XIII. Investor Protections of Dodd-Frank

A. Introduction

The investor protection provisions of Title IX of *Dodd-Frank* made sweeping changes in securities enforcement and regulation. For example, Title IX increased whistleblowers' incentives, lowered the mens rea requirement for secondary actors, increased SEC funding, created the ability for the SEC to impose fiduciary standards on brokers and to obtain penalty awards in administrative cases, fashioned industry-wide bars for securities professionals, and restricted the ability to craft customer arbitration agreements. These provisions significantly changed the way public companies and their directors and employees conduct business.

B. Whistleblower Provision

Section 922 of the Act contains specific requirements for qualifying for the significant monetary incentives (known colloquially as "bounties") that are available for individuals who know of a securities violation and contact the SEC (i.e. "blow the whistle").[1] In order to qualify for the bounty, the whistleblower must have voluntarily provided this information to the SEC and the information must be original.[2] Original information is information that was "derived from the independent knowledge or analysis" of the whistleblower.[3] Information that was known to the SEC from another source or was exclusively derived from external, publicly available information, such as a governmental report, hearing, audit or investigation, or from the news media does not qualify as "original".[4] Further, if a regulatory or self-regulatory agency, the

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 922, 124 Stat. 1376 (2010) to be codified at 15 U.S.C. § 78.
[2] *Id. at § 922(b)(1).*
[3] Kevin Griffith, *Whistleblowing Galore Under the Dodd-Frank Act*, BANKING & FINANCIAL LAW REPORT, Aug. 24, 2010, http://www.bankingandfinancelawreport.com/2010/08/articles/bank-regulation/whistleblowing-galore-under-the-doddfrank-act/.
[4] Gibson Dunn, *The Dodd-Frank Act Reinforces and Expands SEC Enforcement Powers,* July 21, 2010, http://www.gibsondunn.com/publications/Pages/DoddFrankActReinforcesAndExpandsSECEnforcementPowers.aspx.

Department of Justice, the Public Company Accounting Oversight Board, or a law enforcement organization employed the whistle-blower, the whistle blower will not be able to benefit from the provision.[5] Even if the whistleblower is the offender himself, the bounty must still be paid to him unless he is criminally convicted of a crime related to the action.[6] However, it is not enough that the whistleblower just report the violation to the SEC. In order for the whistleblower to collect their bounty, the information provided must lead the SEC to a successful enforcement action with monetary sanctions over $1 million dollars.[7]

If the above mentioned criteria are met, the whistleblower is entitled to a bounty of anywhere from 10% to 30% of the total monetary penalties imposed by the SEC.[8] With SEC enforcement actions historically resulting in penalties worth hundreds of millions of dollars, whistleblowers have a large carrot placed in front of them, but the stick can be ruthless.[9] "Basically, [whistle-blowing] ruins your life….What is worth your life getting ruined? It's pretty expensive."[10] Congress had similar concerns and greatly expanded the protections available to whistleblowers.[11] One of the greatest protections available is anonymity; whistleblowers may submit information to the SEC through counsel and remain anonymous until a bounty payment.[12] Further, if the identity of the whistleblower is known to the corporation, they 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

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[5] *Id.*

[6] *Id.*

[7] Bruce Carton, *Pitfalls Emerge in Dodd-Frank Whistleblower Bounty Provision*, SECURITIES DOCKET, Sept. 09, 2010, http://www.securities docket.com/2010/09/09/pitfalls-emerge-in-dodd-frank-whistleblower-bounty-provision.

[8] *Michael F. Perlis & Wrenn E. Chai, Will Whistle-Blowing Be Millions Well Spent?, FORBES,* Sept. 15, 2010, http://www.forbes.com/2010/09/15/whistle-blowers-sec-opinions-columnists-perlis-chais.html.

[9] Carton, *supra* note 7.

[10] Sara Johnson, *Paid to Whistle*, CFO.COM, July 23, 2010, http://www.cfo.com/article.cfm/14512666/c_14512775?f=home_todayinfinance.

