

## Financial Reform 101: A Litigator's Toolkit

*Law360, New York (July 29, 2010)* -- The new Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law on July 21, 2010, is broad-ranging.

The provisions that relate to securities and commodities liability and enforcement reflect a reaction to the events of the past several years, focusing on enhanced enforcement powers of the SEC and CFTC, enhanced whistleblower provisions, derivatives, credit rating agencies, asset-backed securities and investment advisers. References to the relevant provisions of the Act are in parentheses.

### Enhanced SEC Enforcement Authority

#### ***Aider and Abettor Liability.***

The Act expands SEC enforcement authority to aiders and abettors. The mental state that is required is now knowingly or recklessly. (929M, 929N, 929O)

#### ***Extraterritorial Jurisdiction.***

The Act allows the SEC or the DOJ to bring actions that involve conduct within the U.S. that constitutes significant steps in furtherance of a violation, even if the securities transaction occurs outside the U.S. and involves only foreign investors or conduct occurring outside the U.S. that has a foreseeable substantial effect within the U.S. (929P)

#### ***Nationwide Service of Process.***

The Act provides for nationwide service of process in SEC administrative or District Court proceedings. (929E)

#### ***Collateral Bar.***

The SEC is given broader authority to bar persons from being associated with a broker-dealer, investment adviser, municipal securities dealer, municipal adviser, transfer agent or nationally recognized statistical rating organization. (925)

The SEC is given additional power to disqualify felons and other bad actors from participating in any regulation D offering by disqualifying any offering or sale of securities in which such a person is associated. (926)

#### ***Expanded Anti-Fraud.***

The Act expands several anti-manipulation provisions to the OTC market by expanding the scope of Secs. 9 (manipulative



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transactions, options transactions), 10(a) (1) (short sales) and 15(c)(1)(A) (broker-dealer manipulation). (929L)

#### ***Manipulative Short Sales.***

The Act adds the provision that it shall be unlawful to effect a manipulative short sale of any security and requires that a broker notify its customers that they may elect not to allow their fully-paid securities to be used in connection with short sales

and that the broker may receive compensation in connection with lending the customer securities. (929X)

#### ***Accounting Documents.***

The SEC may now demand the production of documents from foreign public accounting firms which provide material services on which a registered public accounting firm relies in the conduct of an audit or interim review, issue an audit report, perform audit work or conduct interim reviews. (929J)

#### ***Civil Penalties.***

The SEC may seek civil penalties against any person who is the subject of an administrative proceeding, not just persons associated with registered broker-dealers, and the administrative penalties are enhanced under the Act. (929P) The SEC is given expanded authority to seek penalties against control persons in administrative proceedings (929P), as well as formerly associated persons. (929F)

#### ***Beneficial Ownership Rules.***

Beneficial ownership and short-swing profit reporting is enhanced by allowing the SEC to shorten the reporting time. (929R)

#### ***Expanded Statute of Limitations.***

The statute of limitations for securities fraud offenses or a conspiracy or attempt to violate such provisions is extended to six years after the commission of the offense. (1079A)

### **Whistleblower Protection**

The Act adds and expands whistleblower provisions to the Commodity Exchange Act and the Securities Exchange Act. (748, 922) Both provisions provide incentive provisions to compensate whistleblowers if their information leads to a civil or criminal enforcement action resulting in monetary penalties exceeding \$1 million. The whistleblowers are entitled to receive payment between 10% - 30% of the monetary penalties collected, at the discretion of the relevant agency.

Both provisions create a new District Court private right of action for whistleblowers against employers who discharge, demote, suspend, threaten, harass or discriminate against them. The Act enhances SOX whistleblower protection by extending the limitations period and providing for jury trial for those whistleblowers who file a whistleblower protection claim under 18 USC § 1514(A).

Sec. 922 also expands protections for whistleblowers employed by credit rating agencies by permitting them to bring civil enforcement actions in the event of discrimination. The Act also amends SOX to clarify that employees of consolidated subsidiaries and affiliates of public companies are included in whistleblower protection under 18 USC § 1514(A) (929A).

### **Derivatives Reform**

The Act provides for comprehensive regulation of over-the-counter derivatives markets and forces swaps transactions onto a centralized exchange or regulated facility and forces clearing of the transactions through a regulated clearing house. The CFTC was given authority over swaps (721), swap dealers and major swap participants (731); the SEC was given authority over security-based swaps, security-based swap dealers and major security-based swap participants. (761)

The definition of "security" now includes security-based swaps. This subjects them to registration, anti-fraud provisions, margin, capital, and books and records provisions. (761)

Section 6(b) of the Commodity Exchange Act is amended to add swaps, and to add anti-fraud language that parallels SEC Rule 10b-5. (741)

Security-based and swap market participants must designate a Chief Compliance Officer who must ensure compliance with applicable rules, established procedures and prepare annual compliance reports. (731, 764)

Swap market participants must follow business conduct standards requiring them to disclose specific information to their non-swap market participant counterparties including material risks, material conflicts of interest, material incentives and the daily mark of the transaction (for uncleared swap and security-based swap agreements, this will require disclosure of the swap market participants mark to market)

associated with the swap transactions. The swap market participants must communicate with their non-swap market participant counterparties on the basis of fair dealing and in good faith. (731, 764)

The swap market participants are given higher duties to "Special Entities," counterparties that are a federal agency, state, state agency, city, county, municipality or other political subdivision, employee benefit and governmental plans, and tax-exempt endowments.

