SULLIVAN & CROMWELL LLP

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DC Circuit Vacates SEC's Retroactive Application of Dodd-Frank Remedial Provision

Decision Limiting SEC's Authority to Bar Based on Misconduct Occurring Prior to Enactment of Dodd-Frank May Provide a Basis for Objecting to Certain CFPB Sanctions

SUMMARY

On July 14, 2015, the U.S. Court of Appeals for the District of Columbia Circuit (the "DC Circuit") held that the Securities and Exchange Commission (the "SEC" or "Commission") could not employ certain remedial provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act")[1] to retroactively punish an investment adviser for conduct that occurred prior to enactment of the Act. The court's decision not only casts doubt on numerous similar punishments previously levied by the SEC based on pre-enactment misconduct, but could provide a basis for institutions to object to certain sanctions sought by the Consumer Financial Protection Bureau (the "CFPB").

BACKGROUND

A. DODD-FRANK EXPANDED SEC AUTHORITY

The Securities and Exchange Act of 1934 (the "Exchange Act") makes it unlawful for "any person," in connection with the purchase or sale of securities, "[t]o use or employ . . . any manipulative or deceptive device or contrivance in contravention of [SEC] rules."[2] The Investment Advisers Act of 1940 (the "Advisers Act") prohibits investment advisers from engaging in similar conduct.[3] Prior to enactment of Dodd-Frank Act, the SEC could bar individuals who violated either the Exchange Act or the Advisers Act

from associating with various securities industry participants, including stock brokers, dealers and investment advisers. The Act expanded that power to include municipal advisers and nationally recognized statistical rating organizations ("credit rating agencies").

B. DODD-FRANK CONFERRED AND EXPANDED CFPB AUTHORITY

Title X of Dodd-Frank empowers the CFPB to pursue remedial measures, including cease and desist orders, penalty assessments and injunctive relief, against any covered person or service provider who violates Federal consumer financial law or engages in any unfair, deceptive, or abusive act or practice ("UDAAP"), as well as against any person who knowingly or recklessly provides substantial assistance to a covered person or service provider in violation of the prohibition on UDAAP.[4]

Dodd-Frank defines Federal consumer financial law broadly to encompass more than a dozen enumerated consumer protection statutes that were extant prior to enactment of the Act, including the Equal Credit Opportunity Act, the Truth in Lending Act ("TILA"), the Fair Debt Collection Practices Act, the Home Mortgage Disclosure Act of 1975, and the Real Estate Settlement Procedures Act ("RESPA").[5] Effective July 20, 2011, Dodd-Frank conferred on the CFPB the "powers and duties" vested in the Federal banking agencies (and certain other agencies) related to consumer protection functions, including the authority to issue orders pursuant to Federal consumer financial law.[6] Under various "savings provisions," the Act preserves legal rights relating to any transferred consumer financial protection function that existed on July 20, 2011.[7] Accordingly, the other agencies' authorities to take enforcement actions under the enumerated consumer protection statutes transferred to the CFPB as of that date. The same cannot be said of the prohibition on UDAAP or new enforcement powers conferred on the CFPB by Dodd-Frank, including under RESPA and TILA.

UDAAP did not exist prior to enactment of Dodd-Frank, and the Act specifically excludes from the definition of Federal consumer financial law the Federal Trade Commission Act's separate but similar prohibition on unfair or deceptive acts and practices. The CFPB's UDAAP authority, unlike its authority under the enumerated consumer protection statutes, did not have a pre-existing statutory basis. Similarly, certain amendments to TILA did not become effective until on or after the enactment of Dodd-Frank.[8] Likewise, the agency charged with enforcing RESPA prior to enactment of Dodd-Frank, the U.S. Department of Housing and Urban Development, had no authority to obtain civil money penalties for violations of RESPA and, therefore, there was no power to assess penalties that transferred to the CFPB. The power to assess penalties for RESPA violations came into effect on the Act's effective date.

KOCH v. SEC

A. FACTUAL BACKGROUND

Donald L. Koch was the sole investment adviser, owner and principal of Koch Asset Management ("KAM"). His investment strategy was to buy stock from small community banks as long-term

investments. KAM used a registered broker-dealer, Huntleigh Securities Corporation ("Huntleigh"), to execute trades and maintain client accounts. According to the SEC, Koch traded stock in three small banks at the end of the trading day so as to artificially inflate the respective stocks' value—a practice called "marking the close." This conduct occurred on two trading days in 2009.