[11] Stephen J. Crimmins, et al., *Investor Protection Provisions of Dodd-Frank Financial Services Reform Alert*, K&L GATES NEWSSTAND, July 1, 2010, *available at* http://www.klgates.com/newsstand/detail.aspx?publication=6518.

[12] *Id.*

his employment".[13] For those whistleblowers who think they have been discriminated against, they can bring an action in federal court seeking double back pay, reinstatement with appropriate seniority, attorney and expert costs and other relief.[14]

The benefits of the whistleblower provisions are straight-forward, but critics raise some legitimate arguments. More lucrative bounties plus greater whistleblower protection will result in more tips getting reported to the SEC and an increase in the number of whistleblowers coming forward.[15] Critics state that the provision will greatly increase the number of false claims that are reported to the SEC, and employees will prematurely report when they have any suspicion of fraudulent activity with the hopes of becoming millionaires.[16] The new whistleblower provision could also cause employees to head straight to the SEC and report the violation, not even giving the company a chance to fix the problem internally.[17] Furthermore, employees who feel secure in their jobs are more likely to report the violation internally than those who might be on the verge of being let go or are no longer with the company.[18]

The law will also affect company behavior. Companies are likely to start taking steps now to encourage their employees to report violations internally to their supervisors because a company does not want to find out about a violation for the first time when an SEC enforcement action official calls about it.[19] Companies have also started reexamining their internal whistleblower program to try and strengthen it.[20] Most publicly traded companies have had one since Sarbanes-Oxley was passed in 2002.[21] Because having an

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[13] *Id.*
[14] *Id.*
[15] Jim Kim, *Dodd-Frank prompting more whistleblowers already?*, FIERCE FINANCE, Sept. 06, 2009, http://www.fiercefinance.com/story/dodd-frank-prompting-more-whistle-blowers-already/2010-09-16.
[16] Carton, *supra* note 7.
[17] *Id.*
[18] James J. Baressi, et al., *Investor protections in the Dodd-Frank Wall Street Reform and Consumer Protection Act: companies need to act to avoid potential new expenses*, SQUIRE SANDERS, July 30, 2010, http://www.ssd.com/investor_protections_in_the_doddfrank_wall_street_reform_and_consumer_protection_act_companies_need_to_act_to_avoid_potential_new_expenses/.
[19] *Id.*
[20] *Id.*
[21] Johnson, *supra* note 8.

anonymous tip-line might not suffice when the SEC is dangling a million-dollar carrot in front of employees, companies might also enact internal whistleblower programs that provide employees incentives like the SEC's program.[22] Finally, companies should strongly consider self-reporting violations to the SEC when made aware of them.[23] Although self-reporting will not save a company from all liability, it will often benefit by leading to a potentially lower fine or sentence.[24]

C. Expanding the Scope of Secondary Liability

Section 929M of the Act provides for the SEC to impose aiding and abetting liability on persons who "recklessly" provide substantial assistance to someone who violates the Exchange Act.[25] Previously, federal court decisions held that under the Private Securities Litigation Reform Act of 1995, the aiding and abetting standard was "knowingly."[26] However, now those decisions are immaterial as the requisite mens rea has been reduced to recklessness. This lower standard of proof will ultimately make it easier for the SEC to bring aiding and abetting charges against someone who assisted in the fraud but did not have actual knowledge of it.

In addition, the Act clarifies the SEC's ability to bring claims based on control-person liability.[27] Under the control-person theory, a person who directly or indirectly controls another person who commits a securities violation is responsible for that violation unless that person can show that they acted in good faith and did not directly or indirectly induce the violation.[28] The SEC had rarely asserted control-person claims in the past, as there were doubts about whether the SEC could bring them.[29] However, the Act now expressly authorizes that the SEC can bring such actions.[30] Thus, not

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[22] Baressi, et al., *supra* note 18.
[23] *Id.*
[24] *Id.*
[25] Dodd-Frank, *supra* note 1, at § 929M (to be codified at 15 U.S.C. § 78j).
[26] Crimmins, *supra* note 11.
[27] *Id.*
[28] *Laura Greco*, *The Buck Stops Where*? Defining *Controlling Person Liability*, 73 S. CAL. L. REV., Vol. 169, 173-74 (1999).
[29] *Id.*
[30] Dodd-Frank, *supra* note 1, at § 929P (to be codified at 15 U.S.C. § 78t).

only does the SEC have a new means to investigate and prosecute senior managers, directors and board members, it also makes companies significantly more vulnerable to personal liability for lower level employees' securities violations.

