

Congress Set to Arm SEC with Increased Enforcement Capability

The U.S. financial reform legislation that recently passed in the Senate and House is expected, after reconciliation in joint committee, to bring a new expansion of SEC market oversight, including collateral bars for securities laws violators, new whistleblower incentives and protections, and increased regulation of municipal securities.

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On May 20, the U.S. Senate passed the Restoring American Financial Stability Act of 2010 (the Senate bill).¹ The Senate bill will be reconciled with a similar bill the U.S. House of Representatives passed on December 11, 2009, the Wall Street Reform and Consumer Protection Act of 2009 (the House bill).² These legislative measures are broadly designed to improve accountability and transparency in the financial system. In addition, these bills include an array of provisions which, if enacted into law, would reinforce and expand the enhancement of U.S. Securities and Exchange Commission (SEC) oversight of the financial markets and enforcement of the federal securities laws that began as a result of the recent financial crisis.

Although differing in some respects, the Senate and House bills both aim to provide the SEC with additional tools to keep watch over the securities markets, and reinforce the SEC's ongoing regulatory efforts to enhance investor protection. We highlight below key subject areas that are addressed in both the Senate and House bills that would impact the SEC's regulatory and enforcement program. We also summarize key stand-alone provisions within the House bill that, if they survive reconciliation, would further enhance the SEC's enforcement powers by enacting proposals that have been on the SEC's legislative "wish list" for many years.

The Senate and House Bills: Enhanced SEC Enforcement and Market Oversight

Collateral Bars for Securities Laws Violators

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

¹ The key provisions related to SEC regulation and enforcement are contained principally within Title IX, Subtitle B, titled Investor Protections and Improvements to the Regulation of Securities.

² The key provisions within the House bill related to SEC regulation and enforcement are contained principally within Subtitle C, titled Investor Protection Act.

impose collateral bars, so that, for example, a person who had violated the Securities Exchange Act of 1934 (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 Investment Advisers Act of 1940 (Adviser Act).³ The new legislation would permit the SEC, in one stroke, to remove such a violator from the financial industry entirely.

Securities Whistleblower Incentives and Protections

The Senate and House bills include 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. The SEC currently has 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 may be paid from a civil penalty may not exceed 10% of the collected penalties.⁴

Both bills would expand the SEC's current bounty program to cover *any* potential violation of the securities laws, but they vary in some respects in their approach.⁵ The Senate bill would make mandatory a bounty of between 10% and 30% of monetary sanctions exceeding \$1,000,000 from a successful judicial or administrative action brought by the SEC, and the SEC would have discretion to set the reward between those points. In reporting the Senate bill out of committee, the Senate Committee on Banking, Housing, and Urban Affairs stated that it “[felt] the critical component of the Whistleblower Program is the minimum payout that any individual could look toward in determining whether to take the enormous risk of blowing the whistle in calling attention to fraud.” In contrast, the House bill leaves the amount of the reward entirely subject to the SEC's discretion.

Under both bills, the SEC in determining the amount of a potential reward would balance the significance of the information and the degree of assistance provided, along with the programmatic interest of the SEC in deterring violations. Under the Senate bill, the SEC would be required to consider these factors, while the House bill would make such consideration discretionary.

Moreover, under the proposed new rules, 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.

In addition, the legislation would expand the whistleblower protections already in place under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)⁶ to expressly prohibit retaliation against whistleblower employees of subsidiaries and affiliates of publicly traded companies,⁷ and the Senate bill would extend whistleblower protections to employees of nationally recognized statistical rating organizations (credit rating agencies).

³ The Senate bill § 925; the House bill § 7206.

⁴ Exchange Act § 21A(e).

⁵ The Senate bill § 922; the House bill § 7203.

⁶ Sarbanes-Oxley § 806 creates protections for whistleblowers who report securities fraud and other violations from retaliation by their public company employers.

⁷ The Senate bill § 929A; the House bill § 7607.

Enhanced Oversight and Regulation of Municipal Securities⁸

The Senate and House bills both contain provisions aimed to strengthen oversight of municipal securities and to broaden market protections to cover previously unregulated market participants and previously unregulated financial transactions.⁹

Broadly, the legislation would require municipal advisors who provide advice to a municipal securities issuer with respect to the issuance of securities, the investment of proceeds of municipal offerings, or derivatives on municipal securities to register with the SEC, and would grant the SEC authority to regulate and sanction municipal advisors for violations of the federal securities laws.

The Senate bill would create an expanded role for the Municipal Securities Rulemaking Board (MSRB) to provide guidance and assistance to the SEC (and FINRA) in compliance examinations and the enforcement of MSRB rules, to impose penalties for violations of its rules (the MSRB currently does not have enforcement authority of MSRB rules), and to share fines equally with the SEC and FINRA.

