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Investor Protection Provisions of Dodd-Frank

K&L Gates published this alert prior to July 21, 2010, the date on which President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. However, this alert discusses the final version of the bill that would eventually be signed into law.

The investor protection provisions of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010) promise to make major changes in the world of securities enforcement and regulation. Thanks to Dodd-Frank, we will shortly see whistleblowers enticed by potentially lucrative bounties for reporting violations to a much larger and more powerful SEC. In addition to seeing its budget likely double over the next five years, the SEC will benefit from relaxed proof standards in pursuing secondary actors, expanded jurisdiction over foreign cases, the ability to obtain penalty awards in SEC administrative cases, industry-wide bars for securities professionals, and the ability to subpoena trial witnesses nationally. The SEC will also have the power to impose fiduciary standards on brokers, regulate short selling, restrict customer arbitration agreements, and engage in other extensive rulemaking.

With further changes in this area unlikely as the bill moves towards final enactment over the next few days, this alert reviews key provisions that will soon begin to impact investors, public companies, securities professionals and their counsel.

Whistleblower Provisions

Dodd-Frank Section 922 provides powerful monetary incentives for individuals who know of a securities violation to contact the SEC and provide assistance in the investigation and prosecution of wrongdoing. At the same time, Section 922 creates significant new protections for such persons.

Section 922 provides mandates that, where information provided by a whistleblower leads to an SEC enforcement action that results in monetary sanctions of more than \$1 million, the SEC must pay that individual a bounty of between 10 and 30 percent of those amounts. The SEC must also pay a bounty where information provided by the whistleblower leads to enforcement action by the Justice Department, another federal agency, an SRO, or a state attorney general. Determination of the precise amount of the bounty is left to the discretion of the SEC, taking into consideration factors such as the importance of the information and the degree of assistance provided.

To qualify for a bounty, the whistleblower must have voluntarily provided information that was “derived from the independent knowledge or analysis” of the whistleblower, that was not known to the SEC from any other source, and that “led to the successful enforcement of” the SEC or other proceeding. The program begins immediately, and whistleblowers can get bounties for information provided even before the SEC issues its implementing regulations. (§924) The SEC is expected to actively promote the whistleblowing program, and the Act tasks the SEC’s Inspector General with reporting to Congress whether the SEC does so. (§922)

Bounties must be paid even to whistleblowers who are themselves violators, unless they are criminally convicted. (Whistleblowers may also be eligible for cooperation agreements limiting their civil liability under the SEC Enforcement Division's new cooperation policy for individuals). The Act also provides that whistleblowers may remain anonymous (by acting through counsel) until prior to payment of the bounty. Whistleblowers who provide false information are not entitled to any award, and whistleblowers are not entitled to awards in connection with information acquired while they were employed by a regulator, law enforcement agency or SRO.

The SEC will pay bounties from a newly-created "Investor Protection Fund," funded with undistributed sanctions from other SEC cases, and it is anticipated that this will always be sufficient, even where the whistleblower's tip in a particular case leads to a monetary sanction that is collected by a non-SEC enforcer such as a state attorney general.

The Act also significantly enhances the protections available to these whistleblowers, providing for a private right of action by persons who provide information to the SEC or testify in or otherwise assist an SEC investigation or proceeding. An employer may not "discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against" such a person in the "terms and conditions of employment," and a whistleblower can bring an action in federal court seeking double back pay, reinstatement with appropriate seniority, attorney and expert costs, and other relief. (§922)

Expanded Secondary Liability

Section 929-O of the Act provides for the SEC to impose aiding and abetting liability on persons who "recklessly" provide substantial assistance to someone who violates the Exchange Act. Previously, the SEC was generally required to show that such assistance was provided "knowingly." In addition, the Act provides, for the first time, for aiding and abetting liability under the Securities Act, the Investment Company Act and the Investment Advisers Act. (§§929-M and 929-N)

The Act will not create a private right of action for aiding and abetting liability claims, but the Act directs the GAO to study whether private plaintiffs should also be allowed to sue aiders and abettors. (§929-Z) Private plaintiffs have been unable to bring such claims since the Supreme Court's Central Bank decision in 1994, and the Court's 2008 Stoneridge decision has blocked plaintiffs from bringing similar "scheme" liability claims.

