and with the clarity and detail so often lacking in current UAE legislation.

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Patent Strategies: Recent Developments and Trends to Watch

The patent industry has been unusually dynamic lately, in response to broader changes in the economy, the law, and technology. The following are important recent developments and trends to watch regarding patent strategies for business.

Developments in the First Five Months of 2010:

- More U.S. Patents. The number of new patents issued by the U.S. Patent and Trademark Office ("PTO") during the first four months of 2010 increased by 35 percent over the same period in 2009. This was without any major changes in PTO staffing, budget, the patent statute, case law, or regulations. Instead, it was the result of changes in PTO practice enabled by the new top management at the PTO. This would indicate that the PTO may have passed its low point, and that the level of service at the PTO may continue to improve. This is great news for patent applicants.
- More Chinese Patents. Statistics were released that indicate that in 2009, for the first time, the Chinese Patent Office became the most active patent office in the world, in terms of the number of new applications filed. (Furthermore, 80 percent of these applications were China-sourced. Compare this to the U.S. PTO, where slightly more than half of new applications in 2009 were foreign-sourced.) Similarly, the most active patent applicant in the world in 2009, in terms of new PCT applications filed, was for the first time a China-based company.

These statistics indicate that China may have developed beyond the early stage of being a net technology importer and copier, and may now be at the advanced stage of being a net technology developer and exporter. Combined with China's large foreign exchange reserves and its high rates of savings and investment, this would forecast an increasingly competitive role for China in international technology industries.

Trends to Watch for the Balance of 2010:

- Increased Patent Activity. The improving economy and bullish stock market should promote increased patent activity across all fronts, including patent litigation and enforcement, patent sensitive transactions, and new patent applications at the Patent Office. Intellectual property budgets that have been prepared over the last two business years are being reevaluated and in many cases increased by technology companies to maintain competitiveness in the improving economy.
- Increased Influence of Intellectual Property Due Diligence by Investors. In the past few years, the investor community has become increasingly sensitive to the impact of intellectual property on equity evaluations. For equity financing transactions, this has enabled intellectual property due diligence to have an increasing impact on price and terms, for example in mergers and acquisitions and private placements. Also, there is increasing interest by stock investment funds to inform their investment decisions with analysis of intellectual property portfolios.
- Continuing Convergence of Patent Monetization Practice Among Patent Trolls, NPEs (non-practicing entities), and Corporate Patent Owners. Corporate patent owners that manufacture and sell their inventions continue to develop an interest in patent monetization. This is leading them, in some cases, to adopt aggressive monetization procedures, which first came to popular attention through their use by NPEs and patent aggregators. We may also see an increasing proliferation of patent monetization intermediaries such as patent aggregators, patent auctions, patent brokers, spin-offs of patent enforcement entities from corporate manufacturers, third-party financing for patent development and monetization, and outsourcing of patent monetization projects.
- Reduced Periods of Pendency for Patent Applications. Recently it appears that the pendency of at least some types of patent applications has begun to come down. It is certainly a declared goal of the management of the PTO to reduce average patent application pendency. If this trend continues, then patents will be faster and more valuable, since they will be more current when first issued. By reducing the number of office action cycles, this may also make issued patents cheaper to obtain.
- Will There Be a Major Patent Reform Act in 2010? This is a complex issue with many topics under consideration in the Senate and the House. For example, one bill under consideration, S. 515, contains 18 major sections including, among others, sections regarding a first to file system, changes in

China may now be at the advanced stage of being a net technology developer and exporter.

calculation of damages, post-grant review proceedings, submissions by third parties during examination, changes in venue rules, fee setting authority to the PTO, and changes in the best mode requirement. Any new law from this activity is unpredictable but could be of broad impact.

- Continuing Evolution of Patent Law and Practice. It is expected that there will be a continuing evolution of patent law and patent practice, through case law decisions in 2010 and through budgetary and administrative practice at the Patent Office. Actions in this area may include, for example, (1) further Supreme Court decisions on patent cases, (2) other court decisions on issues such as proportional damages, venue, and the patentability of newly-discovered genes, (3) more expeditious Patent Office examination procedure, and (4) increased funding to the Patent Office, enabling the hiring of more examiners to reduce average patent application pendency.
- More Patent Rocket Dockets. We may see the use of new local rules in some federal district courts to enable the development of more patent "rocket dockets." The Eastern District of Virginia and the Eastern District of Texas are well-known patent rocket dockets. The ITC (International Trade Commission) has a similar role within its limited jurisdiction regarding the import of allegedly infringing goods. The Western District of Wisconsin may recently be developing in this regard. Will other patent rocket dockets appear?
- *Bilski*. The Supreme Court handed down its decision in *Bilski v. Kappos* on June 28, 2010, regarding the question of whether certain classes of business method patents qualify as candidate subject matter for patents under § 101 of the Patent Act. The Court ruled that the "machine or transformation" test continues to be a useful and important tool to answer this question, but may not be the sole test, as the decision below by the Federal Circuit had held.

  Despite speculation to the contrary, the Bilksi decision caused no fundamental change in basic patent strategy for software, computer-related, business method, telecom, biotech, pharmaceutical, and financial patents. If some projects may have been on hold pending this decision, then they may now be enabled, since the uncertainty of a pending decision has been removed. A continued trend is expected to acquire and exploit patent estates in these technologies, with the resulting continued impact on business plans and market capitalizations of patent holders and competitors. Some specific situations, such as some long-pending patent applications, may be impacted and require accommodation, for example, amendment of pending claims.

  On the day of the decision, the Patent Office issued a memorandum to patent examiners, instructing them to continue following prior Interim Instructions to apply the "machine or transformation" test to patent applications for methods, consistent with the *Bilski* decision, and indicating continuity in Patent Office practice in this area. Anecdotal evidence indicates that the Interim Instructions have resulted in more expeditious and predictable prosecution for business method patent applications.
- More Interviews at the Patent Office. The management of the Patent Office has been encouraging increased use of interviews between the applicant and the examiner to expedite and improve the quality of patent examination. These interviews may be face-to-face at the Patent Office in Washington, D.C., or by telephone to the Patent Office. This trend may be further encouraged by recent discussions by PTO management to support interviews before the first office action for each patent application. This trend might yield faster, cheaper and better patents. Anecdotal evidence indicates that the interviews are particularly effective if the supervisors of the examiners also attend the meetings.

However these topics develop in the next 12 months, they will each present their own opportunities and dangers. All of these developments will take place in a context of increasing impact of intellectual property strategies on the success of the corporate business plan, and the market capitalization of the corporate owner.

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Telecommunciations, Media, and Technology: A Time of Rapid Change

The U.S. Market

With the U.S. Federal Communications Commission's ("FCC") release of its National Broadband Plan ("NBP" or "Plan"), a court decision striking down the FCC's jurisdictional basis for regulating broadband-related activities, and the FCC's proposal of a controversial alternative approach to asserting jurisdiction over broadband, the telecommunications, media and technology ("TMT") sector promises to be very active for the balance of 2010, presenting risks and opportunities for TMT businesses. We summarize the key developments and outlook for the balance of 2010 here.

National Broadband Plan

In March, the FCC released its NBP, a roadmap to meet the goals of improving the innovation, access and affordability of broadband Internet. The Plan is the largest undertaking of the FCC since the Telecommunications Act of 1996, requiring potentially more than 40 rulemakings to implement, many of which the FCC has already initiated. The NBP urges:

- Establishment of new competition policies, including consideration of regulations on privacy, wholesale competition, wireless backhaul, data roaming, and video set-top boxes and potential mandates for a new video gateway intended to foster the development of applications and devices that could combine Internet and TV content for display on TVs and other devices.
- The reallocation and more efficient management of spectrum to promote deployment of wireless broadband networks, a potential benefit to wireless providers and a significant concern to broadcasters, which could lose spectrum.
- Reform and redirection of the universal service and intercarrier compensation mechanisms, which currently support high-cost and rural telcos, in order to support fixed and wireless broadband deployment in high-cost areas.
- Additional reforms to maximize the benefits of broadband use in government-influenced sectors like health care, education, and energy.

The FCC's Authority to Regulate Broadband

In April, the D.C. Circuit in *Comcast v. FCC* cast serious doubt on the FCC's statutory authority to implement large portions of the NBP and new "net neutrality" rules that it proposed in a proceeding to "preserve an open Internet," which, among other things, would mandate nondiscriminatory treatment of all online content and applications. In response, the FCC Chairman has proposed to "reclassify" the transmission component of broadband Internet access, which is currently deregulated, as a regulated common carrier service, but subjecting it to a regulatory "light touch." Under this "Third Way" approach, the Chairman proposes to impose only a narrow range of common carrier requirements on broadband access, viewed as necessary to implement targeted FCC policy prescriptions (including key aspects of the NBP and new net neutrality rules).

