

## ADVISORY | Dodd-Frank Act

July 21, 2010

### ENHANCED PROTECTION OF INVESTORS AND OTHER CHANGES TO SECURITIES REGULATIONS

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). A central intent of the Act is to improve investor protection in the financial regulatory framework and make other related enhancements to securities regulation. This advisory describes a number of those provisions.

Many of the changes described in this advisory will be implemented through rulemaking by the Securities and Exchange Commission (SEC) and certain other agencies. Annex A provides a summary of the various rulemakings and applicable deadlines, if any, under the Act.

- Provides for the payment of bounties to whistleblowers in connection with certain securities enforcement actions and greater protection from retaliatory actions by employers in response to whistleblower tips and participation.
- Augments investor protection administrative functions at the SEC.
- Expands the bases for finding aiding and abetting violations in securities enforcement actions.
- Directs the SEC to
  - establish rules disqualifying “bad actors” from relying on the private placement exemption under Rule 506 of Regulation D; and
  - narrow the definition of the term “accredited investor.”
- Exempts non-accelerated filers from compliance with the auditor attestation requirements in Section 404(b) of the Sarbanes-Oxley Act.
- Directs the SEC to conduct a study to evaluate the effectiveness of the existing standards of care for broker-dealers and investment advisers for providing personalized investment advice regarding securities to retail customers.
- Subjects credit rating agencies to increased regulation, as well as heightened standards of liability.
- Subjects municipal advisors to registration with the SEC and regulation by the MSRB. Also, imposes a fiduciary duty on municipal advisors providing advice to municipal entities.

#### Whistleblower Incentives and Protections

##### Whistleblower Bounty Program

Section 922 of the Act provides for the payment of bounties to whistleblowers who voluntarily provide to the SEC original information about a securities law violation that leads to a securities

enforcement action resulting in more than \$1 million in monetary sanctions.<sup>1</sup> The award to a whistleblower in the SEC's discretion must be no less than 10 percent and no more than 30 percent of the monetary sanctions actually collected by the SEC in connection with the action. Awards will be paid out of a fund established in the U.S. Treasury and funded by the monetary sanctions collected by the SEC. Information that could reasonably be expected to reveal the identity of the whistleblower must be kept confidential.

### **Greater Protections Against Retaliation**

In addition to creating, through the payment of bounties, an incentive for whistleblowers to report violations, Section 922 also provides protections to those individuals against retaliation by their employers. In particular, the Act prohibits an employer from directly or indirectly discriminating against a whistleblower in any manner (including by threatening, demoting or discharging such individual) in response to the following whistleblower actions:

- providing to the SEC information regarding securities law violations in accordance with the Act;
- participating in a judicial or administrative action brought by the SEC in connection with such information; or
- making disclosures that are protected under certain federal laws, including the Securities Exchange Act of 1934 (the Exchange Act), the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act) and other laws and regulations within the SEC's jurisdiction.

A whistleblower who alleges such retaliatory action may bring an action against the offending employer in federal court within six years from the date of the violation or within three years from the date when material facts regarding the right of action reasonably should have been known to the whistleblower. Under no circumstances may a whistleblower bring such an action more than 10 years from the date of the violation.

These measures are significant because they are separate and apart from the existing whistleblower protections under the Sarbanes-Oxley Act, which, in Section 806, protects whistleblowers from employer retaliation in connection with similar kinds of protected activities to those described above. The Sarbanes-Oxley Act provisions, however, have more restrictive procedural hurdles than the new protections under the Act. For instance, whereas under the Act, whistleblowers can bring retaliation claims directly in federal court, under the Sarbanes-Oxley Act, the whistleblower must file a complaint first with the Department of Labor. Additionally, the Sarbanes-Oxley Act has a much shorter statute of limitations than under the Act—180 days (as extended by the Act—see below) versus up to 10 years (described above). Consequently, the Act provides whistleblowers with a different and potentially surer path to being heard with respect to retaliation claims than under the Sarbanes-Oxley Act protection scheme.

### **Changes to Whistleblower Provisions under the Sarbanes-Oxley Act**

The Act also makes certain changes to the whistleblower provisions in Section 806 of the Sarbanes-Oxley Act. Most importantly, Section 922(c) doubles the statute of limitations period for reporting retaliations claims from 90 to 180 days. It also provides for jury trials and prohibits waiver of rights and predispute arbitration agreements.

---

<sup>1</sup> Under Section 922, "original information" is (i) derived from the independent knowledge or analysis of the whistleblower, (ii) not known to the SEC from any other source, and (iii) not exclusively derived from allegations made in judicial or administrative hearings, governmental reports, hearings, audits, or investigations, or from the news media.

