

Securities Litigation and Enforcement

Get Prepared for Dodd-Frank

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The new Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act” or the “Act”) will have significant consequences for public companies across every industry. Indeed, less than a week after President Obama signed the Act into law, there has already been a complaint filed under the Act’s “whistleblower” provisions, according to the announcement of the filer’s legal counsel. Undoubtedly, there will be many more such filings and many more such announcements. Companies should take steps to better position themselves for whistleblower complaints, government investigations, and securities litigation and enforcement under the Dodd-Frank Act. Ultimately, these steps boil down to the not-so-new issue of how to create a corporate culture that minimizes the securities fraud risk exposure of the company, its officers and directors, and its employees. In this article, we briefly summarize the provisions of the Act from a litigation/enforcement perspective and then discuss these steps companies can take to prepare for the new regulatory scheme.

The Dodd-Frank Act

Signed into law on July 21, 2010 by President Obama, the Act represents an attempt to reenergize the U.S. Securities and Exchange Commission (“SEC” or the “Commission”) and other government agencies. The Act follows the recent criticism leveled at the SEC caused by the Madoff and Stanford scandals and a host of other incidents that collectively contributed to the view that the SEC had not been sufficiently proactive in preventing fraud on consumers and investors.

To correct these perceptions, the Act adds significant new enforcement authority and resources to the SEC. In particular, the Act increases the SEC’s funding by more than \$1 billion over its requested budget, and provides the SEC with a self-funding mechanism through which it can keep certain of the fines it levies against companies and individuals. The SEC’s newly enhanced powers are meant to give the Commission greater authority and flexibility. And through its whistleblower provisions, the Dodd-Frank Act creates new financial incentives and protections for those who provide the SEC with information relating to a violation of the securities laws. In a sense, the Act empowers these whistleblowers to act as deputies for the SEC in its goal to ferret out financial fraud by public companies and their officers and directors.

Enhanced Power of the SEC

The importance of the whistleblower provisions, which will be discussed further below, must be seen in the context of the significant new enforcement powers given to the SEC. The Dodd-Frank Act represents a true reinvigoration of the SEC’s and Commodity Futures Trading Commission’s (CFTC) abilities to bring and prosecute financial fraud cases. It will



be surprising if public companies, hedge funds, as well as their officers and directors and other SEC-regulated entities do not see a significantly more aggressive enforcement effort by the SEC and CFTC. Discussed below are some of the new powers or improvements on old powers that the SEC will have to accomplish its goals:

Expansion of Aiding and Abetting Liability

The SEC has long had the power to bring aiding and abetting claims, and it has used that power frequently. The Act makes bringing such claims even easier by lowering the state of mind standard to include reckless conduct. Formerly, the Commission had to show the aider and abettor had actual “knowledge” of the wrongdoing. The Act substantially decreases the SEC’s burden on such claims. The Act also now gives the SEC authority under the Securities Act, the Investment Company Act (ICA), and the Investment Advisors Act (IAA) to bring aiding and abetting claims under the same lower standard. While the Dodd-Frank Act does not provide a private cause of action for aiding and abetting liability, it does require the Comptroller General to conduct a study on the impact of authorizing such a private right of action. The Comptroller has one year after the date of enactment to submit a report to Congress on the findings of the study.

Control Person Liability Under the Exchange

The Act clarifies that the SEC has the power to pursue Control Persons under the Exchange Act. While this is a relatively minor change, it adds one more claim that could have relevance to officers, directors, and major shareholders of entities who come under the SEC’s scrutiny.

