ARTICLE

The Dodd-Frank Act: Potential Implications for Professional Liability Insurers

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President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) into law on July 21, 2010. [1] The Act, over 2,300 pages in length, attempts to reform the financial system and the manner in which it is regulated by the federal government. It addresses a myriad of issues, including banking regulation, investment advisors, corporate governance, and Securities and Exchange Commission (SEC) enforcement. Several sections of the Act may be particularly significant to professional liability insurers because of their potential to increase the number and scope of claims that are brought against policyholders.

This article addresses a number of the provisions in the Act that we believe have the potential to affect professional liability insurers and explains their potential impact. Part I summarizes how the Act attempts to increase SEC enforcement authority and enforcement actions. Part II describes reforms in the Act concerning corporate governance and executive compensation. Part III addresses reforms impacting investment advisors and broker-dealers. Finally, Part IV discusses changes to the applicability of securities laws to credit rating agencies.

I. SEC Enforcement

The Act includes several measures that will give the SEC greater enforcement authority and will likely lead to a significant increase in SEC investigations and enforcement actions.

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Practice Areas

D&O and Financial Institution Liability
E&O for Lawyers, Accountants and Other Professionals
Insurance
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A. Whistleblower Incentive

From an insurer perspective, Congress's most significant reform in the Act may be the creation of a whistleblower incentive program. The Act establishes a framework for the payment of money to whistleblowers who voluntarily provide to the SEC original information concerning the violation of securities laws that leads to a successful administrative or judicial action by the SEC or other government agency in which more than $1 million is collected ("Whistleblower Incentive"). [2] The Whistleblower Incentive is based on a similar program established by Congress to incentivize whistleblowers to report underpayment of taxes to the Internal Revenue Service. [3] The whistleblower may provide the information anonymously through counsel, and the SEC is required to keep a whistleblower's name confidential unless the name is required to be disclosed in a public proceeding, in a grand jury proceeding, or to witnesses and defendants in a criminal investigation. [4] Significantly, the Whistleblower Incentive applies to information provided about securities violations that may have occurred before the enactment of the Act. [5]

Congress gave the SEC discretion to determine the appropriate amount of an award based on statutory criteria, but a qualifying whistleblower, as determined by the SEC, must be paid "not less than ten (10) percent, in total" and "not more than thirty (30) percent, in total" of the amount collected by the SEC or other government agency. [6] As with many other provisions of the Act, the SEC is required to issue final regulations implementing the Whistleblower Incentive program within 270 days after the enactment of the Act, and the Act mandates that the SEC establish a "separate office" within the SEC to "administer and enforce" the Whistleblower Incentive program. [7]

B. Enhanced SEC Penalty Authority

The Act gives the SEC, for the first time, authority to impose civil penalties in cease and desist proceedings brought under the Securities Act of 1933 (the "Securities Act"). [8] The SEC is authorized to impose civil penalties, after a hearing on the record, on "a person" who violates or causes a violation of the Securities Act or any regulation issued under that act if such civil penalty is in the public interest. [9]

The SEC is empowered to impose civil penalties under the Securities Act based on the type of violation. Under the so-called "first tier," the maximum penalty is $7,500 per person or $75,000 per entity for each act or omission if the person or entity violates or causes a violation of the Securities Act or its accompanying regulations. The second tier of civil penalties allows for a maximum civil penalty for each act of omission of $75,000 for persons and $375,000 for corporate entities if the violation "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." The SEC is authorized to impose a maximum civil penalty for each act or omission of $150,000 for persons and $725,000 for corporate entities under a third tier of violation when the violation "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" and the violation resulted in either (1) substantial loss or the potential for substantial loss to others or (2) resulted in "substantial pecuniary gain" to the person who violated the Securities Act. In determining whether a civil penalty is in the "public interest," the SEC may, "in its discretion," consider evidence that a person or entity is unable to pay such penalty.

C. Extended Authority Against "Aiding and Abetting" Violations of Securities and Investment Advisor Laws

Congress authorized the SEC to bring actions against those who aid and abet violations of the securities laws or laws related to investment advisors. [10] The Act broadens the authority of the SEC to bring civil actions and seek monetary sanctions for those who knowingly or recklessly provide substantial assistance to another person in violation of the Securities Act, the Investment Company Act of 1940, or the Investment Advisers Act of 1940 to the same extent as the person to whom such assistance is provided. Previously, those statutes did not authorize the SEC to pursue aiders and abettors.