## New Investor Protection Administration at SEC

The Act augments the administrative functions surrounding investor protection at the SEC in a number of respects. This will require a new and permanent allocation of SEC staff to support the activities of the new functions, staff that will be redeployed from other areas of the agency.

- *Office of the Investor Advocate.* Section 915 of the Act amends Section 4 of the Exchange Act to establish the Office of the Investor Advocate. The Investor Advocate (the head of this office who is appointed by the SEC Chairman) is, among other things, charged with (i) assisting retail investors in resolving significant problems with the SEC or self-regulatory organizations (SROs), (ii) identifying areas in which investors would benefit from changes in SEC regulations or SRO rules, (iii) identifying problems that investors have with financial service providers and investment products, and (iv) analyzing the potential impact on investors of proposed regulations of the SEC and rules of SROs.
- *Ombudsman.* Under Section 919D of the Act, the Investor Advocate will appoint an Ombudsman who will (i) act as a liaison between the SEC and retail investors in resolving the problems described above, (ii) review and make recommendations regarding policies and procedures to encourage individuals to utilize the Investor Advocate as a resource regarding securities law compliance questions, and (iii) establish safeguards to maintain the confidentiality of investor communications with the Ombudsman.
- *Investor Advisory Committee.* Section 911 of the Act establishes on a permanent basis the Investor Advisory Committee comprised of, among others, the Investor Advocate, a representative of State securities commissions, a representative of senior citizen interests and representatives of individual debt and equity investor interests.<sup>2</sup> In general, the committee will advise and consult with the SEC on (i) regulatory priorities, (ii) issues relating to the regulation of securities products, trading strategies, fee structures, and the effectiveness of disclosure, and (iii) initiatives to protect investor interest and to promote investor confidence and the integrity of the securities markets.

## Expansion and Clarification of Aiding and Abetting Liability

Currently, the SEC can bring enforcement actions against aiders and abettors under the Exchange Act and Investment Advisers Act of 1940 (the Advisers Act). Section 929M of the Act expands this authority, providing that the SEC can bring such actions under the Securities Act of 1933 (the Securities Act) and the Investment Company Act of 1940. In addition, Section 929O of the Act expands the bases for liability by imposing liability on persons who “recklessly” provide substantial assistance to someone who violates the Exchange Act. Finally, Section 929N of the Act permits the SEC to pursue monetary penalties against aiders and abettors in actions brought under the Section 209(e) of the Advisers Act.<sup>3</sup>

---

<sup>2</sup> In June 2009, the SEC established an Investor Advisory Committee with a charter that provides for termination of such committee in June 2011.

<sup>3</sup> The House and Senate conferees considered including in the Act a provision essentially overruling *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) and *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008) and establishing a private right of action against aiders and abettors for violations of the securities laws. Ultimately, however, they opted against including such a measure, although Section 929Z of the Act does direct the General Accounting Office to study whether private plaintiffs should be permitted to bring actions against aiders and abettors.

## Standards of Care for Broker-Dealers and Investment Advisers

One of the most widely discussed aspects of the Act with respect to investor protection has been how it might harmonize the standards of care applicable to and employed by broker-dealers and investment advisers. Under the Advisers Act, registered investment advisers are subject to implicit fiduciary duties. By contrast, broker-dealers owe their customers more limited duties of suitability and are subject to general anti-fraud prohibitions under the Exchange Act and other standards imposed by the Financial Industry Regulatory Authority. Consequently, significant debate has concerned whether substantive distinctions exist between the activities of broker-dealers and investment advisers to justify fragmented standards of care.

In the end, the Act takes only limited steps towards addressing this issue.<sup>4</sup> Under Section 913(b) of the Act, the SEC must conduct a six-month study to evaluate the effectiveness of the existing standards of care for broker-dealers and investment advisers (and their associated persons) for providing personalized investment advice regarding securities to “retail customers.”<sup>5</sup> In addition, such study must evaluate whether there exist legal or regulatory gaps, shortcomings, or overlaps with respect to such standards of care that should be addressed by rule or statute, taking into consideration a number of enumerated factors.<sup>6</sup>

Following the conclusion of the study and submission of a report to Congress, the SEC is *authorized* (but not directed) under Section 913(f) of the Act to establish rules to address the standards of care for broker-dealers and investment advisers providing personalized investment advice to retail customers. To this end, Section 913(g) of the Act modifies Section 15 of the Exchange Act to provide that the SEC may adopt rules providing that broker-dealers that provide personalized advice to retail customers are subject to the same standard of care applicable to investment advisers under Section 211 of the Advisers Act. In parallel, the Act modifies Section 211 of the Advisers Act to provide that the SEC may establish rules to provide that the standard of care applicable to broker-dealers and investment advisers when providing such advice is to act in “the best interest of such customer without regard to the financial or other interest” of the intermediary in providing the advice. Such rules must be no less stringent than the anti-fraud provisions contained in Sections 206(1) and 206(2) of the Advisers Act.

