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ADVISORY | Dodd-Frank Act

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DODD-FRANK BEEFS UP SEC AND CFTC ENFORCEMENT

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The Act institutes the most wide-ranging changes to the banking, securities, derivatives, and financial services industries since the 1930s. This advisory briefly summarizes the new law's key provisions affecting SEC and CFTC enforcement that will soon take effect.

New SEC Causes of Action

Aiding and Abetting

The Act empowers the SEC to bring more aiding-and-abetting claims, which will now also be much easier to prove. It gives the SEC the right to bring aiding-and-abetting claims for violations of the Securities Act of 1933 and the Investment Company Act of 1940. In addition, the Act gives the SEC the authority to seek monetary penalties for aiding and abetting violations of the Investment Advisers Act of 1940. Several federal district courts had held that the SEC had no right to bring aiding-and-abetting claims under the Securities Act and the Investment Company Act, and no right to pursue monetary penalties for such claims under the Investment Advisers Act. The SEC has now obtained through the Act the express right to bring aiding-and-abetting claims under all of the federal securities statutes.

The Act also lowers the state of mind required for the SEC to prove aiding and abetting. The SEC no longer needs to prove "actual knowledge" in every case. Recklessness now suffices. The Private Securities Litigation Reform Act of 1995, which gave the SEC (but not private litigants) the right to sue for aiding and abetting a violation of the 1934 Act, stated that aiding and abetting required "knowing" misconduct. Federal court decisions held that Congress meant what it said — that the SEC must prove actual knowledge, and not mere recklessness, to prevail on an aiding-and-abetting charge. The SEC has effectively nullified those decisions by obtaining from Congress the state-of-mind requirement that it wanted.

Control-Person Liability

The Act expressly authorizes the SEC to bring cases based on "control person" liability under Section 20 of the 1934 Act. Under the control-person theory, a person who directly or indirectly controls another person who commits a securities violation is responsible for that violation unless that person can show that he/she acted in good faith and did not directly or indirectly induce the violation. Control-person liability is a staple of private securities actions, but the SEC has rarely asserted control-person claims as there long were questions about whether it had the authority to bring them. Those questions have now been resolved in the SEC's favor.

This change creates significant new exposure for a company's officers and directors. If a low- or mid-level employee violates the federal securities laws, it potentially opens up the officers and directors to a control-person claim from the SEC, shifting the burden to the officer or director to show good faith and that he/she did not directly or indirectly induce the violation by the lower-level person. Thus, the SEC has a potent new tool to go after directors and senior management.

Other New SEC Powers

Broader Penalty Authority in Administrative Proceedings

Under the Act, the SEC now has the right to seek monetary penalties against any person in an administrative cease-and-desist proceeding before an SEC Administrative Law Judge. Previously, the SEC's right to seek penalties in this forum was limited to SEC-regulated entities such as broker-dealers, investment advisers, mutual funds, and their associated persons. Now, the SEC can seek this remedy from an administrative law judge against a public company and/or its current or former officers, directors, or employees, or against any individual alleged to have violated the federal securities laws.

Depending on how extensively the SEC makes use of this new power, it could radically affect the rights of companies and individuals outside the securities industry who become subject to SEC enforcement action. Previously, the SEC could seek a penalty against such defendants only by suing them before an independent Article III judge in a U.S. District Court, where they would enjoy the right to extensive discovery and a jury trial. Now, the SEC can impose a potentially substantial penalty against any person or company through an administrative proceeding with quite limited discovery and no right to a jury trial, before an administrative law judge employed by the SEC itself.

Collateral Bars

Previously, the SEC could seek to bar an associated person of a regulated entity only from the type of business the person was in when the violation occurred. Thus, a person working for an investment advisor could be barred from the investment advisory business or a person working for a broker-dealer could be barred from the brokerage business. Federal appellate courts, however, have held that the SEC could not bar a person wholesale from the securities industry — that is, a violation committed while in the investment advisory business could not be the basis for barring a person from the brokerage business, and vice-versa. The Act now provides that the SEC can seek a collateral bar that bars a person from any part of the securities business.