The Act also clarifies that the SEC may pursue enforcement actions against so-called "control" persons – those found to "directly or indirectly control" a violator – unless they acted in "good faith" and did not "directly or indirectly induce" the violative conduct. Previously the relevant Exchange Act provision (Section 20) could have been interpreted to restrict such "control person" claims to private plaintiffs. (§929-P(c))

Jurisdiction Over Foreign Securities Transactions

In June 2010, the Supreme Court, in the *National Australia Bank* case, rejected the notion that the Exchange Act applies to private claims by foreign investors relating to transactions on foreign exchanges (so-called "f-cubed" claims). Dodd-Frank provides for U.S. jurisdiction over actions brought by the SEC under the antifraud provisions of the Exchange Act and Investment Advisers Act relating to securities transactions outside the U.S. where the defendant took "significant steps" in the U.S. to further the violation, or if the foreign misconduct had a "foreseeable substantial effect" within the U.S.

Foreign plaintiffs have often preferred to file in U.S. courts, where pretrial discovery is extensive and where juries can award substantial amounts in damages. (§929-P(b)) Dodd-Frank directs the SEC to conduct a study on whether extraterritorial jurisdiction should to apply to private actions under the antifraud provisions. (§929-Y)

Doubling the SEC's Budget

For most of the Senate-House conference on Dodd-Frank, it appeared that the SEC would finally achieve the so-called "self-funding" status used to fund most other financial services regulators. The

SEC has actually generated enough to fund itself for years with relatively inconsequential transaction and registration fees Congress authorized long ago, but the self-funding proposal would have allowed the SEC to adopt the banking agency model of adjusting its own budget to cover its operational needs, subject to general Congressional oversight. Proponents, including prominent securities practitioners, argued that this would allow the SEC to respond quickly to market developments and to engage in long-term planning on technology and staffing.

During the final days of the Senate-House conference, despite the absence of significant opposition, the self-funding provision was suddenly replaced by a compromise measure providing that, while the SEC will remain subject to the annual appropriations process, it will no longer be folded into a small corner of the Administration's general budget request. Instead, for fiscal 2012 and after, the SEC will prepare its own budget that the President "shall" transmit to Congress "in unaltered form" and separate from the Administration's budget. The SEC's budget is to itemize amounts the SEC needs for its operations, designate additional "contingency funding" to be used to meet "unanticipated needs," and designate particular activities for which "multi-year budget authority" would be suitable. Congress can then determine to provide the amount requested in the SEC's budget or make adjustments.

Dodd-Frank has preliminarily "authorized" a series of increases in SEC funding over the next five years from \$1.3 billion in fiscal 2011 to \$2.25 billion in 2015, effectively doubling the SEC's budget over that period. If the SEC proposes annual budgets within these "authorized" amounts – and bearing in mind that SEC budgets are funded out of existing transaction and registration fees, not tax dollars – it is likely that Congress will "appropriate" these substantially increased amounts it has already "authorized." In addition, the SEC will be able to tap a new \$100 million SEC "Reserve Fund" to supplement its budget and facilitate long-range planning and commitments, and that fund will be replenished in \$50 million annual increments out of SEC fee income. These increases should have a profound effect on the number and complexity of enforcement cases it files, and it should allow a

substantial expansion of the number and quality of its examinations. (§991)

Penalties in Administrative Proceedings

Since 1990, the SEC has been authorized to bring administrative cease-and-desist proceedings before its own administrative law judges as an alternative to bringing injunctive actions in federal court. Like court proceedings, these administrative proceedings could result in an order prohibiting future violations and requiring disgorgement of illegal profits – but only a federal court could award additional amounts (which have often been substantial) as a "penalty" to deter future misconduct. The Act provides for penalty awards to be made in administrative proceedings as well. As a result, the SEC may now bring more of its cases as administrative proceedings, where pretrial discovery is limited, where there is no right to a jury trial, and where the administrative law judge's decision is reviewed de novo by the SEC commissioners who originally directed that the proceeding be filed. (§929-P(a))

Fiduciary Standard for Brokers

The Act authorizes the SEC to issue rules to impose fiduciary duties on brokers and dealers when they provide "personalized investment advice about securities to a retail customer" after conducting a study. The SEC is empowered to "harmonize" the standard of conduct for such brokers and dealers with that presently imposed on investment advisers, requiring them to "act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice," and to disclose "any material conflicts of interest." (§913(g) and (h)) The SEC may also issue rules requiring brokers to provide particular information before purchase of an investment product or service by a retail investor, including information about investment objectives, strategies, costs and risks, as well as the compensation and other financial incentives of the broker and any intermediary. (§919)

Securities Industry-Wide Bars

The Act provides that when a securities professional is suspended or barred because of misconduct, the suspension or bar will extend to prohibit that person's association with any "broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization."

