WSGR ALERT

JULY 2010

PRESIDENT TO SIGN FINANCIAL OVERHAUL BILL

Securities and Exchange Commission and Securities Law Enforcement Update

On July 15, 2010, after months of deliberation, Congress passed a comprehensive financial reform bill, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). President Obama is expected to sign the bill into law this week. The Dodd-Frank Act is the successor to Senator Dodd's previous bill, the Restoring American Financial Stability Act of 2010, which was discussed in the WSGR Alert entitled "Senate Set to Debate Financial Reform Bill," released on March 29, 2010.

While the central focus of the Dodd-Frank Act is aimed at regulating banks and non-bank financial institutions, it also includes provisions affecting the Securities and Exchange Commission (SEC), as well as securities law enforcement provisions that may affect all publicly traded companies. The following WSGR Alert discusses these provisions. A companion WSGR Alert on this case addresses the corporate governance and executive compensation provisions of the Dodd-Frank Act.

I. Increasing Investor Protection

The Dodd-Frank Act creates an Office of the Investor Advocate that is headed by the Investor Advocate, who is appointed by the SEC chairman in consultation with the other commissioners. The Investor Advocate will be responsible for assisting individual investors in resolving significant issues with the SEC or a self-regulatory organization, identifying possible regulatory changes that would benefit investors, and identifying problems that investors have with financial service providers and investment products. The Investor Advocate will be required to submit an annual report to Congress. He or she also will name the ombudsman, who will act as a liaison with retail investors to help resolve issues with the SEC or self-regulatory organizations.

In addition, the Dodd-Frank Act creates an Investor Advisory Committee (IAC) that will become part of the SEC. The IAC will advise and consult with the SEC on: matters concerning regulatory priorities; issues relating to the regulation of securities products, trading strategies, and the effectiveness of disclosure; and initiatives to protect investor interest and promote investor confidence. The IAC also will submit findings and recommendations to the SEC, including proposed legislative changes. The members of the IAC, who shall serve four-year terms, will include the Investor Advocate, a representative of state securities commissions, a representative of the interests of senior citizens, and 10-20 members appointed by the SEC itself. The SEC is not obligated to accept or act upon the IAC's findings and recommendations.

At this point, it is difficult to predict the potential impact of the Investor Advocate and the IAC. It is possible that the Investor Advocate and the IAC could promote a greater expansion of the SEC's regulatory and enforcement powers.

II. Increased Standard of Care for Brokers and Dealers

The Dodd-Frank Act directs the SEC to conduct a study and report to Congress within six months of enactment concerning the effectiveness of existing legal or regulatory standards of care for brokers, dealers, and investment advisors who provide personalized investment advice and investment recommendations to retail customers.

The SEC also is authorized, but not required, to issue rules requiring brokers or dealers who provide personalized investment advice about securities to retail customers to have the identical fiduciary duty that is imposed on paid investment advisers. In addition, the SEC is authorized to issue rules providing that brokers, dealers, and investment advisors who offer personalized investment advice must act in the best interest of the customer without regard to their own financial or other interest.

Such rules would significantly increase the standard of care for securities brokers, who traditionally have adhered to a "suitability" standard with respect to their customers, but who have not had the same kind of fiduciary standard imposed on paid investment advisors. For example, a broker who recommends that a customer invest in his firm's low-risk mutual fund likely would conform to the suitability standard. But under a fiduciary standard, the broker may be obligated to refer the customer to a different mutual fund that charges lower fees than his firm's fund. Would a broker be liable under a fiduciary standard for providing investment recommendations in response to a casual request from a customer if he did not perform research that, unlike investment advisors, he is generally not paid to provide? For such reasons, it is expected that the securities

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industry will continue to oppose a fiduciary duty standard.

III. Whistleblower Protections

The Dodd-Frank Act creates new protections and potential rewards for whistleblowers. Employers may not discharge, demote, suspend, threaten, harass, or in any other manner discriminate against a whistleblower for providing information to the SEC, assisting in any SEC investigation, or making disclosures required by the securities laws. A whistleblower who claims that he or she was the victim of such conduct may bring a lawsuit in federal court seeking reinstatement with the same seniority status or two times the amount of back pay that is owed, as well as compensation for litigation costs. The suit must be filed within three years after the whistleblower became aware of the employer's violation and no more than six years after the violation. In addition, whistleblowers who provide original information to the SEC that results in a SEC action involving monetary sanctions of at least $1 million are entitled to collect a reward of 10 to 30 percent of the total sanction, so long as the whistleblower is not himself convicted of a criminal violation related to the same matter.