Although the Securities Exchange Act of 1934 (the Exchange Act) allowed the SEC to pursue aiding and abetting claims in some circumstances, the Act lowers the standard by which the SEC can bring such actions against persons who aided and abetted violations of the Exchange Act. The pre-existing aiding and abetting provisions of the limited the SEC's enforcement authority to persons who "knowingly" aided and abetted another person who violated the Exchange Act. The Act lowers the intent requirement for proving a person aided and abetted an Exchange Act violation. The SEC may now bring an action against a person who "recklessly" provides substantial assistance to a person that violates the Exchange Act. [11]

D. Authority over Extraterritorial Violations of U.S. Securities Laws

The Act also gives jurisdiction to federal courts over SEC proceedings brought under Section 17 of the Securities Act for an extraterritorial violation of U.S. securities laws. [12] This provision responds to the Supreme Court's recent decision in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), which limited the private right of action under Section 10 of the Exchange Act to when a security is purchased or sold on an American stock exchange or when the purchase or sale of the security occurs in the United States. The Act authorizes federal courts to exercise extraterritorial jurisdiction in SEC civil actions when the conduct occurring within the United States significantly furthers a violation of the securities laws even though the security is purchased or sold in a foreign country. Additionally, courts may exercise extraterritorial jurisdiction in SEC enforcement actions when the allegedly fraudulent conduct occurring outside the United States "has a foreseeable substantial effect in the United States." The Act does not appear to broaden the scope of a private right of action for extraterritorial violations of U.S. securities laws.

E. SEC Budgetary Reforms

The Act makes significant reforms to the manner in which the SEC funds its operations, which, among other things, may increase resources available for enforcement. [13] The Act mandates that the SEC collect fees and impose assessments from exchange-traded securities to "recover the costs to the Government" of its annual appropriation to the SEC. [14] The Act sets forth collection targets for fees and assessments for fiscal year 2012 at $425 million and increases that target at a rate of approximately $35-$50 million per fiscal year until reaching $705 million in fiscal year 2020. [15] Additionally, Congress has appropriated an additional $1-$2 million to the SEC for fiscal years 2011-2015. [16]

The Act also establishes a "Reserve Fund" as of October 1, 2011, which is a separate fund established within the U.S. Treasury. [17] The Reserve Fund appears to provide the SEC with increased flexibility to shift resources more quickly and address shortfalls in congressional appropriations. The Reserve Fund will be supported by securities registration fees. The SEC may not collect more than $50 million in fees in any one fiscal year for the Reserve Fund, and the Reserve Fund may not exceed more than $100 million. The SEC is empowered to use the money in the Reserve Fund to "carry out the functions" of the SEC, with notice to Congress of the amount and purpose of the expenditure from the Reserve Fund.

F. Potential Impact

The Act gives the SEC a broader range of tools to enforce the nation's securities laws. The increased number of these enforcement tools as well as a potentially significant increase in the SEC budget will likely lead to more SEC investigations and enforcement actions. The increase in SEC enforcement will inevitably lead to more civil suits that piggy back on the work of the SEC.

The most significant reform may prove to be the Whistleblower Incentive, which will likely lead to an increase in the amount of voluntary information provided to the SEC to initiate investigations. The IRS whistleblower program, upon which the Whistleblower Incentive program is based, has sharply increased the number of tips received by the IRS on individuals and entities underreporting taxes. [18] Before the IRS program was implemented, the IRS received tips from 428 informants in 2004 and 2005. [19] During the first year in which the program was in place, the IRS received leads concerning potential, large underreporting violations by 1,246 taxpayers and on 1,900 taxpayers in the following year. [20] The potential for large awards to whistleblowers as well as significant protections provided to whistleblowers who disclose information will incentivize employees as well as officers to provide information concerning potential violations of securities laws to the SEC. If the IRS program is indicative of the effect of the Whistleblower Incentive program, companies can expect a large increase in the number of tips provided to the SEC. Moreover, the budget reforms will give the SEC additional reserves with which to pursue these and other violations.

With increased information from insiders, investigations, both formal and informal, of companies can likely be expected. Defense costs associated with SEC investigations are substantial and can increase the exposure under D&O policies to the extent such investigations are covered.

Although the new penalties imposed may be uninsurable, the penalty authority provided to the SEC in cease and desist proceedings could increase the costs of defending insureds against SEC administrative proceedings. Individuals and companies who are faced with having to pay a penalty out of their own pockets may have a greater incentive to fight the SEC rather than settling, thereby driving up defense costs.

