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Landmark Legislation Gives SEC New Enforcement Capability

The newly approved financial reform bill contains new measures expanding the SEC's enforcement authority and strengthening its oversight and regulatory authority over the nation's securities markets.

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On July 15, the U.S. Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Wall Street Reform Act, or the Act), which President Obama is expected to sign into law shortly. This landmark legislation contains an array of important new measures that significantly expand the enforcement authority of the U.S. Securities and Exchange Commission (SEC) and strengthen its oversight and regulatory authority over the securities markets.[1] These new measures will dramatically improve the SEC's "real-time enforcement" abilities, as it attempts to deliver on its promise to move more swiftly in enforcement actions to restore investors' faith in the markets.[2]

Many important questions related to the new legislation, such as whether fiduciary duties will be imposed on broker-dealers, whether the SEC will attempt to restrict mandatory predispute arbitration, or whether aiding and abetting liability for securities laws violations should be extended to private civil actions, have yet to be answered. The compromises that were necessary for passage of the Act resulted in the authorization of studies and granting of agency rulemaking authority without specific mandates as to any particular outcome. Thus, additional significant changes to the enforcement and regulatory landscape will continue to be considered and debated for some time while agency study and rulemaking proceeds.

Nevertheless, existing provisions in the Act that do not require further consideration before becoming effective provide substantially increased enforcement capabilities to the SEC. We highlight below key provisions not requiring further agency action or study that directly impact the SEC's enforcement and regulatory program.

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1 The key provisions within the legislation related to SEC regulation and enforcement are contained principally within Title IX, "Investor Protections and Improvements to the Regulation of Securities"; subtitle A, "Increasing Investor Protection"; subtitle B, "Increasing Regulatory Enforcement and Remedies"; and subtitle H, "Municipal Securities."

2 Morgan Lewis has published several articles about the SEC's reform efforts, including: "SEC Announces New Cooperative Initiatives, *available at* http://www.morganlewis.com/pubs/WP_SECAnnouncesNewCooperationInitiative_Jan2010.pdf; and "SEC Speaks 2010: Fast-Paced Reform Continues in 2010," *available at* http://www.morganlewis.com/pubs/SecuritiesLF_SECSpeaks2010_11feb10.pdf.

CHANGES TO SEC ENFORCEMENT AND MARKET OVERSIGHT

Extension of Liability and Jurisdictional Regulations

Aiding and Abetting Liability[3]

Prior to the Act's passage, the Exchange Act of 1934 (Exchange Act) and the Investment Advisers Act of 1940 (Advisers Act) permitted the SEC to bring actions for aiding and abetting violations of those statutes in federal civil proceedings. The Act extends the SEC's enforcement authority to prosecute those who aid and abet primary violators of the federal securities laws under the Securities Act of 1933 (Securities Act) and the Investment Company Act of 1940 (Investment CompanyAct), and codifies the SEC's authority to impose penalties against aiders and abettors under the Advisers Act. The Act therefore brings the SEC's federal civil enforcement authority in line with its existing administrative authority to institute proceedings and seek sanctions against regulated entities and individuals for aiding and abetting violations.[4]

In addition, the Act clarifies the SEC's authority to pursue aiders and abettors for *reckless*, as well as *knowing*, conduct. The preexisting law permitted the SEC to charge individuals who knowingly provided substantial assistance to primary violators. The courts have been split, however, on the question of what constitutes knowing assistance, with some courts holding that "knowingly" meant what it said—actual knowledge, rather than recklessness. The Act resolves this issue and makes clear that the knowledge requirement can be satisfied by reckless conduct.

Control Person Liability under the Exchange Act[5]

The Act amends the Exchange Act to permit the SEC to impose joint and several liability on control persons. Under the preexisting statute, control persons were liable, to the same extent as persons they controlled, to any *person* to whom the controlled person was liable.[6] Although the SEC routinely brings enforcement actions against individuals based on control person liability, some disagreement among the courts has existed based on the preexisting language as to whether control person liability is available as an enforcement mechanism to the SEC. In *SEC v. First Jersey*, 101 F.3d 1450 (2d Cir. 1996), the court upheld the SEC's authority to pursue an enforcement action under the Exchange Act control person provision; the court in *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974) however, found that the SEC had no such authority. The Act resolves the issue, giving the SEC authority to pursue such actions.

