

MAKING SENSE OF THE FINANCIAL SERVICES REFORM ACT

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Agenda

- Introduction
- Presentation
 - Salvatore Graziano, Partner, Bernstein Litowitz Berger & Grossmann LLP
 - Peter J. Henning, Professor of Law, Wayne State University Law School
- Questions and Answers — (*anonymous*)
- Slides — now available on front page of Securities Docket
 - www.securitiesdocket.com
- Wrap-up

Webcast Series

- Series of webcasts — every other week
- www.securitiesdocket.com/webcasts
- NEXT—September 22, 2010: **The Impact of the Dodd-Frank Whistleblower Provisions**

Panel



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Dodd-Frank and Its Impact on Institutional Investor Protections

Making Sense of the Financial
Services Reform Act





**At over 2,300 pages, the
“Dodd-Frank Wall Street Reform and
Consumer Protection Act”
was signed into law on July 21, 2010.**

Key Provisions Impacting Investor Protections

- ▶ Credit Rating Agencies
- ▶ F-Cubed/Extraterritorial Reach of the Federal Securities Laws
- ▶ Other Provisions to Empower SEC
- ▶ Creation of New Entities Within the SEC
- ▶ Whistleblower Protections
- ▶ Executive Compensation
- ▶ Securitizations
- ▶ Mortgage Reform and Anti-Predatory Lending Act
- ▶ Enhanced Proxy Disclosure
- ▶ Fiduciary Duties on Brokers and Dealers
- ▶ Nationwide Subpoenas in SEC cases
- ▶ Other Provisions



Credit Rating Agencies

The Dodd-Frank Act:

- ▶ Creates new Office of Credit Rating Agencies at the SEC to strengthen regulation of credit rating agencies, to create new rules for internal controls, independence, transparency, and penalties for poor performance.
- ▶ Subjects credit rating agencies to new disclosure requirements that mandate public disclosure of rating methodologies, use of third parties' due diligence, and conflicts of interest.
- ▶ Under Section 933, it creates the Private Right of Action Against Credit Rating Agencies
 - Extends liability for private securities fraud actions to nationally recognized statistical rating organizations under Section 15E of the Exchange Act. The plaintiff must plead with particularity only that the defendant rating agency knowingly or recklessly failed to conduct a reasonable investigation or obtain reasonable verification of the factual elements used in reaching its conclusion about credit risk.
- ▶ Amends Section 436(g) of the Securities Act of 1933 that shielded rating agencies from liability as "experts" to now allow liability for rating agencies for incorrect ratings. However, the SEC has allowed for a delay on implementation of this provision because the rating agencies refused to issue ratings on certain offerings or debt registrations.



F-Cubed/Extraterritorial Reach of the Federal Securities Laws

- ▶ Under Section 929 the law:
 - Gives federal district courts jurisdiction over SEC actions charging violations of the anti-fraud provisions of the federal securities where (1) conduct within the U.S. constitutes a significant step in furtherance of a violation even if securities transactions occur outside the U.S. and involve only foreign trades, or (2) conduct occurring outside the U.S. has a foreseeable substantial effect within the U.S. Appears to be codification of the conduct and effects test.
 - Section 929P(b), which was supposed to make clear that in actions brought by the SEC or the DOJ, the provisions of the Securities Act, the Exchange Act, and the Investment Advisors Act may have extraterritorial application. However, the provision addresses only the “jurisdiction” of the district courts, and in the recent *Morrison v. National Australia Bank* case, the Supreme Court addressed the territorial scope of federal securities law not as a “jurisdiction” issue but as an issue of “substance” of what the law was meant to prohibit.
 - Section 929Y addresses private securities litigation, but does not change the extraterritorial standards in the *National Australia Bank* case. It only directs the SEC to “solicit public comment” and to “conduct a study to determine the extent to which private rights of action” should extend extraterritorially.



Other Provisions To Empower SEC:

- ▶ **Section 929-O: Aiding and Abetting**
 - Allows the SEC to impose aiding and abetting liability on persons who “recklessly” provide substantial assistance to someone who violates the Exchange Act. Previously, the SEC was required to show that the assistance was provided “knowingly.”
 - The Act provides, for the first time, aiding and abetting liability under the Securities Act, the Investment Company Act and the Investment Advisers Act. (§§929-M and 929-N).
 - The Act does not create a private right of action for aiding and abetting liability claims, but the Act directs the GAO to study whether private plaintiffs should be allowed to sue aiders and abettors. Private plaintiffs have been unable to bring these claims since the Supreme Court’s *Central Bank* decision, and the *Stoneridge* decision has blocked plaintiffs from bringing similar scheme liability claims.

- ▶ **Section 929-P(c): Control Person Claims**
 - The Act clarifies that the SEC may pursue enforcement actions against “control” persons for joint and several liability unless they acted in good faith and did not induce the violation. Previously, Section 20 of the Exchange Act could have been interpreted to restrict such “control person” claims to private plaintiffs.

- ▶ **Access to Foreign Audit Workpapers:**
 - The SEC previously faced challenges getting access to foreign audit workpapers during investigations. The Act requires that if a foreign public accounting firm performs material services upon which a PCAOB-registered public accounting firm relies in the conduct of an audit of interim review or audit work, the foreign accounting firm and/or the PCAOB-registered firm are now required to produce the foreign audit workpapers and related documents to the SEC.

- ▶ Empowers SEC to regulate swaps and short sales, and to restrict or prohibit arbitration clauses between broker-dealers or investment advisors and their clients.