Previously, such suspensions or bars could relate only to working in the capacity in which the person committed the violation – e.g. an investment adviser could only be suspended or barred from working as an investment adviser, but not also from working as a broker. (§925)

SEC Authority to Restrict Customer Arbitration Agreements

The Act authorizes the SEC to issue rules limiting, imposing conditions on, or even entirely prohibiting agreements that require arbitration by customers of brokers, dealers, municipal securities dealers and investment advisers. The SEC can issue such rules if it determines they are "in the public interest and for the protection of investors." To the extent the SEC restricts the arbitration of customer disputes, customers will be free to litigate their claims in court, unrestrained by the confidentiality that applies to arbitration proceedings and where they can conduct pretrial discovery and have their cases decided by juries, with legal points ruled on by judges and decisions subject to judicial review. (§921)

Nationwide SEC Trial Subpoenas

The Act enables both the SEC and defendants in SEC federal court litigation to issue subpoenas requiring witnesses located anywhere in the United States to appear in person at trials and hearings. Previously, with a few technical exceptions, witnesses could only be required to appear if they were within a 100-mile radius of the courthouse, which often meant that juries heard much of the testimony by watching videotapes of pretrial depositions, sometimes taken months earlier before trial strategies had coalesced. The SEC has long had nationwide subpoena power for its administrative proceedings and investigations, and giving the SEC the same power for its federal court litigation puts

the SEC on the same footing as many other federal agencies. (§929-E)

Deadlines for SEC Enforcement Actions, Inspections and Examinations

Once the SEC's enforcement staff notifies a target that they are considering enforcement action (the SEC's so-called "Wells" notice), the staff will have 180 days to actually file their case. Similarly, once the SEC's compliance inspections and examinations staff completes an on-site examination or inspection and obtains all requested records, the staff has 180 days to request corrective action or provide notice that the matter is concluded. Either of these deadlines can be extended for a second 180-day period on notice to the SEC Chairman and, with Commission approval, for any number of successive 180-day periods. This provision reflects an effort to address situations in which matters have gone unresolved, sometimes for years, although it will not address delays in investigations that have not yet advanced to the Wells notice stage. (§929-U) In a similar vein, Dodd-Frank requires SEC action to approve or disapprove proposed SRO rule changes within 180 days from publication or, subject to certain exceptions, the rule will be deemed to be approved. (§916)

Investor Advocacy

Dodd-Frank creates an "Investor Advocate," who will report directly to the SEC Chairman and be responsible for identifying issues of concern to retail investors. (§915) The Investor Advocate will appoint an "Ombudsman" to act as a liaison between the Commission and retail investors. (§919-D) Additionally, a new "Investor Advisory Committee" composed of the Investor Advocate, state regulators and representatives of a broad cross-section of the investing public will meet at least twice a year to advise and consult with the SEC on investor protection issues. (§911)

SEC Operational Improvements

Dodd-Frank makes a number of additional technical improvements in the way the SEC executes its investor protection mission, including:

- Hiring Market Specialists. The SEC will be able to use the streamlined hiring authority it already has in recruiting certain professionals to add staff with “specialized knowledge of financial and capital market formation or regulation, financial market structures or surveillance, or information technology.” This will assist the SEC’s ongoing efforts to build greater securities industry experience into an agency largely dominated by lawyers and accountants. (§929-G)
- Sharing Information with Other Agencies. The Act provides for the maintenance of any privileges that may apply to information that the SEC exchanges with other federal agencies, the PCAOB, any SRO, and any state or foreign securities or law enforcement authority. This will assure continued protection of information covered by the government law enforcement and deliberative privileges, the attorney-client privilege, the work product protection and other privileges. This provision is likely to facilitate greater coordination and cooperation among securities enforcement agencies, including the sharing of internal evidence and market data analyses and dialogues on possible prosecution theories. (§929-K)
- Paying Penalties to Victims. Regardless of whether it has collected any disgorgement in a particular case, the SEC may contribute all amounts collected as penalties to any fund established for the victims of the violation. Previously, due to a technicality in Sarbanes-Oxley, the SEC could only pay penalties to victims if the SEC had also collected disgorgement. (§929-B)
- Investor Testing. The SEC will be able to engage in “investor testing programs” and other initiatives to gather information from investors. The SEC may consult with “academics and consultants” in carrying out these programs. (§912)
- Self-Examination. Within 90 days, the SEC must hire an independent consultant to examine

its internal operations, structure, funding, and the need for comprehensive reform of the SEC, as well as the SEC’s relationship with and the reliance on SROs and other entities relevant to the regulation of securities and the protection of investors. The report of this consultant – due within six months after retention of the consultant – must be provided to the relevant Congressional committees.

