

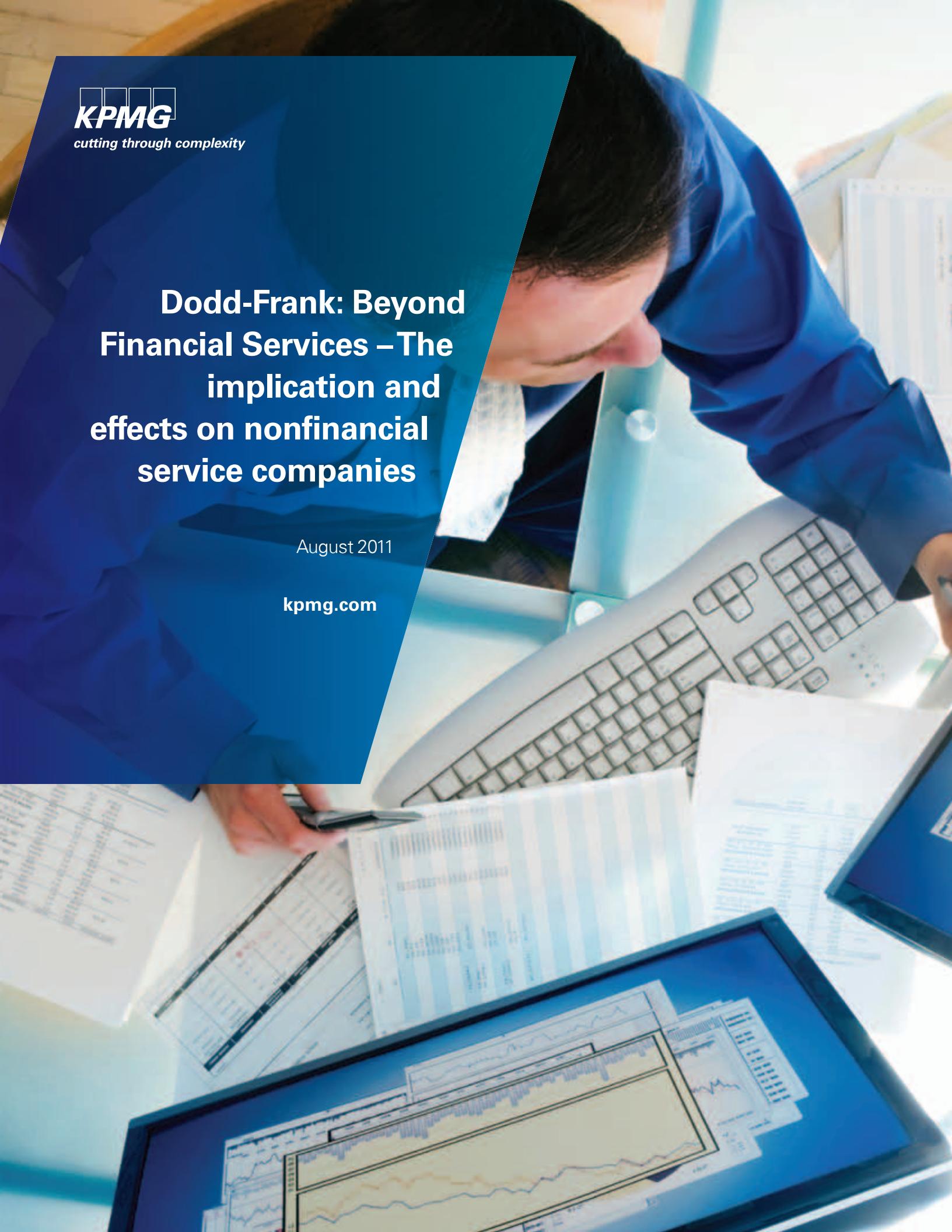


cutting through complexity

Dodd-Frank: Beyond Financial Services – The implication and effects on nonfinancial service companies

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Section 1: Introduction

While much of the conversation around the impact of The Dodd-Frank Wall Street Reform and Consumer Protection Act¹ ("Dodd-Frank" or the "Act") focuses on assuring the stability in the U.S. financial markets—mainly by regulating institutions deemed systemically important, the over-the-counter (OTC) derivatives market, investment advisers, and the enhancement of consumer protections—the sweeping legislation and accompanying rules contain numerous provisions intended to strengthen corporate accountability that will affect all U.S. public and many private companies.