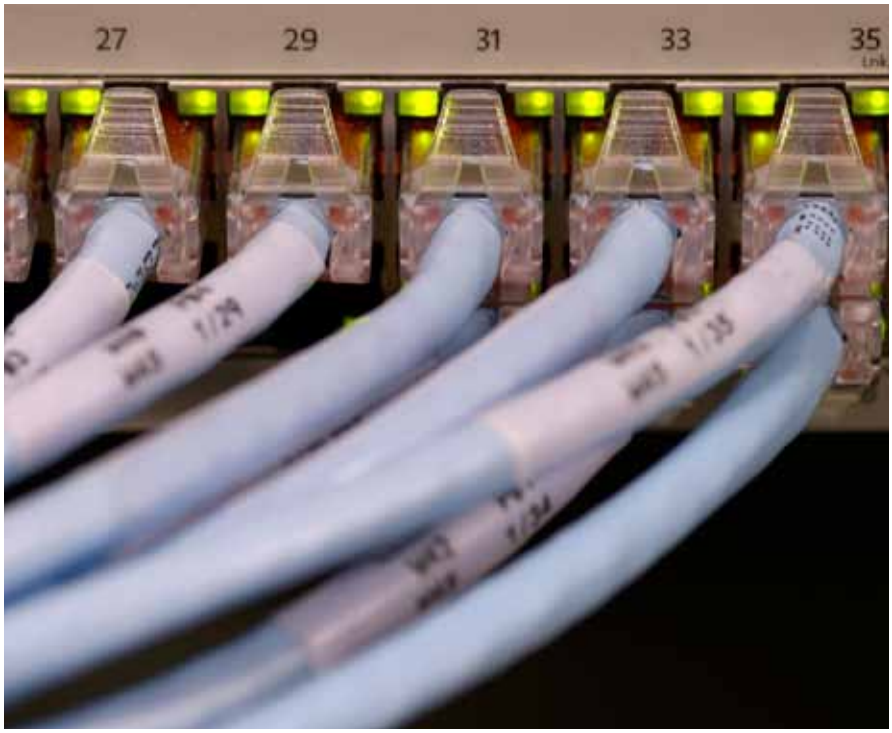
While generally enjoying the support of the public interest community and a cross-section of technology and content companies, the telecom sector is largely opposed to the proposal, with both sides girding for a fight at the FCC, in Congress, and in the media, which will likely extend beyond the end of 2010. The FCC, split along party lines, is set to open a proceeding on this issue in June, and the politics in Congress on the issue are extremely murky. Significantly, while the FCC Chairman enjoys support for his proposal among the chairmen of key congressional committees, a majority of U.S. representatives and some 37 senators have indicated opposition to the reclassification proposal. The relevant congressional committees have also indicated that they intend to start a process to update the Communications Act (key provisions of which date back to 1934) to both provide jurisdictional support to the FCC and make other necessary updates.

FCC Ownership Rules and Competition Policy

On more solid jurisdictional footing, the FCC has begun its required four-year review of its media ownership rules, asking whether the strictures of the current

The National Broadband Plan is the largest undertaking of the FCC since the Telecommunciations Act of 1996.

rules should be liberalized. Given the state of advertising markets and the newspaper industry, and pressure these sectors face from digital media, the rules are expected to get a hard look. Indeed, the FCC, concerned with the state of the newsgathering and information sectors, has started a separate Future of Media Project to more comprehensively examine these issues. Finally, in its just released annual Wireless Competition Report, the FCC failed to conclude, for the first time since 2003, that the mobile wireless sector is "effectively competitive," which signals that the FCC may be taking a closer look at competitive issues in the industry.



The European Market

European Digital Agenda

In May, the European Commission (the "EC") released its Digital Agenda (the "Agenda"), outlining an action plan to improve the sustained growth of the European economy in the digital era, and to spread the benefits arising from this growth to all sections of European society. To meet the objectives of the Agenda, the EC has outlined seven key areas for action, prioritizing the following key Agenda actions:

- Digital Single Market: (1) engage in collective rights management and pan-European licensing for online rights management; (2) facilitate digitization and dissemination of cultural works; and (3) review the EU data protection regulatory framework.
- Fast and ultra-fast Internet access: (1) lay out a common framework for EU and member state actions, including funding through EU instruments, more efficient management of radio spectrum, and investment in competitive NGA networks; and (2) develop member state national broadband plans by 2012 meeting Europe 2020 targets: basic broadband for all by 2013, fast broadband (30+ Mbps) for all by 2020, and ultra-fast broadband (100+ Mbps) for half of all households by 2020.

Other Agenda areas identified for action include: Internet trust and security; more investment in research and development; enhancing digital literacy skills and inclusion; and applying information and communications technologies to address societal challenges like climate change and the ageing population.

Germany

In a May spectrum auction, the four major German mobile network operators bought 360 MHz of spectrum for approximately EUR 4.3 billion. The Federal Network Agency ("FNA") also proposed new cable regulations to release the main cable network operators (KDG, Unity, Kabel-BW) from the jurisdiction of the German Telecommunications Act, revoking the former access regulation for the cable network operators. Additionally, FNA is expected to conclude proceedings on mobile operator termination fees this fall.

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U.S. Department of Labor: An Ambitious Agenda

The United States Department of Labor ("DOL") has announced an aggressive agenda for the remainder of the year that includes enhanced compliance obligations for employers, greater influence for workers and increased government enforcement actions.

DOL's Spring Regulatory Agenda, issued the end of April 2010, focuses on revamping compliance obligations of employers under several statutes and furthering its previously announced goal of eliminating purportedly widespread misclassification of employees as independent contractors. With hundreds of new enforcement personnel and a proposal to "increase staffing in the Department's worker protection agencies to levels not seen in almost a decade," DOL is proposing multi-pronged programs ("Programs") it calls "Plan/Prevent/Protect" and "Openness and Transparency to Achieve Compliance." (DOL Regulatory Agenda Narrative, Spring 2010)[1]. One of the themes of the Programs is that all employers should be subject to compliance planning obligations similar to those currently imposed on federal contractors by the DOL's Office of Federal Contract Compliance Programs. Another theme is that employees should be empowered, both with information and with participation in what traditionally could be considered management prerogatives. As described by the DOL, the Programs would effect a sea change in the scope and nature of both regulation and enforcement.

"Plan"—DOL states that it will propose that employers and other regulated entities be required to create plans for identifying and remediating risks of legal violations and risks to employees. Employees would be permitted to participate in creating the plans and would be entitled to copies of them "so they can fully understand them and help to monitor their implementation."

"Prevent"—DOL states that it will propose a requirement that employers and other regulated entities thoroughly and completely implement their plans in a manner that prevents legal violations.

"Protect"—DOL states that it will propose a requirement that employers and other regulated entities ensure that their plans' objectives are met on a regular basis.

"Openness and Transparency"—Employees would be entitled to information about employer plans and their legal rights and benefits. DOL states that this is designed both to enhance compliance and to enable workers to report violations.

A complete list of the specific actions included in these Programs may be found on DOL's website at the link referenced above. Among them is an Occupational Safety and Health Administration ("OSHA") project that is described as the prototype for the entire Plan/Prevent/Protect Program and which would require employers to develop, maintain and monitor injury and illness prevention programs. Details of the OSHA project are not yet available. As described in the OSHA Agenda Fact Sheet, key components of the OSHA project would (1) require employers to systematically identify and remediate risks to workers by, for example, reviewing health and safety information and developing procedures for inspecting workplaces; (2) require employers to provide workers with opportunities to participate in the plan; (3) make the plan available to workers so they can understand it and help monitor its implementation; (4) require employers to implement the plan so it actually protects workers; and (5) prevent employers from not covering workers by classifying them as independent contractors.

Also included in DOL's Spring Regulatory Agenda are amendments to the Fair Labor Standards Act ("FLSA") recordkeeping regulations. The Wage and Hour Division Agenda Fact Sheet description of these changes is both extremely broad and extremely vague. It states that DOL is considering a proposed rule that would require covered employers to "notify workers of their rights under the FLSA, and to provide information regarding hours worked and wage computation. Any employers that seek to exclude workers from the FLSA's coverage will be required to perform a classification analysis, disclose that analysis to the worker, and retain that analysis to give to [Wage and Hour Division] enforcement personnel who might request it." It also states that the proposal will address burdens of proof in cases of noncompliance and recordkeeping requirements for live-in domestic employees and industrial homeworkers.

The DOL's programs would effect a sea change in the scope and nature of both regulation and enforcement.

The proposed requirements of a classification analysis and disclosure to employees are obviously designed to enhance the DOL's ongoing campaign against perceived widespread misclassification of employees as independent contractors. Furtherance of that campaign is also seen in a similar analysis and disclosure proposal under OSHA and a proposed requirement that the Employee Benefits Security Administration work in conjunction with the Wage and Hour Division to ensure that employee benefit plan issues are addressed in all misclassification settlements. Some of these proposals might be characterized as an attempt by DOL to accomplish by rulemaking what Congress has not accomplished by statute. Several recent bills regarding independent contractors have included provisions that seem directly parallel to what the Wage and Hour Division now proposes by regulation. The proposed "Independent Contractor Proper Classification Act," the "Employee Misclassification Prevention Act" and the "Taxpayer Responsibility, Accountability, and Consistency Act of 2009" all contained requirements of classification analysis and disclosure to employees. For example, the Independent Contractor Proper Classification Act would have required notice to independent contractors of their right to a determination of their status and of the protections that apply only to employees. The Employee Misclassification Prevention Act would have required notification to workers of their right to challenge classification as independent contractors. It remains to be seen how much the proposed regulations will borrow from these bills. It is clear even now, however, from these proposed actions, that along with the Internal Revenue Service's ongoing focus on employment audits, the proper classification of independent contractors and employees should be a top employer priority.

It should also be noted that the proposed requirements with respect to the worker classification also appear to be directed to the classification of employees as exempt under the FLSA. Although the Wage and Hour Division Agenda Fact Sheet refers generally to "employers that seek to exclude workers from the FLSA's coverage," the stated goals of the proposal include enhancing "awareness among workers of their status as employees or independent contractors and employee rights and entitlements to minimum wage and overtime pay, and to facilitate DOL enforcement."

In a recent question and answer session, the Deputy Administrator of the Wage and Hour Division declined to specify what the scope of the proposed rule would be. She was asked whether employers will be required to formally notify each employee of their FLSA status and how it had been determined. She was asked whether employers will be required to inform employees of their exempt status. She was asked whether the proposal will be limited to independent contractors or whether it will include every employee designated as exempt. Each time she responded that the proposal was in development; that final decisions had not been made; and that comments on the proposal were encouraged. Depending on the answers to those questions, an enormous new burden may be imposed on employers. A proposed rule is expected in August.

