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SEC Enforcement Given New Tools Under Dodd-Frank Bill

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The full impact of the Dodd-Frank bill will not be known until the extensive rulemaking process is completed. However, the bill immediately implements a number of changes that enhance the SEC's enforcement program.

On July 21, 2010, the president of the United States signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) into law. The mammoth, more than 2,300-page bill is intended—in theory—to address market and regulatory issues underlying the financial crisis.

Much of the public discussion and debate concerning Dodd-Frank centered on its broad structural provisions, such as regulation of the over-the-counter derivatives markets, limitations on the proprietary trading of banks, and stricter capital and leverage requirements for large financial firms. The U.S. Securities and Exchange Commission (SEC) and other regulators have been tasked with extensive study, report and rulemaking responsibilities to fill in the details of this massive legislation. This process requires the attention and participation of affected constituencies. However, a number of provisions within Dodd-Frank that have received little public attention are designed to enhance SEC investigations, enforcement actions and remedies. Several of these provisions have long been part of the SEC Division of Enforcement's "legislative wish list."

Expansion of Aiding and Abetting Liability

Prior to Dodd-Frank, the SEC could only charge aiding and abetting violations under the Securities Exchange Act and the Investment Advisers Act. Dodd-Frank now permits the SEC to charge aiding and abetting violations under the Securities Act and the Investment Company Act as well. It also authorizes the SEC to seek a penalty for aiding and abetting violations under the Investment Advisers Act. In addition, Dodd-Frank expands the state of mind element necessary for aiding and abetting violations of the securities laws. The prior standard required that an aider or abettor "knowingly" provide substantial assistance to another person's violations. Dodd-Frank provides for liability for those who aid and abet violations knowingly *or* recklessly. These changes will make it easier for the SEC to bring aiding and abetting charges.

Collateral Bars

The ante in enforcement actions has been raised for financial services industry professionals. The SEC is now authorized to suspend or bar a regulated person who violates securities laws in one part of the financial services industry from associating with a regulated entity in another part of the industry. For example, if an individual associated with a broker-dealer is the subject of an enforcement action, the SEC may now suspend or bar that person not only from associating with a broker-dealer, but also from associating with an investment adviser, municipal securities dealer, municipal advisor, transfer agent or nationally recognized statistical rating organization.

Authority to Impose Penalties in Administrative Proceedings:

Previously, the SEC could only impose a civil penalty in an administrative proceeding against an individual associated with a regulated entity, such as a broker-dealer or investment adviser. This required the SEC to file an action in federal district court to seek a civil penalty against a person not associated with a regulated entity. Dodd-Frank now authorizes the SEC to seek a civil penalty against *any* person in an administrative proceeding. It also increases the penalty amounts the SEC can seek in administrative proceedings. These changes will likely increase the number of administrative enforcement actions filed by the SEC, but will also provide defendants the opportunity to resolve cases through administrative action rather than a potentially more significant federal district court action.

Enhanced Whistleblower Protections

The SEC recently instituted a new cooperation program to provide incentives for individuals, such as corporate insiders, to cooperate in SEC investigations and actions. Dodd-Frank provides even stronger incentive—substantial monetary rewards—for individuals to assist SEC investigations. The act authorizes the SEC to reward whistleblowers who provide information leading to an enforcement action and financial recovery exceeding \$1 million, with amounts ranging from 10 to 30 percent of the collected funds. In certain cases, such as major financial fraud or Foreign Corrupt Practices Act cases, where the financial sanctions imposed have been huge, the potential financial payoff to a whistleblower could be massive. For a more detailed discussion of this provision and its implications, see [“Whistleblower Provisions Make Noise in New Financial Reform Bill.”](#)

Increased Access to Foreign Audit Work Papers

Many U.S.-listed companies have substantial foreign units, affiliates and subsidiaries, or are themselves foreign-based corporations. Foreign operations are often audited by foreign public accounting firms. The SEC previously faced challenges in gaining access to foreign audit work papers during investigations.