The full impact of Dodd-Frank will not be known until all the required implementation rules are written. What is already known, however, demonstrates the Act's far-reaching impact on:

- Approximately all 8,500 banks across the United States
- Because of Title XV *Miscellaneous Provisions*, approximately 6,000 companies using certain minerals in their supply chain
- Many nonbank financial service companies
- All publicly traded companies, irrespective of industry due to governance reforms and new investor protections.

Although many financial service companies are developing strategies and processes to comply with the Act, it appears as though many non-financial service companies may not fully appreciate or understand how the legislation and its required rules will affect their businesses. Among the

issues of immediate concern are those dealing with whistleblower provisions, required disclosures relating to executive compensation, incentive compensation clawback requirements under certain conditions, and mine-safety disclosures.

Companies unaware of these and other powerful provisions of the Act risk being noncompliant, which may result in fines and penalties and damage to their corporate credibility and reputation.

This document is offered not only as a reminder of some of the key aspects of Dodd-Frank affecting nonfinancial services companies, but also as a starting point for a conversation about ways to evaluate and address possible vulnerabilities and risks facing these businesses.

¹ PUBLIC LAW 111 – 203, JULY 21, 2010,
AVAILABLE AT [HTTP://WWW.SEC.GOV/ABOUT/LAWS/WALLSTREETREFORM-CPA.PDF](http://WWW.SEC.GOV/ABOUT/LAWS/WALLSTREETREFORM-CPA.PDF)



Direct areas of the Dodd-Frank Act that affect nonfinancial service companies

Section 2: Miscellaneous provisions

Title XV comprises three key areas: Conflict Minerals, Mine Safety Disclosures, and Payments to Governments by Resource Extraction Issuers. In signing this section into law, it was the intent of the U.S. Congress to ensure industry transparency and give investors and citizens new tools to hold companies and governments accountable for their actions around selected corporate responsibility-type initiatives.

Section 1502 of the Act, known as the “conflict minerals” provision, may directly impact as many as half (roughly 6,000) of all U.S. publicly traded companies and perhaps thousands more suppliers not publicly listed but part of the supply chain. A Securities and Exchange Commission (SEC) issuer that uses so-called *conflict minerals* that are necessary to the functionality or production of a product manufactured, or contracted to be manufactured, by that issuer would be required to give investors additional disclosures in its periodic financial reports. Complying with the provisions of the proposed SEC rule would require an issuer to complete a three-step process:

1. Determine whether the issuer is subject to the Conflict Minerals Provision
2. Determine whether the conflict minerals originated in the Democratic Republic of Congo (DRC) or an adjoining country
3. Make the required disclosures and submit a Conflict Minerals Report to the SEC, if necessary.²

Companies that use conflict minerals, which include gold, wolframite, cassiterite, columbite-tantalite and their derivatives (such metals as tin, tungsten, and tantalum), are obliged to disclose whether the minerals are “necessary

to the functionality or production of a product manufactured.”³

Consequently, disclosure would be required in a company’s SEC filings if it is determined that the qualifying minerals it uses are sourced from the DRC or an adjoining country. The company would then be required to submit a Conflict Minerals Report, which would be subject to an independent audit. This requirement will impact a number of industries, from makers of jewelry, to cell phones, to aerospace, to auto parts, and many more. Management and boards are urged to thoroughly investigate how their businesses and their extended suppliers, vendors, distribution and/or joint venture partners are affected by the requirements. Boards of directors may consider asking management to report the progress on their findings and the next steps as a result of their findings.

Ultimately, many organizations will need to develop or update a strategy and put in place a plan that ensures compliance by examining applicable policies, procedures, and controls in their manufacturing processes, their supply-chain management procedures, and their compliance programs. There are no simple, off-the-shelf solutions; each organization faces unique circumstances as this will be an annual exercise.⁴

Section 1503 requires that mining companies disclose to investors certain information about mine safety and health standards. The SEC proposed rules to include information about mine safety and health standards in a company’s annual and quarterly reports filed with the SEC. Mining companies also would be required to file a Form 8-K with the SEC when they receive certain notices from the U.S. Labor Department’s Mine Safety and Health Administration (MSHA).