Extra-Territorial Jurisdiction for the SEC

The Act expands the SEC’s jurisdiction over violations of the Securities Act, the Exchange Act, and the IAA to include “conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors,” and to “conduct occurring outside the United States that has a foreseeable substantial effect within the US.” This provision prevents application to the SEC of the Supreme Court’s recent holding in *Morrison vs. National Australia Bank, N.A.*, U.S., No. 08-1191 (June 24, 2010), which held that private securities litigation applies only to fraud arising out of the purchase or sale of securities listed on American stock exchanges or the purchase or sale of any other securities in the United States. The Dodd-Frank Act further requires the SEC to solicit public comment and conduct a study to determine the extent to which private rights of action should apply as broadly as SEC enforcement actions. A report on the study is due 18 months after the date of the enactment of the Act.

New Authority to Impose Civil Penalties in Cease and Desist Proceedings

The Dodd-Frank Act amends the Securities Act, the Exchange Act, the ICA, and the IAA to allow the SEC to seek monetary penalties in addition to cease and desist orders in SEC administrative actions. The Act requires the use of the familiar three-tiered penalty grid



already used in Exchange Act cases, but raises the penalty by half. The SEC has had the power to seek monetary penalties but now it can do so through an administrative action, rather than in a separate action in federal court. However, this amendment has the potential to do more than remove a procedural hurdle for the SEC because in administrative actions, defendants do not have many of the rights that defendants in civil trials possess. For instance, there is no right to discovery or trial by jury, administrative actions are subject to a compressed time line, and review of the administrative law judge's decision is, in the first instance at least, by the SEC Commissioners, who authorized the suit in the first place. Although there are other remedies that may only be imposed in a civil proceeding, it is possible that this amendment will push more enforcement action into the administrative law arena and give the SEC additional settlement leverage.

New Deadlines Imposed on the SEC's Enforcement Actions

The Act imposes deadlines within which the SEC must complete its enforcement investigations and compliance examinations and inspections. Not later than 180 days after the date on which the staff provides a written Wells Notice, the staff must take action against the person or provide notice to the Director of Division of Enforcement of its intent not to file an action. A similar deadline applies for examinations or inspections. In both instances, the Act authorizes an additional 180 day extension for investigations or examinations that are deemed "sufficiently complex." These two deadlines will provide some comfort to targets of SEC investigations or examinations because they provide a known timetable. On the other hand, the deadlines could create a more aggressive SEC enforcement or examination.

Greater Subpoena Power in SEC Actions

The Act now allows nationwide subpoena power in any securities fraud action brought in a U.S. district court for any judicial district. This new power will benefit both the SEC and defendants, but it represents a significant increase in the power to compel witnesses to testify in enforcement actions and could serve as an enormous inconvenience, particularly for directors, former officers, and witnesses, who often reside far from the judicial proceeding in which they may be compelled to testify.

Expanded Authority to Share Privileged Information With Other Authorities

A frequent problem for the SEC has been in obtaining and sharing information with foreign authorities. The Act removes that impediment by allowing the SEC and domestic and foreign authorities to share information without waiving privileges that might protect that information. The Commission shall not be deemed to have waived any privilege to any information by transferring that information to or allowing that information to be used by foreign securities authorities, foreign law enforcement authorities, state securities or law enforcement authorities, the Public Company Accounting Oversight Board (PCAOB), other self regulatory organizations, or any other agency of federal government. For information produced to the SEC, the Commission shall not be compelled to disclose the privileged information obtained from any foreign securities authority or foreign law enforcement authority if the authority has in good faith determined or



represented to the SEC that the information is privileged. Finally, federal agencies, state securities and law enforcement authorities, self regulatory organizations, and the PCAOB shall not be deemed to have waived any privilege applicable to any information by transferring that information to or permitting that information to be used by the Commission. This ability to share information should facilitate far greater cooperation among securities enforcement authorities.

Greater Funding and Resources for the SEC

For the SEC to accomplish all the goals set forth in the Dodd-Frank Act, it will be necessary for it to have substantially more funding and personnel resources. The Act authorizes extra funds to be appropriated, including for 2011 an extra \$1.3 billion over the SEC's current budget for that year. The amounts increase each year, ultimately up to \$2.25 billion by 2015, and these amounts are in addition to funds already budgeted for the SEC. The SEC will need this money, as it already anticipates adding approximately 800 new positions over time to handle the extra work envisioned by the Dodd-Frank Act.

