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Treasury Proposal for Enhanced Investor Protection: SEC Authorized to Set New Regulatory Standards for the Retail Financial Services Industry

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On July 10, 2009, the Department of the Treasury ("Treasury") delivered to Congress draft legislation that would put into effect several of the legislative changes to the federal securities laws recommended in Treasury's June 17, 2009 white paper on financial regulatory reform ("White Paper").[1] Most significantly, if enacted, the legislation would provide authority for the Securities and Exchange Commission to establish a new standard or standards of conduct for broker-dealers and investment advisers that provide investment advice about securities to "retail" investors.[2] In addition, the legislation proposes that the SEC be required to examine and, if appropriate, to ban "compensation schemes," sales practices and conflicts of interest involving broker-dealers or investment advisers that are contrary to the public interest. The latter proposal is not limited on its face to financial intermediaries advising retail investors.

The legislation also directs the SEC to facilitate the provision of "simple and clear disclosures" to investors regarding the terms of their relationships with investment professionals. Separately, the legislation would authorize the SEC to impose the so-called "point of sale" disclosure requirements in connection with mutual fund sales. Presumably, the content of any such new disclosure requirements would be subject to the new "consumer testing" provision of the proposed legislation.

Other aspects of the legislation would (a) authorize the SEC to restrict or limit mandatory pre-dispute arbitration, compensate whistleblowers, and impose collateral bars, (b) make permanent the SEC's recently-established investor advisory committee, and (c) harmonize the liability for aiding and abetting under the federal securities laws.

Standards of Conduct for Advisers and Broker-Dealers. The legislation would authorize the SEC, under both the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940, to establish standards of conduct by rulemaking that would provide:

> that the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice about securities to retail customers or clients (and such other customers

> or clients as the [SEC] may by rule provide), shall be to act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.[3]

The wording of the legislation on this point is significant for several reasons. First, as the White Paper recommended, the legislation simply attempts to establish a uniform standard regarding the provision of investment advice. Although the new standard would be more stringent than the current duty of suitability for broker-dealers, it does not try to effect a broader harmonization of the rules governing investment advisers and broker-dealers or attempt to clarify when a broker-dealer providing investment advice is deemed to be an investment adviser. Second, the legislation would not displace the existing standards of conduct that apply to investment advisers and broker-dealers. Thus, to the extent there are material differences in regulatory treatment resulting from existing requirements, it is not at all clear that the legislation would harmonize that treatment. Third, although it would require that the SEC establish standards of conduct by rulemaking, thus providing an opportunity for notice and comment, the legislative provision would not require the SEC to adopt express, clearly-defined standards, so it is possible that the SEC might simply promulgate broad standards, and leave their ultimate interpretation to administrative and enforcement matters, frustrating the apparent goal of regulatory certainty and clarity.

Relationship Disclosure, Sales Practice and Compensation Issues. The SEC also would be empowered to "take steps to facilitate the provision of simple and clear disclosure to investors regarding the terms of their relationships with investment professionals" and to "examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors."[4] The first prong calling for the relationship disclosure requirement appears to contemplate the creation and delivery of an SEC-mandated disclosure document, perhaps similar to Form ADV, that would be furnished to all investors, regardless of the regulatory status of the investment professional. There is no such requirement today for broker-dealers, and it is not clear whether the required disclosure would need to address the investor's relationship with the individual broker or advisory representative acting as an "investment professional" or with the legal entity that maintains the account relationship with the investor.

The second prong of the Treasury proposal relating to the sales practice and compensation issues provides for the SEC's authority not only to examine financial intermediaries but also to ban outright any compensation arrangements that the SEC considers inappropriate. If adopted, this would be a significant policy shift from the disclosure-based approach used today to regulate certain practices that are considered by some market participants to be controversial, such as revenue sharing and payment for order flow. In addition, it could allow the SEC to mandate, at least indirectly, a compensation model in some cases.[5] To the extent that this particular proposal seeks to harmonize sales practices across investment advisers and broker-dealers, it is not clear if that could be effectively accomplished, since it would not displace existing SEC authority or any sales practice rules and regulations adopted by various self-regulatory organizations, to which broker-dealers (but

not investment advisers) are subject today.