## Exemptions from Registration under the Securities Act

The Act directs the SEC to narrow exemptions from registration under the Securities Act in two respects.

---

<sup>4</sup> Whereas the version of financial reform legislation passed by the House would have authorized the SEC to establish a unified duty standard of care for broker-dealers and investment advisers, the Senate version instead would have directed the SEC to conduct a two-year study of the effectiveness of existing standards of care for such intermediaries and to engage in appropriate rulemaking as needed to address any identified regulatory gaps or overlaps. After significant debate, the House and Senate conferees reached the compromise described herein.

<sup>5</sup> Under Section 913(a) of the Act, a “retail customer” is a natural person or the legal representative of such natural person who receives personalized investment advice and uses such advice primarily for personal, family, or household purposes.

<sup>6</sup> In debating whether to establish a unified standard of care, many argued that such a study was unnecessary, particularly in light of the SEC’s previous efforts to examine the issue. For instance, a 2008 study by the Rand Corporation commissioned by the SEC concluded that retail investors generally had difficulty distinguishing between the services of investment advisers and broker-dealers.

### **Disqualification of Bad Actors**

Pursuant to Section 926 of the Act, the SEC must establish within one year of the Act's enactment rules that disqualify persons from relying on Rule 506 of Regulation D who have been shown to have committed certain improper acts. The disqualifications must operate to bar persons based on provisions similar to those already applicable to limited offerings under Rule 505 of Regulation, as well as securities law felons and violators of various State laws.

### **Adjustment to Accredited Investor Test for Natural Persons**

Section 413 of the Act directs the SEC to change the definition of "accredited investor" for purposes of the SEC's rules under the Securities Act. The changes will have the effect of raising the financial threshold for natural persons to qualify as accredited investors in exemptions from registration for issuers. Specifically, starting at the fourth anniversary of the Act's enactment, the SEC must adjust the net worth threshold required for a natural person to qualify for accredited investor status to more than \$1 million (the current level), as such amount may be adjusted periodically by SEC rules. Until such time, this threshold must remain at \$1 million. Importantly, however, the net worth threshold must now (and on a going-forward basis) exclude the value of such person's primary residence. Additionally, such section of the Act directs the SEC to review every four years the definition of an accredited investor, as it applies to natural persons, to determine whether such definition should be adjusted or modified for the protection of investors, in the public interest and in light of the economy.

### **Sarbanes-Oxley Exemption for Small Companies**

In an effort to lessen a perceived compliance burden on small companies, Section 989G of the Act exempts non-accelerated filers (i.e., companies with less than \$75 million in public float) from compliance with Section 404(b) of the Sarbanes-Oxley Act, which requires an issuer's auditor to attest to, and report on, management's assessment of the effectiveness of the issuer's internal control structure and procedures for financial reporting. In addition, Section 989G directs the SEC to conduct a study to determine how it can reduce the burden of complying with Section 404(b) for smaller companies whose market capitalization is between \$75 million and \$250 million without jeopardizing the investor protections for such companies.

### **Credit Rating Agencies**

The Act contains a number of provisions designed to increase the oversight and accountability of credit rating agencies in recognition of Congress' finding that these organizations play a critical "gate-keeper" function in the debt market that is similar to that of securities analysts and auditors. Provisions of the Act that are applicable to credit rating agencies are described below.

### **Repeal of Rule 436(g) under the Securities Act**

Section 939G of the Act repeals Rule 436(g) under the Securities Act, which exempted credit ratings provided by nationally recognized statistical rating organizations (NRSROs) from being considered a part of a registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the Securities Act.<sup>7</sup> Rule 436(g) thus shielded an NRSRO from liability under Section 11.

Repeal of Rule 436(g) requires issuers that refer to an NRSRO or an NRSRO's credit rating in a registration statement or prospectus filed under the Securities Act to file the NRSRO's consent as an exhibit to the registration statement. NRSROs that provide such a consent potentially will be subject

<sup>7</sup> Credit rating agencies registered as such with the SEC are known as "nationally recognized statistical rating organizations." There are ten firms currently registered as NRSROs.

to liability as “experts” under Section 11 of the Securities Act. The repeal of Rule 436(g), thus, removes a liability shield and places NRSROs in the same position as unregistered credit rating agencies and other entities deemed experts with respect to potential Section 11 liability.

