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Dodd-Frank, Aiding-and-Abetting Scienter, and Principles of Fairness: Why the SEC Should Not be Allowed to Apply Section 20(e) Retroactively



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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank''). Dodd-Frank revised Section 20(a) of the Securities Exchange Act of 1934 (''Exchange Act'') to permit the Securities and Exchange Commission to bring an aiding-and-abetting claim against ''any person that knowingly or recklessly provides substantial assistance to another person in violation of any provision'' of the Exchange Act. [1] This amendment changed the requisite state of mind for an aiding and abetting violation from ''knowingly'' to ''knowingly or recklessly.''

With this clarifying amendment, the time is ripe for the SEC to recognize that any alleged aiding-and-abetting misconduct which occurred prior to the enactment of Dodd-Frank should be brought only under the former standard; namely ''knowingly.'' As SEC Com-

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[1] 15 U.S.C. 78t(e).

missioner Kathleen Casey acknowledged at the SEC Speaks conference this January, principles of fairness should override any pressure on the SEC to ''hold Wall Street accountable.'' That is, the SEC should decline to apply this provision of Dodd-Frank retroactively.

A. A Brief History of Aiding-and-Abetting Liability for Securities Violations

Prior to 1994, there was general agreement among the courts that Section 10(b) of the Exchange Act provided a private right of action for both primary and secondary defendants such as aider-abettors. However, in 1994, the Supreme Court held in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* that, because aiding-and-abetting liability is not explicitly provided for in the Exchange Act, such liability is no longer tenable.[2] This holding was short-lived. In 1995, Congress responded to *Central Bank* by passing the Private Securities Litigation Reform Act (''PSLRA''). Though the PSLRA did not give a private right of action, it promulgated Section 20(e) of the Exchange Act, which restored the Commission's ability to bring aiding-or-abetting claims against a defendant who ''knowingly provides substantial assistance to another person in violation of a provision of [the Exchange Act].''[3] There is strong support in the legislative history that Congress, in enacting Section 20(e), meant it to only apply to knowing violations, in that the SEC's request for authority to prosecute persons who recklessly aid and abet violations of the act was rejected.[4] Additionally, there are other portions of the Exchange Act that use the ''knowing or reckless'' language, a good indication that when so intended to do so, Congress could use a clear formulation of a more lenient standard.[5]

The time is ripe for the SEC to recognize that any alleged aiding-and-abetting misconduct which occurred prior to the enactment of Dodd-Frank should be brought only under the former standard; namely ''knowingly.''

Leading up to PSLRA, there was much debate among courts and scholars as to whether constructive knowledge in the form of recklessness satisfied the scienter requirement for secondary liability. The courts differed in their approach, with some holding that only actual knowledge sufficed, others holding that one who recklessly failed to know about the primary actor's conduct may be charged, and the majority holding that constructive knowledge due to recklessness is sufficient if the alleged aider-abettor owed a fiduciary duty.[6] After the PSLRA, many commentators hoped that the insertion of ''knowingly'' into the Exchange Act would stem this debate. Commentators argued that the plain text, legislative history, and statutory purpose made clear that only actual knowledge of the primary violation would suffice.[7] Many courts, however, continued to adhere to the view that recklessly ***not*** knowing was sufficient to establish the ''knowingly'' scienter for aiding-and-abetting liability pursuant to the Exchange Act, while others acquiesced and acknowledged that the plain text of the provision required actual knowledge. For example, in *SEC v. Fehn*, the court recognized that it previous held that recklessness or knowledge was sufficient, but noted that aiding and abetting liability under 10(b) of the Exchange Act now required actual knowledge ''by its plain terms.''[8] Yet, the Supreme Court continued to reserve the question of whether recklessness sufficed under the newly-enacted Section 20(e) of the Exchange Act.

B. Dodd-Frank's Impact on Aiding-and-Abetting Liability

In 2010, Dodd-Frank once again changed the landscape of aiding-and-abetting liability for securities violations. In addition to giving the SEC the right to bring

[2] 511 U.S. 164 (1994).

[3] Private Securites Litigation Reform Act of 1995, § 104, 15 U.S.C. § 78t(e) (2000).

[4] *See* 141 Cong. Rec. S9056 (June 26, 1995) (testimony of SEC Commissioner Author Levit noting that the SEC was seeking language in 20(e) that included a ''knowing or reckless'' standard).

[5] *See, e.g.*, 15 U.S.C.A. § 78u-1 (establishing that ''No controlling person shall be subject to a penalty under subsection (a)(1)(B) of this section unless the Commission establishes that— (A) such controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred; or (B) such controlling person knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under section 78*o*(f) of this title or section 80b-4a of this title and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation.'')

