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U.S. Legislative Proposal: House Committee on Financial Services Releases Draft Investor Protection Act

On October 1, 2009, the Committee on Financial Services of the U.S. House of Representatives released a draft of the Investor Protection Act of 2009.[1] If adopted, this sweeping proposed legislation would, among other things, amend various federal securities laws to:

(a) establish a uniform fiduciary duty for broker-dealers and investment advisers;

(b) create a new fee for registered investment advisers to offset the costs of examinations;

(c) double the budget of the U.S. Securities and Exchange Commission ("SEC") with a view of enhanced enforcement;

(d) grant the SEC the authority to restrict the use of mandatory arbitration; and

(e) direct a study into SEC, self-regulatory organization ("SRO"), and financial industry governance reform.

Beyond the specifics, however, the proposed legislation is significant for the fact that the legislation appears to be growing in size and scope. The first draft of the legislation, which was sent to Congress in July by the U.S. Department of Treasury, was a slim 20 pages;[2] the latest proposal runs to almost 120 pages and touches on many more topics. In its current form, this is a bill that seeks to act as a vehicle for dozens of proposals affecting many areas of financial services, and its final shape is hard to judge.

Major provisions of the proposed legislation

SEC reform; Enhanced budget for enforcement; New fee for registered investment advisers

SEC reform: SEC directed to hire independent consultant to examine SEC structure, operations, and compensation

The proposed legislation directs the SEC to hire an independent consultant to "examine the internal operations, structure, funding, and need for comprehensive reform of the SEC, SROs, and other entities relevant to the regulation of securities and the protection of securities investors."[3] In particular, the consultant is directed to study, at a minimum: (A) whether any of the SEC's units are redundant; (B) the need to improve communication among SEC divisions and offices; (C) the SEC's hiring structure; (D) the need for improvement of the SEC's "chain of command structure";[4] and (E) whether the "present reliance on [SROs] promotes efficient and effective governance for the securities markets."

[1] The proposed legislation is available at http://www.house.gov/apps/list/press/financialsvcs_dem/discussion_draft_of_the_investor_protection_act_of_2009.pdf. An earlier Obama Administration White Paper on the topic is available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[2] The Treasury's July 2009 release is available at http://www.treas.gov/press/releases/tg205.htm.

[3] *See* Section 304 of the proposed legislation.

[4] Section 304(a)(2) of the proposed legislation directs the consultant to place special emphasis on the "chain of command" with respect to enforcement, examinations, and compliance inspections. The consultant is also directed to study whether "there is need to further streamline hiring authorities for those who are not lawyers, accountants, compliance examiners, or economists", as well as to review whether there is need for compensation reforms for SEC personnel and whether there is sufficient "experiential mix of SEC employees."

The proposed study of the effectiveness of industry-funded SROs, such as the U.S. Financial Industry Regulatory Authority ("FINRA") in the broker-dealer arena, is especially interesting against the backdrop of a long running debate on whether the investment adviser community should be governed by an SRO – an outcome the asset management industry has fought off successfully for years on the grounds that it adds unnecessary expense and duplicates regulatory authority and oversight programs maintained by the SEC. There is concern among investment advisers that the reference to an SRO study is yet another effort to advance the cause of an investment adviser SRO.

The SEC is also directed to formalize a process it has already begun in terms of establishing a specific mechanism for investor representatives to participate in the SEC's policymaking activities. The proposed legislation would establish a permanent Investor Advisory Committee at the SEC to meet at least twice annually and advise the SEC on investor perspectives on new financial products, trading strategies, fee structures and disclosure practices. Members of the committee should be drawn from both the retail and institutional investor communities.[5]

Increased SEC budget

The proposed legislation would double the funding for the SEC to $2.25 billion between fiscal years 2010 and 2015. This enhanced SEC budget is meant, among other things, to complement a series of new enforcement powers to be granted to the SEC, including, for example, the authority to impose civil monetary penalties in cease and desist orders.[6]

Whistleblower provisions

The proposed legislation authorizes the SEC to establish rules for whistleblower bounties to be paid in the case of judicial or administrative actions brought by the SEC under any of the principal federal securities laws that result in monetary sanctions exceeding $1 million. The payment may not exceed 30% of the amount of the sanctions.