Other Substantive Changes

Additional Dodd-Frank measures designed to enhance investor protections include the following:

- SIPC Limits. The Act increases SIPC protection for investors, raising the “maximum cash advance amount” from \$100,000 to \$250,000, with the possibility of further increases for inflation. (§929-H)
- Foreign Accountants. The Act expands Sarbanes-Oxley provisions relating to foreign public accounting firms, placing them under the jurisdiction of U.S. courts and requiring them to produce to the SEC and PCAOB audit work papers “and all other documents of the firm related to” audits or interim reviews of any issuer. (§929-J)
- Market Manipulation. The Act extends to over-the-counter securities existing prohibitions on market manipulation of listed securities contained in Sections 9 and 10(a) of the Exchange Act. Previously, manipulations of OTC securities have been prosecuted under Section 10(b) and Rule 10b-5. (§929-L)
- Short Selling. The Act prohibits any “manipulative short sale of any security” and authorizes the SEC to issue rules to enforce this provision. The SEC must issue rules providing for public disclosure at least monthly of short sale activity in each security. Brokers must notify customers that they may elect not to allow their securities to be used in connection with short sales, and brokers must disclose that they may receive compensation for lending their customers’ securities. The SEC may by

- rule specify the “form, content, time, and manner of delivery” of such customer notifications. (§929-X)
- Reg D Disqualifications. The SEC must issue rules within one year to bar felons and various civil violators, among others, from participating in private placements under Regulation D. (§926)
 - Asset-Backed and Municipal Securities, Credit Rating Agencies and Corporate Governance. Title IX of the Act includes various other important investor protections and securities regulatory improvements not specifically discussed above. These deal, among other things, with the regulation of credit rating agencies, the asset-backed securitization process, corporate accountability and executive compensation, strengthening corporate governance, and municipal securities. Most of these areas will be discussed in detail in separate K&L Gates alerts to be issued shortly.

Potential Areas for Future Changes

In lieu of undertaking reforms in a number of controversial areas, Dodd-Frank instead directs the SEC to undertake a wide variety of studies – most due within six months – which may in turn lead to further legislation or rulemaking. These mandated SEC studies will include:

- the effectiveness of existing standards of care applicable to brokers, dealers and investment advisers in providing personalized investment advice and recommendations about securities to retail customers, and regulatory gaps relating to these issues;
 - whether the SEC should engage the assistance of SROs in conducting examinations of investment advisers;
 - the adequacy of examinations of investment advisory activities of dually registered broker-dealers and investment advisers and their affiliates;
 - the level of financial literacy of retail investors, and what means might be most effective to further educate them;
 - potential improvements in disclosures to investors regarding financial intermediaries, investment products, and investment services;
 - methods to increase the transparency of expenses and conflicts of interests in transactions involving investment services and products, including shares of open-end companies; and
 - how to better facilitate investor access to information regarding disciplinary actions; regulatory, judicial, and arbitration proceedings; and other information about registered investment advisers, brokers and dealers.
- Additionally, the Act directs the Government Accounting Office to conduct studies – most due within eighteen months – regarding:
- mutual fund advertising;
 - conflicts of interest that may result from having investment banking and securities analyst functions within the same firm;
 - regulation of financial planners;
 - employment of former SEC personnel by institutions regulated by the SEC;
 - proprietary trading by and within insured depository institutions, bank holding companies, financial holding companies and certain of their affiliates and other entities;
 - person-to-person lending; and
 - the impact of the amendments made by the Act to the exemption for smaller issuers from the registered public accounting firm attestation requirements mandated by Sarbanes-Oxley Section 404(b).

Finally, the Act requires the SEC's Inspector General to conduct a study of the whistleblower protections established under the Act, to be completed within 30 months.

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