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Securities Litigation Implications of the Dodd-Frank Act

On June 25, 2010, a House-Senate conference committee reached agreement on the text of the conference report for the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act has been approved by the House and is expected to be approved by the Senate and signed into law in the near future. The Act contains several procedural and substantive provisions that are designed to facilitate enforcement of the securities laws through civil litigation and expand the scope of available remedies. This memorandum provides an overview of the areas in which the Act will impact future securities civil litigation.

New Provisions Affecting Regulatory Enforcement and Remedies

New Liabilities for Swap Dealers

Sections 731 and 764 of the Act amend the Commodity Exchange Act of 1936, subjecting swap dealers and security-based swap dealers to "business conduct" standards to be prescribed by rule by the CFTC. These standards will require swap dealers to verify the eligibility of swap transaction counterparties, to communicate based on the principles of "fair dealing and good faith" and to disclose certain material information (including conflicts of interest). The Act also imposes on swap dealers a fiduciary duty in their dealings with "special entities" (governmental entities and pension plans, endowments and employee benefit plans as defined under Section 3 of ERISA).

- *Swap dealers and security-based swap dealers acting as advisers.* Where swap dealers act as advisers, the Act creates additional conduct requirements, expressly making unlawful (i) the use of any "device, scheme, or artifice to defraud any Special Entity," (ii) the performance of "any transaction, practice, or course of business that operates as a fraud or deceit on any Special Entity" and (iii) "any act, practice, or course of business that is fraudulent, deceptive, or manipulative."
- *No private right of action against swap dealers for breaches of new duties.* Section 741 limits the power to enforce the substantive provisions of Subtitle A of Title VII (including the provisions creating business conduct standards and fiduciary duties) to the CFTC, and, in certain cases, a "prudential regulator" assigned to cover the specific swap dealer at issue.
- *Private right of action for market manipulation.* Section 753 extends the private cause of action in Section 22(a)(1) of the Commodity Exchange Act to claims for market manipulation in swap transactions. This liability provision also extends to aiders and abettors.

Limitations on Mandatory Pre-dispute Arbitration

Section 921 amends the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to allow the SEC to prohibit or impose limits upon the power of brokers, dealers, and investment advisers to require their customers and clients to arbitrate disputes arising under the Federal securities laws.

Whistleblower Protection

Section 922 creates substantial monetary awards for whistleblowers in any SEC enforcement action resulting in a sanction of over \$1,000,000, with award amounts determined as a percentage of the SEC's recovery. It also grants whistleblowers a private right of action against employers that retaliate. This right of action enables whistleblowers to claim reinstatement, double back pay and litigation costs and attorneys' fees. Section 748 creates an analogous award and protection structure for whistleblowers reporting to the CFTC.

"Bad Actors"

Section 926 disqualifies certain offerings from the protections of Regulation D under the Securities Act of 1933, if such offerings are made by certain "bad actors." "Bad actors" are defined as persons who (i) have been convicted of a felony or misdemeanor in connection with the purchase or sale of any security or a false filing with the SEC, or (ii) are barred from association with regulated entities or from engaging in the business of securities, insurance or banking or in savings association or credit union activities because of fraud, manipulation or deception.

Aiding and Abetting Liability

Sections 929M, 929N, and 929O clarify and extend the scope of liability for aiders and abettors in government enforcement actions by expressly making liable aiders and abettors who act "recklessly." Sections 929M and 929N impose liability upon "any person that knowingly or recklessly provides substantial assistance to another person in violation" of any provision of the Securities Act or the Investment Company Act of 1940, and upon "any person that knowingly or recklessly has aided, abetted, counseled, commanded, induced, or procured a violation" of any provision of the Advisers Act. Section 929O amends Section 20(e) of the Exchange Act to allow the SEC to bring actions against any person who knowingly or recklessly provided substantial assistance for violations of the Exchange Act.

Strengthening SEC Enforcement

Section 929P strengthens the SEC's enforcement powers in three keys respects. First, it allows the SEC, under certain circumstances, to impose monetary penalties in administrative cease and desist proceedings against any person, not only regulated entities. Second, it expands federal court jurisdiction by allowing the SEC to bring enforcement actions against (i) persons taking "significant steps in furtherance" of a violation, even where the securities transaction takes place outside the United States and (ii) persons engaging in conduct outside the United States that has a foreseeable impact within the United States. Third, it specifies

that control person liability under Section 20(a) of the Exchange Act applies in SEC enforcement actions, as well as in private actions.

Deadlines for the SEC

Section 929U requires the SEC to either file an action or provide notice of its intent not to file an action within 180 days of providing a Wells notification to any person. Similarly, it provides that the SEC will have a maximum of 180 days after completing an onsite compliance examination or inspection or receiving all requested records to issue a written notification providing the results of the examination.

Short Sale Reforms

Section 929X requires the SEC to prescribe rules providing for certain public disclosures and notifications to investors relating to short sales of securities. It also specifically makes unlawful the manipulative short sale of any security.

Private Right of Action against Credit Ratings Agencies

Section 933 extends liability for private securities fraud actions under Section 15E of the Exchange Act to nationally recognized statistical ratings organizations (“NRSROs”). In a private action authorized under this section, the plaintiff must plead with particularity only that the defendant NRSRO knowingly or recklessly failed to conduct a reasonable investigation or obtain reasonable verification of the factual elements used in reaching its conclusions about credit risk.

Central Bank, Stoneridge and Gustafson Survive

Senator Arlen Specter and Representative Maxine Waters introduced amendments at various stages of the bill’s evolution seeking to create a private right of action against persons who knowingly aid or abet violations of federal securities laws, thereby overturning 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). These proposed amendments received substantial press coverage; however, the House-Senate conference committee ultimately did not adopt the amendments. Rather, Section 929Z of the Act requires the Comptroller General to conduct a study of the potential impact of authorizing such a private right of action in the future.

Separately, Senator Carl Levin proposed an amendment that would have overturned *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995), the Supreme Court case holding that private securities transactions are insulated from the liability provisions of Section 12(a)(2) of the Securities Act. The proposed amendment (SA 3969) would have extended Section 12(a)(2) liability to sellers’ material misstatements and omissions in offering memoranda used in private placements of securities. Ultimately, the conference committee did not adopt the amendment.

Additional Provisions

Title IX contains several additional measures designed to facilitate regulatory enforcement, including provisions allowing nationwide service of subpoenas (Section 929E), enhancing confidentiality of materials submitted to the SEC (Section 929I) and strengthening remedies available under the securities laws by increasing cash advances for customer claims in SIPC proceedings (Section 929H). The Act stops short of creating a private right of action against extraterritorial violators of the antifraud provisions of the Exchange Act and, as noted above, against aiders and abettors of securities fraud, but it requires studies and reports on the impact of such private rights, leaving open a potential avenue for their creation. (Section 929Y; Section 929Z.)

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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