

Financial Re-Regulation Teleseminar Series Follow-Up

Securities and Exchange Commission Enforcement and Related Issues

Agency Funding

SEC's Budget Doubled

Under the Dodd-Frank Act (the “Act”), the Securities and Exchange Commission’s (“SEC”) budget was doubled, from \$1.3 billion in fiscal 2011 to \$2.25 billion in 2015. In addition, the Agency will have access to a \$100 million SEC “Reserve Fund” that will facilitate long-range planning and be replenished out of fee income. (Section 991)

Matters Expressly Relating to SEC Enforcement Proceedings

Nationwide Service of Process – Both the SEC and defendants in SEC federal court cases will be able, under the Act, to issue subpoenas requiring witnesses located anywhere in the United States to appear in person at trials and hearings, and produce document and other materials. (Section 929E) The Agency has always had this power in connection with its administrative proceedings and investigations.

Expanded Statute of Limitations – The statute of limitations for a securities fraud offense, or conspiracy or an attempt to commit securities fraud, is extended, such that a case must be brought or indictment returned within six years after the commission of the offense. (Section 1079A) This would include the criminal securities fraud statute, as well as willful violations of the Exchange Act, the Securities Act, the Investment Company Act, Investment Advisers Act, or Trust Indenture Act.

SEC Enforcement Investigation and Compliance Examination and Inspection Deadlines

Enforcement – Under the Dodd-Frank statute, the SEC staff is given 180 days after issuing a “Wells Notice” to either file an action or notify the Director of Enforcement that the staff does not intend to pursue an action; this deadline can be extended for one 180-day period. (Section 929U)

Examinations – Similarly, the statute provides that within 180 days after the staff completes the on-site portion of its compliance examination or inspection or receives all records requested from the entity being examined or inspected, the staff shall provide written notice indicating that the exam or inspection has concluded, and has concluded without findings or that the staff requests corrective action. Again, in complex matters, an additional 180 days is available to the staff. (Section 929U)

Expansion of Secondary Liability – For aiding and abetting liability, the SEC previously had to demonstrate “knowing” conduct on the part of the actor, but under Section 929-O of the Act, the SEC can now seek to impose aiding and abetting liability on those who knowingly or recklessly provide substantial assistance to one violating the Securities Exchange Act.

The Act also provides, *for the first time*, that the SEC may seek to impose aiding and abetting liability under the Securities Act, the Investment Company Act, and the Advisers Act. (Sections 929M-929N)

Control persons are usually entities officers, directors, or senior management. The statute also clarifies the SEC’s ability to pursue claims against those found to “directly or indirectly” control a violating person—usually an entity—unless they are found to have “acted in good faith and did not directly or indirectly induce...the violation or cause of action.” (Section 929P(c))

Expansion of Penalties in Administrative Proceedings – The SEC has long been authorized to bring administrative proceedings as an alternative to federal court proceedings. However, although censures, cease-and-desist orders, disgorgement orders and other types of remedies were universally available in these proceedings, civil penalties could only be awarded in administrative proceedings against SEC-regulated individuals and entities. Under the Act, civil penalties can now be imposed in any administrative proceeding, against any respondent. (Section 929P)

Collateral Bars – Under the Act, when a securities industry professional is barred or suspended, those limitations will apply collaterally to any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized rating organization. (Section 925)

Expansions to SEC Jurisdiction and to Existing Statutes

Expansion of Market Manipulation Prohibition to Over-the-Counter Securities – Manipulations of OTC securities had previously been pursued by the SEC only under the antifraud provisions of the Exchange Act, but the Act has extended to over-the-counter securities the prohibition on market-manipulation of listed securities set forth in Sections 9 (manipulative transactions, options transactions), 10(a)(1) (short sales), and 15(c)(1)(A) (broker-dealer manipulation) of the Exchange Act. (Section 929L)

Nationally Recognized Statistical Rating Organizations ('NRSROs') – Credit Rating Agencies – Under the Act, NRSROs will be subject to SEC enforcement actions, as well as private rights of action, and statements made by credit rating agencies will be subject to the same enforcement and penalty provisions as statements made by public accounting firms or securities analysts, and will not be considered “forward looking statements” under Section 21E of the Exchange Act. (Section 933/939B)

The Act also repealed the protection for credit rating agencies under the Securities Act from liability as experts under Sections 7 and 11 for material misrepresentations or omissions with respect to credit ratings that are included in a registration statement. (Section 939G)

Jurisdiction Over SEC Cases Concerning Foreign Investors, Transactions, Exchanges – Unlike private litigants under the current state of the law, the Act affords the SEC the ability to bring cases under the antifraud provisions of the Securities Act, the Exchange Act, and the Advisers Act relating to transactions outside of the United States, where either the defendant took “significant steps” in the United States “in furtherance of the violation,” or if the conduct occurred abroad, it had a “foreseeable substantial effect” within the United States. (Section 929P) Under the Act, the SEC is also to conduct a study on whether this same extraterritorial jurisdiction should apply to private actions under the antifraud provisions. (Section 929Y)

