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Investor Protections in the Dodd-Frank Wall Street Reform and Consumer Protection Act: Companies Need to Act to Avoid Potential New Expenses

On July 21, 2010, President Obama signed into law the financial reform bill, formally known as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

The Dodd-Frank Act contains a variety of provisions intended to protect investors. Among the most significant provisions pertaining to investor protections are:

- whistleblower bounties and protections;
- expanded aiding and abetting liability for securities law violations;
- establishment of fiduciary duties for brokers, dealers and investment advisers;
- restrictions on binding arbitration clauses in the context of customer agreements; and
- establishment of the Investor Advisory Committee within the Securities and Exchange Commission (SEC).

This Alert summarizes these provisions and suggests actions that companies should consider now to ensure compliance.

Whistleblower Award and Protections

Summary

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The Dodd-Frank Act creates a new whistleblower program within the SEC that will offer bounties to those who report securities laws violations. The legislation also bolsters their legal protections from retaliation, with a goal of making it more likely that persons who suspect such violations will report them to the SEC.

Under the program, the SEC is directed to pay an award to whistleblowers who voluntarily provide "original information" to the SEC that leads to the successful enforcement of a judicial or SEC administrative action that results in monetary sanctions exceeding US\$1 million. "Original information" is defined as information that (i) is derived from the independent knowledge or analysis of a whistleblower, (ii) is not known to the SEC from any other source, unless the whistleblower is the original source of the information, and (iii) is not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit or investigation, or from the news media, unless the whistleblower is the source of the information.

The amount of the award is to be not less than 10 percent, but not more than 30 percent, of the total monetary sanctions imposed and collected in the action or in certain defined related actions. The SEC will have discretion to set the amount of the awards within the 10-percent to 30-percent range after taking into consideration (i) the significance of the information provided by the whistleblower to the success of the action, (ii) the degree of assistance provided by the whistleblower in the action, (iii) the interest of the SEC in deterring violations of the securities laws by making awards to whistleblowers, and (iv) such additional relevant factors as the SEC may establish by rule or regulation. The award would be paid from a newly established Securities and Exchange Investor Protection Fund in the US Department of the Treasury that would be funded by sanctions collected by the SEC.

Awards may not be made to whistleblowers who (i) are, or were at the time the original information was acquired, a member, officer or employee of a certain governmental agency or a self-regulatory organization, (ii) are convicted of a criminal violation related to the action for which the whistleblower otherwise could receive an award, (iii) gained the information during a financial audit required under securities laws and for whom submission of the information to the SEC would be contrary to the audit requirements in Section 10A of the Securities Exchange Act of 1934, or (iv) failed to submit information to the SEC in such form as the SEC may, by rule, require. It is worth noting that a whistleblower who was involved in the securities law

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violation would be eligible to collect an award unless the whistleblower was *criminally convicted* for the violation.

Whistleblowers may submit information to the SEC anonymously and still be eligible for an award, so long as the whistleblower is represented by counsel and the identity of the whistleblower, along with other information required by the SEC, is provided to the SEC prior to payment of the award.

The Dodd-Frank Act also protects whistleblowers by providing that no employer may "discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and conditions of employment" as a result of the whistleblower (i) providing information to the SEC, (ii) initiating, testifying in or assisting in any investigation or action by the SEC based upon or related to information provided by the whistleblower, or (iii) making disclosures that are required or protected under various securities laws. A whistleblower who alleges a violation of these protections may bring an action against his or her employer in federal court for reinstatement, twice the amount of back pay otherwise owed to the whistleblower, with interest, and attorneys' fees and costs.

What to Do Now

The new whistleblower program provides a strong economic incentive for employees to contact the SEC when they suspect a violation of securities laws, whether their suspicion is grounded in reality or not, making it less likely that they will report the violation internally so that the company can take remedial action. Although it is debatable how often current employees who feel secure in their jobs will contact the SEC, former employees or current employees who perceive their employment to be at risk may feel there is no reason not to blow the whistle in pursuit of a sizable monetary award.

