Recent Corporate Governance Developments in the US

Douglas M. Branson

W. Edward Sell Chair in law

University of Pittsburgh

Permanent Senior Fellow

University of Melbourne School of Law

Asset Securitization
AKA Structured Finance
AKA Asset Backed Securities (ASBs)

- A few hundred million in 1990; $2-3 trillion US by 2000.
- Example: home mortgages. Other candidates: commercial mortgages, home improvement loans, truck lease receipts, student loans, movie box office receipts, airplane lease payments, or any other cash flow stream (if backed by "paper").
- Transfer by a retailer to a wholesaler (Fannie Maw, Freddie Mac, Home Gold, Peoples Choice, Countrywide, Citigroup, B of A).

Offshore Placement (True Sale and Bankruptcy Remote)

- Creation of a special purpose entity (SPE or SPV).
- Transfer to the SPE (e.g., SLC - 9 one billion US transfers).
- Creation of tranches.
- Addition of credit enhancements (residuals, insurance, over collateralization, interest cutoffs for lower tranches) to help sell the deal.

The Final Enhancement – Credit Rating Agencies

- Rating by a credit agency: Moody's, Standard & Poors, Fitches, AM Best (Insurance), Royal Bank of Canada.
- Since the crash: Krolls.
- Inside the black box: 600 analysts at S & P emails ("we would rate a cow if we were paid to do so").
- Inconsistency of the Ratings: CDOs squared and CDOs cubed.
- Creation of tranches: an art rather than a science.

Sales to the Public

- Fixed income securities mainly to institutional investors (pubic employee pension funds, labor union retirement systems) and high net worth individuals.
- Hollowness of the ratings.
- Conflicts of interest: costs of the ratings and coziness with the big boys.
- Read the fine print: limitations to re-payment of principal and to public documents.

Deterioration in Quality

- Sub prime loans and alt-A mortgages.
- Ninja loans and liar loans.
- Pick-a-payment and teaser rates.
- Ticking time bombs: two year adjustable rate mortgages. Jingle foreclosures; underwater mortgages.
- Easy money and leverage: 42 to 1; 38 to I, 32 to I; 30 to 1.
- Use of Repo 105s to disguise leverage ($51 billion).

Beginning of the End

- Closure of mortgage origination subsidiaries.
- Bear Stearns closure of real estate hedge funds (July 2007).
- Inability to deleverage (always have an exit plan).
- April 2008: failure of Bear Stearns.
- September: receivership of Fannie and Freddie.
- Later in September: Lehman Brothers fails.
- Dow Jones Industrial Average declines from 0ver 14,000 (October 2006) to 6,500 (October 2008).

Distress Sales

- Countrywide and Merrill Lynch to B of A.
- Bear Stearns and Washington Mutual to JP Morgan.
- Only two of the "Big 5" left standing: Goldman Sachs and Morgan Stanley.
- Goldman and MS become banks for access to the Fed window.
- TARP: AIG (credit default swaps), big banks (which got bigger)(PNC).

Fallout from the Bailout Dodd-Frank of July, 2010

- "The Wall Street Reform and Consumer Protection Act of 2010."
- Creates the Financial Stability Council.
- Creates the Consumer Financial Protection Agency (CFPA).
- Centralized derivatives trading.
- Recommendations as to whether broker-dealers should be fiduciaries.
- Creation of a securities whistleblower bounty system.

Seven Corporate Governance "Reforms."

1. Say on Pay required of public companies.
2. Indirect requirement for a compensation (remuneration) committee.
3. Comparative compensation disclosures (compare with financial performance and with rank-and –file employees).
4. Additional compensation clawbacks (cf. original SOX clawback provisions (2002)).

Dodd-Frank: 3 More CG Provisions

5. Limited Shareholder Access to Management Proxy Solicitation.
6. Mandatory Disclosure re Separation of CEO and Board chair Positions.
7. Internal controls attestation (SOX 404) relief for smaller public companies).

