

Dodd-Frank One Year Later ...and Still Waiting

By Joseph Goodman

Vociferous Opposition and Lack of Funding for the SEC Have Left Many Promises Unfulfilled

It has been more than a year since President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or the “Act”). The official purpose of the Act is to “promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices and for other purposes.” The Act proposed to achieve these goals by expanding the SEC’s power in certain important ways, providing

for additional regulation of aspects of the financial sector, and creating several new regulatory bodies. Dodd-Frank’s provisions did not go into effect immediately, and lawmakers left many of the details to be fleshed out by regulators. However, due to vociferous opposition and a lack of funding, many of the Act’s provisions have still not been implemented. In this article, we examine the additional powers and responsibilities assigned to regulators, the steps taken to put them into practice, and the ways in which the promise of Dodd-Frank has been left unfulfilled.

Continued on next page.



In August, the SEC's new whistleblower office opened and a webpage was launched to help whistleblowers report violations and apply for rewards. A similar program had previously existed at the SEC, but it resulted in few prosecutions. Thus, it remains to be seen whether the new program, with a new website and larger rewards for a greater range of violations, will be more successful.

Additional Powers and Responsibilities to the SEC

Pursuant to the Act, the SEC was supposed to gain many of the enforcement powers that have been stripped from private litigants over the last several decades, including the power to pursue the ratings agencies and persons who provide crucial assistance to those violating investor protection laws. One year later, however, it remains unclear how much impact these revised powers will have, particularly in light of the numerous hurdles regulators face in implementing the Act's provisions.

Regulation of Credit Ratings Agencies

Dodd-Frank established a new regulatory structure to oversee credit ratings agencies. In enacting Dodd-Frank, Congress expressly found that the ratings agencies had been compromised by their relationships with investment banks and that, as a result, the agencies issued inflated ratings on securities backed by pools of mortgage loans. Thus, Congress concluded that the ratings agencies "contribut[ed] significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States." Investors relied on these erroneous ratings and suffered billions of

dollars in damages. To address these problems, Dodd-Frank placed "Nationally Recognized Statistical Rating Organizations," like Standard and Poor's, Moody's, and Fitch, under a new system of regulation and accountability.

Despite the magnitude of the problems, the SEC has not yet established a new office to oversee credit ratings agencies. Instead, due to severe budgetary limitations, the SEC has simply added personnel to existing offices to perform examinations on the ratings agencies and has deferred full implementation of these regulations "due to budget uncertainty."

Whistleblowers

Dodd-Frank provides the SEC authority to pay financial rewards to whistleblowers who provide "original information" about a securities law violation. On August 12, 2011, the SEC's new whistleblower office opened and a webpage—www.sec.gov/whistleblower—was launched to help whistleblowers report violations and apply for rewards. To be eligible, the information must lead to a successful SEC enforcement action resulting in a monetary penalty greater than \$1 million. The SEC, at its discretion, may pay a whistleblower up to 30 percent of the penalty. A broad range of actors are eligible to benefit from the whistleblower provisions, including even those who may have been complicit in the underlying conduct.

A similar program had previously existed at the SEC, but it was limited to insider trading cases, awards were capped at 10 percent of the penalties, and it resulted in few prosecutions. Thus, it is unclear

whether the new program, with a new website and larger rewards for a greater range of violations, will be more successful.

Aiding and Abetting Claims

Private litigants are unable to bring claims against accounting firms, consultants, and law firms that assist a company in violating the federal securities laws. While the SEC has been able to bring certain aiding and abetting claims against those who assist in the perpetration of a fraud, Dodd-Frank authorizes the SEC to bring aiding and abetting claims under several other investor protection statutes. Perhaps more significant for investors, however, Dodd-Frank also makes it easier for the SEC to establish aiding and abetting claims by lowering the necessary state of mind from acting “knowingly” to “recklessly.” The lowered standard increases the likelihood that third parties who help carry out a fraudulent scheme will be held liable in SEC civil suits.

Unfortunately for investors, to date, the SEC has had limited success in pursuing aiding and abetting claims under the new provisions of Dodd-Frank, at least partly because the statute may not apply retroactively. For example, on June 6, 2011, in *SEC v. Daifotis*, Judge William H. Alsup of the U.S. District Court for the Northern District of California dismissed the SEC’s aiding and abetting claims against two executives at subsidiaries of Charles Schwab on the ground that Dodd-Frank’s provisions could not be applied retroactively. Thus, the effect of the SEC’s increased authority remains to be seen.