Further, the Senate bill would establish an Office of Municipal Securities within the SEC to administer the SEC's rules with respect to municipal securities dealers, advisors, investors, and issuers and to coordinate directly with the MSRB for rulemaking and enforcement actions.

The House bill would impose upon municipal financial advisors and any person associated with such municipal financial advisor a fiduciary duty to any municipal securities issuer for whom such municipal financial advisers act as a municipal financial adviser.¹⁰

The House Bill: Key Provisions Not Included in the Senate Bill

The House bill contains several provisions that are not included in the Senate bill, as discussed below. These provisions may be in jeopardy during the reconciliation process since they did not appear in the Senate bill but, if passed, would significantly expand the SEC's enforcement capabilities.

Aiding and Abetting Liability

The Exchange Act and the Advisers Act currently permit the SEC to bring actions for aiding and abetting violations of those statutes in civil proceedings. The House bill would extend 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 and the Investment Company Act of 1940.¹¹

⁸ The SEC has increased its focus on oversight and regulation of municipal securities, and has called for enhanced investor protection in this area. In August 2009, the SEC created a specialized unit, the Municipal Securities and Public Pensions Unit, dedicated to the oversight of municipal securities, and recently approved rule changes to enhance municipal securities disclosures. These rule changes 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>.

⁹ The Senate bill §§ 975 and 979; the House bill § 7801.

¹⁰ As discussed in prior Morgan Lewis updates, the House bill also would change the standard of conduct for broker-dealers, while the Senate bill instead would require a study of the issue. See the May 24, 2010 Morgan Lewis LawFlash, "Impact of Senate Financial Reform Bill on Retail Brokerage and Private Client Services," available at http://www.morganlewis.com/pubs/FRR_PrivateClientServices_LF_24may10.pdf.

¹¹ The House bill § 7207.

In addition, the legislation would clarify the SEC’s authority to pursue aiders and abettors for *reckless*, as well as *knowing*, conduct.¹² The current law permits the SEC to charge individuals who knowingly provide substantial assistance to primary violators. The courts are split, however, on what constitutes knowing assistance, with some courts holding that “knowingly” means what it says—actual knowledge rather than recklessness. The House bill would resolve this issue and clarify that the knowledge requirement can be satisfied by reckless conduct.

Civil Penalties in Cease-and-Desist Proceedings

The House bill would increase 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.¹³ Currently, the SEC may 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 accountants, by granting the SEC administrative penalty authority over them.

Nationwide Service of Subpoenas

The House bill would grant the SEC nationwide subpoena power in connection with civil actions filed in federal courts.¹⁴ The proposed legislation would allow 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

The House bill 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.¹⁵ The SEC, however, 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 action cannot be completed within the 180-day deadline.

Access to Grand Jury Materials

To aid the SEC in its investigations, particularly in parallel investigations with the U.S. Department of Justice (DOJ), the House bill would permit a federal court to grant the SEC access to certain information and materials related to matters occurring before a grand jury that otherwise would be subject to the grand jury secrecy rule.¹⁶ Under existing law, the DOJ is generally prohibited from

¹² The House bill § 7215.

¹³ The House bill § 7211.

¹⁴ The House bill § 7210.

¹⁵ The House bill § 7209.

¹⁶ The House bill § 7214.

sharing grand jury materials with the SEC, except in the rare circumstance where the SEC demonstrates a substantial need for the information in connection with a judicial proceeding.¹⁷

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:

Miami

Ivan P. Harris	305.415.3398	iharris@morganlewis.com
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New York

Michele A. Coffey	212.309.6917	mcoffey@morganlewis.com
Anne C. Flannery	212.309.6370	aflannery@morganlewis.com
Joanna C. Hendon	212.309.6377	jhendon@morganlewis.com
Ben A. Indek	212.309.6109	bindek@morganlewis.com
Michael S. Kraut	212.309.6927	mkraut@morganlewis.com
Kevin T. Rover	212.309.6244	krover@morganlewis.com
Robert M. Romano	212.309.7083	rromano@morganlewis.com

Washington D.C.

Christian R. Bartholomew	202.739.6400	cbartholomew@morganlewis.com
Patrick D. Conner	202.739.5594	pconner@morganlewis.com
Christian J. Mixter	202.739.5575	cmixter@morganlewis.com
E. Andrew Southerling	202.739.5062	asoutherling@morganlewis.com

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¹⁷ Fed. R. Crim. P. 6(e); 18 U.S.C. § 3322.