Companies that may be affected include any reporting company that operates or has a subsidiary that operates coal or other mines in the United States. This may generally include foreign private issuers (except as to Form 10-Q and Form 8-K disclosures) and smaller reporting companies.

The disclosure must include information about certain orders, violations, and citations regarding mine safety and health standards under U.S. Federal Mine Safety and Health Act of 1977 requirements, proposed assessments from the MSHA under the Mine Act, mining-related fatalities, and pending legal actions before MSHA.

The timing, including the effective date of final rules, is unclear; but companies should take the proposal into account in preparing their annual reports for the 2011 fiscal year.

Section 1504 requires all U.S. and foreign companies registered with the SEC to publicly report how much they pay governments for access to their oil, gas, and minerals. The disclosure must report payments made during the fiscal year covered by the report to any foreign government or the U.S. federal government for the purpose of the commercial development of oil, natural gas, or minerals.

The disclosure requirement applies to any reporting company that is a “resource extraction issuer,” defined as an issuer that is required to file an annual report with the SEC and that engages in the commercial development of oil, natural gas, or minerals. This may also include foreign private issuers and smaller reporting companies.

The provisions will apply beginning with annual reports filed for the first full fiscal year ending after the rule is finalized.

² KPMG’s Defining Issues®, Issue No 10-55, SEC Proposes Rules for Disclosures about Conflict Minerals and Extractive Industry Payments, December 2010.

³ The Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 1502(p)(2)(B)

⁴ For more discussion on the impacts of DFA on the strategic business planning process see: *Public Policy Alert: Legislative complexity challenges traditional business and compliance strategies*, KPMG, LLP, July 2011

Section 3: Corporate governance and executive compensation

Dodd-Frank's corporate governance provisions authorize the SEC to adopt proxy access rules and require disclosure regarding whether a public company has separated or combined the roles of chief executive officer and chairman of the board of directors. The SEC may issue rules permitting the use by shareholders of proxy solicitation materials supplied by an issuer for the purpose of nominating individuals or membership on the board of directors of the issuer.

The provisions related to Corporate Governance include:

■ **Say on Pay Vote** (Section 951) – Not less frequently than once every three years, at any annual or other meeting of shareholders held six months after the date of enactment of the Act where the proxy statement or such meeting is required to disclose compensation, companies must provide their shareholders with a nonbinding shareholder vote on whether to approve the compensation of executives. Shareholders will also be provided with a nonbinding shareholder vote, at least once every six years, to determine whether this vote should be held every one, two, or three years.

■ **Golden Parachute Compensation** (Section 951) – In any proxy or consent solicitation for a meeting of shareholders occurring six months after the date of enactment of the Act where shareholders are asked

to approve an M&A transaction, companies must provide their shareholders with a nonbinding shareholder vote on whether to approve payments to any named executive officer in connection with such M&A transaction.

Final rules for Section 951, Say on Pay Vote and Golden Parachute Compensation, were adopted by the SEC on January 25, 2011.

■ **Broker Voting** (Section 957) – The listing exchanges must prohibit broker discretionary voting in connection with the election of directors, executive compensation, or any other significant matter, as determined by the SEC.

■ **Proxy Access** (Section 971) – Effective immediately, the SEC may issue rules permitting the use by shareholders of proxy solicitation materials supplied by an issuer for the purpose of nominating individuals or membership on the board of directors of the issuer.

■ **Retaining Compensation Consultants and Other Advisers** (Section 952) – The compensation committee of an issuer may, in its sole discretion, retain a compensation consultant, legal counsel, and other advisers. If the compensation committee retains an adviser, the compensation committee must be directly responsible for the

compensation and oversight of such adviser's work.

■ **Independence of Compensation Consultants and Other Advisers** – The SEC must identify factors that affect the independence of a compensation consultant, legal counsel, or other adviser to the compensation committee. The committee may only select such an adviser after taking into consideration those factors identified by the SEC.

■ **Disclosure** – In any proxy or consent solicitation for an annual meeting, or special meeting in lieu thereof, that is one year after enactment, each issuer must disclose in the proxy statement or consent material, in accordance with regulations of the SEC, whether its compensation committee retained a compensation consultant and whether the work raised any conflict of interest.