For more information on the whistleblower protections of the Dodd-Frank Act, please see our separate WSGR Alert at http://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgralert_national_australia_bank.htm.

IV. Disqualifying Felons and Other "Bad Actors" from Regulation D Offerings

Within one year of enactment of the Dodd-Frank Act, the SEC is required to issue rules that will disqualify from Regulation D offerings those persons who:

- are subject to a final order of state regulators that bars a person from any regulated entity or the banking business, or is based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the prior 10 years; or

- have been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or the making of any false filing with the SEC.

V. Expanding Scope of Prohibition against Manipulation

Section 9(e) of the Securities Exchange Act of 1934 (Exchange Act) currently allows individuals to file lawsuits against those who engage in specifically delineated kinds of stock manipulation so long as the securities in question are registered on a national securities exchange. The Dodd-Frank Act eliminates the requirement that the securities be registered on a national exchange, and permits such lawsuits concerning manipulation by any security other than a government security. In addition, the Dodd-Frank Act amends Section 10(a)(1) of the Exchange Act, concerning manipulation of short sales, to cover all securities other than government securities. The Dodd-Frank Act also extends Section 9(b), regarding transactions in options, to cover non-exchange transactions. Further, the SEC is directed to issue rules requiring public disclosures by institutional investment managers concerning the short sales of securities at least monthly.

VI. Expanding Aiding and Abetting Liability

The SEC currently has the authority to bring actions against a person who "knowingly" provides substantial assistance to another person who commits a violation of the Exchange Act. The Dodd-Frank Act permits the SEC to bring aiding and abetting actions against those who "knowingly or recklessly" provide substantial assistance to the primary violation. This revision should greatly enhance the SEC's ability to bring aiding and abetting actions, because it is easier for the SEC to provide evidence that a person's conduct was merely reckless than to prove that a person knowingly sought to assist the primary violation. In addition, the SEC would for the first time have the express authority to bring aiding and abetting actions under the same knowingly or recklessly standard for violations of the Securities Act of 1933 (Securities Act) and the rules thereunder, as well as the Investment Advisors Act and the Investment Company Act. However, a proposal to enable private plaintiffs to bring aiding and abetting claims in securities fraud actions (essentially overruling the Supreme Court's decisions in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164 (1994) and *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.,* 552 U.S. 148 (2008)) was not included in the final legislation.

VII. Expanding the SEC's Extraterritorial Jurisdiction

The Dodd-Frank Act authorizes the federal courts to have jurisdiction of an action or proceeding brought or instituted by the SEC under Section 17(a) of the Securities Act, the antifraud provisions of the Exchange Act (including Section 10(b)), or Section 206 of the Investment Advisors Act, involving:

- conduct within the United States that constitutes significant steps in furtherance of the violations, even if the transaction occurs outside the United States, and involves only foreign investors; or

- conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

This express grant of extraterritorial jurisdiction to the SEC is intended to override the recent decision by the United States Supreme Court in *Morrison v. National Australia Bank Ltd.,* No. 08-1191 (June 24, 2010), which held that Section 10(b) of the Exchange Act applied only to securities that were listed on domestic exchanges and domestic transactions in other securities. The Court rejected the so-called "conduct/effect" test employed by the lower courts, which allowed Section 10(b) actions filed by foreign investors involving foreign corporations where

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the alleged fraud involved significant conduct in the United States or the fraud had a substantial effect on U.S. citizens.[1] Because *Morrison* concerned private investors, the Court did not address whether the SEC had such extraterritorial jurisdiction, but it is assumed that the Court's holding would apply equally to SEC actions. Thus, Congress has acted to expressly grant the SEC authority to bring actions based on the conduct/effect standard. However, it is unclear whether the legislation will successfully do so, since the Supreme Court in *Morrison* held that the controlling issue is not the jurisdiction of the federal courts to hear such actions, but the fact that Section 10(b) itself does not provide for relief for extraterritorial claims. On the other hand, the courts may conclude that the legislation reflects the congressional intent to permit the SEC to bring extraterritorial actions pursuant to Section 10(b) and the other provisions identified in the Dodd-Frank Act. Further, the legislation directs the SEC to conduct a study as to whether the conduct/effects test should be expressly extended to private rights of action under the antifraud provisions of the Exchange Act.

