Dodd-Frank Financial Reform Legislation Contains Many Little-Noticed Provisions that Enhance SEC Enforcement Powers

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Many provisions of this legislation have been widely discussed and have been the subject of intense public debate. Less attention has been paid to a host of provisions that significantly enhance SEC enforcement powers.

Whistleblower Compensation and Protection

On March 29, 2010, the SEC's Inspector General issued a report on the SEC's program to compensate whistleblowers, a program designed to provide a financial incentive for persons to report violations of law to the SEC. According to the report, although the SEC has had the authority to reward whistleblowers in insider trading cases since 1988, the SEC has only paid out $159,537 to five whistleblowers. (This total changed radically when, on July 23, 2010, the SEC paid $1 million to a husband and wife who allegedly provided information that led to the Pequot insider trading case. *SEC v. Pequot Capital Mgmt., Inc., et al., SEC Litigation Release No. 21601* (July 23, 2010). The Inspector General's report alleges that the SEC's failure to compensate whistleblowers more frequently arose from the SEC's failure to adequately publicize its whistleblower compensation program and lack of awareness and support for the program within the SEC.

Dodd-Frank materially changes the SEC's whistleblower program in a manner that provides substantial incentives for whistleblowers to come forward and for the SEC to foster such reports. Under Dodd-Frank, whistleblowers can now be compensated for tips that lead to any type of SEC enforcement action, not just insider trading charges, where the amount of monetary sanction (penalties plus disgorgement) exceeds $1 million. Second, the maximum amount a whistleblower can receive has been raised to 30 percent of the monetary compensation from the previous cap of 10 percent and seems to contemplate a minimum award that a whistleblower can receive – 10 percent of the monetary sanction obtained in the SEC action. Third, the SEC's process for reviewing claims by whistleblowers is made subject to express appellate court review and annual reports to Congress, apparently in an effort to encourage the SEC to reward whistleblowers more frequently. Section 924 of Dodd-Frank also requires the SEC to create a separate office to process claims by whistleblowers and to adopt rules by late April 2011 to implement the whistleblower compensation system. Finally, protections for whistleblowers from retaliation are strengthened. Whistleblowers now have an express private right of action against employers who retaliate against them, with remedies including reinstatement and two times back pay. Protections for whistleblowers in the Sarbanes-Oxley Act are expanded to cover employees of subsidiaries of public companies.

Collectively, these changes may well encourage the SEC to reward whistleblowers more frequently. The recent Pequot award no doubt demonstrates the SEC's resolve to compensate whistleblowers more generously. This effort should complement the "cooperation initiative" the SEC announced in January 2010, under which individuals who report violations of law to the SEC are offered a variety of inducements to reward such conduct. The "cooperation initiative" together with the expanded program to compensate whistleblowers may significantly increase the instances in which employees of organizations report alleged misconduct within their firms to the SEC.

In addition to these whistleblower provisions, Section 934 of Dodd-Frank requires credit rating agencies to report information about possible misconduct at an issuer of securities to the SEC. This is the first instance in which a regulated entity is required to report possible misconduct to the SEC and may serve as model for future legislation that applies this requirement to other regulated entities.

Clarification of Control Person Liability

The SEC recently has indicated that it may rely more frequently on control person liability in its enforcement actions, and has brought two settled enforcement actions against executives based solely on control person liability. *See SEC v. Nature's Sunshine Prods., et al., SEC Litigation Release No. 21162* (July 31, 2009); *SEC v. Maurice R. Greenberg and Howard I. Smith, SEC Litigation Release No. 21170* (Aug. 6, 2009). However, the U.S. Courts of Appeal are split over whether the SEC can maintain an enforcement action for control person liability under section 20(a) of the Exchange Act. For example, both the Second and Third Circuits have held that the SEC can maintain an enforcement action under Section 20(a). *SEC v. First Jersey Secs., Inc.,* 101 F.3d 1450, 1472 (2d Cir. 1996); *SEC v. J.W. Barclay & Co., Inc.*, 442 F.3d 834, 842 (3rd Cir. 2006). The Sixth Circuit, however, appears to have issued conflicting opinions on the issue. *Compare SEC v. Coffey*, 493 F.2d 1304, 1318 (6th Cir. 1974) (holding that Section 20(a) may not be relied upon by the SEC in an injunctive enforcement action), *with United States v. Smith*, 208 Fed. Appx. 402 (6th Cir. 2006) (affirming summary judgment against the defendant under Section 20(a) without substantial discussion).

Section 929O(c) of Dodd-Frank resolves this split in the Circuits by clarifying that the SEC can allege control person liability in its enforcement actions.

Control person liability is similar to supervisory liability for regulated entities. Generally, individual supervisors and parent companies can be held liable as control persons, subject to the good faith defense that is akin to the adequate supervision defense from supervisory liability.

