

ClientAlert

Financial Markets Developments

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Dodd-Frank Wall Street Reform and Consumer Protection Act

Expansion of SEC Enforcement Powers

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") expands the Securities and Exchange Commission's (the "SEC") enforcement authority.¹ The Act empowers the SEC to bring new causes of action which may be easier to prosecute, broadens its jurisdiction and imposes stricter penalties on defendants. The expanded enforcement powers are likely to affect the scope and conduct of SEC investigations.

Expanded Aiding and Abetting Liability

Section 929M-O of the Act empowers the SEC to prosecute "any person that knowingly or recklessly provides substantial assistance to another person in violation of" the Securities Act of 1933 (the "'33 Act"), the Securities Exchange Act of 1934 (the "'34 Act"), the Investment Company Act of 1940, and Investment Advisors Act of 1940.²

1. Who may bring claims for aiding and abetting federal securities fraud?

Section 929M-O expands the power of the SEC to pursue claims against alleged aiders and abettors of securities fraud or violations of other securities laws. Significantly, the Act does not create a private right of action for aiding and abetting, which had been proposed by some in Congress.³ Instead, subsection 929Z directs the Comptroller General to study the potential impact of authorizing a private right of action against alleged aiders and abettors of securities fraud.⁴ Accordingly, the Act leaves unchanged the US Supreme Court's 2008 ruling in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, which held that private federal securities fraud claims under the '34 Act may not be asserted against parties that allegedly aided and abetted an issuer's alleged false or misleading public statements.⁵

2. Who may be liable for aiding and abetting securities fraud?

"[A]ny person" may be liable for aiding and abetting a violation of federal securities laws.⁶ Individuals, companies doing business with an issuer, investment advisors, accounting firms and law firms are all potentially covered by the Act.

3. Does the alleged aider and abettor need to have actual knowledge of the underlying federal securities violation to be found liable?

No. To prove aiding and abetting, the SEC generally must prove (i) a securities law violation by a primary wrongdoer; (ii) knowledge of the violation by the alleged aider and abettor; and (iii) that the alleged aider and abettor substantially assisted in the primary wrongdoing. Prior to the Act, the courts were split on whether the SEC could satisfy the knowledge element by anything less than actual knowledge. Under the Act, knowledge of the wrongdoing now



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may be satisfied by a showing that the alleged aider and abettor acted recklessly, i.e., in a way which was highly unreasonable and was an extreme departure from the standards of ordinary care. An egregious refusal to see the obvious, or to investigate the doubtful, could give rise to an inference of recklessness.⁷

4. Under which federal securities laws may the SEC bring claims for aiding and abetting securities violations?

The SEC now may pursue alleged aiders and abettors under the '33 Act, the '34 Act, the Investment Company Act of 1940, and the Investment Advisors Act of 1940.⁸ It also may bring actions to impose monetary penalties on persons who aid and abet violations of the Investment Advisors Act of 1940.⁹ Before the Act, the SEC could only expressly pursue alleged aiders and abettors of securities fraud under the '34 Act¹⁰ and could not seek monetary penalties for aiding and abetting violations of the Investment Advisors Act.

5. How grave are the penalties for aiding and abetting?

The Act empowers the SEC to prosecute aiders and abettors "to the same extent as the person that committed such violation."¹¹ This means that the SEC can now bring injunctive actions in federal court and administrative cease-and-desist proceedings against alleged aiders and abettors. The SEC also may now impose civil monetary penalties in administrative proceedings against aiders and abettors, a remedy it could only seek in federal courts prior to the Act.¹² As noted above, the SEC also may, for the first time, seek monetary penalties in federal court actions for aiding and abetting violations of the Investment Advisors Act of 1940.¹³

6. How will the SEC's expanded powers to pursue aiding and abetting affect securities litigation and investigations?

The Act may increase the number of companies and persons subject to investigation and prosecution by the SEC because (i) the standard of proof has now been reduced from actual knowledge to a gross deviation from some standard of care and (ii) the number of laws now covered by the aiding and abetting provisions has been expanded (although certain areas, such as potential violations of the disclosure requirements under the '33 Act may often overlap with potential violations of the '34 Act).

