The Dodd-Frank Reform Act and the Criminal Law

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Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on July 21, 2010 as Public Law 111-203.[1] Given the trend over the last couple of decades, I expected to find the kind of harsh and pervasive criminal sanctions that were a part of the Sarbanes-Oxley Act[2] or the myriad of other statutes relating to federal regulation of business. As we have discussed in prior *Criminal Justice* columns, there has been a confluence of opinion from many points on the political continuum to the effect that the federal government has overcriminalized the doing of business in this country.[3]

Having now had a chance to study Dodd-Frank, it seems that the trend toward criminal enforcement is partially in remission, at least in this iteration of reform legislation. Enforcement seems to be envisioned as primarily through administrative or civil enforcement actions. Nevertheless, there are three parts of the Act that may have a significant impact on criminal justice. First, while there are not many, there are some new criminal statutes in the Act. Second, a new Bureau is created by the Act to enforce those new laws and all of the others relating to consumers and financial transactions. Finally, one of the most controversial aspects of the Act is the system of incentives for whistleblowers. We will look at all these in this month's column.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

Most business lawyers are acquainted with the Dodd-Frank Wall Street Reform and Consumer Protection Act. Much has been written about it in ordinary newspapers as well as business and law journals. The Act is comprised of 10 constituent Titles and the enrolled version of the Act is 848 ages long in the Government Printing Office version. The impact of the Act will not be know perhaps for years due to the fact that many of the provisions of the Act will be implemented through Regulations yet to be promulgated. The bureaucracy to enforce the Act is, in part, a reorganization of existing entities and, in part, newly created.

The Act is a response, of course, to the financial crisis of the last two years. It addresses, to one extent or another, the lack of regulation of certain previously unregulated financial institutions and schemes. It also seeks to require additional reporting and transparency on the part of the investment industry as a whole. The Act adds or amends countless sections of the United States Code. Regrettably, the Act does not do anything to simplify the argot that makes some of it seem impenetrable and introduces even more terminology that will keep lawyers employed if, for no other reason than to decipher the vocabulary.

Trying to cut through the minutiae and looking to some secondary sources[4] for guidance, we can make some generalizations. First, there is an effort throughout the Act to reduce risk-taking activities. Second, there is an effort to regulate a broader set of organizations, including the "shadow" banking system. And, third, there is an effort to enhance consumer protections.[5]

Our colleagues who do transactional law and who represent the financial investment community have their work cut out to understand and advise on all the details. In part, this will involve trying to predict the future course of the implementing regulations.   For instance, Title IV of the Act, makes a number of changes to the Investment Advisers Act of 1940. In one particular, the prior exemption from registration for advisors with less than 15 clients is eliminated. This change will require investment advisers to hedge funds and other kinds of privately offered investment vehicles to register under the Advisers Act. So, there are not only new rules but an entirely new class of entities and individuals who will be subject to regulations.

In addition, the entire financial industry will have to be aware of compliance requirements in areas and regarding subject matter that has not been so regulated. People within the organizations will have to be trained and compliance personnel retrained to make sure that unlawful risk taking behavior is eliminated and that consumer protection rules are honored. And, of course, everyone will have to be all the more sensitive to possible criminal investigations.

The Criminal Side of Things

The Act does create some new criminal sanctions, some of which are fascinating as we will discuss below. However, unlike many other Acts of recent years, including Sarbanes-Oakely, the Dodd-Frank Act was fairly restrained in the expansion of criminal jurisdiction. What it does do, in addition to promulgating a few new laws, is expand the universe of entities and individuals who are subject to existing laws and to give enforcement powers to new or reorganized bureaucracies.

New Criminal Laws

There are some new criminal sanctions created in stand alone provisions. For instance, Section 202(a)(1)(C) provides for a maximum penalty of 5 years in prison and a $250,000 fine for recklessly disclosing the existence of a negative investigation relating to a financial institution. The purpose behind this is understandable – if the government is going to be more aggressive in identifying institutions that are a risk for failure, the investigations have to be confidential.

It is of interest that an element of this offense as written is recklessness rather than simply willfully or knowingly. Other federal disclosure statutes do not have such a high standard.[6] Therefore, in defending such an allegation involving recklessness, the mental state of the defendant and the circumstances of the transactions will be critical. Pre-emptively, for the transactional lawyer, this is another situation in which strict compliance is paramount. Employees have to be trained and know these restrictions, there should be strict written guidelines and remedies.