[6] *See* Lewis D. Lowenfels & Alan R. Bromberg, A New Standard for Aiders and Abettors Under the Private Securities Litigation Reform Act of 1995, 52 Bus. Law. 1, 5-8 (1997) (citing the courts' varying application of the knowledge requirement)

[7] *Id.*

[8] 97 F.3d 1276, 1288 n.11 (9th Cir. 1996). *But see* Graham v. S.E.C., 222 F.3d 994 (D.C. Cir. 2000) (''We have held that knowledge or recklessness is sufficient to establish the scienter element of aiding and abetting liability)

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aiding-and-abetting claims for violations of the Securities Act of 1933 and the Investment Company Act of 1940, Dodd-Frank amended Section 20(e) of the Exchange Act to allow the Commission to bring suit against ''any person that knowingly ***or recklessly*** provides substantial assistance to another person in violation'' of the Exchange Act. (Emphasis added.)

As such, it is unequivocal that, going forward, either reckless or knowing assistance will support a claim for aiding-and-abetting under Section 20(e). The emphasized need for clarity around this subject and the belief that Dodd-Frank expanded the SEC's authority regarding aiding and abetting claims further illustrates that, as Section 20(e) stood prior to Dodd-Frank, reckless conduct was not sufficient.

C. The SEC Should Not Retroactively Bring Aiding-and-Abetting Claims for Reckless Misconduct

There is a well-established presumption against retroactive application of statutes and this provision of Dodd-Frank is no exception under the framework the Supreme Court has laid out in *Landgraf v. USI Film Products*.[9] Dodd-Frank does not clearly express intent to apply the provision retroactively. In fact, the scant legislative history underlying this provision of Dodd-Frank merely indicates that the amendment was enacted to ''make clear that the intent standard in SEC enforcement actions for aiding and abetting is recklessness.''[10]

Thus, the legislative history offers little insight into the reasoning behind this amendment and its retroactive effect. As such, under *Landgraf*, the courts should then ask whether the statute, if applied retroactively, ''would impair rights a party possessed when he acted, increase a party's liability for past conduct, or impose new duties with respect to transactions already completed.''[11] In other words, courts should ask ''whether the new provision attaches new legal consequences to events completed before its enactment.''[12] However, to apply Dodd-Frank retroactively to encompass pre-enactment conduct based on reckless conduct would ''impose new duties with respect to'' conduct already completed and ''attach new legal consequences'' which defy ''considerations of fair notice, reasonable reliance, and settled expectations.''[13] Thus, under the authority and analysis of *Landgraf*, Dodd-Frank should not be applied retroactively to encompass past reckless conduct for aiding-and-abetting liability.[14]

The impact of Dodd-Frank, however, does not have to involve complex legal analysis and debate among the courts. As Commissioner Casey proffered in the context of another provision of Dodd-Frank, ''Is it necessary for us to decide exactly where the line of legality lies? Could the Commission instead choose to be guided, as it has in the past, by notions of fairness and a respect for the principle of anti-retroactivity?'' In other words, while the public and media may encourage toughness and put pressure on the SEC to ''hold Wall Street accountable,'' the aiding-and-abetting provision of Dodd-Frank opens the door for the SEC to re-evaluate its aiding-and abetting claims and decide its approach from here. The SEC could uniformly decide that, going forward, it will not bring suit against alleged aider-abettors for reckless misconduct that occurred prior to the enactment of Dodd-Frank regardless of whether the courts have previously permitted such suits.

Given the circuit split from prior to *Central Bank* through PLSRA, and now through Dodd-Frank, it is time for the SEC to embrace principles of fairness and recognize that suits should not be brought against alleged aider-abettors for reckless assistance to a primary defendant that occurred prior to the passage of Dodd-Frank and its much-needed clarifying amendment to Section 20(e) of the Exchange Act. Instead, for actions which occurred prior to July 21, 2010, the SEC should limit its suits to misconduct that occurred with actual knowledge—the only clear and consistent state of mind applied throughout all jurisdictions given the plain text of Section 20(e) prior to Dodd-Frank.

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[9] 511 U.S. 244 (1994).
[10] H.R. 111-517, 111th Cong., at 870 (2010).
[11] *Landgraf*, 566 U.S. at 280.
[12] *Id.* at 270.
[13] *Id.*
[14] In fact, on June 6, 2011, Judge William H. Alsup of the United States District Court for the Northern District of California, touched on this issue in applying *Landgraf* to the question of the retroactive effect of the aiding-and-abetting provision of the Investment Company Act of 1940. Ultimately, the court dismissed the SEC's aiding-and-abetting claims under that Act, holding that the aiding-and-abetting provision of Dodd-Frank cannot be applied retroactively for Investment Company Act misconduct that occurred prior to the passage of Dodd-Frank. *SEC v. Daifotis*, No. C 11-00137 (N.D. Cal, June 6, 2011). Specifically, the court found that to apply the statute retroactively would impair a defendant's rights, increase liability, and impose new duties in violation of the standard for applying a provision retroactively as set forth in *Landgraf*. *Id*.