Expansion of Jurisdiction Over Foreign Accounting Firms – The Act requires the production of audit work papers and other documents relating to audits or interim reviews to the SEC and Public Company Accounting Oversight Board (“PCAOB”), and placing these firms under the jurisdiction of U.S. courts, if such firms “perform material services upon which a 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.” (Section 929J)

Whistleblower Incentives and Protections

Section 922 of the Act offers substantial monetary incentives for those aware of fraud to come forward, report the conduct to the SEC, and cooperate in the investigation, and also provides whistleblowers with significant protections:

- **Incentives:** Where information provided by a whistleblower leads to an SEC enforcement action resulting in monetary sanctions of in excess of \$1 million, the SEC shall pay a bounty of between 10 percent and 30 percent, as determined at the Commission’s discretion. Bounties will be paid from an “Investor Protection Fund” that will be funded from monies collected, but not distributed, in other SEC cases. The bounty will also be paid by the SEC if the information leads to enforcement proceedings commenced by the Department of Justice, another federal agency, a Self-Regulatory Organization (SRO), or a state attorney general. The information provided must be “derived from the independent knowledge or analysis” of the whistleblower, be

otherwise not known to the agency, and must lead to the enforcement proceeding. Even wrongdoers are entitled to whistleblower bounties and may also be entitled to cooperation credit, under the SEC's recently implemented individual cooperation policy and process, unless the whistleblower is convicted of a crime in connection with the same conduct at issue in the proceeding giving rise to the bounty. The statute also makes clear that consolidated subsidiaries and affiliates of issuers are subject to these whistleblower provisions.

- **Protection:** The Act provides that an employer may not “discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against” a whistleblower in the “terms and conditions of employment,” and to assure that this protection has the requisite teeth, the statute grants the whistleblower a private right of action, in federal court, in the event of untoward consequences, in which he or she can seek relief in the form of double back pay, reinstatement, attorney and other litigation costs, and other relief. Whistleblowers may bring such claims against their employers not more than six years after the date of violation, and not more than three years after which they should have known of the violation.

The statute authorizes the SEC to issue rules and regulations implementing the whistleblower provisions, and mandates the creation of a separate office within the SEC to administer the program. (Section 924) The SEC also must report to Congress annually about the efficacy of the program.

Investor Protection Improvements

Investor Advocate/Investor Advisory Committee/Ombudsman – The Act creates an Investor Advocate position, which will report directly to the Chairman of the SEC and whose responsibility will be the identification of issues of import to investors. The Investor Advocate will, in turn, appoint an SEC Ombudsman to act as a liaison between investors and the SEC. The Investor Advocate will also serve on a committee established under the Act, the “Investor Advisory Committee,” which will also include state regulators and a range of public investors, who will meet at least twice a year to consult with the SEC on investor protection issues. The Act expressly provides, however, that the Commission is not required to take any action on any finding or recommendation of the Investor Advisory Committee. (Section 911, Section 919D)

“Investor Testing” and Other Information Gathering – For purposes of evaluating its rules or programs, or for evaluating any considered rules, programs or actions, so as to better enable the Agency to conduct its mission and protect investors, under the Act, the SEC can engage in “investor testing” and other programs to gather information from investors and the public, and may also consult with academics or consultants to better undertake these programs. (Section 912)

Fair Fund Improvements – Under Sarbanes-Oxley, the SEC was given the authority to distribute to investors penalty money paid as sanctions in enforcement actions; however, such penalties could only be distributed to victims if the SEC had also obtained an order of disgorgement in the same proceeding. The Act permits the SEC to contribute all penalty amounts to any distribution or “fair fund” for the benefit of fraud victims. (Section 929B)

Privileges Protected When Information Shared With Other Law Enforcement – The Act provides for the protection of any applicable privileges when the SEC shares privileged information with other federal agencies, the PCAOB, any SRO, or any state or foreign law enforcement or securities regulatory authority, including the attorney-client and work-product privileges, as well as the more government-oriented deliberative process and law enforcement privileges. This non-waiver is reciprocal, in that when such information is provided by such other agencies to the Commission, the privileged information is also protected. And, given that foreign laws about such things are very different from ours, the Act also expressly provides that the Commission shall not be compelled to disclose privileged information obtained from foreign law enforcement or regulatory authorities provided in good faith and based on this protection. (Section 929K)

