Commentary: Dodd-Frank Arms the SEC

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Prior to 1934, FBI agents were not permitted to carry firearms. This changed when "Pretty Boy" Floyd, his sidekick Adam Richetti, and hit man Verne Miller tried to free their friend and fellow bank robber Frank "Jelly" Nash, who was being transported back to Leavenworth by two federal agents and three local policemen. On June 17, 1933, in downtown Kansas City in broad daylight, Floyd's gang attacked with submachine guns, killing four officers, including one federal agent, as well as Nash, and then escaped. The "Kansas City Massacre," as it became known, shocked the voting public, leading Congress to arm the FBI the following year.

Congress has reacted to the Panic of 2008 in much the same way. There might not be much evidence so far that unlawful activity caused the Panic. Nonetheless, the Dodd-Frank Wall Street Reform and Consumer Protection Act grants the Securities and Exchange Commission an entire assortment of new enforcement firearms.

For some time now, the SEC has had the authority under the Securities Exchange Act of 1934 to prosecute persons who, while not actually committing securities fraud themselves, provide "substantial assistance" to fraudsters. However, this authority was limited to violations of the Exchange Act, which, as a practical matter, generally meant violations of Rule 10b-5's prohibitions against fraudulent and deceptive practices.

Dodd-Frank extends the SEC's authority by empowering it to prosecute aiding and abetting violations of the Securities Act of 1933, the Investment Advisers Act of 1940 and the Investment Company Act of 1940. This is a major expansion of the SEC's enforcement powers. In the past, the SEC has brought numerous actions against hedge fund managers under the Investment Advisers Act; under Dodd-Frank, the SEC also will be able to prosecute prime brokers, accountants and lawyers for providing "substantial assistance" to the manager.

Dodd-Frank lowers the standard of proof in such aiding and abetting prosecutions, making it much easier for the SEC to obtain judgments. Dodd-Frank also states that a person who provides substantial assistance to the fraudster "shall be deemed to be in violation . . . to the same extent as the person to whom such assistance is provided." This makes clear that the liability for aiding and abetting will be the same as that of the person who actually committed the fraud. The liability may consist of civil fines and penalties assessed by the SEC in administrative proceedings or damages ordered by a federal court to compensate the victims of fraud.

It is often difficult to obtain compensation for all of the persons who were victims of securities fraud. The persons committing the fraud often end up in bankruptcy or prison and therefore are unable to compensate for all of the harms they have done. So, the private plaintiff's bar has for many years sought the right to obtain compensation from brokerage firms, accountants and lawyers who, while not actually committing the fraud, may have provided assistance without which the fraud would never have taken place. For example, the SEC has long argued that without the substantial assistance of brokerage firms, "pump and dump" schemes and other frauds in micro-cap securities traded in the OTC equity markets would be impossible to accomplish.

The Supreme Court, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, established that the federal securities laws do not provide a right for private plaintiffs to sue aiders and abettors. It then shocked the securities bar by pointing out that the SEC not only had the authority to bring such actions, but by use of the "Fair Funds" provisions, also had the ability to recover losses suffered by private persons.

Since then, the SEC has brought a number of civil actions in which it essentially has represented private plaintiffs to recover damages from aiding and abetting violations. In these cases, it has often been frustrated by the same impediments that have stymied the plaintiff's bar: many courts have required the SEC to establish that the aiders and abetters had "actual knowledge" that they were providing substantial assistance to the fraudsters. In contrast, under Dodd-Frank, the SEC only needs to prove that the aider and abettor acted recklessly, or as this standard is sometimes stated, "recklessly in not knowing."