Taking this as an example, a violation of this sort most likely would be committed by an individual or small group. But transactional lawyers have to prepare in advance to defend the corporation or other organization from liability for these acts, including, disgorgement and punitive fines. In other words, under the Organizational Sentencing Guidelines, showing that the organization had proper policies and procedures in place and that they had a strong compliance program might avoid or, at least, mitigate the eventual punishment. Also, it is important that, upon having information that a potential violation occurred, a corporate internal investigation be commenced immediately which may lead to remedial actions including sequestering or firing the offending employees or taking any other action that might partially remedy the situation. This may also mean – although it seems Big Brotherish and antithetical to the American system of justice -- that corporate employees and officers are forced to denounce each other to the government in order to avoid the most severe penalties.

Other examples of new criminal sanctions are the new regulatory provisions under Title VII of the Act which proscribe the conduct but do not provide for a separate scheme of punishment. For instance, Section 723 prohibits persons from engaging in a swap unless they or the transaction is eligible under the regulations. Sections 724, 724(a), 728, 730, 731, 733, 741, 746, 747 and 753 all proscribe other conduct and require compliance with various regulations. These sections are now part of the existing Commodities Exchange Act[7] and would be punishable under 7 U.S.C. Section 13(a)(5) which provides for a maximum of a $1,000,000 fine and 10 years imprisonment.

Interestingly, however, 7 U.S.C. Section 13(a)(5) has a provision that "no person shall be imprisoned under this paragraph for the violation of any rule or regulation if such person proves that he had no knowledge of such rule or regulation." This means that as to these particular offenses, ignorance of the regulation, is not a defense to the charge but may be a defense to going to prison. This is an unusual shift in the burden of proof in a criminal case.[8] It also means that a person who violates the regulation once and is warned or written up, let alone prosecuted and fined, can no longer claim the defense. Title IX has similar provisions which amend and are enforceable under the Securities Exchange Act of 1934.[9]

So, all in all, there is not as much outright new criminalization as one has come to expect. On the other hand, these crimes are almost all felonies and may be punished by between five and ten years and a fine of between $250,000 and one million dollars. We will have to see how they are prosecuted and whether additional regulations are promulgated in the near future.

New and Reorganized Enforcement Agencies

What may be of more significance to the enforcement of not only these new provisions but to the enforcement of all of the provisions of existing law that may pertain to financial regulations is that there is a reorganization of certain enforcement bureaucracies and the creation of a new one.

Dodd-Frank creates the Consumer Financial Protection Bureau (CFPB)[10] which is established within the Federal Reserve System. The CFPB is given regulatory, supervisory, and enforcement authority over "covered persons" and "service providers." The agency, though created under the Dodd-Frank Act, is given authority to enforce:

- The Electronic Funds Transfer Act
- The Equal Credit Opportunity Act
- The Fair Credit Reporting Act
- The Fair Debt Collection Practices Act
- The Home Mortgage Disclosure Act

- The Real Estate Settlement Procedures Act
- The Secure and Fair Enforcement for Mortgage Licensing Act
- The Truth in Lending Act
- The Truth in Savings Act

In other words, if the transaction involves a consumer or agents or representatives acting on behalf of a consumer and some sort of (non-exempted) financial transaction, the CFPB will have jurisdiction. This means that there is a specific agency now ready to investigate and, potentially, prosecute, what are perceived to be violations of the new provisions or violations of the many other provisions that already exist in federal law to protect consumers in financial transactions. There are also provisions requiring other agencies to coordinate and cooperate in their enforcement efforts to avoid redundancy. However, the reality is that over the last few decades there has been an exponential increase in federal investigative agencies and federal enforcement officers. Although we can keep a good thought, there is not much reason to think that this new bureaucracy will not become involved in the law enforcement interagency turf wars.

Whistleblower Provisions

One of the most significant aspects of the Dodd-Frank Act on its impact on criminal law is that fact that it includes extensive whistleblower provisions. Section 748 provides for whistleblower incentives and protections under the Commodities Exchange Act. Under 748(b), the rewards to a whistleblower are set at between 10 and 30 percent of the monetary sanctions recovered by the government.[11] This amendment also includes enforcement of some of the existing provisions of the Sarbanes-Oxley Act and other aspects of existing law.

Section 922 of the Act provides for a similar whistleblower scheme to be added to the Securities Exchange Act of 1934.[12] Again, the bounty is from between 10 to 30 percent of the sanctions recovered by the government.