Finally, with a likely increase in SEC investigations and enforcement actions, shareholders are likely to bring more follow-on direct and derivative civil suits. Violations and issues that may never have come to light will now be forced into the open by whistleblowers.

II. Corporate Governance and Executive Compensation

A. Corporate Governance

The Act makes an important change in the manner in which the boards of directors are elected, which will increase the likelihood of contested board elections and may raise the pressure on corporate boards to deliver immediate results. The Act empowers the SEC to issue regulations that require companies to include a nominee submitted by a shareholder for the company's board of directors in the company's proxy materials.[21] Although the Act does not mandate such regulations, on August 25, 2010, the SEC adopted final rules pursuant to this authority. [22] Corporations are required to include within proxy materials nominees submitted by shareholders controlling three percent of the company's shares continuously over a three-year period.

B. Executive Compensation

In the Act, Congress mandated that the SEC establish a framework for the implementation of several rules regarding the disclosure of executive compensation. The Act also requires companies to adopt "claw back" provisions in their executive compensation policies.

First, the Act requires the SEC to promulgate rules that require companies to disclose policies for incentive-based compensation. [23] In addition, companies must establish policies that, "in the event the issuer is required to prepare an accounting restatement due to material non-compliance of the issuer with any financial reporting requirement under the securities laws," provide for the company to recover from a former or current executive incentive-based compensation for the three year period preceding the accounting restatement that can be attributed to the accounting errors. [24]

Second, the Act requires that, not less than every three years, publicly-traded companies must hold non-binding shareholder votes on executive compensation. [25] Additionally, all persons who solicit shareholders to vote on an acquisition, merger, or consolidation that involves substantially all the assets of the company and will receive any compensation, whether "present, conferred, or contingent," must disclose that compensation, which is subject to a non-binding vote by the shareholders of the company. The Act does provide, however, that executive compensation disclosures and votes do not "create or imply a change to the fiduciary duties" or "create or imply any additional fiduciary duties" for a company or its board of directors.

Third, the Act requires boards of directors of companies to create "independent compensation committees" composed of members of the board of directors who are defined as independent based on rules to be promulgated by the SEC. [26] The Act sets forth guidelines for the selection of independent consulting and legal counsel to assist the compensation committee with setting compensation for a company's executives.

Fourth, companies are required to make disclosures concerning the relationship between executive compensation "actually paid and the financial performance" of a company. [27] Companies are also required to disclose the median "annual total compensation" of employees, the total compensation of the chief executive officer, and the ratio between the former and the latter. Companies are also required to disclose whether employees or directors are allowed to purchase financial instruments designed to hedge against a decrease in the value of company stock. [28]

C. Potential Impact of Corporate Governance and Executive Compensation Reforms

The changes in corporate governance and executive compensation are likely to lead to an increase in the number of suits against companies and their directors and officers. To the extent that a company falls short of complying with any of the requirements of the Act or implementing regulations, it may face litigation from the SEC and/or shareholders. In addition, the new proxy rules increase the likelihood of contested shareholder elections and potential litigation arising from disputed elections. Although the Act provides that the rules on compensation disclosures do not create new fiduciary duties, those votes and disclosures could still arm potential plaintiffs with information that raises their interest in pursuing litigation.

III. Investment Advisors and Broker-Dealers

A. Fiduciary Duty

The Act requires that the SEC conduct a broad study within six months of the Act becoming law concerning the duty of care, inspection, and examination of investment advisors, brokers, and dealers. It also delegates to the SEC rulemaking authority under the Exchange Act to establish a fiduciary duty for brokers and dealers who provide "personalized investment advice about securities to retail customers." [29] This rulemaking authority allows the SEC to impose the same standard of conduct on brokers and dealers that is applicable to an investment advisor. The Act defines a "retail customer" as a person who receives personalized investment advice from an investment advisor, broker, or dealer and "uses such advice primarily for personal, family, or household purposes." [30] The Act also provides, however, that in any rule promulgated by the SEC, the broker or dealers' receipt of compensation for the sale of a security will not breach his or her fiduciary duty to a retail customer, and the broker or dealer's fiduciary duty does not continue after the provision of the investment advice. [31]

In what appears to be an alternative to the rulemaking authority for brokers and dealers, the SEC is authorized to promulgate a uniform standard of conduct under the Investment Advisers Act of 1940 for investment advisors, brokers, and dealers who provide personalized investment advice to retail customers (and other customers as defined by the SEC). [32] The rule may establish that the standard of conduct "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 advisor." If the SEC does promulgate such a rule, disclosure of any conflict of interest is mandated, but the retail customer may consent to that conflict of interest.