Where the swap market participant acts as an advisor it is subject to a specific anti-fraud provision and must act in the best interest of the Special Entity, make reasonable efforts to obtain from the special entity the information necessary to enable the dealer to make a reasonable determination that any swap recommended the client is in its best interests.

Where the swap market participants act as counterparties, the Special Entity must be advised by an independent representative with sufficient knowledge to evaluate the transaction and risk, not be subject to disqualification, be independent, undertake a duty to act in the best interest of the counterparty it represents, make appropriate disclosures, and provide specified written representations to the Special Entity. (731, 764)

Both the CFTC and SEC have authority jointly or individually to issue a report regarding swaps found detrimental to the stability of the financial market and have further authority to ban such swaps. (714)

Within the CFTC portion of the Act, a new provision states it is unlawful for any person to engage in any trading practice or conduct which violates bids or offers, demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period, or is commonly known to the trade as spoofing (bidding or offering with the intent to cancel the bid or offer before execution) (Anti-disruptive Practices Authority (747))

The Act adds parallel prohibitions against market manipulation, making it unlawful to use a manipulative or deceptive device or contrivance, including for commodities, delivering or causing false or misleading or inaccurate reports concerning crops or market information or conditions affecting the price of any commodity in interstate commerce, knowing or acting in reckless disregard of the fact that such report is false, misleading or inaccurate and for security-based swaps, making fictitious quotations. (753, 763) The Act also preempts the application of state gaming and bucket shop laws. (767)

Another provision provides that any clearing agency that knowingly or recklessly evades or participates in, or facilitates an evasion of the requirements of the law shall be liable for a civil money penalty of twice the amount otherwise available, and any security-based swap dealer or major security-based swap participant that knowingly or recklessly

evades or participates in, or facilitates an evasion of the requirements of the law shall be liable for civil money penalty in twice the amount otherwise available for violations. (773)

## Credit Rating Agencies

The Act contemplates extensive SEC regulations that will change the governance, compliance, methodologies and disclosure by credit rating agencies. It also significantly changes the liability provisions with regard to credit rating agencies. The 1934 Act did not allow private actions against credit rating agencies.

The Act now provides that the enforcement and penalty provisions will apply to statements made by a credit rating agency to the same extent as provisions applied to statements made by registered public accounting firms or securities analysts under the securities laws and shall not be deemed forward-looking statements for the purposes of section 21(E).

Another provision provides that in an action for money damages, it shall be sufficient for purposes of pleading any required state of mind that the complaint state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk or to obtain reasonable verification of such factual elements which verification may be based on a sampling technique that does not amount to an audit from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter. (933)

Another provision repealed SEC Rule 436(g) under the 1933 Act which shielded credit rating agencies from liability as experts under Sec. 11 of the Securities Act for material misstatements or omissions with respect to credit ratings included in the Registration Statement. The abrogation of Rule 436(g) adds potential significant liability to credit rating agencies under Sec. 11 of the 1933 Act. As of the date of this article, this has caused several credit rating agencies to refuse to allow their credit reports to be included in Registration Statements. (939G)

## Asset-Backed Securities

With regard to the securitization of asset-backed securities, the primary reforms relate to the retention of risk and disclosures. Thus, the banking agencies and the SEC are required to develop regulations that govern the retention of risk by securitizers or asset-backed securities. In general, for non-exempt asset-backed securities, the retention will be in the 5% range. (941)

The SEC is also required to issue disclosure regulations that will require at least asset-level or loan-level data if such data is necessary for investors to independently perform due

diligence including data having unique identifiers relating to loan brokers or originators, the nature and extent of the compensation of the broker or originator of the assets backing the security and the amount of risk retention by the originator and the securitizer of such assets. (942)

## Investment Advisers

In order to deal with the perception that private equity funds and hedge funds were operating in a regulatory gap, the Act requires that more such funds be registered with the SEC.

This was done by eliminating the private adviser exemption, limiting the intrastate adviser exemption from registration, providing for a limited exemption for foreign advisers that manage less than \$25 million of U.S. assets and have less than 15 U.S. clients, providing an exemption for venture capital fund advisers and providing a new exemption for investment advisers that are registered with the CFTC as commodity trading advisers and that advise a private fund.

In addition, the Rules mandate that investment advisers managing more than \$150 million of assets must register with the SEC. (402, 403, 407)

For those advisers registered with the SEC, it will require that registered investment advisers annually report the amount of assets under management and use of leverage including a balance sheet leverage; counter-party credit risk exposure; trading in investment positions; valuation policies and practices of the fund; types of assets held; side arrangements or side letters; and trading practices. (404)

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