Rule-Makings and Studies

Standard of Care Applicable to Broker-Dealers and Investment Advisers – The Commission is mandated under the Act, first, to conduct a study into the effectiveness of the current standard of care applicable to broker-dealers and investment advisers, and their associated persons, in connection with the provision of personalized investment advice and recommendations about securities transactions to retail customers. After conducting the study, the Act does authorize the SEC to begin a rulemaking, considering its study findings, and to issue rules to impose fiduciary duties on broker-dealers when they provide personalized investment advice to retail investors—natural persons or their representatives, who receive securities advice from a broker or dealer and who use that advice primarily for personal, family or household purposes; and to “harmonize” the standard for broker-dealers who provide such advice with that imposed on investment advisers, so that investment professionals offering the same type of advice to the same type of investors would be required 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.” (Section 913(g))

Broker Disclosure Rules In Connection with Investment Products – The Act empowers the SEC to issue rules mandating that brokers provide disclosure information in advance of the purchase of an investment product or service by a retail customer, including information about the investment’s costs and risks, how the investment fits within the customer’s investment objectives and strategies, and disclosures about the broker’s financial incentives. (Section 919)

Rules Restricting Customer Arbitration Agreements – The SEC is authorized to issue rules that limit or even prohibit agreements that require customers to arbitrate disputes with their brokers, dealers, investment advisers, and municipal securities dealers, if the SEC determines that such rules are “in the public interest and for the protection of investors.” (Section 921)

Additional Restrictions on and Rulemakings Related to Short Selling – As an addition to the Commission’s Rule 10b-21, known as the naked short selling antifraud rule, the Act expressly prohibits the “manipulative short sale of any security” and authorizes the Commission to promulgate rules to enforce this provision.

Among the rules contemplated by the statute include rules providing for the public disclosure of at least monthly disclosures of short selling activity in each security.

In addition, under the Act, customers may elect not to allow their securities to be lent in connection with short sales, and brokers must disclose that they receive compensation for such stock lending arrangements. The Act anticipates that the SEC may address the “form, content, time, and manner of delivery” of this customer notification by rule. (Section 929X)

Private Placement Disqualification Rulemaking – The Act requires the SEC to issue rules that disqualify convicted felons, as well as those convicted of misdemeanors that relate to the purchase or sale of securities or making false filings to the Commission, and certain civil violators, among others, from participating in Regulation D private placements. Such rules are to issue within one year. (Section 926)

SEC Self-Evaluation – Under the Act, the SEC must undergo the type of evaluation that it often orders litigants to undertake, hiring an independent consultant to review, among other things, the possible elimination of unnecessary or redundant units at the SEC; improving communications between SEC offices and divisions; the SEC’s internal chain-of-command structure; the effect of high-frequency trading and other technological advances on the market and the agency’s ability to monitor the effect of this trading and these advances on the market; the SEC’s hiring, workplace, and personnel practices; relationships with and to SROs and other agencies on which the SEC relies to regulate securities and protect investors; and whether there is a need for reform. The consultant’s report will be due in six months and must be made to the SEC and to Congress. (Section 967)

Studies Relating to Investment Advisers – The SEC is to conduct a study on whether enhanced examination and enforcement resources are needed in connection with investment advisers. Among the issues to be specifically considered are the number and frequency of examinations, and whether one or more SROs should be designated to augment the Commission’s oversight efforts in connection with investment advisers; and the Commission is to study whether its current approach to examinations of the investment advisory activities of dually registered broker-dealers and investment advisers is adequate. (Section 914)

Studies Relating to Investor Education and Financial Literacy – The Act contemplates that the SEC will study the financial literacy of retail investors and what could be done to provide further investor education, and improve the timing and substance of disclosures to investors relating to their financial intermediaries, financial products, and investment services. (Section 917)

Along similar lines, the SEC is mandated to study and promulgate rules where appropriate to improve disclosures to investors concerning their relationships with their broker-dealers and investment advisors, including any material conflicts of interest and compensation and sales practices. (Section 913(l))

The Act also requires that the SEC study how investors might better be able to access information registry information about disciplinary actions, regulatory, judicial, and arbitration proceedings, and other such information about registered investment advisers and brokers, as well as whether additional information should be made public. (Section 919B)

Relevant Government Accounting Office Studies – The Act also requires the GAO to undertake several studies relevant to the work and mission of the SEC and to the business of many of our clients, including studies relating to:

- Mutual fund advertising (Section 918)
- Conflicts of interest presented by having investment banking and analyst functions within the same firm (Section 919A)
- Regulation of financial planners – specifically whether the various designations and state and federal regulations are useful to consumers (Section 919A)
- Employment of former SEC personnel by entities regulated by the SEC (Section 968)

And, although there was some talk about expanding the availability of aiding and abetting claims to lawsuits brought by private plaintiffs, which would have undone several court decisions, notably the Supreme Court's 1994 *Central Bank* decision (*Central Bank of Denver, NA v. First Interstate Bank of Denver, NA*, 511 U.S. 164 (1994)), and 2008 *Stoneridge* case (*Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*, 552 U.S. 148 (2008)), in the end, these changes did not make their way into the Act, although the GAO will be doing a study on the subject under the statute (Section 929Z).

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