In April 2011, the SEC instituted enforcement proceedings, charging both Koch and KAM with market manipulation in violation of the Exchange Act, the Advisers Act and their respective implementing regulations. The SEC sought to bar Koch from associating with various securities industry participants, including the municipal advisors and credit rating agencies that the SEC was empowered to bar him from associating with only by virtue of Dodd-Frank.

The enforcement proceedings were heard before an administrative law judge ("ALJ"), who found that Koch violated the Exchange Act, the Advisers Act and their implementing regulations, and ordered a bar, but declined to extend that bar to those participants added by the Dodd-Frank Act.[9] Koch and KAM appealed to the Commission. In a decision issued in May 2014, the Commission, like the ALJ, found that Koch and KAM violated the Exchange Act, but relying on its December 2012 decision in *In the Matter of John W. Lawton*,[10] concluded that although Dodd-Frank was enacted after Koch's misconduct, "such collateral bars are not impermissibly retroactive because the decision to impose such a bar is based on a present assessment of 'whether such a remedy is necessary or appropriate to protect investors and markets from the risk of future misconduct.'" The Commission concluded that such a remedy was in the public interest and imposed a bar that included associating with municipal advisers and credit rating agencies. Koch and KAM appealed the Commission's decision to the DC Circuit.

B. DC CIRCUIT DECISION

On May 14, 2015, a three-judge panel of the DC Circuit affirmed, except with respect to the Commission's expansive bar. The court's analysis focused in relevant part on whether the Commission's decision barring Koch from associating with municipal advisors and rating organizations represented an impermissible retroactive application of Dodd-Frank. According to the DC Circuit, there is a presumption against retroactive legislation that is "deeply rooted in our jurisprudence and embodies a legal doctrine centuries older than our Republic."[11] Although such legislation is not *per se* unlawful, to lessen its inherent unfairness courts will not enforce a statute retroactively unless Congress has made clear its intention that the legislation apply retroactively.

The court then turned to the relevant provision of Dodd-Frank. That provision, according to the court, contains no mention of retroactive application; the closest the Act comes to such a mention is its "generic statement that '[e]xcept as otherwise specifically provided in this Act,' the Act's provisions 'shall take effect 1 day after the date of enactment'"—language that says nothing about retroactivity.[12] Since the Act does not expressly authorize retroactive application, the court then considered whether applying the provision to Koch "would impair rights [he] possessed when he acted, increase [his] liability for past

conduct, or impose new duties with respect to transactions already completed."[13] According to the court, at the time of Koch's misconduct, the SEC could not bar an individual from associating with municipal advisors or credit rating agencies and the Commission's decision to nevertheless apply such a penalty to Koch attached a new disability to conduct completed well before enactment of the Act, enhanced penalties for a violation of the securities laws, and attached new legal consequences to Koch's conduct. As such, the Commission's application to Koch of Dodd-Frank's bar on associating with municipal advisors and rating organizations was impermissibly retroactive.[14] Accordingly, the court vacated that portion of the Commission's order.

IMPLICATIONS

Since enactment of Dodd-Frank, the SEC has relied on *Lawton* in dozens of proceedings barring individuals from associating with municipal advisers and credit rating agencies based on conduct that occurred, at least in part, prior to enactment of Dodd-Frank.[15] The DC Circuit's decision casts doubt on, and raises a number of questions about, those punishments, including whether they are enforceable. It remains to be seen whether the SEC will seek a rehearing or Supreme Court review.

Much like the SEC bar at issue in *Koch*, a number of the CFPB's enforcement actions address UDAAP violations premised on conduct that, at least in part, predates Dodd-Frank.[16] The same can be said of CFPB penalty assessments for RESPA violations.[17] In limited instances, the CFPB seems to have acknowledged possible constraints on its authority to sanction conduct that predates Dodd-Frank's enactment.[18] Indeed, in the context of civil money penalties for RESPA violations, the CFPB apparently recognizes that it cannot assess penalties for conduct predating Dodd-Frank because the authority to assess such penalties was first conferred in Dodd-Frank.[19] Such recognition by the CFPB, however, is not universal, and the DC Circuit's decision in *Koch* could provide a basis for institutions to object to certain sanctions sought by the CFPB.

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ENDNOTES

1 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 15 U.S.C. § 78j(b).

3 15 U.S.C. § 80b–6(1), (4).

4 12 U.S.C. §§ 5536, 5563 and 5564.

5 12 U.S.C. § 5481.

6 12 U.S.C. § 5581.

7 12 U.S.C. § 5583.