■ **Clawback** (Section 954) – The SEC must, by rule, direct national securities exchanges and associations to prohibit the listing of any security of an issuer that does not implement a policy providing (1) for disclosure of the issuer's policy on incentive-based compensation that is based on financial information, and (2) that the issuer will recover incentive



compensation paid to certain current or former executive officers in the event the issuer is required to prepare an accounting restatement due to the material noncompliance with any financial reporting requirements.

The provisions related to Executive Compensation Disclosure include:

■ Pay Versus Performance

(Section 956) – Federal financial regulators must jointly prescribe regulations to (1) require covered financial institutions to report the structures of all incentive-based compensation arrangements and (2) prohibit incentive-based payment arrangements that encourage inappropriate risks by providing employees, directors, or principal shareholders with excessive compensation or that could lead to material financial loss to the covered financial institution.

- **Internal Pay Equity** (Section 953) – Issuer to disclose in any proxy statement or consent solicitation for an annual meeting a clear description of any compensation required to be disclosed, including information that shows the relationship between executive compensation actually paid and the financial performance of the issuer. The SEC must also require disclosure of (1) the median annual total compensation of all employees, except the CEO; (2) the annual total compensation of the CEO; and (3) the ratio of the median employee annual total compensation to that of the CEO.
- **Hedging by Employees and Directors** (Section 955) – Companies will be required to disclose in their annual proxy statements whether employees or directors are permitted to purchase financial instruments

designed to hedge any decrease in the market value of equity securities they hold.

■ Disclosures regarding Chairman and CEO Positions (Section 972) –

Companies will also be required to discuss in their annual proxy statements why they have, or have not, separated the positions of chairman of the board and chief executive officer. Although the SEC delay in the rulemaking process could mean the rule will not go into effect until the beginning of 2012, some companies already are examining how they might strengthen their existing corporate governance and executive compensation policies and their disclosure practices. Pending the adoption of final listing rules by the national exchanges, companies will want to review their existing clawback policies and executive compensation agreements—as well as any new agreements.



Section 4: Investor protection and securities enforcement

Section 922, the Whistleblowing Provisions, extend beyond purely financial services companies to all publicly traded companies and establish comprehensive procedures through which corporate whistleblowers report information relating to corporate frauds, including breaches of securities laws, commodities law, or the Foreign Corrupt Practices Act (FCPA), to the SEC, the Department of Justice (DOJ), or the Commodities Futures Trading Commission (CFTC).

On May 25, 2011, the SEC approved in a 3–2 vote the final rule relating to corporate whistleblowers under Section 922.⁵ Perhaps the most significant change from former

whistleblowing provisions under Sarbanes-Oxley, False Claims Act, and the IRS provisions, is the financial incentive provided by the new rule to report to the SEC. The whistleblower may receive a financial award amounting to 10–30 percent of the resulting enforcement action penalties in excess of \$1 million. The final rule allows the SEC to consider a higher payment for whistleblowers who report internally first; failing to cooperate with internal compliance could result in a lower award. Additionally, whistleblowers can collect payment without reporting to the SEC at all, if the company subsequently passes along the information to the SEC.

As a result of this final rule, companies may need to reassess their current compliance programs. Promoting a culture of compliance and tone at the top—starting with the board of directors—continues to be of paramount importance, and companies should consider ways to encourage employees to report potential violations internally. This will allow companies the opportunity to investigate instances of potential misconduct, determine the extent of wrongdoing, address and correct any problems and, if applicable, self-report to the proper regulatory authorities and/or government enforcement agencies.

⁵ Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, File No.: S7-33-10, Release No. 34-64545



Section 5: OTC derivatives instruments

Title VII of the Act increases the Commodity Futures Trading Commission's (CFTC) regulatory authority over derivatives. In addition, the law gives the SEC authority over security-based derivatives and provides guidelines for addressing potential CFTC-SEC overlap issues, while also providing processes aimed at promoting consistency in approach across the two agencies. The law also relies on the CFTC and SEC to make rulings to clarify and interpret a number of critical issues, with the bulk of the new regulations to be written within a year of the law's enactment. There are a number of key provisions related to market clearing, definitions of market participants, reporting, and capital requirements that will potentially impact companies.

Definitions of market participants: The law specifically addresses the following types of derivative users: swap dealers, major swap participants (MSP), and

commercial end-users. In addition, it refers to the previous definition of eligible contract participants (ECP) from the Commodity Exchange Act.