The Newest "New Thing": JOBS ACT of 2012 (April 5, 2012)

- Jumpstart Our Business Startups (JOBS).
- Most noted is "Crowd Funding" ("Capital Raising Online While Deterring Fraud and Unethical Disclosure Act of 2012."
- Allows what amounts to a general solicitation (previously forbidden in exempt offerings) by "funding portals" or by registered broker-dealers.
- Can only dribble it out: $2000 or 5% of net worth or annual income for little people (under $100,000 per year).

Crowd Funding

- Can sell up to $100,000 to others (bigger men and women).
- Overall limitation is $1 million in a running 12 month period.
- A number of restrictions apply:

1. Insure that investors review information abut risk.
2. Portal must have an escrow or holdback on process until target amount has been raised.

3. Must provide 15c2-11 type information to investors.
4. Have resale restrictions of year duration.
5. Subject to “bad boy” disqualifications.

A number of portals have started up (Earlyshares.com, Crowdfunder, Crowdcube, Symbid, RelayFund, Grow VC, Peoples VC, Indieggogo, and SOMoLend) but SEC is dragging its feet in adopting implementing regulations, and crowdfunding has limited potential (author’s opinion).

More JOBS Act

Provisions for "emerging growth companies" (less than $1 billion in annual sales and less than 5 years out from IPO):

1. Relaxed proxy statement disclosure requirements (no comparative compensation, no selected financial information section etc.).
2. Expanded exemption from SOX 404 internal controls exemption.

3. Allows some gun jumping (broker-dealer research reports, test the waters pre-screening).
4. permits confidential reviews of draft registration statements.

At Last, Final Jobs Act

- Raises the potential 3(b) exemptive limit from $5 million to $50 million as the SEC allows. Requires an abbreviated registration-like procedure (Regulation A).
- Changes the SEA 12(g)definition to forestall corporations' entry into the SEC's continuous disclosure system ($10 million in assets and class of equity securities held by 2000 or more persons).

Reverse Mergers from the PRC

- Costs of a registered public offering in the US: $980,000.
- Costs of "going public by the back door": $80,000 (Zlotnick).
- Approximately 365 companies from China in last 2 years (Yanchu Gas).
- Alternative route to going public by the backdoor: companies from Canada (go public first over the Vancouver BC Stock Exchange).

How To.

1. Find a corporate shell (a dormant public company)(Boca Raton (Florida), Spokane Stock Exchange or Salt Lake City – gold, silver and uranium mining companies).
2. Purchase a numerical control interest (e.g., 51%, 60% or 70%)($40,000 US?).
3. Do a reverse merger (the foreign company as the survivor) including a name change.
4. File SEC Rule 15c2-11 information with various brokers.
5. Begin trading

Risks

1. Holdbacks by selling broker dealer or other shell vendor.
2. Pump and dump schemes.
3. Market manipulation (wash sales, matched orders)
4. Shell games.
5. Soft and inaccurate financial disclosure.

Addendum on Sarbanes-Oxley (July 2002)

1. Officer and director bar orders (unfitness to serve – ALJ rather than a federal district court).
2. Prohibitions on loans or arranging credit for public company officers or directors).
3. Near real time SEA of 1934 section 16 reporting.
4. Audit Committee Requirements (now mandatory, financial expert, all independent, hotline monitoring).
5. CEO and CFO quarterly certifications (SOX 302).

More Sarbanes-Oxley

6. Compensation clawbacks for "misconduct": all incentive based and equity compensation.

7. Mandatory codes of ethics for senior financial personnel.
8. Rotation of audit partner every 5 years.
9. One year revolving door prohibition on audit partner.
10. Auditing firms' registration with new Public Company Accounting Oversight Board.

SOX – Last 5 provisions

11. Creation of PCAOB as independent government owned corporation.
12. Mandatory separation of auditing and consulting services for accounting firms.
13. Attorney SOX 307 duty for intracorporate whistleblowing.
14. Umbrella protections for whistleblowers.
15. Amendment of bankruptcy law: no discharge for securities law judgments

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