More importantly, the Act may alter how the SEC approaches investigations and actions by changing how the SEC assesses the behavior of potential defendants. Because recklessness requires a party to have deviated from some standard of care, the Act opens up a broader inquiry than "what did the company

or executive know and what did they do (or not do) when they found out?" Instead, the issue may now be "what was known, what should have been known, and why was something not known?" This would be a broader inquiry than determining whether a potential defendant had knowledge because they ignored a classic "red flag." Instead, the inquiry now could become what constituted a potential warning sign of a problem (i.e., when does one or more "yellow flags" become a "red flag") and how did someone react to potential warning signs (i.e., are there warning signs short of red flags which may require attention to avoid reckless conduct).¹⁴ Inquiries of this kind could put compliance systems, record keeping procedures, and reporting lines under heightened scrutiny, and could raise significant questions about how companies structure compliance systems and monitor compliance performance.

Control Person Liability

Section 929P(c) of the Act makes "any person who, directly or indirectly, controls any person liable under any provision" of the '34 Act jointly and severally liable to the SEC "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."¹⁵

1. Who is a control person?

A control person is anyone who directly or indirectly controls another person who violates a rule or provision of the '34 Act. A control person is likely to be a company's or firm's officers, directors or senior management.

2. When is a control person liable for violating the '34 Act?

A control person is jointly and severally liable to the SEC if they directly or indirectly control another person who violates the '34 Act unless they can prove they (1) acted in good faith and (2) did not induce the violation.¹⁶ The Act does not require the SEC to prove that the control persons themselves committed a violation; rather, it shifts the burden to the control persons to prove that they acted in good faith and did not induce the violation.

3. What are the implications of this provision?

This provision increases the risks to officers and directors by expanding the scope of potential parties against whom claims may be asserted.

Extraterritorial Jurisdiction

1. What does the Act do as to extraterritorial application of US securities laws?

Section 929P(b) of the Act expands the SEC's jurisdiction to pursue actions involving the antifraud provisions of the '33 Act,¹⁷ the '34 Act, and the Investment Advisors Act of 1940.¹⁸

2. Why is this provision about extraterritorial jurisdiction significant?

In a recent landmark decision, the US Supreme Court abandoned 40 years of lower court precedent regarding the application of the US securities laws to fraud claims (a) brought by foreign investors, (b) against foreign issuers, and (c) regarding securities bought or sold on a foreign exchange—so-called “f-cubed” or “foreign-cubed” claims. *Morrison v. National Australia Bank* held that non-US plaintiffs who purchased the shares of a non-US issuer on a non-US exchange could not pursue securities fraud claims under the '34 Act even though the non-US issuer had a sponsored US ADR program (in connection with which it had made allegedly false SEC filings) and the alleged fraud occurred in a US subsidiary.¹⁹

Specifically, *Morrison* held that, as a matter of statutory construction, “unless there is the affirmative intention of the Congress clearly expressed” toward extraterritorial effect, “we must presume [Congress] is primarily concerned with domestic conditions.”²⁰ Finding no indicia of extraterritorial intent in the '34 Act, the Court held that it was required to find that Congress intended none.²¹ In so holding, the Court rejected decades of precedent relating to tests applied by the lower courts to support extraterritorial application of the securities laws which were based on whether the alleged fraud had significant US effects or arose from significant US conduct.²² While the Court did not find these tests inherently invalid, it rejected them as a means of extending a statute to reach conduct Congress did not otherwise expressly cover. Among other things, the Court noted that extraterritorial application of US securities laws raised issues of potential interference with the securities laws of other nations.²³ The Court then found that the US conduct alleged in *Morrison* was not within the scope of the '34 Act because none of that conduct related to US listed or purchased securities.²⁴

Addressing the issue highlighted in *Morrison*, the Act expressly provides for extraterritorial application of certain provisions of the securities laws, but *only* as to the SEC. Thus, the SEC may pursue alleged violations based on (i) US conduct that constitutes significant steps in furtherance of a securities violation *even if* the securities transaction at issue occurs outside the United States and involves only foreign investors; or (ii) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.²⁵ As to the types of private actions prohibited by *Morrison*, the Act provides for the SEC to take public comment and study the issue further.²⁶