Point of Sale Disclosure. In a related portion of the legislation, the Investment Company Act of 1940 would be amended to authorize the SEC to "promulgate rules designating documents or information that must precede a sale to a purchaser of securities issued by a registered investment company."[6] In other words, the legislation would expressly authorize the SEC to require point of sale disclosure for persons selling shares of mutual funds.[7]

Arbitration. The legislation would amend the Exchange Act to authorize the SEC to "prohibit, or impose conditions or limitations on the use of" mandatory pre-dispute arbitration agreements.[8] This would effectively override the provisions of the Federal Arbitration Act, which provides that such arbitration agreements are enforceable.

Whistleblowers. As to whistleblowers in a judicial or administrative proceeding brought by the SEC under the securities laws, the legislation would authorize the SEC to establish a fund out of which it would compensate whistleblowers, using monies that it collects from enforcement actions that are not distributed to investors. It also would provide for confidentiality of information provided by whistleblowers.[9]

Collateral Bars. The collateral bar provision would authorize the SEC to impose collateral bars across all aspects of the financial services industry.[10] To give a concrete example, this would authorize the SEC to bar persons in one portion of that industry (for example, a broker-dealer representative) from another portion of that industry (for example, an investment adviser or transfer agent).

Aiding and Abetting Liability. The legislation would amend the Securities Act, the Investment Company Act and the Advisers Act to harmonize the liability for aiding and abetting under the federal securities laws.[11]

Consumer Testing. The legislation also would authorize the SEC, in "evaluating its rules and programs and for considering, proposing, adopting, or engaging in rules or programs," to "gather information, communicate with investors or other members of the public, and engage in such temporary or experimental programs as it in its discretion determines is in the public interest or for the protection of investors."[12] Although this general concept would seem to be uncontroversial, the wording of the authorization is quite broad, and in theory could be used by the SEC to avoid the restrictions of the Paperwork Reduction Act and even to engage in broad inspection "sweeps."

Investor Advisory Committee. The legislation would formally establish and make permanent the SEC's investor advisory committee, which would be required to meet at least twice a year.[13]

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Many aspects of the legislation are likely to be quite controversial, especially the provisions affecting the standards of conduct of investment advisers and broker-dealers. There have been calls for a

broader articulation of the fiduciary standard and for a re-examination of the structure of regulation of investment advisers and broker-dealers in general.[14] Thus, some will question whether the proposed legislation goes far enough, particularly because the SEC is authorized to adopt new rules, but is not required to do so.

[1] The draft legislation is available here.

[2] There is no statutory definition of "retail" under the federal securities laws.

[3] Section 913 of the legislation would amend Section 15 of the Exchange Act to add new subsection (k) and would also amend Section 211 of the Advisers Act to add new subsection (f).

[4] Section 913 of the legislation would also add subsection (l) to Section 15 of the Exchange Act and subsection (g) to Section 211 of the Advisers Act. We understand that disclosure similar to the type contemplated by the proposed legislation may already be provided in some cases by broker-dealers in the ordinary course of their business.

[5] The SEC's prior experience with tackling broker compensation has shown how complex the issue can be, however. *See, Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007) (citing the SEC's Committee on Compensation Practices' 1995 "Tully Report," which extolled the benefits of a fee-based program as best aligning the interests of registered representatives and broker-dealers with those of retail investors).

[6] Section 914 of the legislation would amend Section 24 of the Investment Company Act to add new subsection (h).

[7] The SEC last proposed point of sale disclosure rules for mutual fund sales in 2004. Investment Company Act Release No. 26341 (Jan. 29, 2004).

[8] Section 921 of the legislation would amend Section 15 of the Exchange Act to add new subsection (m) and Section 205 of the Advisers Act to add new subsection (f).

[9] Section 922 would add new Section 21F to the Exchange Act. Section 923 of the legislation would add a conforming amendment to Section 20(d)(3)(A) of the Securities Act of 1933 ("Securities Act"), Section 42(e)(3)(A) of the Investment Company Act, and Section 209(e)(3)(A) of the Advisers Act.

[10] Section 925 of the legislation would amend Sections 15, 15B and 17A of the Exchange Act as well as Section 203 of the Advisers Act.

[11] Section 926 of the legislation would amend Section 15 of the Securities Act and Section 48 of the Investment Company Act. Section 927 would amend Section 209 of the Advisers Act.

[12] Section 912 of the legislation would amend Section 19 of the Securities Act, Section 23 of the Exchange Act, Section 38 of the Investment Company Act, and Section 211 of the Advisers Act.

[13] Section 911 of the legislation would add new Section 38 to the Exchange Act.

[14] *See, e.g.*, Speech by SEC Commissioner Walter, "Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization?" May 5, 2009.

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