Application of Antifraud Laws to Wrongdoing or Securities Transactions Occurring Outside The United States

The Supreme Court recently decided that certain private litigants who purchased their securities abroad could not bring suit in the United States, even if a significant part of the fraud occurred in the United States. Dodd-Frank attempts to restore some protections for these investors by providing the SEC the right to bring these claims. Specifically, Dodd-Frank allows the SEC to bring suits related to “conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors,” or “conduct occurring outside of the United States that has a foreseeable substantial effect within the United States.”

One year later, it remains unclear how much impact the SEC’s revised powers will have, particularly in light of the numerous hurdles regulators face in implementing the Act’s provisions.

Continued on next page.

At more than 2,000 pages, Dodd-Frank authorizes regulators to write the details of over 300 new rules and invites them to study more than 100 others. Congress set aggressive deadlines for regulators to make rules to enforce Dodd-Frank, and, unsurprisingly, they are not being met.



The impact of this provision also is uncertain at best, as it appears that these provisions may not be applied retroactively. Thus, it appears that the SEC will not be able to use the new law against the perpetrators of frauds contributing to the recent financial crisis.

Consumer Financial Protection Bureau

Dodd-Frank also provided for the creation of the Consumer Financial Protection Bureau (“CFPB”), which was established as a “watchdog dedicated to safeguarding consumer financial security” and which formally began operations on July 21, 2011. The CFPB inherits consumer protection responsibilities from seven agencies and has authority to police “unfair, deceptive, or abusive” financial services products. The CFPB will create new rules and enforce existing ones for banks having assets of at least \$10 billion and the thousands of related companies, including mortgage brokers, payday lenders and student loan companies. According to Americans for Financial Reform (AFR), a coalition of consumer groups: “The CFPB has authority to write rules affecting mortgage down payments and disclosures, loan modifications, credit card rates and fees, bank overdraft programs, credit score usage, and eligibility for student loans, credit cards, prepaid cards and more. . . . The [CFPB] will have the authority to impose fines on companies, require restitution (repayment) to aggrieved consumers, rescind consumer contracts and/or file lawsuits against firms that violate its rules.”

Opposition to the CFPB, however, has been forceful. The Chamber of Com-

merce has called it an “unprecedented expansion of government intervention” and a “new tax” on small businesses. Some Republican members of Congress have called the CFPB a “rogue agency” with an “authoritarian structure” and “one of the greatest assaults on economic liberty in [a] lifetime.” In May, the House Committee on Financial Services passed three bills designed to weaken the CFPB. Other bills passed by the committee sought to change the leadership structure of the Bureau from a single director to a bipartisan commission and sought to prevent the Bureau from assuming any power until the Senate confirms a director. Senate Minority Leader Mitch McConnell of Kentucky and 43 other Republicans announced in May that they would not vote to confirm anyone as director until changes were made to its structure: “Senate Republicans still aren’t interested in approving anyone to the position until the President agrees to make this massive new government bureaucracy more accountable and transparent to the American people.” Despite this opposition, President Obama nominated Richard Cordray, former Ohio Attorney General and the head of the Bureau’s Enforcement Division, to be the first Director of the CFPB on July 18, 2011. Although his nomination is currently pending before the Senate, certain Republicans have indicated they will block a vote, leaving the CFPB without leadership.

Roadblocks to Implementation of Dodd-Frank

Congress left many of the details of Dodd-Frank to be worked out by various agencies, and regulators have been working to

develop rules to implement many of Dodd-Frank's provisions. It is a daunting task. At more than 2,000 pages, Dodd-Frank authorizes regulators to write the details of over 300 new rules and invites them to study more than 100 others. Congress set aggressive deadlines for regulators to make rules to enforce Dodd-Frank, and, unsurprisingly, they are not being met. The House Committee on Financial Services reported that, a year after passage: 62 percent of rules have yet to be proposed; deadlines have been met in only 33 of the 163 required rule-makings; 7 studies have been missed; and only 51 of Dodd-Frank's 400 total rulemaking requirements have been completed. In July 2011 alone, 104 rule-making deadlines were missed. "The decisions that are coming down are not promising," said Ted Kaufman, the former Democratic senator from Delaware who worked on the legislation. "The regulators are not making the hard decisions. If the Congress would not make the hard decisions, how can you expect the regulators to make them?"

These delays have given the financial industry additional time to lobby the government to unwind Dodd-Frank rules well after its passage; indeed, forceful opposition and a lack of funds have made it difficult to implement most of Dodd-Frank's provisions. The tedious rulemaking process also requires the participation of 20 different regulatory agencies, thus occasionally pitting one agency against another.