Civil Penalties in Cease-and-Desist Proceedings

Section 929P(a) empowers the SEC to impose civil monetary penalties on any person in an administrative cease-and-desist proceeding under the '33 Act, the '34 Act, the Investment Companies Act of 1940, or the Investment Advisors Act of 1940.²⁷

1. Against whom can the SEC impose civil penalties?

The SEC may impose civil monetary penalties on any person in an administrative cease-and-desist proceeding, such as a public company and/or its directors, officers, or employees who violate federal securities laws.²⁸ Before the Act, the SEC could only impose civil penalties on SEC-regulated entities such as broker-dealers.

2. Can the SEC impose civil penalties without seeking leave of a court?

Yes. Section 929P(a) authorizes the SEC to impose civil penalties as part of an administrative proceeding before an SEC administrative law judge, although any administrative decision may be appealed to a federal court.²⁹ Before the Act, the SEC only could seek a civil penalty by suing a defendant in federal court.

3. How do a defendant's rights differ in SEC administrative proceedings than federal court?

SEC administrative proceedings permit less discovery than federal litigation and deny the right to a jury. Administrative law judges in these proceedings are employed by the SEC itself, while federal court judges are nominated by the President, and, once confirmed by the Senate, hold a lifetime appointment.

Collateral Bars

Section 925 of the Act empowers the SEC to bar persons associated with regulated entities not only from their specific securities business, but from the entire securities industry.³⁰

1. What is a collateral bar?

In seeking remedies against those who violate the securities laws, the SEC has sometimes sought to bar a person not only from his or her specific business within the industry, but from the industry as a whole (or some broader segment than the person's specific business). There have been questions about the SEC's authority to do this, which the Act addresses.

2. From which regulated securities businesses may a person be barred?

Persons associated with an investment advisor, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization may be collaterally barred from any other securities business.³¹ The Act thus provides the SEC with more certain enforcement powers, which may allow the SEC to be more demanding in negotiating settlements to investigations or proceedings.

Nationwide Service of Subpoenas

Section 929E of the Act authorizes parties in federal proceedings instituted by the SEC to serve subpoenas nationwide "to compel the attendance of a witness or the production of documents or tangible things (or both) at a hearing or trial."³² Prior to the Act, any potential trial witness who did not live within the federal judicial district where the proceeding was pending or within 100 miles of the district could not be compelled to appear in person at trial. Under these circumstances, the parties to those proceedings were left to use deposition transcripts or videotapes of depositions at trial.

1. May the defendant in an action instituted by the SEC serve nationwide subpoenas?

Yes. Section 929E permits any party in an action initiated by the SEC to serve a trial subpoena nationwide.³³

2. How will nationwide service of subpoenas affect federal securities litigation?

Prior to the Act, strategic decisions about who to depose and how to conduct those depositions were strongly influenced by whether potential witnesses were within subpoena range for trial. Now all witnesses within the US are potentially available for trial testimony and that will significantly impact decisions regarding the scope of discovery and trial strategy.

Whistleblower Protection

Section 922 of the Act provides strong incentives and protections for whistleblowers to expose violations of federal securities laws.³⁴

1. What incentives are being offered to whistleblowers?

The SEC will provide whistleblowers with anywhere between 10 – 30% of the monetary sanctions collected by the SEC if (i) the whistleblower provides "original information" relating to a securities law violation, (ii) the enforcement action is successful against the violator, and (iii) the sanctions exceed US\$1 million.³⁵

2. How will the SEC protect whistleblowers?

The Act prohibits an employer from retaliating against a whistleblower.³⁶ It also provides whistleblowers with a cause of action against an employer for alleged retaliation.³⁷ Whistleblowers may bring claims against their employers no more than six (6) years after the date of the violation or no more than three (3) years after the date upon which they should have known of the violation.³⁸

3. What remedies are available for whistleblowers?

A prevailing whistleblower is entitled to full reinstatement, two times back pay with interest and compensation for litigation costs, expert witness fees and reasonable attorneys' fees.³⁹

4. How will the Act's new whistleblower provisions affect federal securities regulation?

The Act is likely to increase the number of whistleblower claims. These claims may in turn increase the likelihood of SEC investigations and/or private litigation to the extent a whistleblower's claims become public upon the filing of a retaliation action. As noted above, the availability of new whistleblower rewards and remedies combined with expanded liability for aiding and abetting securities violations may create problems for companies as to compliance issues that arise with regard to employees who may be disgruntled for one reason or another.