The Act also attempts to harmonize the enforcement of the standard of conduct applicable to investment advisors, brokers, and dealers. [33] The SEC is given enforcement authority to police violations of the standards of conduct and prosecute actions against potential violators in the same manner as allowed under the Investment Advisers Act of 1940.

Finally, the Act requires the SEC to study the need for "enhanced examination and enforcement resources" for investment advisors. [34] The study will include findings on the need for greater frequency in examinations for investment advisors.

B. Potential Impact

The impact of a potential uniform standard of care could lead to increased suits against investment advisors, brokers, and dealers for breach of that standard of care, creating additional claims under D&O and E&O policies. The SEC is also given greater authority to bring enforcement actions against those who violate the standard of care or breach a fiduciary duty, which may lead to an increase in investigations and civil suits for which investment advisors would seek coverage under investment advisor professional liability policies.

IV. Credit rating agencies

The Act increases the exposure of credit rating agencies to suits alleging violations of securities laws. First, the Act abrogates SEC Rule 436(g). [35] Rule 436(g) limited the exposure of credit rating agencies when credit ratings were included in registration statements. The removal of this exemption will potentially make credit rating agencies liable under Section 11 of the Securities Act when they allow issuers of securities to include credit ratings in registration statements. (Credit rating agencies could, however, respond by restricting the use of their ratings in registration statements.)

Second, the Act expands the enforcement provisions of Section 15 of the Exchange Act to apply to credit rating agencies in the same manner in which the provisions apply to registered public accounting firms and securities analysts. [36] The Act also lowers the threshold for pleading the required state of mind in a suit against a credit rating agency for violating the securities laws. A complaint need only allege facts with particularity that give rise to a strong inference that the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation or to obtain reasonable verification from factual information from competent and independent sources.

V. Conclusion

Although many provisions of the Act are subject to further rulemaking by the SEC, several sections of the Act will have an impact on professional liability insurers in the immediate future. Since the government is likely to increase its investigation of potential violations of the securities laws and bring more enforcement actions for which policyholders will seek coverage, professional liability insurers can expect an increase in the number of suits for which policyholders will seek coverage under professional liability policies.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter, the "Act"].

[2] Act, § 922(a)-(b); *see also* Act, §§ 922(a)(5), 922(h)(2)(d) (providing that actions brought by certain federal, state, and local entities may qualify a whistleblower for an award when an action brought by that entity is based upon the whistleblower's information).

[3] 26 U.S.C § 7623.

[4] Act, §§ 922(d)(2)(B), 922(h)(2)(a)-(c).

[5] Act, § 924(c).

[6] Act, § 922(b)(1).

[7] Act, § 924(a).

[8] Act, § 929(P)(a).

[9] The Act also empowers the SEC to impose civil penalties in cease and desist proceedings under the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.

[10] Act, §§ 929M, 929N.

[11] Act, § 929O.

[12] Act, § 929P(b).

[13] The SEC's budget increased by approximately $60 million from FY 2009 to FY 2010. SEC, FY 2011 Congressional Justification, www.sec.gov/about/secfy11congbudgjust.pdf.

[14] Act, § 991(a)(1)(A); *id.* at 991(a)(1)(D).

[15] Act, § 991(b)(1)(L).

[16] Act, § 991(c).

[17] Act, § 991(e)(1); *id.* at 991(e)(2).

[18] 26 U.S.C § 7623; Janet Novack and William P. Barrett, *Tax Informants Are on the Loose*, Forbes Magazine, Dec. 14, 2009.

[19] *Id.*

[20] *Id.*

[21] Act, § 971(a)(2).

[22] Facilitating Shareholder Director Nominations Rule, 17 C.F.R. §§ 200, 232, 240, 249 (2010).

[23] Act, § 953.

[24] Act, § 954.

[25] Act, § 951.

[26] Act, § 952.

[27] Act, § 953.

[28] Act, § 955.

[29] Act, § 913(g)(1).

[30] Act, § 913(a).

[31] Act, §913(g)(1).

[32] Act, § 913(g)(2).

[33] Act, § 913(h).

[34] Act, § 914.

[35] Act, § 939G.

[36] Act, § 933.