The SEC defines "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. §230.405 (2005). In *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 85 (1st Cir. 2002), the First Circuit held that the alleged controlling person must not only have the general power to control the company, but also must exercise control over the company. *See also Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 880-81 (7th Cir. 1992). A later First Circuit district court noted that, "even if culpable participation is required, . . . it appears from the First Circuit's decision in Aldridge that [a plaintiff satisfies the test by] showing that [the] defendant was an active participant in the decision-making process." *Neely v. Bar Harbor Bankshares*, 270 F. Supp. 2d 50, 54 (D. Me. 2003) (citing *Aldridge*, 284 F.3d at 85). Thus, directors, officers and controlling shareholders act as control persons only if they "dominate[] the activities of the corporate entity." *Rand v. M/A-Com, Inc.*, 824 F. Supp. 242, 262 (D. Mass. 1992) (citing *Dowling v. Narragansett Capital Corp.*, 735 F. Supp. 1105, 1122 (D.R.I. 1990)). Once the plaintiff establishes a primary violation by the controlled entity and that the defendant was a "controlling person" within the meaning of the statute, "the burden shifts to the defendant to show that she acted in good faith." *Neely*, 270 F. Supp. 2d at 53.

In applying the good faith defense, courts generally look to whether the controlling person "failed to establish, maintain, or diligently enforce a proper system of supervision and control." *Paul F. Newman & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1120 (5th Cir, 1980) (citation omitted). To satisfy their burden with regard to the good faith defense, defendants must show that they did not act recklessly. Negligence on the part of defendants is insufficient to establish liability. See *Carpenter v. Harris, Upham & Co*., 594 F.2d 388, 394 (4th Cir. 1979). As one court explained:

> [O]ur task is to examine what the defendants could have done under the circumstances to prevent the violation, and then ask whether the defendants - aware that they could take such measures - decided not to.

> This is just to say that we are to determine whether there is a genuine issue of fact regarding the defendants' recklessness. *Donohoe v. Consolidated Operating & Prod. Corp*., 30 F.3d 907, 912 (7th Cir. 1994); *see also G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 960 (5th Cir. 1981) (holding that controlling persons must establish that they did not act recklessly to qualify for the good-faith defense).

In sum, the SEC may now more freely assert control person liability against senior corporate officers when their subordinates violate the law, thereby creating expectations of supervision and compliance that have heretofore applied only within regulated entities such as brokers and advisers.

Expanded Authority in Administrative Proceedings

The SEC enjoys considerable tactical advantages when it litigates in an administrative proceeding, rather than in federal court in a civil injunctive action. These advantages include: the absence of juries in administrative proceedings, the generally more supportive attitude of administrative law judges, the absence of meaningful pre-trial discovery and motion practice in administrative proceedings, the short deadlines imposed on the completion of the administrative trial, less strict application of the rules of evidence during administrative trials, and appeal from a decision of an administrative law judge to the SEC Commissioners rather than to a Court of Appeals.

In general, the SEC would prefer to litigate all of its cases in administrative proceedings, but has been constrained by its inability to obtain certain remedies in those proceedings. In particular, prior to Dodd-Frank, the SEC could not obtain fines against persons who were not associated with regulated entities, such as employees of public companies and accountants, in administrative proceedings.

Dodd-Frank expands the SEC's fining powers in administrative proceedings, now permitting the SEC to obtain fines against all persons, including those not associated with regulated businesses, in administrative proceedings.

Dodd-Frank also raises the amount of penalties the SEC can obtain.

Availability of Collateral Industry Bars

In its administrative proceedings, the SEC frequently seeks to bar persons from association with regulated entities, such as broker-dealers, investment advisers, investment companies, and transfer and clearing agents. Dodd-Frank expands this remedy in two respects.

First, Dodd-Frank overrules *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999), where the SEC was held to lack the authority to impose "collateral bars" on violators of the securities laws. (*Teicher* held that Exchange Act Section 15(b)(6) does not give the SEC authority to bar an individual from associating with an investment adviser. *Id*. at 1021-22.) Collateral bars refer to sanctions in which a person who is found to have violated a provision of the federal securities laws applicable to a particular industry, for example a registered representative of a broker-dealer who is found to have violated rules applicable to broker-dealers, is barred from association not just with broker-dealers but also from association with other regulated businesses such as investment advisers and investment companies. Section 925 of Dodd-Frank amends the relevant provisions of the federal securities to permit the SEC to impose collateral bars.

Section 929F of Dodd-Frank also expands the SEC's jurisdiction to institute administrative proceedings against persons who are no longer associated with regulated entities at the time the SEC commences the proceeding, but were so associated when the alleged misconduct occurred.