Companies should be proactive to encourage their employees to report suspected violations internally, rather than to the SEC, so that potential violations can be investigated and remediated promptly without the involvement of the government. Companies should immediately review their policies and procedures for handling suspected violations, and revisions should be made if appropriate.

Employees should be reminded to report suspected violations either to their supervisors or to their company's anonymous whistleblower hotline. Companies should re-double their efforts to publicize

the fact that they have a whistleblower hotline and that the anonymity of the caller will be maintained. Companies should consider giving incentives to employees who report securities violations internally, to motivate employees to blow the whistle to the company rather than to the SEC.

Finally, companies should carefully consider the benefits of self-reporting of violations to the SEC to take advantage of published SEC statements that such self-reporting and cooperation will lead to less-stringent enforcement efforts. Such self-reporting can also reap benefits under applicable Federal Sentencing Guidelines.

Liability for Recklessly Aiding and Abetting Securities Law Violations

Summary

The Dodd-Frank Act amends the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940 and the Investment Company Act of 1940 to make it easier to hold persons liable for aiding and abetting a violation of securities law. Previously, the Securities Exchange Act of 1934 required that a person "knowingly" assisted in a violation, while the other three statutes were silent on the issue. Now, all four statutes provide that "any person that knowingly *or recklessly* provides substantial assistance to another person in violation of a provision of this Act, or of any rule or regulation issued under this Act, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided" (emphasis added). The subject of liability for aiding and abetting securities law violations has been discussed in several prominent court cases lately, and these amendments will almost certainly lead to more litigation on this subject.

What to Do Now

Although all employees should already know not to commit or condone any violations of securities laws, companies should make clear that all suspected violations should be reported by employees to their supervisor or the company's whistleblower hotline. Further, managers should be encouraged to contact the legal department when securities transactions are an issue, to help ensure that the company fully complies with applicable laws.

Fiduciary Duties for Broker-Dealers

Summary

The Dodd-Frank Act calls for a study about, and authorizes the SEC to establish by regulation, fiduciary duties for broker-dealers. The Dodd-Frank Act requires the SEC to conduct a study to evaluate the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers (i.e., individuals who receive personalized investment advice about securities primarily for personal, family or household purposes), and determine whether there are gaps, shortcomings or overlaps in legal or regulatory standards in the protection of retail customers relating to such standards of care. The Dodd-Frank Act requires the SEC to consider 14 enumerated factors when conducting the study (including the regulatory, examination and enforcement resources devoted to enforcing standards of care; the substantive differences in the regulation of brokers, dealers and investment advisers; and the potential impact on retail customers of imposing upon brokers, dealers and persons associated with brokers or dealers the standard of care applied to investment advisers under the Investment Advisers Act of 1940) and to seek and consider public input, comments and data. The SEC is required to submit a report describing its findings, conclusions and recommendations from the study to the Senate Committee on Banking, Housing, and Urban Affairs and the House of Representatives Committee on Financial Services within six months after the date the Dodd-Frank Act is enacted.

The Dodd-Frank Act also amends the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to authorize the SEC to promulgate rules establishing fiduciary standards for brokers, dealers and investment advisers. Under the amendment to the Exchange Act, the SEC may promulgate a rule that the standard of conduct for a broker or dealer with respect to retail customers shall be the same as the standard of conduct applicable to investment advisers. Under the amendment to the Investment Advisers Act, the SEC may promulgate a rule that the standard of conduct for brokers, dealers and investment advisers shall be 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. The Dodd-Frank Act also amends the Exchange Act and the Investment Advisers Act to harmonize the enforcement authority of the SEC in this regard.

Given the current environment, we believe it is likely that the SEC will promulgate regulations creating

fiduciary (rather than just contractual) duties for broker-dealers.