- The law defines a swap dealer as an entity who "(i) holds itself as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account, or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps."⁶
- An MSP is anyone who maintains a substantial net position in swaps (excluding positions held for hedging purposes) or whose positions create substantial counterparty exposure that could potentially have serious adverse effects on the stability of the U.S. banking system or financial markets.
- Companies that use derivatives to hedge underlying exposures for commercial purposes only are deemed to be commercial end-users. However, the commercial end-user exemption only applies to nonfinancial entities, with the definition of financial entity including companies "predominantly engaged in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956."⁷ The activities listed in section 4(k) include "Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any State" and "Providing financial, investment, or economic advisory services, including advising an investment company (as defined in section 3 of the Investment Company Act of 1940)."
- An eligible contract participant is given specific meaning in Section 1a(12) of the Commodity Exchange Act and redesignated and amended by Sections 721(a)(9) and 741(b)(10) of the Act. In general, an ECP refers to a financial institution, insurance company, investment company, or commodity pool that enters into swaps for its own account. Designation as an ECP is subject to certain conditions, limitations, and potentially further determination by the CFTC or SEC. Broadly speaking, it appears that financial and noncommercial end-users will fall into the ECP category.



⁶ The Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 721, (49)(A)

⁷ The Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 723, (h)(7)(C)(i)(VIII)

Following requirements imposed by Title VII of the Act, federal regulators have issued proposed margin requirements for uncleared swaps. The margin requirements will impact certain swap dealers and major swap participants. Dodd-Frank requires many swaps that are currently executed in the OTC market to be cleared through derivatives clearing organizations. However, for those swaps that will continue to be transacted in the OTC market, the proposed margin requirements issued mark a significant departure from current practices. Specifically, with certain exceptions, including a limited exception for swaps entered into between nonfinancial end-users and nonbank swap dealers or major swap participants, market

participants would be required to post both initial margin and variation margin to their swap dealer and major swap participant counterparties.

The SEC has not yet issued proposed margin requirements for security-based swap dealers and major security-based swap participants that are not regulated by a Prudential Regulator.*

The Act will force participants to comply with more comprehensive and real-time regulatory reporting requirements for standardized and nonstandardized interest rate, currency, equity, credit, and other commodity swaps. This includes all cleared and uncleared trades regardless of the method of execution (e.g., executed on a swap execution

facility (SEF), designated contract market or exchange, or bilaterally negotiated). These proposed changes will generate a profound change to a firm's business practices, operational infrastructure, supervisory system, and governance model, making the current rigorous demands on the firm's operational infrastructure become even more critical to the success of the OTC derivatives regulatory reform business and to the regulatory compliance framework. Under the Act, some of these changes include:

- Building a comprehensive source of standardized reference data
- Establishing real-time trade and position reporting
- Enhancing transparency and liquidity.

The Act offers a comprehensive set of trade and position reporting requirements that will aim to increase transparency of the OTC derivative marketplace through the dissemination of real-time execution data and aggregation of position data by Swap Data Repositories.



* The "Prudential Regulators" include the Federal Reserve, Federal Deposit Insurance Corporation, Office of Comptroller of the Currency, Farm Credit Administration, and Federal Housing Finance Authority.

Section 6: Securitization

The securitization provisions of Dodd-Frank focus on “credit risk retention” that would require originators and securitizers of financial assets to retain a portion of the credit risk of securitized financial assets or, in more popular terms, to have “skin in the game.” In addition, the securitization provisions in the Act set forth disclosure requirements for the issuer and credit rating agencies who rate the issuer’s securities.

The securitization markets could be significantly affected by the recently proposed risk retention requirements for asset-backed securities. Six federal agencies jointly released a proposed rule⁸ on March 30 that would require sponsors of asset-backed securities to retain

at least five percent of the credit risk of the assets underlying the securities and would not permit sponsors to transfer or hedge that credit risk.

The Act provides for regulations to require securitizers to disclose, for each tranche or class of security, information regarding the assets backing that security. Companies would need to reevaluate their current securitization programs in light of this new proposed rule. This could require certain companies to look at their underwriting of certain products, perhaps to meet the final definition of Qualified Residential Mortgage in order to participate in securitization activities without impacting profitability.

As companies reevaluate their securitization programs, they may consider the following:

- Understand the accounting and tax implications as a result of the five percent credit risk retention for future securitization vehicles.
- Evaluate alternative sources of funding if the five percent credit risk retention provisions do not allow certain companies access to the securitization market.