Extension of Statute of Limitations for Securities Laws Violations[7]

The Act extends the statute of limitations for the prosecution of a "securities fraud offense" from five years to six years from the commission of the offense. The Act defines a securities law offense to include criminal securities fraud and willful violations of the Securities Act, the Exchange Act, the Advisers Act, the Investment Company Act, and the Trust Indenture Act of 1939. Previously, the SEC and the federal

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3 Wall Street Reform Act §§ 929M, 929N, and 929O.

4 *See, e.g.*, Exchange Act § 15(b)(4)(E); Investment Advisers Act § 203(e)(6).

5 Wall Street Reform Act § 929P(c).

6 Exchange Act § 20(a).

7 Wall Street Reform Act § 1079A (Financial Fraud Provision). This provision adds a new Section 3301 to Chapter 213 of Title 18 of the U.S. Code.

government were subject to a five-year statute of limitations set forth under 28 U.S.C. § 2462 for enforcement actions seeking civil penalties.

Expansion of the Application of Antifraud Provisions[8]

The Act modifies the market manipulation provisions of Section 9 and the short sale provisions of Section 10(a)(1) of the Exchange Act to extend to any security other than a government security, rather than only to securities registered on a national securities exchange. Further, the Act extends Section 9(b) of the Exchange Act, which relates to puts, calls, straddles, and options, to expressly cover transactions that do not occur on a national exchange. Additionally, the Act modifies Section 9(c) of the Exchange Act, which relates to the endorsement or guarantee of puts, calls, straddles, or options, to specifically cover all broker-dealers, rather than only members of a national securities exchange. The Act also amends Section 15(c)(1)(A) of the Exchange Act to bring exchange transactions within its antimanipulation restrictions.

Extraterritorial Jurisdiction[9]

The Act expands the jurisdiction of federal courts in actions brought by the SEC or the Department of Justice (DOJ) that allege violations of the antifraud provisions of the Securities Act, the Exchange Act, and the Advisers Act. Congressional leaders have stated that the purpose of this provision is to make clear that in actions or proceedings brought by the SEC or DOJ, the specified provisions of the Securities Act, the Exchange Act, and the Advisers Act may have extraterritorial application, and that for potential Securities Act or Exchange Act violations, extraterritorial application is appropriate regardless of whether the securities are traded on a domestic exchange or the transactions occur in the United States, when the conduct within the United States constitutes "significant steps in furtherance of the violation" or when conduct occurring outside the United States has a "foreseeable substantial effect" within the United States.[10]

The Act's provisions concerning extraterritoriality of the federal securities laws are intended to rebut the presumption against extraterritorial application of the federal securities laws that the U.S. Supreme Court announced recently in its decision in *Morrison v. National Australia Bank*, No. 08-1191, wherein the Court ruled that for purposes of private rights of action, antifraud provision Section 10(b) of the Exchange Act applies only to transactions listed on U.S. stock exchanges and securities transactions within the United States. Thus, while the Act does not override the Court's decision, it prevents the potential extension of the Court's decision to actions brought by the SEC or DOJ.

Jurisdiction over Formerly Associated Persons[11]

The Act authorizes the SEC to institute proceedings against persons formerly associated with a registered entity (such as the Municipal Securities Rulemaking Board (MSRB), broker-dealers, government securities brokers or dealers, investment companies, national securities exchanges, registered securities associations, registered clearing agencies, self-regulatory organizations, and public accounting firms). This authorization is consistent with FINRA rules that permit the agency to bring suits against persons formerly associated with a member within two years after the effective date of the person's termination or

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8 Wall Street Reform Act § 929L.

9 Wall Street Reform Act § 929P(b).

10 Congressional Record, June 30, 2010, at H 5237.

11 Wall Street Reform Act § 929F.

cancellation of registration, or in the case of a nonregistered person, two years after the date that the person ceased to be associated with the member.[12]

Enhanced Remedies

Collateral Bars for Securities Laws Violators[13]

In *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999), the SEC was held to lack the authority to impose "collateral bars" on violators of the securities laws. The new legislation would permit the SEC to impose collateral bars, so that, for example, a person who had violated the Exchange Act provisions relating to broker-dealers could be barred not only from the broker-dealer business, but also the municipal securities dealer business regulated under other provisions of the Exchange Act and the investment advisory business regulated by the Advisers Act. The new legislation would permit the SEC, in one stroke, to remove such a violator from the financial industry entirely.