International Jurisdiction

The Act also codifies that the SEC's jurisdiction extends to enforcement actions with extraterritorial dimensions. First, the SEC has enforcement jurisdiction over conduct that constitutes "significant steps in furtherance of a violation" even if that violation occurred outside the United States. Second, the SEC has enforcement jurisdiction over conduct that occurred outside the United States if that conduct has a "foreseeable substantial effect" in the United States. In this regard, the Act clears up any uncertainty over the territorial scope of the SEC's enforcement jurisdiction.

Nationwide Service of Trial Subpoenas

Previously, the SEC had nationwide service of process only in administrative proceedings. By contrast, in federal court cases, given the national or international scope of many SEC enforcement actions, most of the SEC's trial testimony was given by videotaped depositions, which are generally less compelling than live testimony. Now, the SEC will be able to force its trial witnesses to testify in person, no matter how far they live from the courthouse where the case is being tried.

Whistleblowers

The Act provides a hefty monetary incentive for those aware of wrongdoing to report it to the SEC. It directs the SEC to pay whistleblowers who provide "original information" relating to a securities law violation an amount of no less than 10%, and no more than 30%, of the monetary sanctions actually collected by the SEC in connection with a successful enforcement action against the violator if the sanctions exceed $1 million. Previously, the SEC had the discretion to pay bounties only in insider trading cases, but rarely did so.

The Act also provides strong protection to whistleblowers. In particular, the Act permits whistleblowers to bring actions in federal court against their employers for retaliation. They may bring such claims within six years from the date of the violation or within three years from the date when material facts regarding the right of action reasonably should have been known to the whistleblower. The remedies include not just reinstatement, but also double back pay and litigation costs.

SEC Funding

The SEC has complained for decades that it lacked adequate resources to conduct examinations and investigations, given the number, size, complexity, and sophistication of the entities and persons it regulates. The SEC sought self-funding through the fees it collects from registrants. Congress refused to provide for self-funding, but the Act did provide for major funding increases, including establishing a $100 million reserve. It also prohibits the President from changing the SEC's budget request before it is transmitted to Congress.

New CFTC Enforcement Powers

The Act significantly expands the range of liability available for malfeasance in derivatives trading. The CFTC is charged with enforcement of the new liability provisions associated with the trading of over-the-counter derivatives.

First, the Act amends Section 4b of the Commodity Exchange Act ("CEA") to add a fraud liability provision mirroring Section 10(b) of the Securities Exchange Act. Now, just as Section 10(b) and Rule 10b-5 operate with respect to securities, Section 4b of the CEA will prohibit fraudulent activity and material misrepresentations in connection with commodity futures contracts and swaps. Section 4b now prohibits a wider range of fraudulent activity, and brings derivatives enforcement rules in line with those already in place for securities.

In a second and related provision, the Act expands liability for "manipulation" under the CEA both by broadening the scope of manipulative conduct and by including swaps within the proscriptive ambit of the statute. The Act also broadens liability for providing false or misleading information to the CFTC, by eliminating the requirement that such information had to be provided in a registration statement or report filed with the CFTC.

Finally, the Act proscribes a variety of additional practices, including forms of insider trading, newly defined "disruptive practices," and fraudulent activity where a swap dealer is acting as an advisor. The CFTC is also given authority to establish "business conduct requirements" for swap dealers, which will include duties to disclose material information to transaction counterparties.

According to the Act, the CFTC's enforcement authority includes nationwide subpoena power, and the ability to seek sanctions including industry bars, civil monetary penalties, and restitution.

Conclusion

Dodd-Frank has ramped up the enforcement mandates of the SEC and CFTC more than at any time since the agencies were created. Their jurisdictional reach is broader, the causes of action they can bring have increased, and their remedies have expanded. Public companies, regulated entities, and hedge funds, as well as their officers, directors, and employees, should brace themselves and prepare for a significant increase in enforcement activity by both the SEC and the CFTC.

If you would like to discuss the Act and our capabilities to assist you in SEC and CFTC enforcement matters, please contact the following members of our firm:

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