In addition to the logjam of regulation, lack of funding has seriously hampered Dodd-Frank's implementation. For example, the House Appropriations Committee



cut the SEC's fiscal 2012 budget request by \$222.5 million, to \$1.19 billion (the same as 2011), even though the SEC's responsibilities were vastly expanded under Dodd-Frank. An SEC memo on the Committee's proposed budget warns: "We may be forced to decline to prosecute certain persons who violate the law; settle cases on terms we might otherwise not prefer; name fewer defendants in a given action; restrict the types of investigative techniques employed; or conclude investigations earlier than we otherwise would." According to a report by Boston Consulting Group, Inc., the SEC is about 400 employees short of what it needs to manage its current workload: "Without sufficient human resources, the agency will be unable to complete the requirements of Dodd-Frank while maintaining its current activities." SEC staff levels have declined since 2005 and employees consistently complain their departments are understaffed. In testimony to the Senate Banking Committee earlier this year, SEC Chairman Mary Schapiro stated that the

In addition to the logjam of regulation, lack of funding has seriously hampered Dodd-Frank's implementation. For example, the House Appropriations Committee cut the SEC's fiscal 2012 budget request by \$222.5 million, to \$1.19 billion (the same as 2011), even though the SEC's responsibilities were vastly expanded under Dodd-Frank.

Quotable

“That one in seven frauds is now discovered by chance puts question marks over the effectiveness of controls and management review at detecting and preventing fraud.... It is highly likely, therefore, that many known instances of fraud go unreported.”

KPMG, reporting on its 2011 analysis of global patterns of fraud in “Who is the Typical Fraudster?”

SEC needs a larger budget and eventually 800 more workers to implement the regulatory demands of Dodd-Frank.

Despite the fact that Dodd-Frank is intended to prevent another economic meltdown, there are vociferous calls to repeal it. “It was doomed at the outset and nothing can possibly salvage it,” said Arthur Levitt, a former SEC chairman. Financial industry trade magazines such as *American Banker* contribute to industry alarmism with headlines such as “Will Dodd-Frank drive the financial industry overseas?” Indeed, large banks are spending millions to lobby Congress in an effort to stifle Dodd-Frank’s implementation. The twenty-six largest financial firms spent more money on lobbying in recent months than during the peak of the initial reform fight in 2010. The American Bankers Association by itself has spent \$2.2 million on lobbying and has eleven lobbyists working on the CFPB. The Chamber of Commerce has an entire division devoted to fighting Dodd-Frank. In the first few months of 2011, the Cham-

ber spent \$17 million on federal lobbying, far more than any other group, with a dozen lobbyists focused on the CFPB alone.

Repeal of Dodd-Frank also has become a popular position for several Republican Presidential candidates, with Rep. Michele Bachmann calling for its repeal and Mitt Romney agreeing, claiming that “The extent of regulation in the banking industry has become extraordinarily burdensome following Dodd-Frank.” Meanwhile, President Obama has stated his position clearly: “I will fight any efforts to repeal or undermine the important changes that we passed.”

It thus appears that Dodd-Frank and its unfulfilled promise will be a focal point of the 2012 elections. ♦

Joseph Goodman is an associate in BLB&G’s California office. He can be reached at joseph.goodman@blbglaw.com.

How to Contact Us

We welcome your letters, comments, questions and submissions. *The Advocate’s* editors can be reached at:

Katie Sinderson:

(212) 554-1392 or katie@blbglaw.com

Jon Worm:

(858) 720-3194 or jonw@blbglaw.com

Editors: Katie Sinderson and Jon Worm

Editorial Director: Alexander Coxe

“Eye” Editor: Sean O’Dowd

Contributors: Steven Davidoff, Jeremy Friedman, Joseph Goodman, Mark Lebovitch and Kristin Meister

The Advocate for Institutional Investors is published by Bernstein Litowitz Berger & Grossmann LLP (“BLB&G”), 1285 Avenue of the Americas, New York, NY 10019, 212-554-1400 or 800-380-8496. BLB&G prosecutes class and private securities and corporate governance actions, nationwide, on behalf of institutions and individuals. Founded in 1983, the firm’s practice also concentrates in the litigation of intellectual property, general commercial litigation, alternative dispute resolution, distressed debt and bankruptcy creditor representation, civil rights and employment discrimination, consumer protection and antitrust actions.

The materials in *The Advocate* have been prepared for information purposes only and are not intended to be, and should not be taken as, legal advice.

BLB&G Bernstein Litowitz
Berger & Grossmann LLP
800-380-8496
E-mail: blbg@blbglaw.com

New York
1285 Avenue of the Americas, New York, NY 10019
Tel: 212-554-1400

California
12481 High Bluff Drive, San Diego, CA 92130
Tel: 858-793-0070

Louisiana
2727 Prytania Street, New Orleans, LA 70130
Tel: 504-899-2339

© 2011. ALL RIGHTS RESERVED. Quotation with attribution permitted.