

# **The Dodd-Frank Wall Street Reform and Consumer Act**

## **Implications of the New Financial Reform Legislation on Public Pension Funds**

### **SEC and Improving Investor Protections**

#### **1. Encouraging Whistleblowers**

- Provides significant monetary incentives for individuals who know of a securities violation to contact SEC and assist in investigation and prosecution of wrongdoing.
- When information provided by the whistleblower leads to an SEC enforcement action that results in monetary sanctions of more than \$1 million, the SEC must pay whistleblower 10-30% of those amounts.
- SEC shall also pay whistleblower when the information leads to an enforcement action initiated by Justice Department, another federal agency, a Self Regulatory Organization (“SRO”) or State Attorney General.
- Whistleblowers must voluntarily provide the information and it “has to be derived from independent knowledge or analysis” not known to SEC from any source.
- SEC should actively promote the whistleblower program.
- Paid to whistleblowers even if they are violators, unless criminally convicted.
- Whistleblowers eligible for cooperation agreements limiting their civil liability.
- Whistleblowers can remain anonymous by action through counsel.
- Paid by “Investor Protection Fund” funded with undistributed sanctions from other SEC cases.
- Private right of action for whistleblower against an employer who retaliates against whistleblower.

- Provides to whistleblower, if successful in court for retaliation, double pay back, reinstatement with appropriate seniority, attorney fees and expert costs.

## **2. Expanded Secondary Liability**

- SEC impose aiding and abetting liability on persons who “recklessly” (previous standard was “knowingly”) provide substantial assistance to someone who violates the Exchange Act.
- Provides aiding and abetting liability under the Securities Act, the investment company Act and Investment Advisors Act.
- No private right of action for aiding and abetting liability, but directs Governmental Advisory Committee (“GAC”) to study whether private plaintiffs should be permitted to sue aiders and abettors.
- Clarified that SEC may use enforcement actions against “control” persons unless they acted in “good faith” and did not directly induce the conduct.

## **3. Jurisdiction Over Foreign Securities Transactions**

- Although Supreme Court rejected that Exchange Act applies to private claims by foreign investors relating to transactions on foreign exchanges, Bill provides U.S. jurisdiction over actions brought by SEC under Exchange Act and Investment Advisors Act relating to securities investments outside the U.S. where the defendant took “significant steps” in the U.S. to further the violation, or if the foreign misconduct had a “foreseeable substantial effect” within the U.S.

## **4. Fiduciary Standard for Brokers**

- Authorizes SEC to issue rules to impose fiduciary duties on brokers and dealers when they provide “personalized investments advice about securities to a retail customer.”

## **5. SEC Budget Increases**

- Doubling the budget between 2011 and 2015.
- Still subject to annual appropriations process but starting fiscal 2012 SEC prepare over budget.
- Because SEC budget is funded out of existing transactions and registration fees likely that Congress will “appropriate.”
- New \$100 million SEC “Reserve Fund” to supplement budget.

## 6. **Investor Advocacy**

- Creates "Investor Advocate" who will report to SEC Chairman.
- Will identify issues of concern to retail investors.
- Investor Advocate will appoint "Ombudsman" to act as liaison between Commission and retail investors.
- New "Investor Advisory Committee" comprised of Investor Advocate, state regulators and representatives of a broad cross-section of investing public to meet at least twice a year and advise and consult with SEC on investor protection issues.

## 7. **SEC Operational Improvements**

- **Hiring Market Specialists** - SEC will use streamlined authority to recruit and hire professionals to add staff with "specialized knowledge of financial and capital market formation or regulation, financial market structures or surveillance, or information technology."
- **Sharing Information with Other Agencies** -- Maintenance of any privileges that may apply to information the SEC exchanges with other federal agencies, any state or foreign securities or law enforcement agency. Likely to facilitate greater coordination and cooperation.
- **Paying Penalties to Victims** -- SEC may contribute all amounts collected as penalties to any fund established for victims of violations.
- **Investor Testing** -- SEC will be able to initiate "investor testing programs" to gather information from investors.
- **Self Examination** -- SEC will hire an independent consultant to examine for reform of the SEC its internal operations, structure, funding, and the need for reform of the SEC.

## 8. **Penalties in Administrative Proceedings**

- Penalty awards can now be made in administrative proceedings.
- Should result in more cases brought as administrative hearings, where pretrial discovery is limited, no right to jury trial and the administrative law judge's decision is reviewed by SEC commissioners who originally directed the proceeding to be filed.