Whistleblowers are also explicitly protected from retaliation. A private right of action is to be established to enforce that protection.[7]

Additional fees from registered investment advisers

The proposed legislation directs the SEC to collect from registered investment advisers fees "designed to help recover the cost of inspections and examinations . . . ."[8] The proposed fee would attach at the time of registration with the SEC and each fiscal year thereafter. Although the fee amount is not specified, the SEC is directed to consider the following criteria when determining the fee: (A) the size of the investment adviser; (B) the risk profile of the investment adviser; and (C) the types of clients of the investment adviser. As highlighted in our October 6, 2009 client publication, the Committee on Financial Services of the U.S. House of Representatives also released the "Private Fund Investment Advisers Registration Act," which will require virtually all advisers to register.[9]

Uniform fiduciary duty for broker-dealers and investment advisers

The proposed legislation directs the SEC to promulgate rules to provide that, with respect to a broker-dealer that is providing investment advice to a retail customer, the standard of conduct for such broker-dealer shall be the same as the standard applicable to an investment adviser under the U.S. Investment Advisers Act ("Advisers Act"). A "retail customer" would be defined as an individual or the legal representative of such individual who (A) receives personalized investment advice from a broker-dealer and (B) uses such advice primarily for

[5] *See* Section 101 of the proposed legislation.

[6] *See* Section 210 of the proposed legislation.

[7] *See* Section 202 of the proposed legislation.

[8] *See* Section 302 of the proposed legislation.

[9] Our previous client alert (dated October 6, 2009) is available at http://www.shearman.com/new-developments-on-us-legislative-proposals-for-the-registration-of-advisers-to-private-funds-10-06-2009/.

personal, family, or household purposes.[10] While the SEC is given authority to define fiduciary duty, the following parameters are already set out in the proposal: "in providing investment advice about securities ... [a fiduciary is] to act solely in the interest of the customer or client without regard to the financial or other interest of the ... [fiduciary] providing the advice."

The same provision is to be inserted into both the Advisers Act in respect of investment advisers and the U.S. Securities Exchange Act of 1934 ("Securities Exchange Act") in respect of broker-dealers. That is in contrast to current law under which broker-dealers and investment advisers are subject to different regulatory standards. The Advisers Act subjects investment advisers to fiduciary and anti-fraud obligations. Broker-dealers, which are regulated by the Securities Exchange Act, are subject to the general anti-fraud provisions of that Act, and to a substantial requirement that investments recommended to clients be suitable to those clients. Broker-dealers have also traditionally been held to a standard of fair dealing with the public.

The possibility of new statutory text defining fiduciary duty in the context of investment advisers is of special interest for investment fund managers, given the SEC's potential interest in expanding the duties owed to fund investors.

Ending of mandatory arbitration

The proposed legislation would give the SEC the power to prohibit or limit the use of mandatory arbitration provisions related to disputes with brokers, dealers, municipal securities dealers and investment advisers arising under the federal securities laws or SRO rules if the SEC finds that such action is in the public interest and protects investors.[11] Currently, such mandatory pre-dispute arbitration provisions appear in a majority of retail investor account agreements for both broker-dealers and investment advisers.

Addition of aiding and abetting authority

The proposed legislation extends the SEC's authority to pursue aiding and abetting violations under the U.S. Securities Act of 1933 ("Securities Act") and the U.S. Investment Company Act of 1940 ("Investment Company Act"). Specifically, the SEC is permitted to bring such claims against "any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of the [Securities or Investment Company] Act."[12]

The proposed legislation also permits the SEC to impose penalties for aiding and abetting violations under the Investment Advisers Act by amending Section 209 thereof. Under the proposed terms, the SEC may impose a penalty on any person under the Investment Advisers Act that "knowingly or recklessly has aided, abetted, counseled, commanded, induced, or procured a violation of any provision under the [Advisers] Act."[13] The proposal does not set a maximum penalty for such violations.