Creation of New Entities Within the SEC

- ▶ Office of Investor Advocate
 - Reports directly to the Chairman of the SEC on behalf of retail investors.
- ▶ Investor Advisory Committee
 - Represents individual and institutional investors.
- ▶ Ombudsman
 - Liaison between investors and the SEC.



Whistleblower Protections:

▶ Section 922: Encourages whistleblowers:

- Creates a program within the SEC to encourage people to report securities violations, provides protections to whistleblowers, and creating rewards of between 10-30% if the funds recovered based on the information provided exceeds \$1 million.
- Bounties must be paid even to whistleblowers who are themselves violators, unless they are criminally convicted.
- The whistleblower bounty for securities-law recoveries that exceed \$1 million.
- An employer may not “discharge, demote, suspend, threaten, harass or discriminate” against the whistleblower, and a whistleblower can bring an action in federal court seeking double back pay, reinstatement, and other relief.



Executive Compensation

- ▶ Section 951 – provides for non-binding shareholder vote to approve executive compensation at least once every 3 years. Also provides for shareholder vote to approve golden parachute compensation in connection with mergers & acquisitions.

- ▶ Compensation Clawbacks:
 - Directs the SEC to adopt rules mandating that listed companies implement “clawback” policies for executive compensation in the event of a financial restatement due to material noncompliance with any financial reporting requirements. These rules would apply to current or former officers who received incentive-based compensation in excess of the amount that should have been received under the restated financials within 3 years prior to such restatement.

- ▶ Strengthens shareholders rights:
 - Gives shareholders a say on pay with the right to a non-binding vote on executive pay. (Section 951).
 - Gives SEC authority to grant shareholders proxy access to nominate directors
 - Compensation committees have to include only independent directors
 - Requires public companies set policies to take back executive compensation if it was based on inaccurate financial statements that don't comply with accounting standards
 - Requires SEC to clarify disclosures relating to compensation



Securitizations:

- ▶ Requires companies that sell securitized products, including mortgage-backed securities, to retain at least 5% of the credit risk, unless the underlying loans meet standards that reduce riskiness.
- ▶ Requires issuers to disclose more information about the underlying assets and to analyze the quality of the underlying assets.



Mortgage Reform and Anti-Predatory Lending Act:

- ▶ Provides various consumer protections for residential mortgages and strengthens underwriting by prohibiting creditors from extending residential mortgages to borrowers who cannot document a reasonable ability to repay the loan. The act also bans a variety of residential mortgage lending practices, and imposes further restrictions on mortgages that are not deemed “qualified.” The act bans certain practices in mortgage origination, imposes new requirements on mortgage services, establishes standards for property appraisals, and places conditions on certain high-cost and higher-risk mortgages.



Enhanced Proxy Disclosure:

- ▶ Will require companies to disclose in the compensation section of the proxy statement (i) the relationship between executive compensation actually paid and the company's financial performance; (ii) the ratio between the CEO's compensation and the median compensation of all other employees; (iii) requires companies to disclose whether they prohibit employees and directors from hedging against a decrease in the value of the company's equity securities.



Section 913(g) and (h) – Fiduciary Duties on Brokers and Dealers:

- ▶ The Act authorizes the SEC to issue rules to impose fiduciary duties on brokers and dealers (similar to those on investment advisors) when they provide “personalized investment advice about securities to a retail customer” after conducting a study. The SEC is empowered to require them 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.” The SEC may also require them to provide particular information before purchase of an investment product or service by a retail investor.



Section 929-E – Nationwide Subpoenas in SEC cases:

- ▶ The Act enables the SEC and defendants in SEC federal court litigation to issue subpoenas requiring witnesses located anywhere in the U.S. to appear in person at trials and hearings. Previously, witnesses could only be required to appear if they were within a 100 mile radius of the courthouse, which often meant that juries heard much of the testimony watching videotapes of pretrial depositions.



Other Provisions

Creates new committees and councils:

- ▶ Creates Consumer Financial Protection Bureau to protect consumers from unfair, deceptive and abusive financial products and make sure people get clear information on loans and other financial products
- ▶ Creates new Financial Stability Oversight Council to identify, monitor and address systemic risks posed by large, complex firms, and products and activities that spread risk across firms. Will make recommendations to the Federal Reserve re capital, leverage, liquidity, risk management and other requirements.
- ▶ Creates a new office within the Treasury to monitor the insurance industry.



Other Provisions

- ▶ Volcker Rule: requires implementation of regulation to limit banks' proprietary trading, and investments and relationships with hedge and private equity funds
- ▶ Requires derivatives to be centrally cleared and traded on exchanges or comparable facilities.
- ▶ Requires large, complex companies to periodically submit plans for their rapid and orderly shutdown should the company go under.
- ▶ FDIC can guarantee debt of solvent insured banks only if they meet a series of checks.



Other Provisions

- ▶ Identifies clear lines of responsibility:
 - FDIC – regulate state banks and thrifts with assets under \$50 billion
 - OCC – regulation national banks and federal thrifts with assets under \$50 billion. The Office of Thrift Savings is eliminated.
 - Federal Reserve – regulate banks and thrifts with assets over \$50 billion.
- ▶ Eliminates taxpayer bailouts of failing financial institutions through direct equity investments.
- ▶ Hedge funds that manage over \$100 million will be required to register with the SEC as investment advisors and to disclose financial data.
- ▶ Municipal Securities:
 - Because financial advisors have recommended unsuitable derivatives for small municipalities and have been involved in scandals, it requires SEC registration for municipal financial advisors, swap advisors and investment brokers.
 - Gives investors and public representatives a majority on the Municipal Securities Rulemaking Board.



Questions?

Thank You

Thank you for attending this webcast.