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[1] http://www.dol.gov/regulations/2010RegNarrative.htm

FDA: Active Enforcement Targets "New" Measures and Industries

Since U.S. Food and Drug Administration (FDA) Commissioner Dr. Margaret A. Hamburg announced an aggressive new enforcement stance nearly a year ago, the agency has undertaken significant enforcement efforts in nearly every category of product it regulates. Clearly, FDA has moved away from its former ways of "partnering" with companies to assure their legal and regulatory compliance, in favor of requiring grand gestures of contrition and expensive corrective actions. Among the more significant enforcement actions have been the following.

Medical Devices

After working for more than ten years with an infusion pump manufacturer to correct numerous flaws in its devices, in April 2010 FDA forced the company to recall nearly 200,000 infusion pumps from the U.S. market, and to pay substantial refunds to customers. The manufacturer had consented, in 2006, to a permanent injunction requiring it to stop manufacturing and distributing the pumps until manufacturing deficiencies were corrected. Although the company had submitted a proposed schedule for correcting these defects, the agency rejected this proposal and required the recall. The case is significant for at least two reasons:

- FDA has rarely initiated mandatory medical device recalls. While this recall was brought under the terms of a consent decree, FDA has mandatory recall authority under the medical device provisions of the Federal Food, Drug, and Cosmetic Act, and this action indicates a new willingness to use the mandatory recall authority.
- This is the first time FDA has ordered a device company to pay a refund to customers. In this case, FDA conducted a survey of user facilities and determined that the largest barrier to customers transitioning to an alternative pump was the cost of doing so; thus, FDA felt that customer refunds were warranted. The costs involved with this recall are enormous—with the manufacturer predicting an initial cost as high as $600 million.

Drugs

After an 11-day on-site inspection, FDA determined that more than 40 products offered by a major provider of over-the-counter (OTC) infants' and children's medicines were super-potent or otherwise contaminated, and the company ceased manufacturing the drugs, and voluntarily initiated an unprecedented nationwide recall. Reportedly, FDA's Center for Drugs has referred the inspectional findings to FDA's criminal investigative unit. The recall affected a large portion of the children's OTC drug market, and led to immediate hearings on Capitol Hill, at which FDA Deputy Commissioner Joshua Sharfstein said that the agency was working to strengthen its drug recall processes, and requested new legislation that would give FDA mandatory drug recall authority, broader civil money penalties and easier access to company records.

In addition, in May 2010, FDA launched its "Bad Ads" program aimed at encouraging health care practitioners to report to the agency prescription drug advertising and promotions that may be untruthful or misleading. The program seeks to "increase the

effectiveness" of FDA's surveillance program, particularly in connection with private communications made by drug company representatives in office visits to health care professionals, presentations during industry-sponsored dinners, and continuing medical education programs. Critics of the program suggest that it inappropriately turns physicians into "police officers"; in any event, the program may significantly change the relationship between drug manufacturers and the health community which, in the past, tended to view each other as potential teammates in providing patients with health care options.

Foods and Cosmetics

In an unprecedented crackdown on food labeling, the FDA in February 2010 issued seventeen warning letters to a broad range of companies. In an open letter to the industry, Commissioner Hamburg expressed concern that companies have not done enough in terms of food labeling to help consumers distinguish healthy food choices from less healthy ones, or identifying labeling that may be false or misleading. The warning letters took aim at a variety of labeling practices, including 1) nutrient content claims made on food for infants (e.g., "high in …" or "good source of …"); 2) trans-fat-free claims made on products to imply nutritional superiority despite a high saturated fat content; 3) claims that a food can treat or mitigate diseases; 4) misleading claims that a food is "healthy"; and 5) multiple ingredient juice products labeled as single juice products.

In May 2010, FDA released what appears to be the first warning letter issued to a dietary supplement manufacturer for violations of Good Manufacturing Practices (GMPs). The letter cited a number of deficiencies, including inadequate ingredient identity testing, lack of documentation of specification determinations, and incomplete corrective actions. The letter sent a clear message to industry that FDA will be aggressively inspecting dietary supplement manufacturing practices, and firms that have become accustomed to less oversight should be prepared for significantly greater scrutiny.

FDA has moved away from its former ways of "partnering" with companies to assure their legal and regulatory compliance, in favor of requiring grand gestures of contrition and expensive corrective actions.

Shortly thereafter, the Government Accountability Office (GAO) presented to the U.S. Senate Special Committee on Aging findings of its investigation into a broad range of dietary supplements. The GAO reported that nearly all of the herbal dietary supplements tested in its investigation contained trace amounts of lead and other contaminants, and that some supplement sellers made improper claims that their products could cure cancer and/or other diseases. The report will strengthen the FDA's resolve to aggressively enforce GMPs for dietary supplements, and manufacturers should move quickly to upgrade their facilities and processes.

With regard to cosmetics, FDA reissued a 1988 Import Alert addressing "Skin Care Products Labeled as Anti-Aging Creams." At the same time, importers have experienced increased scrutiny of cosmetic products at the U.S. border. FDA appears to be looking for examples of exaggerated "anti-aging" claims that would cause the products to be deemed to be unapproved drugs. For example, claims that the products can "counteract," "retard," or "control" the aging process risk subjecting them to regulation as drugs.

Conclusion

FDA continues to implement a broad program of significantly heightened enforcement, and statements by senior officials reflect an effort to expand such authority through new legislation. Firms subject to FDA jurisdiction must remain particularly vigilant and ensure that their processes are in compliance with applicable FDA laws, regulations and guidance statements, and evaluate any product claims in light of the agency's recent aggressive actions.

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Liner Shipping Competition Rules Receive Attention Worldwide

Spurred by rate increases combined with capacity and equipment shortages resulting from a faster-than-anticipated recovery in demand, authorities in the United States and Europe are investigating competitive practices in international ocean shipping. These reviews come as a number of jurisdictions around the world are reviewing the antitrust and competition rules applicable to the industry. In the United States, legislative attention usually focuses on the industry during times of volatility, like this one. Although the current rate and capacity levels appear to be the result of market forces, the industry can expect continuing scrutiny in this environment.

For more than a century international ocean liner shipping has been exempted from antitrust and competition laws in virtually every jurisdiction. International shipping has historically been organized largely through cooperative agreements known as "conferences," under which groups of carriers coordinated sailing schedules and stabilized prices. Governments have long recognized that such cooperation was justified by the special economic conditions of ocean shipping. In the United States, oversight and enforcement authority is vested in the Federal Maritime Commission (FMC), rather than in the antitrust enforcement agencies.

The system of maritime regulation in the United States has been relatively stable since 1984, when the process for filing and approving carrier agreements at the FMC was made more efficient and predictable, and conferences were required to permit carriers to set their tariff rates independently. Two years later, the European Union adopted a block exemption for liner conferences from its competition laws. In the mid-1990s, after a period of relative instability in the North Atlantic trades, the United States undertook another review, retaining the antitrust exemption and allowing carriers to enter into independent confidential service contracts.

In 2008, largely as the result of protracted litigation over its scope, the EU block exemption for liner shipping conferences was repealed in favor of guidelines as to the scope of permissible cooperative activities, primarily involving information sharing. The EU also revised and extended a block exemption for vessel sharing arrangements known as "consortia." Reviews have also been undertaken in a number of Asian countries, although none so far has resulted in a decision to apply competition laws to liner shipping. China and India are currently studying whether to establish exemptions from their newly-enacted general competition laws, and Singapore is considering the extension of its current exemption. Exemptions remain in place in Japan, Australia and South Korea.

Recent developments in the trades are increasing shipper unrest and government scrutiny. Upturns in economic activity worldwide, particularly in Asia, have led to rapidly increasing demand for liner shipping services at a time when carriers are operating at reduced capacity following the global economic crisis, which resulted in unprecedented declines in demand and rate levels, as well as unprecedented industry losses. Shippers seeking to replenish inventories have faced shortages of capacity and container equipment, and rates have rebounded rapidly. Some shipper groups have gone to the U.S. Congress and the FMC complaining that these shortages have left them unable to ship their goods in a timely fashion.

The U.S. Congress has held several hearings on these developments, with another planned for July 2010, and the FMC is undertaking an investigation into trade conditions, the deployment of vessel capacity and equipment, and service contracting practices. The FMC is expected to issue a preliminary report of its investigation in mid-June and a final report by the end of July. In addition, the EU reports that its regulators are "actively monitoring" the situation, and the Spanish National Competition Commission announced on May 12 an investigation of suspected anticompetitive practices in the scheduled maritime transport of passengers, vehicles and cargo.

It is far from clear that existing antitrust exemptions have anything to do with the current capacity and equipment shortages. Carriers are not permitted to agree on capacity matters, and supply and demand factors, including the high demand for containers at coastal locations, explain container shortages experienced at U.S. inland locations. Nevertheless, maritime antitrust exemptions have always become the subject of political attention when shippers have faced market challenges, and the current momentum towards a reexamination of these exemptions is likely to continue, given that the current environment may favor shipper efforts in this regard.

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Consumer Product Safety Commission: New Rules and New Obligations

For the Consumer Product Safety Commission (CPSC), 2010 started with a new $118.2 million budget, enhanced statutory authority under the Consumer Product Safety Improvement Act of 2008 (CPSIA), and a reconstituted five-person Commission. This combination has proven to be a potent one. CPSC began 2010 at a full sprint, proposing new rules, initiating recalls, and seeking penalties at a record pace. These activities create many new obligations—and many hazards—for regulated firms that must keep pace with these breakneck developments.