The powers and authorities discussed above are but a small part of a much larger regulatory scheme set forward in the Act. Yet, the new enforcement powers and measures alone should create a more robust and nimble enforcement agency with far more tools at its disposal. That could create a lot of extra work for public companies. And the Act paves the way for future changes that could bring more private litigation, including the possibility of creating private aiding and abetting liability and private transnational securities lawsuits.

Whistleblower Provisions

From an enforcement perspective, the centerpiece of the Dodd-Frank Act must be considered the whistleblower provisions found in Section 922. Although there was much debate about the potential private right of action for aiding and abetting, the real driver of new litigation should come from the whistleblower provisions. Whistleblowers are not new to federal law enforcement. The SEC's whistleblower program for insider trading has been around since 1989, but in that time it has paid out just under \$160,000 to just five whistleblowers. Some whistleblower provisions have been successful in enticing employees or those with knowledge of fraud to come forward to the government and report their employers. The *qui tam* provisions of the False Claims Act are one example in which the government has obtained billions from whistleblower-created actions. The whistleblower provisions of the Dodd-Frank Act could accomplish even more.

Under the Dodd-Frank Act, a whistleblower is "any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission." The Act empowers whistleblowers in two ways: (1) by providing substantial financial incentives for whistleblowers to come forward to report information to the SEC; and (2) by providing significant protections from retaliation or mistreatment for whistleblowers that come forward with information.



The incentive for whistleblowers to bring information to the SEC is money. A whistleblower “who voluntarily provided original information to the Commission that lead to the successful enforcement of the covered judicial or administrative action, or related action” that resulted in monetary sanctions over \$1 million, may be awarded by the SEC an amount not less than 10 percent and not more than 30 percent of the monetary sanctions collected. The Act defines “original information” as information “derived from the independent knowledge or analysis of a whistleblower,” (not otherwise known to the SEC) and not derived from “an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media.” The actions encompassed by the whistleblower provisions include any resulting SEC actions or any related actions brought by the Department of Justice, state securities regulators, or self-regulatory organizations based on the whistleblower’s original information.

Monetary sanctions include “any monies, including penalties, disgorgement, and interest.” The amount of the SEC’s award is discretionary, but the requirement that an award be made is mandatory. Whistleblowers will be entitled to appeal the denial of an award directly to the U.S. court of appeals, but cannot appeal the determination of the amount of the award. Payment of awards will be made from a new Investor Protection Fund.

To encourage whistleblowers to come forward, the Act provides significant protections to whistleblowers. First, employers 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 because of any lawful act done by the whistleblower.” Second, the SEC is prohibited from disclosing “any information, including information provided by a whistleblower to the Commission, which could reasonably be expected to reveal the identity of a whistleblower.” Whistleblowers will be entitled to report violations anonymously, through counsel, although their identities must ultimately be revealed to the SEC itself if an award is made. The protections will apply to a broad range of potential whistleblowers, including those who may have been involved in the underlying conduct, unless they are convicted of a criminal violation related to the judicial or administrative action for which the whistleblower seeks an award. The Act also applies protections for whistleblowers found in the Sarbanes-Oxley Act (SOX) to employees of subsidiaries of publicly traded companies “whose financial information is included in the consolidated financial statements of [a publicly] traded company.” Finally, there’s a new private cause of action for retaliation with an extended statute of limitations. Available remedies include reinstatement, double back pay, and attorney’s fees and court costs.

The Act requires the SEC to adopt implementing rules within 270 days of enactment, so, as discussed below, companies should consider commenting to the SEC about the new whistleblower provisions.