Civil Penalties in Cease-and-Desist Proceedings[14]

The Act increases the SEC's existing enforcement authority by permitting the SEC to seek civil penalties in cease-and-desist proceedings against any person found to have violated the securities laws. Under preexisting law, the SEC could impose civil penalties in administrative proceedings only against regulated entities and associated persons. The new legislation would primarily affect public companies, their officers and directors, and their accountants, by granting the SEC administrative penalty authority over them.

Securities Whistleblower Incentives and Protections[15]

The Act includes new whistleblower provisions designed to motivate those with inside knowledge to come forward voluntarily and assist the SEC in identifying and prosecuting persons who have violated federal securities laws. Previously, the SEC had the authority to compensate individuals for providing information leading to the recovery of civil penalties in insider trading cases, but the total amount of bounties that could be paid from a civil penalty could not exceed 10% of the collected penalties.[16]

The Act expands the SEC's current bounty program to cover *any* potential violation of the securities laws and requires the SEC to pay whistleblowers who voluntarily provide original information between 10% and 30% of monetary sanctions exceeding $1 million from a successful judicial or administrative action brought by the SEC, although the SEC would have discretion to set the reward between those points. In determining the amount of the award, the SEC is required to consider a number of factors, such as the significance of the information provided and the degree of assistance provided, along with the programmatic interest of the SEC in deterring securities laws violations.

Moreover, under the Act SEC whistleblowers subject to retaliatory discrimination may directly file suit in federal district court instead of having to first file a complaint with the Department of Labor. Such actions must be filed no more than six years after the date of the alleged violation, or three years after the date

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12 FINRA By-laws Article V, Section 4(a).

13 Wall Street Reform Act § 925.

14 Wall Street Reform Act § 929P(a).

15 Wall Street Reform Act §§ 922–924, and 929A.

16 Exchange Act § 21A(e).

when facts material to the right of action are known or reasonably should have been known by the employee alleging the violation. No action, however, may be brought more than 10 years after the date on which the violation occurred.

In addition, the Act expands the whistleblower protections already in place under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)[17] to expressly prohibit retaliation against whistleblower employees of subsidiaries and affiliates of publicly traded companies, extends the current statute of limitations on Sarbanes-Oxley whistleblower claims from 90 days to 180 days, and allows for a jury trial. The Act also extends whistleblower protections to employees of nationally recognized statistical rating organizations (credit-rating agencies).

The Act requires the SEC to promulgate final rules implementing the provisions of its whistleblower program within 270 days after enactment, and requires that the SEC create an office to administer the program.

Regulation of Municipal Securities[18]

The Act strengthens oversight of municipal securities and enhances municipal investor protections. The Act requires municipal advisers who provide advice to a municipal securities issuer with respect to municipal financial products or the issuance of municipal securities, or who undertake a solicitation of a municipal entity, to register with the SEC. The Act also grants the SEC authority to regulate and sanction municipal advisers for fraudulent conduct and other violations of the federal securities laws.

The Act imposes a fiduciary duty on municipal advisers and associated persons when advising municipal issuers, and instructs the MSRB to adopt rules reasonably designed to prevent conduct inconsistent with this fiduciary duty. The Act imposes liability on municipal advisers for breaches of this fiduciary duty and for fraudulent, deceptive, or manipulative acts or practices.[19]

In addition, the Act expands MSRB rulemaking authority over broker-dealers, municipal securities dealers, and municipal advisers and permits the MSRB to regulate *advice* provided by these entities and individuals to issuers (until now the MSRB had the authority to regulate municipal securities transactions), and requires the MSRB to set professional standards for municipal advisers.[20]

Further, the Act provides for enhanced interaction between the SEC and MSRB. For example, the Act authorizes the MSRB to provide guidance and assistance to the SEC (and FINRA) in enforcement actions concerning MSRB rules, and to share fines collected by the SEC and FINRA for MSRB rule violations; the Act also establishes an Office of Municipal Securities within the SEC to administer the SEC's rules with respect to municipal securities dealers, advisers, investors, and issuers and to coordinate directly with the MSRB for rulemaking and enforcement actions.

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17 Sarbanes-Oxley Section 806 creates protections for whistleblowers who report securities fraud and other violations from retaliation by their public company employers.

18 Wall Street Reform Act §§ 975, 976, and 979.

19 The statutory imposition of a fiduciary duty on municipal advisers in this context is consistent with the Supreme Court's ruling in *SEC v. Capital Gains Research Bureau, Inc*., where the Court held that investment advisers are deemed to be fiduciaries who owe their clients an affirmative duty of utmost good faith, owe their clients full and fair disclosure of all material facts, and are required to employ all reasonable care to avoid misleading their clients. 375 U.S. 180, 194–99.