D. SEC Funding

In the past, the SEC has suffered from inadequate resources to examine and investigate the roughly 35,000 entities it regulates.[31] The SEC sought self-funding for its operations through the fees it collects from registrants, but Congress refused to provide it, despite the absence of significant opposition.[32] However, Dodd-Frank did provide for major funding increases from $1.3 billion in 2011 to $2.25 billion in 2015, nearly doubling the SEC's budget.[33] The Act also established a $100 million reserve account, allowing the SEC more flexibility in its long term planning.[34] Overall**,** these increases should significantly boost investor protection and confidence, as the number and complexity of enforcement cases the SEC files will certainly increase.

E. Fiduciary Standard for Brokers

The SEC is moving swiftly to conduct a study on whether there are regulatory cracks in the protection of retail customers with regard to the differentiating fiduciary standards of brokers and investment advisers when they provide "personalized investment advice about securities to a retail customer".[35] Most investors don't know whether their adviser is an investment adviser or a broker, nor do they know that they are held to different standards.[36] Currently, brokers, unlike investment advisers, are not considered fiduciaries;

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[31] Stephen Grocer, *Want to Fix SEC's Revolving Door? Give the Agency More Money*, WALL ST J. BLOG (JUN 16, 2010), http://blogs.wsj.com/deals/2010/06/16/want-to-fix-secs-revolving-door-give-the-agency-more-money/.
[32] Crimmins, *supra* note 11.
[33] *Dodd-Frank, supra* note 1, at § 991(c) (to be codified at 15 U.S.C. § 78ee).
[34] *Id.*
[35] Suzanne Barlyn, *SEC 'Moving Rapidly' To Complete Fiduciary Study*, Wall ST J. Blog (Sept. 30, 2010), http://online.wsj.com/article/BT-CO-20100930-712110.html.
[36] Susanne Craig, *The Debate Over Broker Standards*, N.Y. TIMES, Sept. 27, 2010,

this means they can sell products to their clients that might be the right fit for the client but not the most beneficial option for them.[37] On the other hand, investment advisers have an obligation 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."[38] If the standard would be applied uniformly in both instances the consumer would not have to worry whether their interest is being put at the forefront. However, litigation would likely increase due to the higher standard and we also may see increased costs being passed on to the consumer.

The Act gives the SEC until January 2011 to complete the study, and it is expected that the SEC will create a uniform standard.[39] However, whether the standard will be the same as the current standard for investment advisers is unknown. The SEC could propose a uniform standard that ends up lowering the current standard for investment advisers.[40] Overall, there is no question that changes will come next year.

F. Penalties in Administrative Proceedings

The SEC has long had the power to seek monetary penalties against individuals, but had to do so through filing an action in federal court.[41] Now it can do so through an administrative action.[42] This will not only make it easier procedurally for the SEC to file more cases, but will also significantly reduce the rights and protections that defendants would have in a civil trial.[43] There is no right to a jury trial or pretrial discovery, and perhaps most importantly the administrative law judge's decision is reviewed de novo by SEC commissioners.[44] However, this will also give defendants the chance to resolve cases through an administrative

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[37] *Id.*
[38] Crimmins, *supra* note 11.
[39] Craig, *supra* note 36.
[40] *Id.*
[41] David Woodcock & Michael Holmes, *Get Prepared for Dodd-Frank*, Vinson & Elkins (Aug. 4, 2010) available at http://www.velaw.com/uploadedFiles/VEsite/Resources/Dodd-FrankAct080410.pdf.
[42] *Id.*
[43] *Id.*
[44] *Id.*

action as opposed to a potentially more costly federal district court proceeding.