## 9. **Nationwide SEC Trial Subpoenas**

- Enable both the SEC and Defendants in SEC federal court litigation to issue subpoenas requiring the witnesses to appear in person anywhere in the United States to appear in person at trials and hearings.

**10. New Deadlines for SEC Enforcement Actions, Inspections and Examinations**

- Once SEC notifies a target that it is considering an enforcement action (“Wells” notice) the staff will have 180 days to file their case.
- Once the SEC’s compliance inspections and examination’s staff completes on-site examination and obtains all requested records, the staff has 180 days to request corrective action or provide notice that the matter is closed.
- Either if the 180 day requirements can be extended for an additional 180 days upon notice to the SEC chairman and can be extended for any number of 180 day periods with Commission approval.

**11. SEC Authority to restrict Customer Arbitration Agreements**

- Authorizes SEC to issue rules limiting, imposing conditions upon, or prohibiting agreements requiring arbitration by customers of brokers, dealers, municipal securities dealers and investment advisors.

**12. Securities Industry-Wide Bars**

- When a securities professional is suspended or barred due to misconduct, the suspension will prohibit that person’s association with any “broker, dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.”

**13. Potential for Future Changes – directs SEC to perform multiple mandated studies to examine:**

- The effectiveness of existing standards of care of brokers, dealers and investment advisors and provide recommendations about securities to retail customers and regulatory gaps.
- Whether the SEC should seek assistance of SROs in conducting examinations of investment advisors.
- The adequacy of examinations of investment advisory activities of registered broker-dealers and investment advisors.
- The level of financial literacy of retail investors and effective ways to enhance their education.

- Potential improvements in disclosures to investors regarding investment products, investment services and/or financial intermediaries.
- Methods to improve transparency of conflicts of interest and expenses in transactions involving investment services.
- How to better provide for investor access to information regarding disciplinary actions, regulatory, judicial, arbitration proceedings and other important information regarding investment advisors, brokers and dealers.

## **Creating Transparency and Accountability For Derivatives**

### **1. Closes Regulatory Gaps**

- Provides the SEC and Commodity Futures Trading Commission (“CFTC”) with authority to regulate over-the-counter derivatives so that irresponsible practices and excessive risk taking can no longer be hidden from regulatory oversight. Most of the changes will become effective July 21, 2011, however some are effective immediately. SEC, CFTC and other regulators must coordinate with each other to develop rules in furtherance of the Act.
- CFTC has jurisdiction over all swaps, which under the new Act include virtually all over-the-counter derivatives, with some exclusions, including an exclusion for a security-based swap.
- The SEC has jurisdiction over security-based swaps (swaps based on a single security or loan or referencing a single issuer.)

### **2. Central Clearing and Exchange Trading**

- Subject to some exceptions, requires central clearing and exchange trading for derivatives that can be cleared and provides a role for regulators and clearing houses to determine which contracts should be cleared.
- There is an “end-user” exemption. An end-user exemption is applicable if one of the parties to the swap: 1) is not a “financial entity;” 2) is using the swap to hedge or mitigate commercial risks; and 3) properly notifies the SFTC or the SEC as to how it meets its financial obligations associated with entering into an uncleared swap. To qualify for an end-user exception, a non- financial end-user cannot be a major swap participant or a major security-based swap participant. This determination is based on whether the end user maintains a “substantial position” in swaps other than for hedging or mitigating

commercial risk. A public company must obtain approval from an “appropriate committee” of the company’s board of directors to utilize the end user exception.

- SEC and CFTC have authority to review swaps to see if they meet the criteria to be exempt.

### **3. Must Register with CFTC and SEC**

- Swap dealers and major swap participants must register and submit periodic reports with CFTC.
- Security-based swaps dealers and major security-based swap participants must register and submit periodic reports with SEC.

### **4. Market Transparency**

- Requires data collection and publication through clearing houses or swap repositories to improve market transparency and provide regulators important tools for monitoring and responding to risks.

### **5. Financial Safeguards**

- Adds safeguards to system by ensuring dealers and major swap participants have adequate financial resources to meet responsibilities.
- Provides regulators the authority to impose capital and margin requirements on swap dealers and major swap participants, not end users.

### **6. Higher standard of conduct**

- Establishes a code of conduct for all registered swap dealers and major swap participants when advising a swap entity.
- When acting as counterparties to a pension fund, endowment fund, or state or local government, dealers are to have a reasonable basis to believe that the fund or governmental entity has an independent representative advising them.