Consequently, this provision may lead to significant changes in the practices surrounding public issuances of rated debt. In the short term, it is possible that NRSROs will respond to this provision by refusing to consent to references to their names or ratings in a registration statement and that issuers would therefore not voluntarily disclose such information in their registration statements or prospectuses (as was generally the case prior to the Act’s adoption). However, repeal of Rule 436(g) may have more widespread consequences if the SEC adopts a rule it has proposed that would require issuers to disclose information about a credit rating in a registration statement if a credit rating is “used” in connection with a registered offering, as such disclosure will now require an NRSRO’s consent.

### **Private Actions Against Credit Rating Agencies**

Section 933 of the Act provides that statements by credit rating agencies (not just NRSROs) will be subject to the enforcement and penalty provisions of the Exchange Act in the same manner as statements made by registered public accounting firms and securities analysts and that such statements will not be deemed to be forward-looking statements under Section 21E of the Exchange Act. Section 933 of the Act also establishes a pleading standard for a civil action brought against a credit rating agency or a controlling person thereof. Under this provision, it would be sufficient for the complaint to state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to (i) conduct a reasonable investigation or obtain reasonable verification regarding the factual elements relied on by its own methodology for evaluating credit risk or (ii) obtain reasonable verification of such factual elements from other sources that the credit agency considers to be competent and that were independent of the issuer and underwriter.

In addition to these provisions, Section 932 of the Act provides that certain reports NRSROs currently “furnish” to the SEC must now be “filed,” thereby exposing NRSROs to claims under Section 18 of the Exchange Act. Section 932 of the Act also replaces Section 15E(m) of the Act, which explicitly protected NRSROs from private rights of action in connection with such reports and any other disclosures required of such entities.

### **Study Regarding Credit Rating Agency Assignment System**

Section 939F of the Act requires that the SEC carry out a two-year study (beginning no later than 90 days following enactment of the applicable subtitle of the Act) of the credit rating process for “structured financial products” with a focus on the feasibility of establishing a system in which a public or private utility or an SRO would assign a particular NRSRO to determine the initial credit rating for each structured financial product.<sup>8</sup> Following the study, the Act directs the SEC to implement rules, as necessary or appropriate, to establish a system for the assignment of NRSROs to determine initial credit ratings for structured financial products. In particular, the SEC must give thorough consideration to a system such as that described in Section 939D of the Senate bill, which would have established a Credit Rating Agency Board to assign an NRSRO to determine the initial credit ratings for any structured financial product.

---

<sup>8</sup> A “structured financial product” is an asset-backed security or another structured product based on such a security.

## Registration and Regulation of Municipal Securities Advisors

The Act also seeks to protect investors by bolstering the regulatory oversight of the municipal securities market by creating a new class of regulated intermediaries, “municipal advisors,” as described below.

### SEC Registration

In particular, Section 975 of the Act, requires “municipal advisors” to register with the SEC in order to (i) provide advice to or on behalf of a “municipal entity” or “obligated person” with respect to municipal financial products (i.e., municipal derivatives, guaranteed investment contracts, and investment strategies), the issuance of municipal securities or (ii) solicit a municipal entity or obligated person.<sup>9</sup> The Act defines the term “municipal advisor” to include a person (who is not a municipal entity or an employee of such entity) who (i) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities or (ii) solicits a municipal entity, other than other regulated advisors (such as broker-dealers, investment advisers, and municipal securities dealers), attorneys and engineers.

### MSRB Regulation

Section 975(b) of the Act charges the Municipal Securities Rulemaking Board (MSRB) with establishing a wide variety of rules regulating the conduct and practices of municipal advisors, including with respect to qualification standards, examinations and recordkeeping. The scope of such rulemaking authority is comparable to that with respect to municipal securities dealers. To promote independence, Section 975(b) requires that the MSRB be composed of a majority of members who are unaffiliated with any broker-dealer, municipal securities dealer, or municipal advisor.

### Municipal Advisor Fiduciary Duty

In addition, Section 975(c) of the Act amends Section 15B(c) of the Exchange Act to impose a fiduciary duty on municipal advisors. In particular, a municipal advisor owes a fiduciary duty to any municipal entity for whom it acts as a municipal advisor. Municipal advisors are prohibited from engaging in practices that are inconsistent with such fiduciary duty. The Act does not specify the precise scope or substance of such duty (i.e., whether it mirrors the implicit fiduciary duties owed by investment advisers in connection with providing investment advice to their clients).

