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Underwriters of D & O and Professional Liability Insurance

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In this issue … we delve into the Dodd-Frank Act and find some less well-known provisions of possible relevance to D&O insurance.

BACKGROUND

The nearly 850 pages of the Dodd-Frank Wall Street Reform and Protection Act ("Dodd-Frank") have become for its critics a byword for legislative overreach and monumental length. Some of its many sections have received greater publicity than others, including two, Whistleblowing and Insurance Reform, which have been discussed in this newsletter.

But tucked away within Dodd-Frank's sections and subsections are a few less well-known items that are, to some degree, relevant to D&O insurance. We will look at three of these items.

1. SECTION 929Z: GAO STUDY OF SECURITIES LITIGATION.

In recent years, one of the issues addressed by the U.S. Supreme Court and closely-watched by the D&O insurance community concerned the concept of the aiding and abetting of securities fraud by "secondary actors." If the primary perpetrator of fraud is the company itself, or issuer, then secondary actors in a supporting role could include accountants, attorneys, bankers, credit-rating agencies and securities analysts.

The Supreme Court first reviewed whether these secondary actors could be subject to private securities class action lawsuits in the *Central Bank* case of 1994 and again in *Stoneridge* in 2008, where an attempt was made by plaintiffs to introduce the concept of scheme liability as a hook on which to hang a class-action lawsuit.

This newsletter examined *Stoneridge* in September 2007, March 2008 and again in September 2009.

In essence, the Supreme Court denied plaintiffs the right to a private action against secondary actors, but implied that Congress should look into it. "The decision to extend the cause of action is for Congress, not for us."

Perhaps because Congress as a whole failed to take up the Supreme Court's suggestion, the Dodd-Frank Act included a provision for the United States Government Accountability Office (GAO) to perform a study on securities litigation —but only insofar as it pertained to providing (or not providing) a private right of action against any person "who aids or abets another in violation of the securities laws." In other words, Dodd-Frank authorized what amounted to a review of the issues raised in *Central Bank* and *Stoneridge*, and that the review be presented to Congress.

Although delivered later than the one-year deadline allowed by the Act, the GAO report was released in July 2011. Setting out the competing arguments, and staying understandably neutral, the report concludes by gently lobbing the ball back to Capitol Hill: "Debate continues over whether a private cause of action for aiding and abetting securities fraud should be created." However, for anyone wishing to read a dispassionate and thorough (but not overlong) analysis of aider and abettor liability, the report would be hard to beat.

2. Section 1079(a)(1) Sentencing Guidelines for Securities Fraud

Perhaps reflecting the anecdotal belief that not enough securities fraud perpetrators go to prison, this subsection of Dodd-Frank directs the United States Sentencing Commission to review and "if appropriate, amend the Federal Sentencing Guidelines and policy statements applicable to persons convicted of offenses relating to securities fraud."

The direction came with no deadline, and it also came with no room for public comment, and so the review's conclusions with any amendments would be implemented as stated (absent action of Congress to the contrary). The review was released on April 30, 2012.

The technical elements of the Sentencing Guidelines can be hard to follow, but the conclusion and the message of the Sentencing Commission are clear: Sentencing guidelines for securities fraud will be tougher. For those found guilty of insider trading, there should be little doubt about their expected sentence: "A defendant who engages in considered, calculated, systematic, or repeated efforts to obtain or trade on inside information … warrants, at minimum, a short but definite period of incarceration."

The new guidelines will become effective on November 1, 2012.

3. Section 939B Elimination of Exemption from Fair Disclosure Rule

When the Securities and Exchange Commission (SEC) promulgated Regulation Fair Disclosure (Regulation FD) in 2000, it sought to level the playing field for corporate disclosures so that a company could not generally disclose material, non-public information to certain groups —typically market professionals— without making that information available to everyone. However, Regulation FD contained an exception for credit-rating agencies, so that they were still permitted to exclusively receive such material information in order to determine or monitor a company's credit rating.

Congress, however, was dissatisfied with the credit-rating agencies, and Section 931 of Dodd-Frank spelled this out:

> *In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed 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 and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies.*

A result of this dissatisfaction was Dodd-Frank Section 939B, which eliminated the rating agencies' exemption from Regulation FD. This meant that the rating agencies would no longer receive their unique insights into a company's business. The exemption's removal was duly executed by the SEC effective October 4, 2010.

However, Regulation FD continued to permit an exemption where the recipient of the information "owes the issuer a duty of trust or confidence" and also an exemption for "communications made to any person who expressly agrees to maintain the information in confidence."

With these exemptions (or loopholes) still intact, the Fitch credit-rating agency felt that: "the removal of the rating-agency exemption in Regulation FD does not diminish Fitch's right to receive material nonpublic information of the issuer."

This might be seen as paradoxical; Dodd-Frank clearly wanted the rating-agency exemption removed, but one such rating agency declares that nothing has changed, and things are business as usual. It has been nearly two years since the SEC amendment to Regulation FD, and so far it appears that neither legislators nor regulators have shown much inclination to resolve that paradox.

COMMENT

Among its numerous and far-reaching provisions, Dodd-Frank has kept in play the question of aider and abettor liability, attempted to remove the privileged status of the credit-rating agencies with regard to fair disclosure, and opened the door for stiffer federal sentences for insider trading. Efforts on the first two appear —for now— to have had minimal impact; but the revised federal sentencing guidelines for insider trading are real and, after November 2012, they will be in force. ❖

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