## **Credit Rating Agencies**

### **1. New Office and New Focus at SEC**

- Creates an Office of Credit Ratings at the SEC with expertise and its own compliance staff and the authority to fine agencies.

- SEC is required to examine Nationally Recognized Statistical Ratings Organizations (“NRSRO”) at least once a year and make key findings public.
- 2. Disclosure**
    - Requires Nationally Recognized Statistical Ratings Organizations to disclose their methodologies, their use of third parties for due diligence efforts and their ratings track records.
  - 3. Independent Information**
    - Mandates that agencies consider information in their ratings that comes to their attention from a source other than the organizations being rated if they determine it to be credible.
  - 4. Conflicts of Interest**
    - Prohibits compliance officers from working on ratings, methodologies, or sales.
    - Installs a new requirement for NRSROs to conduct a one-year look back review when an NRSO employee goes to work for an obligor or underwriter of a security or money market investment subject to a rating by that NRSRO.
    - Mandates that a report to the SEC when certain employees of the NRSO go to work for an entity that the NRSO has rated in the previous 12 months.
  - 5. Liability**
    - Investors can bring lawsuits against rating agencies for a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source.
    - NRSROs now subject to “expert liability” with the nullification of Rule 436 (g) which provides an exemption for credit ratings provided by NRSROs from being considered a part of the registration statement
  - 6. Right to Deregister**
    - SEC can deregister an agency for providing bad ratings over time.
  - 7. Educational**
    - Requires rating analysts to pass certain qualifying exams and have continuing education requirements.
  - 8. Eliminates Many Statutory and Regulatory Requirements to Use NRSRO Ratings**

- Encourages investors to conduct their own analysis and decreases over-reliance on ratings.
9. **Independent Boards**
- Requires at least half the members of NRSRO boards to be independent, with no financial stake in the credit ratings.
10. **Ends Shopping for Ratings**
- SEC will provide a new mechanism to prevent issuers of asset backed-securities from picking the agency they think will give the highest rating, after conducting a study and submission of a report to Congress.

## **Executive Compensation and Corporate Governance**

1. **Vote on Executive Pay and Golden Parachutes**
- Explicitly gives SEC authority to issue rules permitting shareholder access to proxy materials.
  - Provides shareholders a say on pay with the right to a non-binding vote (to be held every 3 years) on executive pay. Shareholders are required to vote at least once every 6 years on whether vote will occur every one, two or three years.
  - Shareholders approve “golden parachutes.”
  - Provides shareholders a powerful opportunity to hold executives of companies accountable and a chance to disapprove where shareholders see misguided incentive schemes that threaten individual companies and then the broader economy.
  - **Institutional investment managers will be required to report at least annually how they voted on any required “say-on-pay” or “golden parachute” votes.**
2. **Nominating Directors**
- Gives the SEC authority to grant shareholders proxy access to nominate directors.
3. **Independent Compensation Committees**
- New standards for listing on an exchange will require that compensation committees include only independent directors and have authority to hire compensation consultants to foster independence from the executives they are reviewing.

- A compensation committee can only select consultants after taking into consideration a variety of factors such as whether the advisor provides other services to the company, the amount of fees received from the company by the advisor as a percentage of the advisor's total revenue, conflict of interest policies and procedures of the advisor, business or personal relationships between the advisor and members of the compensation committee and any stock of the company owned by the advisor.

**4. No Compensation for Lies "Clawback"**

- Public companies must set policies to take back executive compensation if the company is required to restate its financial statements because of material noncompliance with any financial reporting requirement under the securities laws.
- The company will recover from any current or former **executive officer** who received incentive-based compensation (including stock options) during the 3 year period preceding the restatement any amount in excess of the amount that would have been paid under the company's restated financial statements even in the absence of misconduct.

**5. SEC Review**

- SEC must clarify disclosures relating to compensation by requiring companies to provide charts that compare their executive compensation with stock performance over a five-year period.

**6. Decreased Broker Discretion**

- Brokers cannot vote shares held in trust on matters involving executive compensation, director elections or "other significant matters" unless specific instructions are provided by the beneficial owner.

**7. Enhanced Compensation Oversight for Financial Industry**

- Requires Federal financial regulators to issue and enforce joint compensation rules specifically applicable to financial institutions with a Federal regulator.