G. Other Investor Protection Provisions in Title IX

1. Securities Industry-Wide Collateral Bars

Previously, the SEC could only seek to suspend an individual from the type of business the person was in when he committed the violation.[45] For example, an investment adviser would only be barred from working as an investment adviser; he could still work as a broker. However, now the SEC may bar that person's association with any "broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization."[46] Essentially, the consequences of being collaterally barred have significantly increased and actors are likely to think twice before committing a violation.

2. Limitation on Required use of Arbitration

The SEC now has the authority to restrict customer arbitration agreements.[47] The SEC can either limit or completely prohibit mandatory predispute arbitration clauses which are commonly found in investor client forms.[48] This provision follows the trend among legislatures and courts alike to limit the use of mandatory arbitration clauses.[49] Customers will likely have greater freedom to litigate their claims in court with a jury and judge. However, the SEC may decide not to restrict a company's ability to require that disputes be handled exclusively in a particular venue or that the right to jury trial be waived, these conditions are generally found in such agreements.[50]

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[45] Crimmins, *supra* note 11.
[46] *Id.*
[47] Dodd-Frank, *supra* note 1, at § 921 (to be codified at 15 U.S.C. § 78o).
[48] *Id.*
[49] Barresi et al., *supra* note 18.
[50] *Id.*

3. Deadlines for SEC Enforcement Actions, Inspections and Examinations

In an effort to accelerate the enforcement action process, Section 929U requires the SEC to file an action against an individual or notify them of their intent not to no later than 180 days after providing a written Wells Notice.[51] The provision's intent is to combat the criticism that the SEC has let matters go unresolved for years.[52] The Act requires the SEC to file an action against an individual or notify them of their intent not to no later than 180 days after providing a written Wells Notice.[53] The Act authorizes an additional 180 day extension for investigations or examinations that are decided to be complex by the Director of the Division of Enforcement or a designee of the Director.[54] The deadlines should also provide at least some peace of mind to targets of SEC investigations, but the deadlines do not apply until the Wells Notice is provided, so the SEC might not go forward to that stage until they are fully prepared or the deadlines could create a more aggressive SEC.

H. Likely Future Developments

Instead of making reforms in an array of controversial areas regarding investor protection, Dodd-Frank directed the SEC to conduct a wide variety of studies most, due within eighteen months.[55] These include:

- the effectiveness of existing standards of care applicable to brokers, dealers and investment advisers in providing personalized investment advice and recommendations about securities to retail customers, and regulatory gaps relating to these issues;
- whether the SEC should engage the assistance of SROs in conducting examinations of investment advisers;
- the adequacy of examinations of investment advisory activities of dually registered broker-dealers and investment advisers and their affiliates;

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[51] Dodd-Frank, *supra* note 1, at § 929U (to be codified at 15 U.S.C. § 78d).
[52] Dunn, *supra* note 4.
[53] Dodd-Frank, *supra* note 51.
[54] *Id.*
[55] Crimmins, *supra* note 11.

- the level of financial literacy of retail investors, and what means might be most effective to further educate them;
- potential improvements in disclosures to investors regarding financial intermediaries, investment products and investment services;
- methods to increase the transparency of expenses and conflicts of interests in transactions involving investment services and products, including shares of open-end companies; and
- how to better facilitate investor access to information regarding disciplinary actions; regulatory, judicial and arbitration proceedings; and other information about registered investment advisers, brokers and dealers.[56]

Although these studies do not immediately change any laws, their conclusions will likely lead to future legislation in this arena.[57] The effect of investor protection is nearly impossible to accurately predict, but the studies and regulation should bolster it to a degree.

Ryan Kelly[58]

[56] *Id.*
[57] *Id.*
[58] Student, Boston University School of Law (J.D. 2012).