VIII. Deadline for Completing Enforcement Actions

The Dodd-Frank Act requires the SEC either to file an enforcement proceeding or provide notice of an intent not to file an action within 180 days after the SEC provides a written Wells notification to any person. A "Wells Notice" is the notification by the SEC staff that it intends to recommend that the SEC commissioners authorize an enforcement proceeding. The person receiving the Wells Notice is then permitted to file a written submission arguing why no enforcement action should be brought. The SEC too often has waited one year or more to file an enforcement action after the Wells Notice was provided, which has the effect of leaving the affected person or company in a state of limbo as to whether an action would be filed. In addition, memories and knowledge of the underlying facts tend to fade with the passage of time. Thus, the 180-day deadline forces the SEC to "fish or cut bait" as to whether to file an enforcement proceeding. On the other hand, the deadline may compel the SEC to bring enforcement proceedings that otherwise may not have been brought after additional time had lapsed. There is also a loophole to the 180-day deadline, in that the director of the Division of Enforcement may extend the deadline for one or two additional 180-day periods if the enforcement investigation is deemed to be sufficiently complex to warrant the delay.

IX. Authority to Restrict Mandatory Pre-dispute Arbitration

The Dodd-Frank Act authorizes the SEC to issue rules that prohibit or impose limitations on agreements that require clients of brokers, dealers, or municipal securities dealers to arbitrate future disputes arising under the federal securities laws or the rules of any self-regulatory organization.

X. Credit Rating Agencies

The Dodd-Frank Act provides for greater regulation, accountability, and transparency of credit rating agencies. Credit rating agencies must maintain and enforce internal control structures and submit attestations to the SEC annually concerning those structures. The legislation directs the SEC to issue rules to separate the marketing and sales functions of credit rating agencies; ensure that such agencies use sound methodologies and that employees satisfy appropriate standards of training and competence; require credit rating agencies to establish, maintain, and enforce policies that define and disclose the definition of credit rating symbols and to apply such symbols consistently; and require agencies to provide information concerning the assumptions and data underlying their ratings. The SEC is instructed to create an Office of Credit Ratings to enforce the SEC rules, ensure the accuracy of credit ratings, and ensure that ratings are not unduly influenced by conflicts of interest. The SEC would have the authority to suspend or revoke the registration of any securities of any rating agency upon a finding that the agency lacks adequate financial and managerial resources to consistently produce credit ratings with integrity. Further, the SEC is directed to remove the exemption for disclosures to credit rating agencies from Regulation FD, which prohibits selective disclosure of material nonpublic information to market professionals and shareholders. In addition, alleged false statements by credit rating agencies concerning a security will for the first time create a cause of action for the investors who purchased the security to the same extent as statements by accountants or securities analysts. The Government Accountability Office is directed to conduct studies on alternative means of compensating credit rating agencies and on the feasibility and merits of creating an independent body that would establish professional standards for rating analysts. Thus, the eventual impact of the legislation on credit rating agencies largely resides with the SEC, and any subsequent congressional reaction to the new SEC rules.

XI. Nationwide Service of Process

The Dodd-Frank Act grants the SEC nationwide service of process for subpoenas that are issued in connection with any SEC proceeding brought in federal court pursuant to the Securities Act, the Exchange Act, the Investment Advisors Act of 1940, or the Investment Company Act of 1940.

XII. Miscellaneous

The Dodd-Frank Act grants the SEC authority to impose civil penalties in all of its cease and desist proceedings rather than having to go to federal court to impose those penalties. The Dodd-Frank Act also grants the SEC the ability to impose collateral bars prohibiting violators of certain provisions of the Exchange

[1] See our previous WSGR Alert on this case at http://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgralert_national_australia_bank.htm

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Act and the Investment Advisors Act from associating with a greater range of regulated entities, such as investment advisers, brokers, dealers, municipal advisors, transfer agents, and credit rating agencies.

For any questions or more information on these or any related matters, please contact Doug Clark or any member of Wilson Sonsini Goodrich & Rosati's securities litigation practice.

650 Page Mill Road
Palo Alto, CA 94304-1050
Tel: (650) 493-9300   Fax: (650) 493-6811
email: wsgr_resource@wsgr.com

www.wsgr.com