With this new language, the proposed legislation extends the SEC's aiding and abetting enforcement authority across all of the securities laws to include reckless conduct. Currently, explicit SEC authority to pursue aiding and abetting claims exists only under the Securities Exchange Act, although theories of liability approximating aiding and abetting have been invoked under the other statutes as well. The proposal does not give individual plaintiffs the right to pursue private aiding and abetting claims.

Addition of extraterritorial jurisdiction

The proposed legislation would add language asserting extraterritorial jurisdiction for the antifraud provisions of

[10] *See* Section 103(a)(1) of the proposed legislation.

[11] *See* Section 201(a) of the proposed legislation.

[12] *See* Sections 206(a)-(b) of the proposed legislation.

[13] *See* Section 207 of the proposed legislation.

each of the principal federal securities laws. The jurisdiction would apply to "conduct within the United States that constitutes significant steps in furtherance of the [antifraud] violation, even if the securities transaction occurs outside the United States and involves only foreign investors ... or ... conduct occurring outside the United States that has a foreseeable substantial effect within the United States."[14]

New rules for investment companies

In addition to the aiding and abetting provisions, the proposed legislation contemplates several changes to the Investment Company Act. First, the proposed legislation authorizes the SEC to establish point-of-sale disclosure rules for persons selling shares of U.S. registered investment companies.[15] While there is little doubt that the authority already exists, and indeed the SEC and FINRA have both put forward various proposed point-of-sale rules in this area, the fact that the topic is included in the proposed legislation serves as a reminder to both the mutual fund and broker-dealer industries that point-of-sale disclosure reform remains politically salient. Second, the SEC is authorized to establish enhanced recordkeeping and surveillance and examination protocols.[16] (Parallel rules are authorized under the Advisers Act.) Third, the SEC is authorized to implement what appear to be technical amendments to current registered investment company fidelity bonding provisions.[17] Fourth, the SEC is authorized to adopt rules setting new classes of persons who will not qualify as independent directors of registered investment companies.[18] Fifth, the SEC is authorized to adopt rules regarding holdings of illiquid investments by registered investment companies.[19]

Additional regulation of securities lending

The proposed legislation would amend the Securities Exchange Act to make it unlawful for any person, directly or indirectly, to effect or accept a transaction involving "the loan or borrowing of securities in contravention of such rules and regulations as the [SEC] may prescribe."[20] This provision places more attention on the activities of persons engaged in securities lending, and places additional importance on regulations that may be adopted by the SEC relating to securities lending. This provision is of interest insofar as it shows legislative interest in the business – and stronger regulation – of securities lending.

Conclusion

If enacted, the proposed legislation would result in significant structural changes to the financial industry, particularly in respect of broker-dealer practices. Of course, many aspects of the proposal may be modified as lobbyists, industry officials, and lawmakers engage in a debate in Washington over the proposal's terms and, more generally, the future of U.S. financial regulation. We will continue to monitor and report on these and related proposals and counterproposals as the legislation evolves.

As a final note, we emphasize that the proposed legislation is a complex and composite assortment of amendments to multiple parts of the federal securities laws. This publication is not meant to be, and cannot be, a complete discussion of the proposal or its consequences.

[14] *See* Section 215 of the proposed legislation.

[15] *See* Section 104 of the proposed legislation.

[16] *See* Section 217 of the proposed legislation.

[17] *See* Section 216 of the proposed legislation.

[18] *See* Section 412 of the proposed legislation.

[19] *See* Section 413 of the proposed legislation.

[20] *See* Section 401 of the proposed legislation.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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