Dodd-Frank substantially strengthens the SEC's access to foreign work papers. If a foreign public accounting firm performs material services upon which a Public Company Accounting Oversight Board, or PCAOB-registered public accounting firm relies in the conduct of an audit or interim review, issues an audit report, performs audit work or conducts interim reviews, the foreign accounting firm and/or the PCAOB-registered firm are now required to produce the foreign audit work papers and related documents to the SEC. These changes will assist the SEC in investigations involving foreign companies or companies with material foreign operations.

Fiduciary Duty Standard for Broker-Dealers

Dodd-Frank requires the SEC to conduct a study, issue a report and undertake rulemaking to determine whether a broker-dealer providing personalized investment advice about securities to a retail customer should be held to the same fiduciary duty standard of conduct now in place for investment advisers. A fiduciary duty standard would, among other things, require broker-dealers to act in the best interest of their customers without regard to the broker-dealer's financial interest and to disclose material conflicts of interest to customers. Currently, broker-dealers are subject to general anti-fraud provisions and rules under the Securities Exchange Act, and to FINRA, or Financial Industry Regulatory Authority, suitability and other conduct standards, but do not have a fiduciary duty to their customers. A fiduciary duty standard would fundamentally alter the relationship between broker-dealers and their customers while raising significant conflict of interest questions concerning current activities such as sales of proprietary products and principal trading. The imposition of a fiduciary standard may result in higher expenses ultimately being borne by customers.

Extraterritorial Jurisdiction

Financial markets have become global. An increasing number of SEC investigations have involved conduct and actors outside of the United States, posing potential jurisdictional challenges to SEC enforcement actions. Dodd-Frank will make it easier for the SEC to overcome these jurisdictional issues. The law gives federal district courts jurisdiction over SEC actions charging violations of the anti-fraud provisions of the federal securities where (1) conduct within the United States constitutes a significant step in furtherance of a violation even if securities transactions occur outside the United States and involve only foreign traders, or (2) conduct occurring outside the United States has a foreseeable substantial effect within the United States. The extraterritorial jurisdiction provision will likely assist the SEC in cases involving foreign conduct or actors.

Nationwide Service of Trial Subpoenas

Dodd-Frank will assist SEC lawyers when they present their cases at trial in

federal district court. A subpoena issued to compel the attendance of a witness at trial may now be served by the SEC any place within the United States.

Previously, the applicable federal rule of civil procedure placed a 100-mile limit on the distance a witness had to travel, often requiring the SEC to use a videotaped deposition at trial. Now the SEC can require a witness who resides in the United States to appear at trial, no matter the distance traveled. Trial lawyers often believe that presenting live testimony to the jury or court is an advantage, and SEC trial lawyers will now be able to do so under Dodd-Frank. On the other hand, this nationwide service of process is available to defendants as well, providing defense counsel the same access to live trial witnesses as the SEC.

SEC Funding

The SEC sought self-funding of its operations, as other financial services regulators have long had, through registration and transactions fees collected by the agency rather than through annual budget appropriations from Congress. This would have exponentially increased the SEC's budget. While Dodd-Frank did not give the SEC self-funding, it preliminarily authorized a series of increases that will virtually double the SEC's budget over the fiscal period 2011 to 2015 from \$1.3 billion to \$2.25 billion. In addition, the SEC has been given the discretion to tap into a new \$100 million reserve fund, which will be replenished in \$50 million annual increments, to supplement its budget. The significant budget increases will likely be used for technology upgrades, including market analysis technologies, and to significantly bolster the SEC's inspection and examination and enforcement programs.

Conclusion

The massive Dodd-Frank bill requires significant rulemaking by the SEC and other federal regulators. The practical impact of many of its provisions may not be fully known until the rulemaking process is completed. However, Dodd-Frank immediately implements a number of changes that will enhance the SEC's enforcement program and further energize an already aggressive enforcement division.