Expanded Clawback of Executive Compensation

The Sarbanes-Oxley Act of 2002 included a clawback provision, Section 304, which required public company chief executive officers and chief financial officers to disgorge bonuses, other incentive- or equity-based compensation, and profits on sales of company stock that they receive within 12 months following the public release of financial information if there is a restatement because of material noncompliance, due to misconduct, with financial reporting requirements under the federal securities laws. In a recent litigated decision, *SEC v. Jenkins*, No. CV-09-1510-PHX-GMS (D. Ariz., June 9, 2010), the Court held, in a case of first impression, that such a clawback could be awarded even when the CEO and CFO did not engage in personal misconduct.

Dodd-Frank significantly expands this clawback remedy. Section 954 requires exchanges to establish rules requiring public companies to modify their bylaws or charters to require the issuer to clawback from all current or former executive officers (rather than just the CEO and CFO) any compensation earned during the prior three years (rather than just the prior year) that would not have been earned had the financial statements been presented correctly.

Expanded Anti-Fraud Liability

Dodd-Frank expands SEC anti-fraud liability. First, Section 929L amends Section 9 of the Exchange Act, which prohibits certain manipulative practices, and Section 10(1) of the Exchange Act, concerning short sales, to apply to all securities except government securities. These provisions had previously applied only to securities listed on national securities exchanges. Second, a new section, 929X(d), expressly prohibits manipulative short sales. Third, Section 15(c)(1) of the Exchange Act, which prohibits manipulative practices by broker-dealers, is amended to apply to exchange transactions, not just to over-the-counter transactions. Finally, Section 975(a)(5) imposes anti-fraud liability on "municipal advisors," who are advisers to municipalities.

Disqualification of "Bad Boys" from Regulation D Offerings

Prior to Dodd-Frank, Regulation D, a nonexclusive safe harbor establishing that a sale of securities is within the private placement exemption from registration under Section 4(2) of the Securities Act, imposed a limited disqualification from reliance on its provisions for persons who had been found to have failed to file a Form D, a notice form. 17 C.F.R. § 230.501 *et seq*. Section 926 of Dodd-Frank directs the SEC to amend its rules to disqualify certain "bad boys" from use of Regulation D. "Bad boys" generally are persons who have been found to have violated anti-fraud provisions, as set forth in detail in Rule 262 under the Securities Act.

Confirmation of Reckless-Based Aiding and Abetting Liability

Questions were raised about the SEC's authority to allege aiding and abetting following the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). For example, in *SEC v. Bolla*, 550 F. Supp. 2d 54, 63 (D.D.C. 2008), the court concluded that Section 209(e) of the Advisers Act does not authorize the SEC to impose a monetary penalty for aiding and abetting an Advisers Act violation. In 1995, the Private Securities Litigation Reform Act of 1995 amended Section 20(e) of the Exchange Act to make clear that the SEC could assert aiding and abetting claims for violations of the Exchange Act. Pub. L. No. 104-67, 109 Stat. 737 (Dec. 12, 1995). That Section extended liability to "any person who knowingly provides substantial assistance to another in [a] violation. . . ." After this legislation, some Circuits held that the "knowing" requirement imposes a scienter standard that is higher than recklessness, *SEC v. Fehn*, 97 F.3d 1276, 1295 (9th Cir. 1996), while other Circuits, held that recklessness is sufficient to satisfy the state of mind requirements for liability, *Graham v. SEC*, 222 F.3d 994, 1000 (D.C. Cir. 2000). Questions were also raised about whether negligence was ever sufficient to support aiding and abetting liability.

Sections 929M through O of Dodd-Frank amend Section 15 of the Securities Act, Section 48 of the Investment Company Act, and Section 20(e) of the Exchange Act, and add Section 209(f) to the Advisers Act, to clarify that the SEC can institute an enforcement action against a person who aids and abets, either knowingly or recklessly, a violation by another person. Negligent aiding and abetting claims now appear to be precluded.

Extraterritorial Application of the Securities Laws: Response to the Morrison Case

In *Morrison v. Nat'l Australia Bank Ltd.*, No. 08-1191, slip op. at 24 (June 24, 2010), the Supreme Court ruled that Section 10(b) and Rule 10b-5 under the Exchange Act apply "only in connection with a purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States." The Court specifically rejected the position of most lower courts that conduct in the United States could be a sufficient basis for application of the U.S. securities laws: "[w]hile there is no reason to believe that the United States has become the Barbary Coast for those perpetrating frauds on foreign securities markets, some fear that it has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets." *Id.* at 21.