### Key Issues for Rulemaking Phase

The Act leaves many critical issues to be fleshed out in rulemaking proceedings at the SEC and other agencies. Among the key issues for the rulemaking and implementation phase are the following:

- The procedures regarding whistleblower information submitted to the SEC and any additional factors to be considered by the SEC in determining the amounts of whistleblower awards.

---

<sup>9</sup> Under Section 975 of the Act, a “municipal entity” is a State (or political subdivision or municipal corporate instrumentality thereof), including state agencies or authorities, any plans, program, or pool of assets sponsored or established by a State (e.g., a municipal pension plan) and any other municipal securities issuer. Under the same section, an “obligated person” is a person who is generally committed pay all or part of the obligations on the municipal securities to be sold in an offering of such securities.

- The actual role that will be carved out for the Office of the Investor Advocate and how the SEC will manage the Investor Advisory Committee.
- Whether the SEC will adopt a broker-dealer fiduciary duty and, if so, how that duty will be articulated.
- Any additional texture to the rules disqualifying bad actors from relying on Rule 506 of Regulation D.
- Any applicable adjustments to the net worth requirements in connection with determining accredited investor status.
- Whether the SEC adopts final rules requiring the disclosure of information regarding credit ratings in a registration statement in connection with a registered offering.
- The precise substance of any qualification standards for municipal advisors established by the MSRB pursuant to its rulemaking authority.

### What You Can Do

We believe that public companies and other persons potentially affected by the Act will want to consider a number of steps relating to the upcoming rulemaking phase, including:

- Keeping abreast of key developments in the rulemaking phase in the ensuing months so that they can fully understand the implications of proposed rules for their businesses and evaluate what efforts, if any, are being made by other firms/industry groups to participate in, and possibly shape, the rulemaking process.
- Developing realistic strategies to respond to the proposed rules – and ensuring that such strategies are effectively implemented. This would include considering how most effectively to communicate firm and industry views on proposed rules to SEC commissioners, the federal banking regulators, and their respective staffs (for example, individually, through *ad hoc* groups or through trade associations).
- Separately, developing compliance action plans for expected new rules, including internal training and education, and, where appropriate, briefing of senior officers and relevant board members.
- Reviewing compliance policies and procedures relating to employee complaints in response to new whistleblower regulations.

---

If you would like to discuss the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

<b>David Martin</b>	202.662.5128	<a href="mailto:dmartin@cov.com">dmartin@cov.com</a>
<b>Brandon Gay</b>	202.662.5808	<a href="mailto:bgay@cov.com">bgay@cov.com</a>
<b>Bruce Bennett</b>	212.841.1060	<a href="mailto:bbennett@cov.com">bbennett@cov.com</a>
<b>Bruce Deming</b>	415.591.7051	<a href="mailto:bdeming@cov.com">bdeming@cov.com</a>
<b>David Engvall</b>	202.662.5307	<a href="mailto:dengvall@cov.com">dengvall@cov.com</a>
<b>Peter Laveran-Stiebar</b>	+44.(0)20.7067.2021	<a href="mailto:plaveran@cov.com">plaveran@cov.com</a>

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to [unsubscribe@cov.com](mailto:unsubscribe@cov.com) if you do not wish to receive future emails or electronic alerts.

© 2010 Covington & Burling LLP, 1201 Pennsylvania Avenue, NW, Washington, DC 20004-2401. All rights reserved.

**Agency Rulemakings –  
Enhanced Protection of Investors and Other Changes to Securities Regulations**

<b>Section of Act</b>	<b>Subject of Rulemaking</b>	<b>Deadline</b>
413	Rules adjusting the accredited investor test for natural persons	Four years after enactment of Act (and, at least, once every four years thereafter), SEC must review accredited investor test and may adjust accordingly
913	Rules to address the standards of care for broker-dealers and investment advisers (or their associated persons) providing personalized investment advice to retail customers	No deadline -- As necessary and appropriate following conclusion of six-month SEC study
922	Rules to implement provisions relating to whistleblower incentives and protections	No deadline -- As necessary or appropriate to implement such provisions
924	Final regulations to implement provisions relating to whistleblower incentives and protections	270 days after enactment of Act
926	Rules disqualifying bad actors from Regulation D offerings	One year after enactment of Act
939F	Rules establishing system of assigning NRSROs to determine initial credit ratings of structured financial products	No deadline -- As necessary or appropriate following conclusion of two-year SEC study
975	MSRB directed to issue several rules applicable to municipal advisors, including those to prevent acts that are inconsistent with such advisors' fiduciary duties	No deadlines specified. The amendments to the Exchange Act related to municipal advisors take effect on October 1, 2010