What to Do Now

Brokers, dealers, investment advisers and their employers should review their current policies and procedures regarding the duties of brokers, dealers and investment advisers to determine whether and how fiduciary duties are addressed, and they should all prepare for the promulgation of the new duties. Although the SEC has discretion whether or not to establish the new fiduciary duties, it is likely that the SEC will do so, considering the general call to protect investors since the recent economic crisis began in 2007. Although policies and procedures need not be updated to expressly include the new duties until such rules are promulgated, brokers, dealers and investment advisers should consider now what policies and procedures will have to be put in place, and what sort of training should be given, to ensure that the new fiduciary duties are met.

Under the Administrative Procedure Act, the public will be given an opportunity to comment on the SEC's proposed rules before they are finalized. Brokers, dealers and investment advisers should analyze the SEC's proposed rules when they are published for review in the *Federal Register*, and they should consider contacting the SEC if any part of the proposed rules are unclear, impractical or otherwise should be revised in any respect. Squire, Sanders & Dempsey L.L.P. has experience with presenting comments to the SEC and is well suited to provide assistance in this regard.

Limitation on Requirement to Use Arbitration

Summary

The Dodd-Frank Act amends the Securities Exchange Act of 1934 to give the SEC the authority to prohibit or impose conditions or limitations on the use of agreements that require customers or clients of any broker, dealer, municipal securities dealer or investment adviser to arbitrate any future dispute between them arising under federal securities laws, the rules and regulations thereunder or the rules of a self-regulatory organization, if the SEC finds that such prohibition, imposition of conditions or limitations are in the public interest and for the protection of investors. In recent years, there has been a trend among legislatures and courts to limit the use of arbitration agreements imposed by service providers in their standard contracts with customers, and the Dodd-Frank Act continues this trend.

What to Do Now

Brokers, dealers and investment advisers should review their standard customer and client forms to determine the extent to which arbitration is currently required by such forms. Further, it would be a good idea to start thinking about what approach to take and how to revise such forms in the event the SEC does limit the use of arbitration and to consult with counsel about possible alternatives. Possible alternatives include revising such forms to require that disputes be handled exclusively in a particular venue and/or that a jury trial be waived. The SEC's announcements in this area should be monitored closely so that brokers, dealers and investment advisers can act appropriately as soon as necessary.

Investor Advisory Committee

Summary

The Dodd-Frank Act establishes an Investor Advisory Committee within the SEC, charged with advising and consulting with the SEC on (i) regulatory priorities of the SEC, (ii) issues relating to the regulation of securities products, trading strategies and fee structures, and the effectiveness of disclosure, (iii) initiatives to protect investor interest, and (iv) initiatives to promote investor confidence and the integrity of the securities marketplace. The Committee is required to submit to the SEC such findings and recommendations as the Committee determines are appropriate, including recommendations for proposed legislative changes.

The Committee will comprise the Investor Advocate (the head of a new Office of the Investor Advocate established within the SEC by the Dodd-Frank Act to assist investors with respect to SEC matters), a representative of state securities commissions, a representative of the interests of senior citizens and 10 to 20 members appointed by the SEC who (i) represent the interests of individual equity and debt investors, including investors in mutual funds, (ii) represent the interests of institutional investors, including the interests of pension funds and registered investment companies, (iii) are knowledgeable about investment issues and decisions, and (iv) have reputations of integrity. All members of the Committee would have a term of four years.

What to Do Now

Because the Investor Advisory Committee will be a new

function at the SEC, it is difficult to predict how it will operate. However, it is worth noting that the members of the Committee are expressly intended to represent investors' interests, not those of issuers or the market in general. The Committee merely has advisory power to make recommendations to the SEC, though, and it will be up to the SEC to consider whether any such recommendations would go so far as to be impractical and whether the benefit to capital markets would outweigh the burden on the companies to whom the recommendations pertain. The SEC is required by the Administrative Procedure Act to publish for public comment all rules it proposes to promulgate, so companies should continue to monitor such publications and provide comments to the SEC when appropriate.

For more information about the Dodd-Frank Wall Street Reform and Consumer Protection Act and its implications, please contact your principal Squire Sanders lawyer or any of the lawyers listed in this Alert.

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