⁸ The federal banking and housing agencies include the Office of the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Department of Housing and Urban Development, and the SEC. The proposed rule, Credit Risk Retention, is available at www.sec.gov.

Section 7: Indirect areas of Dodd-Frank that affect nonfinancial service companies

Credit rating agencies

The Dodd-Frank Act creates a new regulatory structure to oversee credit ratings agencies: The Office of Credit Ratings. This office is to be established by the SEC with the purposes of protecting users of credit ratings, promoting accuracy in credit ratings, and ensuring that ratings are not influenced by conflicts of interest. This office will be required to audit each Nationally Recognized Statistical Rating Organization (NRSRO) annually and make its inspection reports publicly available.

The Act requires each NRSRO to ensure that: (i) its credit rating procedures are in compliance with standards approved by its senior credit officer or board of directors, (ii) material changes to credit rating procedures and methodologies are applied consistently to all credit ratings, and (iii) credit rating users are notified of any such changes. NRSROs will be required to publicly disclose their initial ratings and any changes to such ratings. This is intended to make it easier for users of credit ratings to evaluate the accuracy of those ratings and benchmark to ratings performance by other NRSROs. Additionally, each NRSRO will be required to disclose the extent to which third-party due diligence services have been used in the credit rating process. Any such third party

providing due diligence services to an NRSRO must certify in writing that it has conducted a thorough review of the relevant data and other necessary information. NRSROs are also required to consider information received from credible outside sources when determining credit ratings.

These regulations may have an impact on public companies that use credit ratings in their periodic filings with the SEC.

The Dodd-Frank Act modifies the "state of mind" requirement for a private action to knowingly or recklessly failed (i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or (ii) to obtain reasonable verification of such factual elements" from a competent party independent of the issuer or underwriter.⁹

Under Dodd-Frank the same enforcement and penalty provisions applied to registered securities analysts and public accounting firms will apply to NRSRO statements. The Act also clarifies that the ratings are not forward-looking statements for purposes of the Exchange Act's Section 21E safe harbor.

In removing the protection from "expert" liability that NRSROs enjoyed

under the Securities Act of 1933, the Dodd-Frank Act opens NRSROs up to potential liability. NRSROs are now held liable for material misstatements or omissions in their ratings that are used in registration statements. This change will require issuers to gain permission from NRSROs to use their ratings in a registration statement. This increase in potential liability has already had an effect. Soon after the bill was passed, three major NRSROs said they would not provide permission for their ratings to be used in registration statements. This, in essence, froze some new issuance of bonds as some types of assets—notably asset-backed securities—are required to include a rating. The SEC has temporarily addressed this issue by granting a six-month exemption that allows bond sales to proceed without ratings.

The SEC has yet to fully staff a new office to oversee credit-rating agencies. The SEC also has indefinitely tabled a provision that holds credit-rating agencies legally liable for their ratings if they are included in securities offering documents.

Impact of regulation on end-users

Perhaps one of the biggest unintended consequences of the Act could be the cost of compliance and limitation on certain business activities that financial

⁹ The Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 933. STATE OF MIND IN PRIVATE ACTIONS



services institutions are facing, resulting in lost revenue. Some areas impacting financial service institutions will be:

- New capital, liquidity requirements, and leverage ratios
- The Volcker rule, which prohibits banking entities from conducting proprietary trading and other certain investment activities
- Consumer Financial Protection Bureau, a new organization created to supervise and enforce consumer protection laws
- Interchange fee, a new rule recently finalized, which limits the amount one bank can charge another bank for a credit card transaction

- OTC derivative regulation with the creation of clearing houses and exchange, new and incremental reporting requirements
- Overall governance and reporting requirements described above.

Financial institutions will, as a result of implementing these and other provisions of Dodd-Frank, incur perhaps significant implementation costs and loss of business revenue. It is anticipated that the pricing of loan products, fees at ATMs, managing of clearing houses, and other revenue producing strategies will be developed to cover the lost revenues and potentially recoup the implementation costs. These costs would most likely be passed on to the end-users of financial services products.

Resources

Contact FS Regulatory Center of Excellence:
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Public Policy Alerts
<http://www.kpmg.com/us/en/issuesandinsights/articlespublications/public-policy-alerts/pages/default.aspx>

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