News Bulletin by Brad Hamilton **October 13, 2010**

Dodd-Frank Wall Street Reform Act: Prologue to Financial Reform

This is the second in a series about the Dodd-Frank Wall Street Reform and Consumer Protection Act. On July 21, 2010 President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. While the Act is 2,319 pages long, it has very little immediate effect on the financial markets. Rather, the Dodd-Frank Act empowers a variety of financial regulators to conduct studies, take testimony and promulgate rules and regulations to enforce the various provisions of the Act. Not unlike Twilight – New Moon, nothing much happens in the Dodd-Frank Act, but it lets you know a lot is coming soon.

The Dodd-Frank Act was primarily crafted to reduce the exposure of the U.S. banking system to a repeat of the 2008 melt-down, and end the potential for "too big to fail" government bail outs. However, the Dodd-Frank Act goes well beyond the initial intent.

47 Studies (or is it 67 Studies?)

Depending on whom you ask, and how you count parts and subparts, the exact number of studies commissioned by Dodd-Frank Act varies. The best number may be "a lot"; "scads" would also be accurate. Studies will be conducted and reports reported by the Financial Stability Oversight Council, the FDIC, the GAO, the FTC, the Federal Reserve, Treasury, the new Bureau of Consumer Financial Protection, and the SEC, among others.

The following studies may be of particular interest:

- Accredited Investors. The GAO will study and report on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds. As reported a few days ago, the Dodd-Frank Act already increased the asset value required for individual investors to be "accredited" by excluding the value of the investor's primary residence. This report is due in 3 years.

- Short Selling and Swaps. The SEC must report on several studies on different aspects of short selling[1] and swap transactions[2]. Particularly, reporting and regulation of certain aspects of short selling are likely to be forthcoming. While selling stock you don't own, gambling that the price will go down, can be an effective hedge (insurance) strategy for persons with substantial and complex stock positions, short selling for speculation often vexes public companies. Management of public companies who watch their stock go down for no apparent reason in the face of growing short positions often believe that speculators are conducting a "short and distort"[3] campaign - taking a short position, then spreading negative rumors or false information about the company to insure a profit from the short position, or that the existence of the short position itself causes other investors to sell their stock, driving the price down and hurting the company.

[1] http://www.hedgefund-index.com/d_shortselling.asp
[2] http://en.wikipedia.org/wiki/Swap_%28finance%29
[3] http://www.investopedia.com/articles/analyst/030102.asp?partner=answers

- Information on Broker-Dealers, Investment Advisors and Registered Reps. The SEC must study and recommend ways to improve investor access to registration information (including disciplinary actions, regulatory, judicial, and arbitration proceedings, and other information) about registered and previously registered investment advisers, associated persons of investment advisers, brokers and dealers and their associated persons. This report is due in 6 by January 21, 2011.

- Aiding and Abetting Violations of Securities Laws. The GAO must study and report on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws. This is of particular interest to securities lawyers, accounting firms, and their insurers. At common law, aiding and abetting occurs through "knowing participation" in the illegal conduct. Although knowing participation is required, wrongful intent by the defendant is not necessary. Nor is it necessary that the plaintiff establish that an agreement existed between the defendant and the guilty party. There is a fine evidentiary line between participating in someone else's conduct, and knowing the conduct was illegal. Thus, when a fraudster commits securities fraud and heads for the border with the money, the aggrieved investors look for people to sue – the lawyers who prepared the offering documents, the accountants who prepared the financial statements, the financial printer, the broker dealer who sold the securities, the investment banker who advised on the deal.

  Under current law the SEC may bring action against aiders and abettors,[4] but individuals may not. In addition, the Dodd-Frank Act provides for the SEC to impose aiding and abetting liability on persons who "recklessly" provide substantial assistance to someone who violates the Exchange Act. Previously, the SEC was generally required to show that such assistance was provided "knowingly." Private plaintiffs have been unable to bring such claims since the Supreme Court's Central Bank decision in 1994, and the Court's 2008 Stoneridge decision has blocked plaintiffs from bringing similar "scheme" liability claims.

  The Dodd-Frank Act also extends aiding and abetting liability for the first time to the Securities Act, the Investment Company Act and the Investment Advisers Act. The Act also clarifies that the SEC may pursue enforcement actions against so-called "control" persons – those found to "directly or indirectly control" a violator – unless they acted in "good faith" and did not "directly or indirectly induce" the violative conduct. This report is due in 1 year.

- Lessen Impact of Sarbanes-Oxley on Medium-Sized Companies. The SEC will study how the SEC could reduce the burden of complying with Section 404(b) of the Sarbanes-Oxley Act for companies whose market capitalization is between $75,000,000 and $250,000,000 while maintaining investor protections for such companies, including whether any such methods of reducing the compliance burden or a complete exemption for such companies from compliance with such section would encourage companies to list on exchanges in the United States in their initial public offerings. See Sarbanes-Oxley discussion below. This study is due in 9 months.

- Core and Brokered Deposits. The FDIC will conduct a one year study to evaluate:

  (1) the definition of core deposits for the purpose of calculating the insurance premiums of banks;

  (2) the potential impact on the Deposit Insurance Fund of revising the definitions of brokered deposits and core deposits to better distinguish between them;

  (3) an assessment of the differences between core deposits and brokered deposits and their role in the economy and banking sector of the United States;

  (4) the potential stimulative effect on local economies of redefining core deposits; and

[4] http://www.aicpa.org/Advocacy/Issues/Pages/AidingandAbettingLiability.aspx

(5) the competitive parity between large institutions and community banks that could result from redefining core deposits.

Current FDIC policy strongly discourages acceptance of brokered deposits by charging an FDIC insurance premium if brokered deposits exceed a specified percentage, and by very broadly interpreting the definition of brokered deposit.

What the Dodd-Frank Act Does Today

- Makes it Harder to Qualify as an Accredited Investor. As detailed in my earlier article,[5] effective immediately, the definition of an individual accredited investor under the SEC's Regulation D for private placements now excludes the value of the investor's primary residence. This reduces the number of people eligible to participate in many private placements, which are often offered only to accredited investors.

- Sarbanes-Oxley Relief. After six compliance extensions by the SEC, including a couple of "final extensions",[6] the matter is taken out of the SEC's hands. The Dodd-Frank Act provides immediate relief from the onerous Sarbanes-Oxley internal control audit provisions for approximately 5,000 smaller public companies. Smaller public companies, (non-accelerated filers – companies with a market cap less than $75 million) are now exempt from Sarbanes-Oxley 404(b) compliance. Sarbanes-Oxley 404(a) requires a management report on internal controls, which smaller public companies must still provide – 404(b) requires external audit of internal controls. Based on a 2007 study by Financial Executives International,[7] the average filer incurred outside audit and legal fees associated with Sarbanes-Oxley compliance of $846,000. The costs of compliance with 404(b) were clearly beyond the reasonable reach of smaller public companies. Smaller public companies comprise approximately 50% of all public companies in the United States.

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[5] http://bradhhamilton.wordpress.com/2010/09/22/dodd-frank-financial-reform-changes-definition-of-accredited-investor/
[6] http://bradhhamilton.wordpress.com/2009/10/19/sec-gives-one-more-and-final-reporting-extension-to-small-public-companies/
[7] http://www.financialexecutives.org/eweb/startpage.aspx?site=_fei