The recklessness standard will change the SEC's litigation focus. Instead of searching for evidence that the aider and abettor actually knew about the fraud, the SEC will look for evidence of "red flags" and other indications that arguably should have put a brokerage firm, accountant or lawyer "on notice" that a fraud may be taking place. Moreover, brokerage firms and accountants are regulated by the SEC, and I would expect the SEC to promulgate rules that require these regulated entities to establish compliance procedures designed to identify frauds by their clients. Some rules already are designed to accomplish this purpose. Now with broadened authority to pursue aiding and abetting violations, the SEC may take the position that a failure to establish adequate compliance procedures is, at least in some circumstances, sufficient to establish recklessness and result in liability.

The courts have never recognized a private right of action under the Investment Advisers Act, even against miscreant hedge fund advisers. Now, the SEC will be able to recover damages for private investors, not only against the portfolio manager, but also against any prime broker, accountant and law firm that has recklessly assisted the manager to violate the Advisers Act.

Section 21(d) of the Exchange Act grants the SEC authority to bring civil actions in federal court against persons violating or about to violate the Exchange Act, or the rules instituted by FINRA, any National Securities Exchange, DTC, the PCAOB and the MSRB. Dodd-Frank extends the SEC's authority to "control persons" who directly or indirectly control the violator, unless the control person can prove he or she acted in good faith and did not induce the violation.

It is already a violation of FINRA's rules to "fail to supervise" the conduct of registered representatives. Dodd-Frank grants the SEC the power to penalize the corporate executives who directly or indirectly control the supervisor, thereby going up the ladder to punish violations. I would expect this provision to put a lot of pressure on high-level corporate executives to ensure the adequacy of a brokerage firm's compliance procedures to avoid personally becoming targets of an SEC enforcement action.

The SEC from time to time bars a person associated with a regulated entity from being associated with similar regulated entities. So, a registered representative who violates the Exchange Act may be barred from association with another broker-dealer. Prior to Dodd-Frank, this SEC bar would not preclude the barred representative from becoming an employee of an investment adviser or some other non-broker-dealer entity. Under Dodd-Frank, however, a barred employee of any regulated entity may be barred from employment within the entire securities industry.

There is more. In this column, we have only discussed some of the SEC's new enforcement powers and prerogatives. In addition, the courts will have to interpret the extent of the SEC's new authority under Dodd-Frank, which will take years of litigation to determine.

There is no doubt, however, that Dodd-Frank greatly expands the SEC's prerogatives to act on behalf of private victims. Personally, I have some misgivings about *Stoneridge* and the notion that the SEC should represent private plaintiffs to recover damages for securities law violations, and expansion of that role should be accomplished with great care. Congress apparently does not share these qualms.

To be sure, the conduct of the private plaintiff's bar in securities litigation certainly has left much to be desired. As a result, there is little enthusiasm for expanding private rights of action. However, at least we can be clear about the motives of the lawyers that prosecute class actions. Their goal is to earn fees for prosecuting successful cases that pay compensation to the victims of fraud. They have no other agenda.

The SEC's motives are not always so obvious to a skeptical public. I have spent my career as a securities lawyer practicing before the SEC and, in my experience, the SEC's staff is composed overwhelmingly of hard-working people who only want to do the right thing. But the main office of the SEC is in Washington, where politics is practiced. It is not hard to imagine that, from time to time, pressure is placed on the SEC to act in ways that further certain political ends. Even if this pressure is resisted, and I believe it usually is, it is hard to avoid the lurking suspicion that political pressure may be a factor in choosing the particular issues and particular miscreants to prosecute.

Less cynically, the SEC has limited resources, and it inevitably must choose those cases to which it will apply the full force of its legal wrath. With a vastly expanded brief to pursue wrongdoers, and without the "back-up" system of private actions to pick up the slack, then the likelihood of punishment becomes less certain and the likelihood of victim compensation becomes more arbitrary. That is a situation that leads to an increase in risk-taking by persons inclined toward fraud, as well as a decrease in fairness for victims.

The FBI has some of the finest firearms training available anywhere on the planet. It is rare for FBI agents to be accused of the misuse of their weapons. Congress has spoken. The die is cast. Let us hope the SEC uses its new weapons wisely.

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