Next Steps

When combined with the SEC’s new enforcement powers, the whistleblower provisions provide a potentially enormous boost to SEC enforcement. These enactments follow the SEC’s recent efforts to encourage greater cooperation by entities and individuals under



investigation, but with their strong financial incentives, they do more than encourage cooperation. While much attention has been paid to how the whistleblower provisions will increase enforcement of the Foreign Corrupt Practices Act (FCPA), the SEC has already been active in its enforcement of the FCPA provisions and it is imperative to note that the Dodd-Frank Act whistleblower provisions apply to a wide range of securities law violations. Companies will need to once again reassess the adequacy of their internal controls over all financial reporting, relevant operational reporting, revenue recognition, and sales functions – assessments already required under provisions enacted by SOX. Common revenue accounting gimmicks could be particularly ripe ground for whistleblowers because they often involve lower level employees or sales personnel who operate below the radar of financial reporting personnel. Some examples include side letter agreements, unapproved agreements to grant liberal return, refund, or exchange rights, channel stuffing, bill and hold transactions, sales to fictitious customers, sham-related party transactions, round-tripping sales, and holding the books open past the end of the period. Other financial improprieties like so called “big bath” charges, creative acquisition accounting, and “cookie jar” liability reserves, all of which have been the subject of recent high profile SEC enforcement actions, could also be ripe for whistleblower exposure.

Companies need to be prepared. First and foremost, management must be vigilant in taking steps to prevent any mistreatment of known or suspected whistleblowers. The stakes are too high and not just because of the whistleblower protections in the Act. Perhaps more important is how the SEC or other government agencies would view the mistreatment of someone claiming whistleblower status. Other steps companies might take:

- Reenergize the company’s control environment, creating an environment that does not tolerate cutting corners or committing fraud – by the company’s employees or those the company does business with. Companies who do not already have an ethics hotline, should consider creating one and companies with ethics hotlines should ensure that the Audit Committee has active oversight over the program and that it operates independent of management. But the changes should go beyond new programs or formal procedures – they must go to the heart of the company’s business ethos.
- Think creatively about how to incentivize employees to make their concerns known internally rather than to the SEC. Because whistleblowers must provide “original information,” using the company hotline might lead to the company self reporting, which in turn would leave the whistleblower with no reward. Given the anonymity and protections against retaliation, companies will have to work hard to overcome the incentives employees will have to report to the SEC.
- Reevaluate hiring and promotion to ensure appropriate attention is paid to ethics and honesty. Background checks are obvious, but companies should think creatively about how to hire people who understand that short term gain through fraud is not in the company’s interest.



- Communicate the company's code of conduct/ethics throughout the company, to all accounting and financial oversight personnel, as well as to those involved with vendors and those involved in the sales functions.
- Ensure that internal auditors are trained to recognize financial accounting manipulation. Internal audit should perform separate, after-the-fact evaluations of whistleblower claims and should build into their normal audit procedures heightened procedures designed to detect fraud risks.
- Training may need to be more frequent and conducted with a wider group of employees. Everyone in the company should be instructed on the company's code of conduct, ethics, and internal reporting procedures for potential fraud.
- Make your voices heard in the comment period. The SEC has set up a website where it will accept comments, all of which will be posted on the SEC's [website](#). Companies should also be involved with their elected representatives to ensure their concerns are heard, at least in the rule making process.

Most companies already consider the risk of fraud, whether implicitly or explicitly. All companies should now consider fraud risks explicitly. This should include all aspects of a company's financial reporting and operations, including the potential for fraud by senior management, and should extend to business units and to significant accounts. The Dodd-Frank Act need not detract from a company's focus on its core business, but it will no doubt be an important part of the regulatory landscape that every public company will have to consider.

For more information, please contact Vinson & Elkins lawyers [David Woodcock](#) or [Michael Holmes](#). Visit our website to learn more about V&E's [Securities Litigation and Enforcement practice](#), or e-mail one of the [practice contacts](#).

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