Enforcement

CPSC has wielded its recall authority and power of the press release to address perceived safety hazards. It has announced many high-profile recalls including recalls of millions of drop-sided and other cribs, high chairs, strollers, children's jewelry with cadmium, roman shades and roll-up blinds, and hooded sweatshirts or tops with drawstrings, as well as items with elevated levels of lead paint. At times, the CPSC approach has been to recall products from the marketplace based on design features that might have alternatively been addressed through rulemaking.

CPSC has also warned the public about classes of products including drop-sided cribs and children's jewelry with heavy metals such as cadmium, and Chinese drywall. The CPSC can issue such notices with very little evidence, analysis, or due process under the amended law, but such notices can have an enormous impact on the products named.

Finally, CPSC continued to pursue civil penalties for lead paint and other children's product violations. Although these cases largely predated the CPSIA and its increase of penalty exposure from $1.8 million to $15 million, at least two of the cases settled with seven-figure penalties. It is likely that CPSC will seek more significant penalties as the year progresses.

Rulemaking

CPSC pressed a number of rulemaking efforts. It finalized procedural rules for recalls and civil penalty factors. It also proposed guidance on the meaning of the term "children's product" and extensive rules governing testing of products and components together with associated recordkeeping obligations. As expected, CPSC also pursued a variety of accreditation rules for testing labs. It also proposed rules governing its public database that will make incident and recall information available via the internet in 2011.

At the same time, that CPSC also acted on a variety of safety standards and bans of products. During the first half of 2010, CPSC initiated, proposed or finalized rules for durable infant products including toddler beds, bath seats, bassinets and cradles, walkers, and cribs. CPSC also proposed novel "substantial hazard rules" using its new authority to do so under the CPSIA, seeking adoption of voluntary standards addressing strings in children's upper garments and electrical hazards in handheld hair dryers.

CPSIA Amendments

Early in the year, the House Committee on Energy and Commerce considered a possible "Consumer Product Safety Enhancement Act" to fix some of the flaws in the CPSIA. This bill was designed to create a more practical lead exemption process, make future lead requirements prospective in nature, limit the phthalate (plasticizer) content requirement to accessible components, and provide some relief for small businesses. Although tremendous progress has been made on these and other proposed amendments, at the time this document was prepared, discussions continued between the majority and minority members regarding the scope of an acceptable bill.

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Auto Industry Faces New Regulatory Environment as the U.S. Government Accelerates Debate on Vehicle Safety

Auto manufacturers around the globe have experienced significant harm from the economic downturn. General Motors was forced into bankruptcy. Saturn and Saab have disappeared. Even Ford, which weathered the recession better than most, has killed its 71-year old Mercury brand. The automotive industry is staring down the barrel again as a result of the recent Toyota safety recalls. Motor vehicle and component manufacturers face significant new safety regulations, higher technical standards, new corporate and executive liability, and new fees to pay for government oversight.

Executive Branch Acts on Safety Problems

The Obama Administration has sent strong signals it will not tolerate similar safety problems, and has taken steps to prevent safety problems before they occur. The National Highway Traffic Safety Administration (NHTSA) has fined Toyota the maximum civil penalty permitted under U.S. law, $16.4 million, for one of its safety violations. NHTSA, with the assistance of the Department of Justice, is also continuing to investigate the causes of the safety problems and whether Toyota complied with their regulatory obligations to notify the agency of potential safety issues.

Congress Presses New Regulations to Improve Safety

The U.S. Congress has moved rapidly to enact new laws to address motor vehicle safety concerns. At least six bills have been introduced that would prescribe new requirements, regulations, and user fees to address motor vehicle safety issues. Both the House and Senate Committees of jurisdiction have held hearings on safety issues and have begun debating legislation that would represent the most significant changes in vehicle safety laws since the enactment of the TREAD Act (Pub. L. 106-414) a decade ago.

Among the leading proponents of this proposed legislation are Representative Henry Waxman (D-CA) and Senator John Rockefeller (D-WV), chairmen of the respective House and Senate Congressional Committees with primary jurisdiction. They have introduced the Motor Vehicle Safety Act of 2010 (H.R. 5381 and S. 3302), companion bills that require motor vehicle manufacturers (except motorcycle and trailer manufacturers) to make several significant changes to the mechanics of their products. The bills also impose significant new Sarbanes-Oxley-type compliance certifications and user fees on all motor vehicle (including trailer and motorcycle) manufacturers.

The key elements of the bills are:

Vehicle Electronic and Safety Standards

The bill would establish a new Center for Vehicle Electronics and Emerging Technologies within NHTSA to "strengthen the agency's expertise in new technologies across all vehicle safety components." The center would be tasked with coordinating with all of the components of the agency responsible for vehicle safety, resulting in a single oversight entity within NHTSA to evaluate technologies being deployed in the automotive industry.

Additionally, it would require NHTSA to promulgate new electronic systems performance standards for motor vehicles, incluiding new standards to prevent gas pedal entrapment, and new keyless entry standards (so that a passenger vehicle can be slowed or stopped during an emergency).

Event data recorders, capable of withstanding and capturing data in the event of an adverse vehicle incident, would be required to be incorporated into

Motor vehicle and component manufacturers face significant new safety regulations, higher technical standards, new corporate and executive liability, and new fees to pay for government oversight.

motor vehicles. There has been significant debate concerning privacy and use of such data as well as the cost of such systems for manufacturers and consumers.

Enhanced Safety Authorities

Both bills dramatically increase the authority and funding levels for NHTSA's vehicle safety efforts. In response to criticisms that Toyota got off lightly with a $16.4 million civil fine, the bills significantly increase the civil penalties that NHTSA can seek for violations of the law and change the maximum civil penalty allowed (the House bill increases the maximum to $200 million while the Senate bill completely eliminates the cap).

Both bills originally contained language enabling NHTSA to unilaterally order recalls of vehicles in cases determined to pose an "imminent hazard"; however, that provision was scaled back in the House during Energy & Commerce Committee consideration. This recall authority in the Senate bill is expected to be revisited in future debates on the bill.

Transparency and Accountability

Under the guise of transparency and accountability, the legislative proposals impose stringent safety certifications on the industry and increase corporate and executive liability resulting from safety violations. Every company submitting safety related materials to NHTSA would be required to have a senior official, based in the United States, certify that he/she has reviewed the information and verify that the filing does not contain false or misleading information. This Sarbanes-Oxley-type requirement for senior executives of motor vehicle manufacturers is backed by potential civil penalties of up to $5 million under the House bill and up to $250 million plus 12 months imprisonment under the Senate bill for any individual filing a false certification.

The bills also impose additional "early warning reporting" requirements on motor vehicle manufacturers for vehicle incidents resulting in injuries or death. It also encourages consumers to report potential defects to NHTSA, further exposing motor vehicle and component manufacturers to additional scrutiny by the agency.

Funding

The House legislation would impose on all motor vehicle manufacturers (including motorcycle and trailer manufacturers) a "user fee" to help pay for increased NHTSA scrutiny. The fee would be assessed per unit produced by each manufacturer. It would be $3 per unit in the first year, $6 per unit in the second year, and $9 per unit in the third year. Thereafter, the fee would be indexed to inflation. This provision, which is not a part of the Senate legislation, was subject to heated debate during the House Energy & Commerce Committee's consideration of the bill, with an amendment to remove it being defeated.

Conclusion

The U.S. Congress and the Administration continue to aggressively pursue regulations that would impact business and industry. Since the beginning of the year, we have seen highly contentious overhauls of the health care and financial systems in the United States. The oil and gas sector will likely to see additional regulations and laws enacted to address energy exploration off the U.S. coast as a result of the Deepwater Horizon spill in the Gulf of Mexico. With the Motor Vehicle Safety Act of 2010, along with actions by the National Highway Traffic Safety Administration, the motor vehicle and component manufacturers face similar fates.

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Antitrust: Developments and Outlook

United States

New Merger Guidelines

One of the key initiatives of the Obama Administration in the antitrust field is a restatement of how mergers should be analyzed under antitrust law. The two U.S. antitrust agencies—the Federal Trade Commission and the Justice Department's Antitrust Division—have been working since last summer on a document updating their basic framework for assessing the competitive significance of mergers, last articulated 18 years ago in the 1992 Horizontal Merger Guidelines. On April 10 they released for public comment their draft revised set of merger guidelines, which depart in ways both large and small from the 1992 Horizontal Merger Guidelines. The most significant change proposed in the new guidelines would greatly downplay the role of market definition, which had previously been the starting point for analysis, to just one tool of many. Instead, a key consideration now would be the assessment of whether the merger would result in price increases to an identifiable group of customers. This could result in challenges to mergers in very narrow markets that previously would not have raised concerns. On the other hand, the new guidelines raise the level of market concentration that would have to be present before a merger would raise concerns. They also include new considerations related to powerful buyers, mergers between competing buyers, and partial acquisitions.

European Union

Change in Leadership at the European Commission

In February 2010 the new European Commission took office. Mr Joaquin Almunia has been appointed as the new Commissioner for Competition, replacing Neelie Kroes whose robust approach saw many high profile cases in the period from 2005 to 2009. Although Mr Almunia, a Spaniard with a background in law and economics, has made it clear that the Commission intends to maintain its vigorous enforcement of EU competition law in pursuing cartels, abuses of dominance and merger control, he has also indicated that, given the financial crisis facing Europe, the Commission intends to be "fair but firm" in assessing the fines to be imposed on firms that have infringed the rules.

A New Approach to Cartel Fines?

Consistent with this position, Commissioner Almunia recently stated that, although his principal concern is maintaining the effectiveness of the competition rules, he has "no interest in putting at risk the viability of firms" and he follows "very closely the real financial situation of firms which have difficulties in paying fines imposed."