Dodd-Frank Wall Street Reform and Consumer Protection Act

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010) (enacted).
2. H.R. 4173, at § 929M – O, 111th Cong. (2010).
3. *Id.* Senator Arlen Specter of Pennsylvania and Representative Maxine Waters of California had submitted amendments to the Act that would have created a private right of action for aiding and abetting as to defendants who allegedly provided substantial assistance to primary violators of the federal securities laws. Senator Specter's amendment required "knowing" assistance of the alleged violation, while Representative Waters' amendment only required plaintiffs to prove that a defendant "recklessly" aided and abetted fraud. Neither amendment was adopted.
4. *Id.* at § 929Z.
5. 552 US 148 (2008); See Owen C. Pell, *Supreme Court Further Limits Securities Claims Against Non-Issuers, Important Ruling for Financial Institutions*, White & Case LLP Client Alert, Jan. 22, 2008, http://www.whitecase.com/alert_litigation_0108/.
6. H.R. 4173, at § 929M – O, 111th Cong. (2010).
7. See, e.g., *SEC v. US Envtl., Inc.*, 155 F.3d 107 (2d Cir. 1998); *SEC v. McNulty*, 137 F.3d 732 (2d Cir. 1998).
8. H.R. 4173, at § 929M – O, 111th Cong. (2010).
9. *Id.* at § 929N.
10. 15 USC. § 78t(e) (2010).
11. H.R. 4173, at § 929M – O, 111th Cong. (2010).
12. *Id.* at § 929P.
13. *Id.* at § 929N.
14. This issue could become particularly vexing because the Act also creates a fund to compensate employees who bring to the SEC's attention securities law violations. *Id.* at § 922. Situations may arise where the line between a true red flag upon which a company would be expected to act and something less than a red flag runs through a whistle-blowing employee, such that the whistle-blowing claim becomes enmeshed with an analysis of whether a company was reckless in not detecting or preventing some securities law violation.
15. *Id.* at § 929P(c); 15 USC. § 78t(a) (2010).
16. H.R. 4173, at § 929P(c), 111th Cong. (2010); 15 USC. § 78t(a) (2010).
17. *Id.* at § 77(q).
18. Section 206 of the Investment Advisors Act, 15 USC. § 80b-6 (2010), prohibits investment advisors from defrauding, deceiving or manipulating clients.
19. 561 US ___, No. 08-1191. For a detailed discussion of Morrison and its implications for f-cubed cases generally, see Owen C. Pell, *Landmark Decision Signals Limits on Extraterritorial Reach of US Laws: US Supreme Court Rejects Claims Under US Securities Laws in "Foreign-Cubed" Cases*, White & Case Client Alert: Financial Markets Developments, July 2010, <http://connect.whitecase.com/content/Lists/Resources/Attachments/2281/Landmark%20Decision%20Signals%20Limits%20on%20Extraterritorial%20Reach%20of%20US%20Laws.pdf>.
20. *Morrison*, Slip Op. at 5.
21. *Id.* at 6.
22. *Id.* at 12.
23. *Id.* at 12.
24. *Id.* at 17.
25. H.R. 4173, at § 929P(b), 111th Cong. (2010).
26. *Id.* at § 929Y.
27. *Id.* at § 929P(a).
28. *Id.* (emphasis added).
29. *Id.*
30. *Id.* at § 925.
31. *Id.*
32. *Id.* at § 929E.
33. *Id.* ("In any action or proceeding instituted by the Commission...a subpoena issued...may be served at any place within the United States.>").
34. *Id.* at § 922(a)
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.*

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