20 These provisions become effective October 1, 2010.

The Act also instructs the Government Accountability Office to conduct several studies of the municipal securities markets, including a study of the disclosure required to be made by issuers of municipal securities.[21] The SEC has demonstrated an acute interest in investor disclosure related to municipal securities. In May 2010, the SEC unanimously approved rule changes designed to improve the quality and timeliness of securities disclosures of municipal issuers.[22] Among other things, the new rules require a broker, dealer, or municipal underwriter to reasonably determine that an issuer has agreed to provide notice of certain important events—*without regard to materiality*—within 10 days after the event's occurrence. These events include the failure to pay principal and interest, financial difficulties experienced by the issuer such as unscheduled payments by parties backing the issuance, and rating changes.

Additional Procedural Enhancements for Enforcement Actions

Nationwide Service of Subpoenas[23]

The Act grants the SEC nationwide subpoena power in connection with civil actions filed in federal courts. The legislation allows the SEC to serve subpoenas "at any place within the United States" in federal civil actions and would remove geographical restrictions imposed by Rule 45(c)(3)(A)(ii) of the Federal Rules of Civil Procedure. The SEC already has authority to serve subpoenas nationwide in administrative proceedings.

"Speedy Trial Act" for Commencement of SEC Enforcement Actions[24]

The Act also requires that the SEC must file an enforcement action within 180 days after notifying a person in writing that it intends to recommend that an enforcement action be instituted against that person, or provide notice to the Director of the Division of Enforcement of its intent to not file an action. However, the SEC may seek an extension of this deadline in instances where the Enforcement Division Director determines, upon notice to the Chairman of the SEC, that the investigation is sufficiently complex that the filing of an action cannot be completed within the 180-day deadline.

Protecting Confidentiality of Materials Submitted to the SEC[25]

In addition, the Act provides limitations on disclosure of certain information registered persons and entities provide to the SEC pursuant to its examination authority, if such information has been obtained by the SEC for purposes of surveillance, risk assessments, or other regulatory and oversight activities, and provides that the SEC shall not be compelled to disclose such information, except in circumstances limited to congressional or other federal agency requests, or a federal court order issued in connection with an action instituted by the DOJ or SEC.

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21 Under the Exchange Act, the SEC and MSRB currently are precluded from requiring disclosure in municipal offerings. *See* Exchange Act §15B(d) (known as the Tower Amendment).

22 These rule changes amend Exchange Act Rule 15c2-12, which generally prohibits underwriters from purchasing or selling municipal securities unless they reasonably have determined that the municipality or other designated entity has agreed to make certain information available to investors on an ongoing basis such as annual financial statements, payment defaults, rating changes, and prepayments. The rule changes become effective December 1, 2010, and can be found at http://www.sec.gov/rules/final/2010/34-62184a.pdf. The SEC's press release announcing these measures can be found at http://www.sec.gov/news/press/2010/2010-85.htm.

23 Wall Street Reform Act § 929E.

24 Wall Street Reform Act § 929U.

25 Wall Street Reform Act § 929I.

Sharing Privileged and Other Information with Other Authorities[26]

The Act allows the SEC and other domestic and foreign law enforcement authorities to share privileged information without waiving any privilege applicable to that information. Further, the Act provides that the SEC shall not be compelled to disclose privileged information obtained from a foreign securities or law enforcement authority if the authority represents to the SEC in good faith that the information is privileged.

The Act, however, *does not* include a provision contained in the original House Bill, which would have permitted a federal court to grant the SEC access to certain information and materials related to matters occurring before a grand jury otherwise subject to the grand jury secrecy rule, as noted in an earlier Morgan Lewis Financial Regulatory Reform LawFlash.

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We will continue to monitor the ongoing developments of Financial Regulatory Reform. If you have any questions or would like more information on the issues discussed in this LawFlash, please contact the authors, **Patrick D. Conner** (202.739.5594; pconner@morganlewis.com) and **E. Andrew Southerling** (202.739.5062; asoutherling@morganlewis.com), or any of the following Morgan Lewis attorneys:

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In addition, Morgan Lewis's multidisciplinary Financial Regulatory Reform resource team is available to assist with a wide range of issues and areas of concern related to the reform effort. You can access a complete collection of the firm's updates and alerts on the subject on our website's Financial Regulatory Reform page.

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[26] Wall Street Reform Act § 929K.

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