Commissioner Almunia referred to point 35 of the Commission's Guidelines governing the method of setting fines for infringement of Articles 101 or 102 of the Treaty on the Functioning of the European Union ("TFEU") (formerly Articles 81 and 82 of the EC Treaty), which provides that the Commission may take into account submissions concerning inability to pay. Commissioner Almunia acknowledged that "reductions may be granted only in clear situations of financial difficulties caused by the fine, since such reductions run the risk of giving unfair advantages to inefficient businesses." He also stated, however, that he was "open to any suggestion for improving and adapting [the Commission's] practices within the limits of the Guidelines and case-law."

Point 35 has been interpreted by the Commission and the Court of Justice of the European Union to apply only in extreme situations, which are very difficult to establish. It may be that Commissioner Almunia is proposing a less rigorous standard, and—at least until the Commission's new approach is clearer—more companies being investigated for infringement of the EU antitrust rules may claim inability to pay.

First Cartel Settlement under 2008 Rules

On 19 May the Commission adopted its first settlement decision in a cartel case. The case involved 10 producers of DRAMs (memory chips), nine of which are non-EU companies. Under the settlement procedure introduced in 2008, parties who have seen the evidence in the Commission file may, at the Commission's discretion, acknowledge their involvement in the cartel and their culpability in return for a reduction of 10 percent in the fine imposed. Once a settlement agreement has been reached, the procedure is shorter and simpler than a normal investigation. The procedure may be combined with immunity from or reduction of fines under the 2002 Leniency Notice. This was the case in the DRAM settlement, where Micron benefited from full immunity since it had revealed the existence of the cartel; the other companies involved all saw their fines reduced by 10 percent.

New Vertical Agreements Block Exemption

Vertical agreements, e.g., distribution and supply agreements for goods or services, benefit from a block exemption from the prohibition on anti-competitive agreements in Article 101 of the TFEU. The 1999 Block Exemption Regulation expired at the end of May 2010 and has been replaced by a new Block Exemption, whose expanded scope reflects the two major developments since the 1999 Regulation: increases in the market power of large distributors and Internet sales.

Under the 1999 Regulation, agreements that involved a supplier with less than 30 percent of the relevant market and did not contain certain prohibited terms, such as price fixing or absolute export bans, would benefit from the exemption. Under the new Block Exemption, both the supplier's and the buyer's market share must be less than 30 percent. This is likely to take a number of agreements outside the Block Exemption and will require those agreements to be carefully assessed for compliance with Article 101.

The new Block Exemption will also clarify that every distributor must be free to use the Internet to advertise or to sell products. A restriction on the use of the Internet will only be compatible with the Block Exemption to the extent that promotion on the Internet or sales over the Internet would lead to active selling into other distributors' exclusive territories or customer groups. In general, however, the use of the Internet is not considered to be active selling: if a customer outside the allotted territory visits a distributor's web site and contacts the distributor and if such contact leads to a sale, including delivery, it is considered only passive selling and therefore is a sale that the supplier cannot prevent the distributor from making.

Legal Professional Privilege

In April Advocate General Kokott delivered her Opinion in the appeal brought by Akzo Nobel before the Court of Justice of the EU against the judgment of the General Court. The issue is whether legal professional privilege protects communications between in-house lawyers and their employer against disclosure to the European Commission in antitrust investigations.

The Advocate General has recommended that the appeal be dismissed, essentially on the basis that in-house lawyers in an employment relationship with their client are not sufficiently independent from their employer to justify the extension of legal professional privilege to communications between them. The Advocate General stated that "[a]s an employed person, an in-house lawyer is typically—rather than only exceptionally—characterised by complete economic dependence on his employer" and that "[i]n addition to their economic dependence on their employer, in-house lawyers usually exhibit a considerably stronger personal identification with the undertaking for which they work, as well as with its corporate policy and corporate strategy than would be true of external lawyers in relation to the business activities of their clients." In the Advocate General's view, even where in-house counsel are enrolled with a national Bar or Law Society which imposes professional and ethical duties of independence upon them, they remain insufficiently independent from their employer for their advice and other communications to be protected by legal professional privilege in Commission investigations.

Although the Advocate General's Opinion is not legally binding, the Court follows the Advocate General in the majority of cases and it would be surprising if the judgment, expected later this year, differed in outcome.

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Securities Enforcement: Fundamental Changes Underway

In our previous report, 2010: The Year Ahead, we anticipated a sharp increase in both the number and intensity of investigations by securities regulators, with increasingly aggressive tactics, harsher sanctions, and more actions against individuals. We also expected that, while most actions would continue to be resolved by settlement, potential subjects of enforcement action would increasingly see litigation as a viable alternative.

These trends have unfolded rapidly over the first six months of 2010, and seem to portend fundamental changes in securities enforcement for at least the near- to mid-term. Although there has not been any dramatic increase in the number of SEC investigations, the agency announced a series of initiatives that promise to transform enforcement into an extremely aggressive, high-stakes process. These changes clearly increase the risks to those that come under the scrutiny of the SEC Division of Enforcement.

What is less certain is whether the agency's approach will result in more effective enforcement of the securities laws. While some subjects of enforcement action will submit more quickly and accept harsher sanctions in the face of the Commission's muscle-flexing, others will put the Commission to the test in federal court, where its record in recent years has been mixed.

Reorganization

The SEC Division of Enforcement is emerging from what it has called "the most profound reorganization in the Division's history." There have been several elements to this.

Delayering. Concerned about redundant levels of supervision and review, the Division has eliminated an entire level of mid-level management, the category known as "branch chiefs," who supervised staff attorneys. Most branch chiefs were re-assigned as front-line investigators, with a few promoted to Assistant Director positions, who will now supervise investigations directly. These changes may enhance efficiencies in the long-run, but the immediate effect appears to have been the demoralization of ground-level investigators, who perceive fewer opportunities for promotion.

Enhancement of expertise. The Division took two measures designed to increase the level of expertise it can bring to bear.

First, breaking with a long tradition of having its investigations handled almost exclusively by lawyers, the Division will now involve non-lawyers with technical industry expertise in developing cases, making charging decisions, and negotiating settlements. To implement this plan, the Enforcement Division is seeking to hire "qualified industry professionals" and identifying outside industry experts who could serve as consultants on an as-needed basis. Enforcement lawyers are also making use of personnel from the SEC's new Division of Risk, Strategy, and Financial Innovation, which has staffed up with specialists in structured finance, derivatives, risk management and other technical matters.

Second, the Division has completed its redeployment of about 20 percent of its staff into five new "specialized" enforcement units, in an effort to grow its expertise through training and concentrated experience. The new groups are focusing on (i) structured and new products; (ii) asset management issues, including investment advisers, investment companies, hedge funds and private equity funds; (iii) market abuse issues, including "large-scale market abuses and complex manipulation schemes" by institutional traders, market

professionals and others; (iv) FCPA enforcement; and (v) municipal securities and public pension issues.

Aggressive Strategies and Tactics

The Commission took several steps to assure that the enforcement process will become both swifter and more hard-hitting.

Pages from the criminal investigation playbook. In the recent Galleon and Disney insider trading cases, the Enforcement Division worked with federal criminal prosecutors to gather evidence through the use of wiretaps and confidential informants, and in the Disney matter, federal agents posed as hedge fund personnel. These tactics have previously been unusual in the securities context, having ordinarily been limited to investigations of organized crime activities.

The Division also announced, in January, a new "cooperation" policy, offering appropriate levels of leniency to culpable individuals able to provide valuable evidence to investigators. In essence, however, the cooperation guidelines are likely to prove to be as much "stick" as "carrot," as they also seem to promise significantly harsher treatment for persons who are offered the opportunity to cooperate but decline to do so.

The Dodd-Frank financial reform legislation expands the SEC's bounty program, permitting the agency to pay whistleblowers up to 30 percent of moneys recovered as a result of the information they provide, much like the *qui tam* provisions relating to government contractors. Previously, the SEC's ability to pay bounties had been limited to insider trading cases. This provision seems certain to lead to an enormous increase in corporate whistleblowing.

The emphasis on incentivizing cooperation and whistleblowing promises to be extremely effective in aiding the Enforcement Division's efforts to develop strong cases. Although the percentage of the enforcement actions that originate in this way is not known, according to a study published by the Association of Certified Fraud Examiners, nearly half of all frauds that come to light are discovered as a result of tips from employees and other sources. The SEC has been particularly attuned to the need to make use of such information, particularly in the wake of its failure to follow up on information suggesting that Bernard Madoff's operations were, in fact, a Ponzi scheme of enormous proportions. The SEC has formed a new Office of Market Intelligence that will use defined risk criteria to effectively analyze and winnow the hundreds of thousands of tips the SEC gets from the public and its regular referral sources each year.

For companies, these developments suggest the need for renewed emphasis on compliance efforts, including effective internal whistleblowing mechanisms, to prevent and detect misconduct at an early stage.

Wells process. As a matter of practice, when the Division of Enforcement makes a preliminary determination to recommend that the Commission bring charges against a party, counsel is generally given the opportunity to make a written submission as to why such charges are unwarranted. Given the benefits that this process provides, both to those who may be charged, and to the Division itself, the so-called "Wells" process continues–but with modifications that sharply limit the dialogue between the Staff and the subjects of its investigations, and that will dramatically change the dynamics of the process.

In the past, the Staff was often willing to meet with counsel and discuss potential issues prior to any Wells notice being provided. This often served to clarify the concerns of both sides, and to resolve misunderstandings at an early stage. The Staff will now ordinarily refuse requests for such "pre-Wells" meetings.

The Staff has also indicated that, following a Wells notice, parties will ordinarily be limited to one in-person meeting with the Staff to discuss the issues, although two meetings may be permitted in some circumstances. The new financial reform legislation may create further time pressure in this regard, as it requires the Commission to file any action within 180 days after a Wells notice, although this period may be extended by the Director of Enforcement for particularly complex matters.

