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The Impact of Financial Reform on Securities Litigation and Enforcement

Posted by Wayne M. Carlin, Wachtell, Lipton, Rosen & Katz, on Friday July 9, 2010

Editor's Note: Wayne Carlin is a partner in the Litigation Department at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton firm memorandum by Mr. Carlin, Peter C. Hein, Eric M. Roth and Olivia A. Maginley.

In addition to many significant regulatory provisions, the conference report text of the proposed Dodd-Frank Wall Street Reform and Consumer Protection Act contains a number of provisions in Title IX (Investor Protections and Improvements to the Regulation of Securities) which, if enacted, would have a significant impact on securities litigation and enforcement. Other proposed provisions were considered and discarded during the conference committee process. The highlights of the conference report text as it now stands include:

Private Cause of Action for Aiding and Abetting Violations Rejected. Efforts by some lawmakers to overturn well-settled Supreme Court authority by creating a private cause of action for aiding and abetting violations of the Securities Exchange Act of 1934 proved unsuccessful. The conference report text, at Sections 929M-929O, instead augments the SEC's existing authority to pursue civil enforcement actions alleging aiding and abetting of violations of the Exchange Act by lowering the requisite state of mind to encompass "reckless," in addition to "knowing," acts, and by empowering the SEC to pursue actions premised on "knowingly or recklessly" aiding or abetting violations of the Securities Act of 1933, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Section 929Z of the conference report text requires the Comptroller General to conduct a "study" analyzing the impact of authorizing a private right of action for aiding and abetting violations of the federal securities laws.

New Incentives and Protections for Whistleblowers. The conferees, in Section 922(a), proposed amendments to the Exchange Act that would create new incentives and protections for whistleblowers. In any judicial or administrative action brought by the SEC (or certain related actions) resulting in monetary sanctions exceeding $1 million, individual whistleblowers would be able to recover 10-30% of monetary sanctions (including penalties, disgorgement and interest, as well as any monies deposited into a disgorgement fund) as a result of any "original information"

voluntarily supplied, to be paid from the newly established SEC Investor Protection Fund funded by monetary sanctions collected by the SEC. Moreover, employees are permitted to bring anti-retaliation claims in federal court — provided suit is brought within six years (and potentially up to ten years) after the violation occurred — seeking relief in the form of reinstatement and double back-pay, with interest, as well as compensation for litigation costs. This new whistleblower regime differs from Section 806 of the Sarbanes- Oxley Act of 2002, which requires aggrieved employees to file a complaint with the Secretary of Labor as a precondition to bringing a civil action, and under which an award of reinstatement and back-pay (not double back-pay) may be awarded. Separately, Section 922(c) would amend Section 806 of the Sarbanes-Oxley Act to preclude waiver by any agreement (including an employment agreement) of the rights and remedies provided to whistleblowers under that section, and to render unenforceable any predispute arbitration agreement that would compel arbitration of a dispute arising under that section.

SEC Empowered to Ban or Limit Use of Mandatory Arbitration Provisions. Section 921 of the conference report text would amend the Exchange Act and the Investment Advisers Act to give the SEC the power by rulemaking to ban or limit the extent to which brokers, dealers, municipal securities dealers and investment advisers can require customers to submit to arbitration future disputes arising under the federal securities laws.

Increased Exposure to Liability for Credit Rating Agencies. In addition to a host of new regulatory requirements imposed in Sections 931 et seq., credit rating agencies may face new litigation challenges under the federal securities laws. If enacted, Section 933 of the proposed legislation would amend Section 15E(m) of the Exchange Act such that the "enforcement and penalty provisions of this title shall apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws, and such statements shall not be deemed forward-looking statements for the purposes of [the PSLRA safe harbor]." Moreover, plaintiffs' state-of-mind pleading burden would be modified for claims against credit rating agencies.

Deadline for Completion of SEC Investigations. While it is not uncommon for SEC investigations to remain pending over long periods of time, Section 929U of the conference report text would require the SEC to bring an action — or provide notice of its intent not to file an action — within 180 days of issuing a written Wells notification, subject to the possibility of a 180-day extension if the investigation is deemed sufficiently complex by the Director of the SEC's Division of Enforcement or the Director's designee. Any further extensions for sufficiently complex investigations could be obtained only with the approval of the Commission.

Short Sale Reforms. In addition to expressly prohibiting the manipulative short sale of any security, Section 929X of the conference report text directs the SEC to promulgate rules requiring public disclosures by institutional investment managers concerning the short sales of securities "[a]t a minimum . . . every month."

SEC Self-Funding Proposal Rejected. A proposal that the SEC should be able to fund itself based on the fees it collects was ultimately rejected. Instead, the conferees agreed in Section 991 that the SEC should continue to be subject to the Congressional appropriations process, and provided for certain baseline appropriations through 2015. The proposed Act further requires the White House to submit unaltered to Congress the SEC's annual budget, and establishes a $100 million reserve fund. While the regulatory provisions of the proposed Act may have the greatest impact on financial institutions and other participants in the markets, the Act also portends increased potential for exposure for securities violations, particularly in SEC enforcement actions.