Section 929O(b) of Dodd-Frank changes this standard, permitting the government to apply the federal securities laws in anti-fraud actions to: "(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

Nationwide Service of Subpoenas in Civil Injunctive Actions

Rule 45(c)(3)(A)(ii) of the Federal Rules of Civil Procedure restricts a party's ability to compel a nonparty witness to appear at trial. A nonparty can only be compelled to travel within 100 miles from where that person resides, is employed, or regularly transacts business in person unless the trial is within the same state as the nonparty's aforementioned activities. This restriction, which applied in SEC civil injunctive actions, restricted the SEC's ability to compel witnesses to travel long distances to testify at trials and often dictated where the SEC filed its actions. If certain witnesses were viewed as important to the SEC's case, the restrictions in Rule 45 would often force the SEC to file its action in a district that was close to these key witnesses, even if more favorable law was available in another jurisdiction.

Section 929E of Dodd-Frank changes Rule 45(c) and now permits the SEC to compel a nonparty to testify at trial from anywhere in the United States. This change will afford the SEC greater freedom to select the jurisdiction in which to file its actions, with the potential for the SEC to select the jurisdiction with the most favorable law for its case.

Harmonization of Broker-Dealer and Adviser Enforcement

Section 913(h) of Dodd-Frank provides that "the Commission shall seek to prosecute and sanction violators of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to a retail customer under this Act to same extent as the Commission prosecutes and sanctions violators of the standard of conduct applicable to an investment advisor under the Investment Advisers Act of 1940." It is unclear how this provision might change the SEC's enforcement actions against brokers and advisers.

Greater Access to Foreign Accountants' Workpapers

Section 106(b) of the Sarbanes-Oxley Act permitted the SEC to obtain the workpapers of a foreign accounting firm if that firm either issued an opinion on the financial statements of an SEC registrant or consented to another accounting firm's reliance on its work. Section 929J of Dodd-Frank expands the SEC's ability to obtain a foreign firm's workpapers to include circumstances in which "a foreign public accounting firm performs material services upon which a registered public accounting firm relies in the conduct of an audit or interim review, issues an audit report, performs audit work, or conducts interim reviews."

Greater Protection of Privileges

Section 929K of Dodd-Frank clarifies that the SEC does not waive any applicable privileges when it shares information with other regulators. Similarly, another regulator is not deemed to have waived any applicable privileges when it shares information with the SEC. This provision should clarify the waiver issue and further encourage the sharing of information among regulators.

Waiver of Compliance with SRO Rules Invalid

Section 29(a) of the Exchange Act previously provided that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void." Section 929T of Dodd-Frank expands this provision to apply to any rules of a self-regulatory organization, such as FINRA.

New Deadlines for Inspections and Investigations; Greater Resources for Enforcement; Annual Certifications

Section 929U of Dodd-Frank imposes new time limits on the completion of SEC inspections and enforcement actions. Subject to certain exceptions, inspections must be completed within 180 days of the completion of the field work portion of the inspection and enforcement actions must either be filed or closed within 180 days of the Wells notice being provided to targets. While these provisions have exceptions, and it is impossible to predict how the SEC will apply these exceptions in practice, it seems likely that these deadlines will cause inspections and enforcement investigations to be completed more quickly.

Dodd-Frank also increases the resources available to the SEC's enforcement program. Although the SEC did not obtain "self-funding" authority, under Section 991 of Dodd-Frank, the SEC can create a reserve fund of up to $100 million for necessary expenses. Section 991 also authorizes appropriations that will significantly increase the SEC budgets. In 2010, the SEC budget was $1.2 billion. Appropriations for subsequent years will be significantly higher:

2011	$1.3 billion
2012	$1.5 billion
2013	$2 billion
2014	$2 billion
2015	$2.25 billion

In addition, in future years the SEC will submit its budget requests directly to Congress, rather than sending them first to the President for review and pre-approval.

Finally, under Section 961 of Dodd-Frank, the Director of the SEC's Division of Enforcement will be required to certify annually to Congress a report on the effectiveness of the SEC's enforcement program.

Extended Statute of Limitations for Criminal Actions; Tougher Criminal Sentences

Section 1079A(b) of Dodd-Frank extends the statute of limitations for criminal prosecutions of the federal securities laws from the current five years to six years.

Section 1079A(a) of Dodd-Frank directs that "the United States Sentencing Commission shall review and, if appropriate, amend the Federal Sentencing Guidelines and policy statements applicable to persons convicted of offenses relating to securities fraud or any other similar provision of law, in order to reflect the intent of Congress that penalties for the offenses under the guidelines and policy statements appropriately account for the potential and actual harm to the public and the financial markets from the offenses." It is unclear how the United States Sentencing Commission will implement this directive.

Studies of Enforcement Activities

Dodd-Frank also requires several studies that may lead to future changes to the SEC's enforcement program. For example, the SEC is directed to study and report on the structure of its enforcement and examination organizations. The SEC must also study whether an SRO for investment advisers would assist in conducting examinations of investment advisers, as well as the adequacy of its examinations of investment advisory activities of dually registered broker-dealers and investment advisers and their affiliates.

If you have any questions, please contact the Ropes & Gray attorney whom normally advises you.