Finally, as signaled by the Commission's April 2010 action against Goldman, Sachs & Co., the Enforcement Division has indicated that, once authorized by the Commission to file charges, it may now proceed to do so without further

The agency announced a series of initiatives that promise to transform enforcement into an extremely aggressive, high-stakes process.

warning. Previously, the Staff has almost invariably provided potential defendants with advance notice of its intention to file charges, providing a final opportunity for settlement discussions. The Commission's action against Goldman was seen as remarkable in a number of respects, including the fact that it appeared to have been filed several months after Goldman's Wells submission, without any indication that a court filing was imminent. Enforcement officials have stressed that settlement discussions should occur during the Wells process, rather than afterwards, although this would effectively deprive parties of the opportunity to present their arguments to the Commission.

These changes will enable enforcement actions to be brought significantly more quickly than in the past, with the elimination of protracted and sometimes redundant discussions between the Staff and counsel for private parties. At the same time, the emphasis on restricting dialogue between the Staff and counsel seems certain to result in increasing opportunities for miscommunication and misunderstanding on both sides, with the resulting miscalculations leading to litigation that may be ill-advised or unfounded.

The Wells process has historically benefited both private parties and the Staff in assessing their respective positions and determining whether to proceed to litigation. If discussions with the Commission's Staff are restricted too severely, one or both of these parties may act on the basis of misperceptions that will be resolved only in the course of litigation. Some risk-averse parties facing SEC enforcement action will agree to settle charges, despite the fact that factual or legal bases for those charges could not withstand challenge. Others, particularly individuals who face the prospect of career-ending sanctions, will conclude that settlement is not a viable alternative, and will litigate with the Commission. The Commission's litigation record is hardly unblemished, and its constriction of the Wells process may facilitate its ability to overlook important facts or pursue unsustainable legal theories. If the Commission's aggressive approach leads to a series of failures in federal court, its law enforcement efforts will have been damaged rather than enhanced.

Settlement on the basis of neither admitting nor denying liability. For decades, a principal inducement to settle with the SEC has been the defendant's ability to avoid admitting or denying liability. In April 2010, the Washington Post reported that Enforcement Director Khuzami had said that the agency was reconsidering this policy, noting that "typically our practice has been not to file in-depth factual findings of the investigation. We're taking a look at the practice and deciding whether it makes sense to provide a more fulsome record." Even if the Commission's policy remains unchanged, its struggle to obtain court approval of the SEC's settlement with Bank of America in February 2010 may signal that courts will now, at least in some cases, demand an acknowledged fact statement and accompanying evidentiary showing to support proposed settlements of federal court actions.

Any departure from the "neither admit nor deny" approach to civil settlements, by requiring defendants to acknowledge the accuracy of the facts alleged against them, is certain to make it significantly more difficult for the SEC to continue to settle the vast majority of its cases upon filing, as is currently the case. Defendants will generally be powerfully motivated to avoid such findings of fact, given well-founded concerns of precluding their ability to dispute those same facts in subsequent private litigation. These developments may be yet another factor suggesting that litigation will form an increasingly important part of the Commission's enforcement efforts.

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Iran Sanctions: The Search for Effective Measures

The U.S. Congress has sent to President Obama, and he has signed into law, the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010, a package of tough Iran sanctions that extend well beyond those the Administration shepherded through the UN Security Council, and those later adopted by the European Union. The new U.S. sanctions appear to avoid the potential for future clashes between the President and some U.S. allies on the one hand, and Congressional supporters of the new law on the other. The nub of that disagreement was the sweeping extraterritorial application of the sanctions as originally approved by the House of Representatives and the Senate and the limited flexibility those bills provided the President to soften their impact in certain cases.

The new law takes aim at companies, whether U.S.-based or not, that assist Iran in obtaining or developing its capacity to refine or otherwise obtain gasoline, and adds new potential punishments to those already on the books. U.S. financial institutions can now be prohibited from processing the foreign exchange, banking, and property transactions of businesses under sanction. Such companies will effectively be prohibited from acquiring federal contracts, and the government will publish semi-annual public reports listing companies that assist Iran in obtaining or refining gasoline. States and local jurisdictions may require that their public institutions divest securities of companies that invest in Iran's energy sector. Generally, the law makes the imposition of sanctions more certain and presidential waivers harder to justify.

Enactment of a new Iran sanctions law had long appeared inevitable. Candidate Obama argued for the adoption of "crippling" international sanctions against Iran, but as the Obama Administration began negotiating UN sanctions, it sought delay on the domestic front until those were approved. The Administration also sought to obtain flexibility to waive sanctions in certain situations, such as in the case of a company otherwise subject to sanctions that is from a country that is cooperating with the multilateral efforts to prevent Iran from acquiring nuclear weapons.

The Administration's concerns were similar to those voiced by previous administrations. Congress has in the past enacted sanctions with stiff penalties, but also provided the President discretion to waive those sanctions—partly to provide the President with some degree of flexibility, and partly to avoid charges that Congress was imposing excessive restrictions on the President's constitutional powers. While waiver provisions do allow a president to blunt the impact of sanctions in particular cases, they nonetheless can force a president to make sometimes difficult public certifications in order to preserve the flexibility that every president feels is required to conduct diplomacy, secure international cooperation, and maneuver in the face of difficult security challenges.

The prior Iran Sanctions Act of 1996 illustrated the nature of the problem. Sanctions against companies violating its investment provisions have been imposed only once, in 1998, and were then promptly waived. President Clinton found that a combination of European outrage at even a single exercise of extraterritorial sanctions, along with promises of cooperation from U.S. allies, provided sufficient reason not to impose the law's penalties. President Clinton took similar action in the face of European outrage over extraterritorial provisions of a Cuba sanctions law. Presidents Bush and Obama have continued to issue such waivers.

The tough approach of the new Iran sanctions law reflects Congressional disappointment with this experience and a determination to "double down" by compensating for the perceived inadequacies of the new UN sanctions. Yet, in the end, Congress also heeded President Obama's arguments for flexibility. The resulting key elements of the new law are as follows:

- **Even after changes that softened the wide scope of the bills originally adopted by each house, the new law remains an aggressive assertion of extraterritorial jurisdiction.** Sanctions may be levied against any foreign company that assists Iran directly and significantly to import gasoline or to maintain or enhance its domestic production of gasoline. Specifically covered are acts facilitating the shipment of gasoline to Iran by providing transportation, financing, brokering, insurance, reinsurance, or underwriting services.
- **The new sanctions are far reaching and punitive, but less so than originally proposed.** They apply to companies that knowingly invest in Iran's gasoline refining capacity or provide services to import gasoline. Gone is the provision found in the House bill that would have applied sanctions to a corporate parent with mere knowledge of the sanctionable acts of a subsidiary.
- **The new sanctions seek to end the current executive branch policy of "slow rolling" the enforcement of Iran sanctions.** Semi-annual regular reports to Congress must describe each investigation of a prohibited investment in Iranian capabilities to refine or otherwise obtain gasoline. Administration discretion in launching such investigations is eliminated unless the President certifies that there has been a substantial reduction of such activities during the period covered by a report, or issues a waiver. The clear intent of this and other required reports is to increase the chances that foreign company activity will be investigated and sanctioned.
- **The other side of this coin is the concept of "name and shame" found in the new law.** Semi-annual public reports will be required identifying any company investing in an energy related partnership in Iran. These reports would both inform the application of sanctions (including the loss of government contracting eligibility) as well as expose an investing company to U.S. public reproach such that, even if it escaped the reach of sanctions (such as through a waiver), it would be branded as having helped Iran to resist international pressure to relinquish its pursuit of a nuclear weapons capability. This in turn could encourage state and local disinvestment in the company's securities.
- **The Administration won the argument that broad presidential waivers were required,** that, for example, sanctioning Chinese or Russian companies, when their governments cooperation had been crucial to adoption of new UN sanctions, would be counter productive. Thus, the new law allows a president to waive sanctions against any company if he certifies to Congress that the company's government is cooperating in multilateral efforts to prevent Iran from acquiring or developing chemical, biological or nuclear weapons, or destabilizing numbers or types of conventional weapons. Such waivers must be made on a case by case basis, not by the blanket waiver the Administration proposed, and notice of a waiver must be made before it goes into effect, thus permitting a Congressional attempt to overturn it by subsequent legislation.

The question remains whether enforcement of the new sanctions will match the powers to impose them. As a Senator and as a candidate, President Obama spoke out clearly in favor of cutting off gasoline supplies to Iran as a way of pressuring the regime. This suggests that the President may not be inclined to insulate foreign companies from the reach of sanctions relating to Iranian acquisition of refined petroleum, especially in a climate in which he and his party are the target of partisan criticism for failing to be "tough" on national security matters.

Arguing in favor of additional presidential waivers is past history. Application of tough Iran sanctions already on the books has been minimal. Predictable foreign reaction to their broad extraterritorial application may be strong. If the Administration believes, as it has said publicly, that the most effective forms of Iranian sanctions are those directed at businesses that provide support to the Iranian Revolutionary Guard, a broad waiver policy may be its likely reaction to new extraterritorial sanctions focused on gasoline.

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Foreign Corrupt Practices Act: The Crackdown Intensifies

Enforcement of the Foreign Corrupt Practices Act (FCPA) continued to intensify over the first half of 2010, with every indication that this trend may be leading to a qualitative change in the nature of U.S. efforts to address official corruption abroad.

More cases, big price tags. As anticipated, the pace of enforcement activity continued to be strong, with many new investigations, indictments, and settlements. As promised by U.S. authorities, a larger proportion of these matters involved individuals and criminal charges. Cases were brought against very large and very small companies, in a variety of industries. Many of the larger cases carried very substantial fines and disgorgements, with the three largest at approximately $40 million (Innospec), $90 million (Daimler), and $400 million (BAE). At least two more $100 million cases are expected to be resolved before the end of the year.