The way the Act is drafted, it does not appear that the whistleblower under either the Commodities Exchange Act or the Securities Exchange Act of 1934 could participate in criminal fines. However, there is a provision that recovery can pertain to related actions. Also, there is a provision that the recovery can be based on penalties and disgorgements. The big consequence for the defense of criminal prosecution – or the attempt of transactional lawyers to keep their clients from being prosecuted – is that the whistleblower incentive will be a source of referrals to the criminal investigators and, eventually, the United States Attorney's Office for parallel criminal prosecutions.

There is also something unsettling about whistleblower incentives, especially these which may result in multi-million dollar awards. We are already contending with corporate rules, influenced by the Organizational Sentencing Guidelines, that require corporations, generally through their officers, to report wrongdoing to the government. In practice, this is done after a corporate internal investigation and upon some reflection. Nevertheless to avoid the worst consequences of disgorgement and draconian penalties – and sometimes to avoid corporate prosecution entirely – one set of officers has to inform on other officers or employees.

Here there is an incentive for any employee to break ranks immediately and be the first through the government door to provide information that will qualify for the big pay-day. This means that, instead of going to the supervisor and allowing the company to correct the problem or instead of allowing the corporation to conduct a proper corporate investigation, the employee has every incentive to denounce his fellow employees or supervisors directly to the government as soon as possible. This will lead to additional criminal prosecutions of corporations and key employees which might have otherwise been resolved internally or through pre-indictment negotiations with the government.

There is also the problem that the rewards are so great, employees will undoubtedly run to the government with whistleblower information that is based more on wishful thinking than fact. Presumably there will be many unsubstantiated cases which are eliminated before costly civil enforcement actions are brought or before they are submitted to the United States Attorneys Office to be presented to the Grand Jury for indictment. But there is little doubt that more weak claims will end up resulting in actual prosecutions under this system than without it.

Conclusion

Overall, the Dodd-Frank Wall Street Reform and Consumer Protection Act is an admirable effort on the part of its drafters and the current Administration to take serious steps to avoid the kind of risk-taking and unfair advantage that allowed this country to get into the financial crisis of the last couple of years. Something had to be done and this 848 page Act is a start. Like any complicated reform, the ramifications will not be known until the regulations are in place and the provisions are tried in place for a few years. It is good that this Act has reduced the proliferation of as many new criminal sanctions as have accompanied such acts in the past and that there seems to be a nod toward those who have been alarmed by the overcriminalization of business.

On the other hand, the criminal justice system – and more importantly, CEO's, officers and corporations – may feel the impact of some of the consequences of the Act, including some of the unintended consequences. These are things to watch and to fix before they get out of hand. As we saw, there is a new Bureau and there are both new and old criminal laws that they can seek to enforce. And, as we have also seen, there are two major sections creating whistleblower incentives.

So, as we often conclude in this *Criminal Justice* Column, time will tell.

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[1] It can be found in its entirety (848 pages)

[2] Public .Law. 107-204.

[3] This has led to the proverbial odd bedfellows, for instance, recently, the National Association of Criminal Defense Lawyers (NACDL) joined with the Heritage Foundation to produce a study entitled *Without Intent*. By Brian Walsh and Tiffany Joslyn with a forward by Edwin Meese. and Norman Reimer (2010)

[4] There are many summaries available, many of which are produced by law firms or consultants who seem to be attempting to frighten potential clients into hiring them as opposed to given actual guidance. However, one source which is substantive and helpful is Deloitte, “Assessing the Impact of U.S. Financial Regulatory Reform” Deloitte Center for Financial Services (2010).

[5] See, Deloitte, *supra*.

[6] Se, e.g., 42 U.S.C. Section 3537a relating to disclosure of HUD funding determinations requires that the act be willful..

[7] 7 U.S.C. Section 1 et seq.

[8] This defense to imprisonment is not available as to all of the new offenses. For instance, Section 768 of the Act is punishable under 15 U.S.C. Section 77x which is part of the Securities Act of 1933.

[9] See Sections 929, 934 and 975 of the Act. Section 1036 also adds what appears to be a criminal prohibition as to certain acts , however, there is no punishment provision associated with it directly or indirectly.

[10] Title X of the Doss-Frank Act.

[11] Codified at 7 U.S.C. Section 23.

[12] Codified at 15 U.S.C. 78a et seq.