8 For example, the effective date of the amendment limiting loan originator compensation, 15 U.S.C. § 1639b(c), was January 10, 2014. At least one federal district court has held that the amendment does not apply retroactively. *See Fowler* v. *U.S. Bank, Nat'l Ass'n, 2 F. Supp. 3d 965* (S.D. Tex. 2014).

9 *In the Matter of Donald L. Koch & Koch Asset Mgmt. LLC*, Initial Decision Release No. 457, n.29 (May 24, 2012).

10 *In the Matter of John W. Lawton*, SEC Release No. 3513 (Dec. 13, 2012). In *Lawton*, the Commission considered whether barring an individual from associating with municipal advisors and credit rating agencies based on pre-enactment misconduct is impermissibly retroactive and concluded that it was not "because such bars are prospective remedies whose purpose is to protect the investing public from future harm."

11 *Koch* v. *S.E.C.*, 2015 WL 4216988, at *8 (D.C. Cir. July 14, 2015) (citations omitted).

12 *Id.* at *9.

13 *Id.* (citations omitted).

14 The Court specifically stated that "this holding does not apply to the other securities industries with which Koch may not associate."

15 *See*, *e.g.*, *In the Matter of Anthony Fields, Cpa d/b/a Anthony Fields & Assocs. & d/b/a Platinum Sec. Brokers*, Release No. 4028 (Feb. 20, 2015); *In the Matter of Herbert Steven Fouke*, Release No. 660 (Aug. 29, 2014); *In the Matter of Anthony Chiasson*, Release No. 589 (Apr. 18, 2014); *In the Matter of Eric T. Burns*, Release No. 582 (Mar. 27, 2014); *In the Matter of Ross Mandell*, Release No. 71668 (Mar. 7, 2014); *In the Matter of Tzemach David Netzer Korem*, Release No. 70044 (July 26, 2013); *In the Matter of Johnny Clifton*, Release No. 9417 (July 12, 2013); *In the Matter of Alfred Clay Ludlum, III*, Release No. 3628 (July 11, 2013). For proceedings in which the SEC barred such association based on pre-Dodd-Frank conduct without explicitly relying on *Lawton*, *see*, *e.g.*, *In the Matter of Daniel Imperato*, Release No. 74596 (Mar. 27, 2015); *In the Matter of John Allan Russell*, Release No. 750 (Mar. 2, 2015); *In the Matter of Michael Robert Balboa*, Release No. 747 (Feb. 27, 2015).

16 *See*, *e.g.*, *CFPB* v. *Affinion Grp. Holdings, Inc.,* Stipulated Final Judgment and Order, Case No. 15-cv-01005 (ordering restitution to consumers for conduct occurring as far back as July 2010); *CFPB* v. *Paypal, Inc.,* Civil Action No. 15-cv-01426, Stipulated Final Judgment and Order (D. Md., May 19, 2015) (ordering restitution to consumers for conduct occurring as far back as January 2011); *In the Matter of Regions Bank*, Consent Order, Administrative Proceeding File No. 2015-CFPB-0009 (Apr. 28, 2015); *In the Matter of Chase Bank, USA N.A.*, Consent Order, Administrative Proceeding File No. 2015-CFPB-0013 (ordering restitution to consumers for conduct occurring as far back as 2009); *In the Matter of Fort Knox Military Assistance Co.*, Consent Order, Administrative Proceeding File No. 2015-CFPB-0008 (ordering restitution to consumers for conduct occurring as far back as September 2009).

ENDNOTES (CONTINUED)

[17] *See*, *e.g.*, *CFPB* v. *Genuine Title, LLC,* Complaint, Case No. 15-cv-01235 (D. Md., Apr. 29, 2015) (seeking penalties for RESPA violations as far back as 2009); *In the Matter of Amerisave Mortg. Corp.*, Consent Order, Administrative Proceeding File No. 2014-CFPB-0010 (ordering restitution to consumers for RESPA violations as far back as January 2010); *In the Matter of Stonebridge Title Servs.*, Administrative Proceeding File No. 2014-CFPB-0006 (ordering civil money penalty for RESPA violations as far back as 2008).

[18] *See*, *e.g.*, *CFPB* v. *Sec. Nat'l Auto. Acceptance Co., LLC*, Civil Action No. 15-cv-401 (S.D. Ohio, June 17, 2015); *CFPB* v. *Corinthian Colleges, Inc.,* Complaint for Permanent Injunction and Other Relief (N.D. Ill., Sept. 16, 2014).

[19] *In the Matter of PHH Corp.,* CFPB Administrative Proceeding File No. 2014-CFPB-0002, Decision of the Director p. 37 (June 4, 2015).

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