Increasing international cooperation. An increasing number of FCPA cases reflected the assistance of non-U.S. authorities in gathering evidence of anticorruption violations. More significantly, the United Kingdom appears ready to emerge as a serious force in its own right. Even in advance of the effectiveness of the United Kingdom's new Bribery Act (discussed elsewhere in this Report), UK authorities showed an unprecedented level of initiative in pursuing anticorruption actions, and in two cases resolved this year (Innospec and BAE), pursued their own charges under UK law, participating alongside U.S. authorities in settlement discussions, and collecting a substantial portion of the settlement funds. Anticorruption enforcement in a number of other countries, including Germany and Russia, also became more active.

Bribery as a variant of organized crime? The key developments thus far in 2010 indicate that U.S. authorities appear to view FCPA violations as among the most serious forms of criminal conduct. For some time now, DOJ and SEC officials have been describing FCPA enforcement as a "top" priority. Over the past six months, these statements have taken on new meaning, as federal authorities investigating potential FCPA violations began to use the types of very aggressive investigative tactics ordinarily reserved for narcotics and organized crime cases.

- **Sting operations.** Less than three weeks into the new year, an FBI sting operation culminated in mass arrests at a Las Vegas gun show, with twenty-two individuals indicted on FCPA-related charges. Federal agents posed as representatives of an African defense minister soliciting bids to provide uniforms and other equipment for the country's presidential guard.
- **Use of informants and grants of immunity**. Early in 2010, the SEC announced that its investigators will now use methods customarily employed by criminal prosecutors, such as paying informants and offering immunity, in its own enforcement actions. The head of the SEC's Enforcement Division, himself a former criminal prosecutor, called this a potential "game changer."
- **Wiretaps**. In late 2009, federal authorities revealed their use of wiretaps in the Galleon insider trading case, and there is no reason to believe that these will not be used in the context of FCPA investigations.
- **Link to the fight against terrorism.** Rhetoric from federal officials about the importance of FCPA enforcement became white hot. In a series of coordinated statements, officials expressly linked the fight against corruption to the most central issues of national security, characterizing corrupt payments as a source of funding for terrorist activities, alongside money laundering, arms sales, and drug trafficking.

Businesses engaged in international commerce face ever-increasing risks from improper payments made by corporate personnel, or by intermediaries acting on the company's behalf. These risks are particularly acute because of the potential for liability notwithstanding actual knowledge or authorization of an improper payment.

Even though no organization can prevent every unauthorized action by its personnel or by third parties acting on the company's behalf, the risks of legal liability can be significantly reduced through a well-designed FCPA compliance program. Although U.S. law does not expressly require companies to have an FCPA compliance program, in practice U.S. law enforcement policy creates powerful incentives for every company involved in international commerce to take meaningful steps to prevent improper payments. For those that do so, the consequences of a violation, if one occurs, are likely to be less severe: penalties may be lessened and, in some cases, prosecution of the company may be avoided altogether. By contrast, the failure to have a program may exacerbate the consequences of any violation that comes to the attention of the authorities.

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U.S. Supreme Court: Mixed Results for the Business Community

This term of U.S. Supreme Court decisions brought mixed results for the business community. The most-watched decision, *Citizens United v. Federal Election Commission*, invalidated on First Amendment grounds federal restrictions on campaign expenditures by corporations. The 5-4 ruling did not settle all issues regarding corporations and political spending. For example, it left unanswered the rights of foreign corporations doing business in the United States and whether limits on corporate donations to candidates, as opposed to expenditures, are constitutional. In addition to setting the stage for corporations to play a far greater direct role in presidential and congressional elections, the decision is also noteworthy because it broadly affirms that corporations are "persons" entitled to invoke constitutional protections.

Several decisions will likely increase business litigation. *Merck & Co. v. Reynolds* held that the statute of limitations for federal securities fraud claims does not begin to run until a plaintiff learns (or should have learned) not only of the underlying facts of the fraud, but also of the corporation's scienter, or intent to commit fraud. Adopting a rule more liberal than that in most appeals courts, the Court held the plaintiff must have "inquiry notice" (actual notice or notice that reasonable inquiry would have given) of all of the elements of fraud, including scienter. And in *American Needle v. NFL* the Court decided in favor of an antitrust plaintiff for the first time in nearly 20 years, holding that a joint venture must be considered concerted activity of its members when it joins together formerly independent economic decision-makers. This will expand the antitrust analysis of many ventures even when they involve cooperation necessary to produce a product or service, though the Court stated that in such cases analysis could often be concluded quickly.

Other opinions considered where and in what kinds of proceedings businesses could be sued. The Court discussed the burdens of class-action litigation when it held in *Stolt-Nielsen, S.A. v. AnimalFeeds Int'l Corp.* that class arbitrations may not be imposed on parties that have not expressly agreed to them. Unlike bilateral arbitrations, class disputes involve many more parties and potentially higher damages, and can affect privacy restrictions. Recognizing that its decisions affect the international business community, the Court noted that "the prospect of a class action in a maritime arbitration would be 'quite foreign' to overseas shipping executives and charterers." However, in *Shady Grove Orthopedic Assocs v. Allstate*, the Court held that a state statute that prohibited class actions to seek statutory penalties could not override the federal rule permitting them in federal courts.

Many claims proceed in federal court not because a federal constitutional or statutory claim is asserted, but because the plaintiffs and defendants are citizens of different states (diversity of citizenship). A corporation is a citizen of the state in which it is incorporated and the state in which it has its principal place of business. Adding certainty to this determination, in *Hertz Corporation v. Friend*, the Court held that a corporation's principal place of business is in the single state where its "high level officers direct, control, and coordinate the corporation's activities" (its "nerve center") and not the state where it has the most "substantial" or "significant" operations.

The Court made protection of confidential or privileged material potentially more difficult in *Mohawk Industries, Inc. v. Carpenter*. A party may generally appeal only from the final order or judgment of a federal trial court. Federal appeals courts were divided about whether

orders requiring disclosure of allegedly privileged material could be immediately appealed as orders "collateral" to a final judgment, since any disclosure of privileged information would be effectively irrevocable and separate from the merits of the litigation. Justice Sotomayor's first opinion for the Court held that such disclosure orders are not immediately appealable, and that parties have to pursue less attractive options to obtain review, such as turning over the privileged matter and trying to reverse the decision only after appeal from the final judgment, or accepting sanctions or a contempt order to get the issue before the appeals court. Despite numerous requests to hear the case, the Court declined to review *Textron v. United States*, which rejected work product protection for tax accrual workpapers containing assessments of potential tax liability.

In *Jones v. Harris Associates*, the Court addressed what a mutual fund shareholder must prove to make out a claim under Section 36(b) of the Investment Company Act of 1940 that the fund's investment adviser breached its fiduciary duty by charging an excessive fee. The Court held that the Second Circuit's opinion in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), sets out the proper standard. Under *Gartenberg*, Section 36(b) is violated when advisers' fees are "so disproportionately large" that they "bear no reasonable relationship to the services rendered." Each of these opinions can be found on the Court's website[1].

In a closely-watched case challenging the constitutionality of the Accounting Review Board established by the Sarbanes-Oxley Act, the Supreme Court in *Free Enterprise Fund v. Public Company Accounting Overisight Board*, agreed that the Board violated separation of powers principles because its members were too independent of the President. Although the Supreme Court thus confirmed Constitutional constraints on Congress' power to insulate an agency's officers from Presidential control, the Court went on to fix problem itself by declaring that the Board would be removable at will by the SEC, thus eliminating one of the layers of "for cause" protection between the President and the Board. The decision thus has little impact on administration of Sarbanes-Oxley. The Court also made clear that its ruling did not extend to other Executive Branch personnel commonly thought of as having a degree of independence, such as senior civil service employees or administrative law judges.

In *Bilski v. Kappos*, the Court considered what innovations may be patented. The petitioners sought to patent a business method for calculating and evening out risk related to rising and falling prices of raw materials. The Federal Circuit held that the idea was not patentable because, for a process to gain patent protection, it must be tied to a particular machine or apparatus or it must transform a particular article into a different state or thing. The Supreme Court rejected the Federal Circuit's test. Writing for a 5-4 majority, Justice Kennedy explained that the test for a patentable process is not as narrow as the Federal Circuit's test suggested. The Court's opinion offers little guidance about what should be the proper test for patentability of a process, but it importantly declined to reject categorically the idea that a business method could be patented (a position the four concurring justices advocated).

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[1] http://www.supremecourt.gov/opinions/slipopinions.aspx

Government Litigation: Developments with the FDIC, Experts, and Takings

Looking to the remainder of 2010, private parties' litigation with the U.S. federal and state governments will emphasize increased litigation with the Federal Deposit Insurance Corporation ("FDIC"), and further developments related to expert testimony. A recent Supreme Court decision touching on "judicial takings" concepts may also lead to an increase in such claims at the state and federal level.

Increased FDIC Litigation

We anticipate that the FDIC will become more active in litigation across the United States as a result of the FDIC's closure of 78 insolvent banks in the first five months of 2010. Those seizures are in addition to the many institutions the FDIC already closed in 2008 and 2009. As with the savings and loan crisis of the late 1980s and early 1990s, we expect a corresponding increase in investigations as banks continue to fail, and an increase in litigation as current FDIC investigations are completed. The FDIC's increasing number of bank seizures also increases the likelihood of the FDIC bringing receivership litigation against third parties, as well as against the directors and officers of the failed banks (often known as "D&O litigation"). The FDIC often takes a year or more to determine whether to pursue such litigation with respect to a particular institution, so increases in third party and D&O litigation this year will likely be related to the seizures from 2008 and 2009.

This litigation increase will also likely drive developments in the case law regarding the FDIC's statutory powers. When the FDIC becomes the receiver of a bank, statutes enable the FDIC to conduct the insolvent bank's business and take any actions it deems necessary to rehabilitate or liquidate the insolvent bank. As receiver, the FDIC is also able to investigate possible claims against third parties on behalf of the bank, as well as claims against officers and directors of the institution. As part of this investigatory authority, the FDIC has the power to take depositions and issue subpoenas relating to any claim by or against the institution. Notably, the statute does not limit the scope of this subpoena power, which raises the possibility of the FDIC seeking far-reaching and burdensome subpoenas and depositions in the course of investigations. Much of the legal precedent discussing the FDIC's powers dates back to the prior savings and loan crisis. At the time, courts were reluctant to limit the FDIC's powers, and upheld the FDIC's claims of relevance so long as the agency was "not obviously wrong." Where the FDIC was able to establish relevance, the subpoenaed party then had the burden to establish that the request was unreasonable, such as where a subpoena was unduly burdensome, or sought information already in the possession of the agency.

Because the main body of legal precedent addressing the powers of the FDIC dates back to the earlier savings and loan crisis, there are likely to be new and noteworthy decisions with respect to interpretations of the FDIC's investigatory powers. In particular, the case law that addressed the scope of the FDIC's powers developed well before the widespread use of electronic record keeping and the changes to the Federal Rules of Civil Procedure in 2006 that addressed Electronically Stored Information ("ESI"). Those changes, such as revisions to Rule 26 and Rule 37, established certain "safe harbor" provisions and other protections against production of ESI that is not reasonably accessible, or that was destroyed as part of the routine operation of an electronic information system. Given the practical issues raised by the current prevalence of electronic records, and the corresponding complexity and burden of modern ESI production, courts are likely to address demands to limit the otherwise expansive scope of FDIC investigatory powers to the parameters set forth in the revised Federal Rules of Civil Procedure. Moreover, going forward, counsel must be vigilant and prepared to challenge the FDIC when it is acting outside the scope of the Federal Rules of Civil Procedure.

Evidentiary Developments Regarding Lost Profits and Financial Performance

Proving lost profits is an important element of damages in many suits with the government and, as a more general matter, evidence of a company's financial performance is often a key aspect of litigation with the government. Evidence of lost profits and financial performance is typically established through the use of an expert witness qualified at a hearing under standards established in case law. A recent Fifth Circuit case highlights the manner in which fact witnesses personally familiar with an injured business may present such evidence without the need for a full hearing under this process.

In *Meaux Surface Protection, Inc. v. Fogleman*, (5th Cir. May 17, 2010), the United States Court of Appeals for the Fifth Circuit upheld a trial court's acceptance of the testimony of a Chief Financial Officer ("CFO") as a fact witness with respect to lost profits. The court held that such an approach was permissible because the CFO had become "intimately familiar" with the subsidiary's financial performance through accounting and budgeting data regularly transmitted to the parent corporation from the subsidiary. In so

holding, the court rejected defendant's argument that it was ambushed by the use of a fact witness to testify about lost profits, and the court noted that the CFO had been properly designated in the pretrial order as a fact or lay opinion witness "familiar with the financial damages sustained" by the plaintiff subsidiary. The result of this holding is that the heightened requirements for an expert witness were not implicated. Nor did the appeals court disturb the trial court's reasoning that any lack of specificity or detail in the CFO's familiarity with the day-to-day operations of the subsidiary simply went to the weight the jury could give the testimony, rather than its overall admissibility.

This *Meaux* case demonstrates the manner in which fact witnesses with personal knowledge of the company's operations and profitability may provide the necessary evidence on a company's financial performance and claims of lost profits. A litigant with the government can use this developing law developing to provide flexibility to its proofs and lower the costs of litigation, providing a tactical benefit that can strengthen a litigant's hand in disputes with the government.

Sowing the Seeds for Future Judicial Takings Claims

On June 17, 2010, the Supreme Court issued its decision in *Stop the Beach Renourishment, Inc. v. Florida Department of Environmental Protection, et al.*, No. 08-1151, a case previously highlighted in our prior report, 2010: The Year Ahead, due to its potential for formally establishing the concept of a "judicial taking." In that case, beachfront landowners challenged a Florida Supreme Court decision holding that a state beach restoration project that added sand to damaged private beaches created a state-owned public beachfront. The petitioners claimed that the Florida decision itself constituted a "judicial taking" of their property because it was, they argued, a sudden and dramatic change in state law that was not predictable from past precedents.

In an 8-0 decision, delivered by Justice Scalia, the Supreme Court held that the state court decision did not contravene existing Florida law, and therefore did not violate the Fifth and Fourteenth Amendments. The Justices effectively split 4-4, however, on the larger question of whether there can be such a thing as a "judicial takings" claim. (Justice Stevens did not participate due to his ownership of potentially affected property in Florida). A close analysis of the decision, however, suggests that the Court is growing more hospitable to the concept of judicial takings. Portions of the decision authored by Justice Scalia and joined in by Justices Roberts, Thomas, and Alito said that the Takings Clause of the Constitution is concerned only with the act of taking, not with which branch of government or which type of governmental actor actually performs the taking. Justice Scalia reasoned that Supreme Court precedent provides "no support for the proposition that takings effected by the judicial branch are entitled to special treatment, and in fact suggest the contrary." Nevertheless, Justice Scalia was not swayed by petitioners' reliance upon an "unpredictability test," noting that judicial decisions may be unpredictable, yet still correct, or that they may be predictable and based on past precedent, yet still constitute a taking.

In separate, parallel concurrences, Justices Kennedy and Breyer, joined by Justices Sotomayor and Ginsburg respectively, focused their concerns on the fact that the judicial takings issue did not need to be reached in this case because the underlying decision comported with Florida law. The concurrences identified various legal and practical issues with a potential judicial takings doctrine, including the risk that federal courts would become the arbiter of complex matters of state property law. Yet none of the four concurring Justices articulated an analysis that flatly prohibits a judicial takings doctrine, and their primary focus was that the nature and scope of any judicial takings doctrine is an issue for another day.

Although the retirement of Justice Stevens and the prospect of a new Justice on the Court adds uncertainty about future rulings in this area, the concepts and issues discussed in *Stop the Beach Renourishment* suggest that the Supreme Court is moving towards formally adopting some variation of a judicial takings doctrine.

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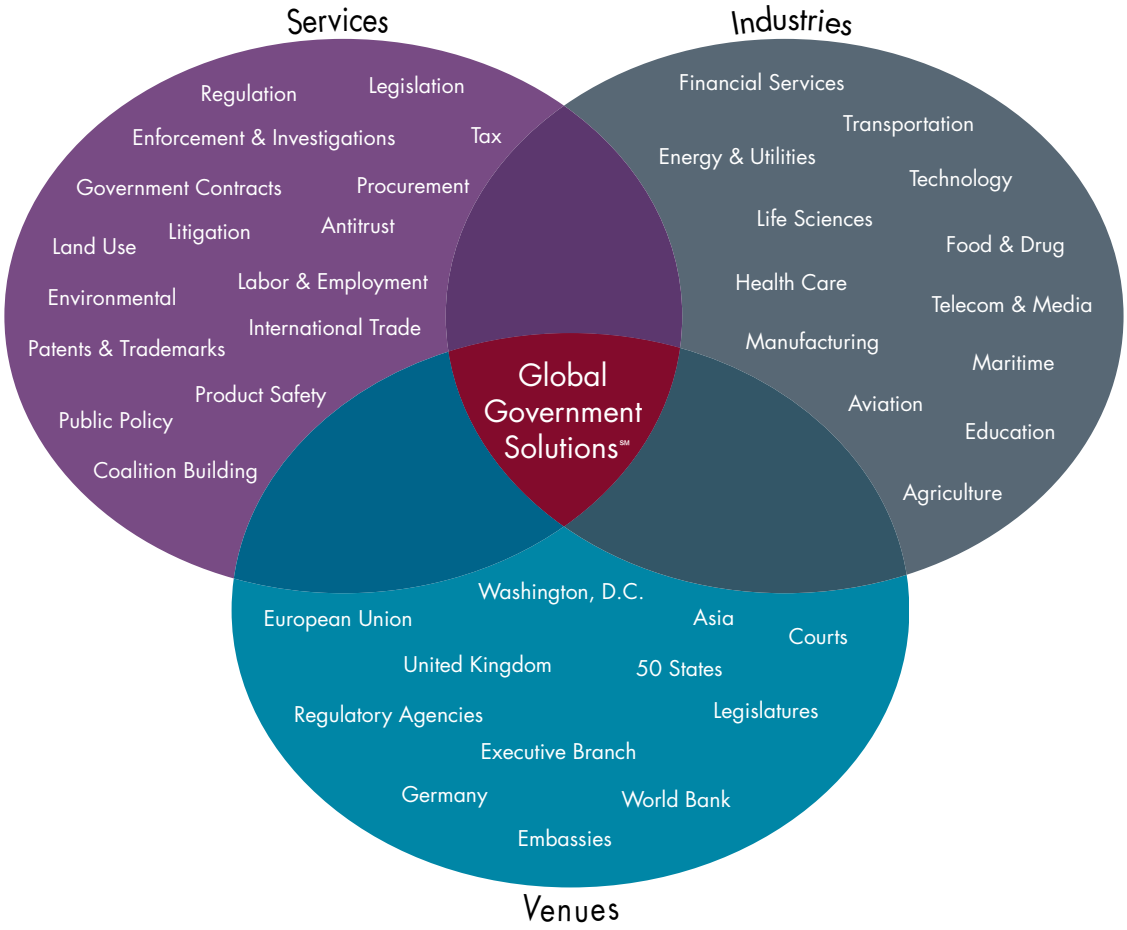

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