PROPOSED INVESTOR PROTECTION ACT OF 2009 PROMISES SIGNIFICANT REGULATORY CHANGES AND POTENTIALLY HIGHER COSTS FOR BROKER-DEALERS AND INVESTMENT ADVISERS

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To Our Clients and Friends:

Overhaul of the financial services regulatory structure took another dramatic step forward on July 10, 2009, when the Obama Administration released draft legislation that would implement certain of the proposals contained in its White Paper issued on June 17, 2009. The draft bill sets forth a number of significant amendments to the federal securities laws that are designed principally to provide the SEC with the authority to impose uniform standards on broker-dealers and investment advisers and to arm the SEC with enhanced enforcement tools to combat unlawful practices. These amendments, if implemented, may well impose considerable costs on broker-dealers and investment advisers and require new training and compliance enhancements.

KEY AMONG THE PROPOSALS

Consistent Standards for Broker-Dealers and Investment Advisers. The most far-reaching proposal would permit the SEC to impose consistent "fiduciary" standards on broker-dealers and investment advisers. This provision is designed to address the concern that although many investors rely on the investment advice of broker-dealers in the same manner as investment advisers, broker-dealers are required only to refrain from fraud under securities laws and, under SRO rules, such as Rule 2310 of FINRA, to assess the suitability of a recommended investment for a retail customer and the ability of an institutional customer to independently evaluate the investment risk. Investment advisers, on the other hand, generally have been held to a stricter fiduciary standard under the Investment Advisers Act of 1940. These differences have been the source of much controversy for several years, particularly as the compensation practices of brokers and investment advisers began to converge.

The draft legislation empowers the SEC to promulgate rules to establish that broker-dealers and investment advisers who are providing investment advice about securities to retail customers or clients will "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." The Obama Administration said in proposing the new legislation that its goal is to "align . . . the

standards [applicable to broker-dealers and investment advisers] based on activity, instead of based on legal distinctions that are no longer meaningful."

Although the draft legislation focuses on investment advice provided to retail customers or clients, it allows the SEC to include other customers and clients within new rules it may promulgate, potentially including institutional and other sophisticated investors. The draft legislation also mandates that the SEC take steps to facilitate "simple and clear disclosures" to investors regarding the terms of their relationships with investment professionals.

In the event that such rules are prescribed, the adoption of a uniform standard of conduct for professionals providing investment advice is likely to have broad implications for the financial services industry. In particular, the proposed legislation could lead to rules that might require broker-dealers to re-evaluate how they conduct a wide variety of activities, such as principal trading/market making, sales of proprietary products and underwriting, in light of their fiduciary obligations. Given the persons and activities potentially captured in this proposed expansion of the fiduciary net, institutions could be required to re-configure their training materials and ramp up their compliance programs.

Sales Practices and Compensation. The legislation directs the SEC to examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest and compensation schemes for financial intermediaries that are deemed to be "contrary to the public interest." The Obama Administration has explained that these provisions are focused on preventing compensation arrangements that incentivize financial intermediaries to steer investors towards products that are profitable for the intermediaries, but not in the client's interest. The proposed language, however, is not limited to situations where investors are steered towards unsuitable products, but gives the SEC broad discretion to craft whatever rules it feels are necessary to combat activities it deems "contrary to . . . the interests of investors." Under this broad language, a broad range of financial products could become subject to compensation limitations, conflict of interest standards and other rules the SEC may prescribe.

Aiding and Abetting Liability. The proposed legislation would subject aiders and abettors of securities violations under the Securities Act of 1933, the Investment Company Act of 1940 and the Investment Advisers Act of 1940 to the same liability as primary violators for purposes of SEC enforcement actions. Aiding and abetting liability under these provisions would apply to "any person that knowingly or recklessly provides substantial assistance to another person" who violates those laws. The Administration has said its proposal is designed to bring the SEC's enforcement powers under these laws in line with the powers it presently enjoys under the Securities Exchange Act of 1934 (and under judicial interpretations of the Investment Advisers Act of 1940). We note, however, that the aiding

and abetting language of the Securities Exchange Act of 1934 is limited to "any person that knowingly provides substantial assistance." These proposed provisions do not apply in private civil litigation or arbitrations.

Arbitration Prohibition. Another potentially significant aspect of the proposed legislation would allow the SEC to prohibit entirely, or limit, pre-dispute agreements that require clients of investment advisers, or clients of any broker, dealer, or municipal securities dealer to arbitrate claims arising out of the federal securities laws or the rules of a self-regulatory organization. Since the Supreme Court upheld the use of arbitration provisions in securities customer agreements in *Shearson/American Express v. McMahon,* 482 U.S. 220 (1987), they have become a standard feature of brokerage account agreements. The Obama Administration premises this change on a philosophical belief that up-front denial of access to the courts "may unjustifiably undermine investor interests," rather than on any statistical or other evidence that arbitration produces less than fair outcomes. This approach appears to be a significant shift away from the long-established federal policy in favor of arbitration. *See, e.g.,* the Federal Arbitration Act, 9 U.S. § 1 *et seq*. The elimination of compulsory arbitration, or its curtailment, could dramatically increase litigation costs for brokers-dealers, and may result in additional workload for an already strained judicial system as well as substantial delays in case resolution.

Pre-Sale Disclosure of Information for Mutual Funds. The draft legislation would allow the SEC to promulgate rules to require specific information or documents to be provided to prospective purchasers of securities issued by a registered investment company prior to the purchase. Such a requirement would alter the common practice of providing prospectuses at the completion of the transaction. The Obama Administration has suggested that this proposal could be satisfied by a summary prospectus and a simple disclosure showing the costs of a fund in a comparative context prior to the completion of a sale, followed later by a full prospectus. As envisioned, the proposed legislation could entail not only additional expense and effort for the fund industry, but potentially open up a second layer of enforcement actions and claims arising out of allegedly misleading or incomplete pre-sale materials.

Whistleblower Provisions. Building on the foundation of similar provisions relating to insider trading, the legislation would not only protect whistleblowers who provide significant information to the SEC pertaining to violations of the securities laws, but also give the SEC discretion to award whistleblowers up to 30% of the monetary sanctions imposed on the wrongdoers in cases resulting in penalties exceeding $1 million. Any such awards would be paid out of a new "Investor Protection Fund," which would be funded from sanctions obtained by the SEC that are not added to a disgorgement fund or otherwise distributed to victims. The amount contained in this Investor Protection Fund could be as much as $100

million. Whistleblowers also would be protected from retaliation by provisions allowing for their reinstatement and potentially awarding them two-times back pay and costs of litigation. While these whistleblower protection provisions are designed to encourage those knowledgeable of wrongdoing to come forward, the prospect of a significant monetary reward could generate a flood of allegations against broker-dealers and investment advisers that the SEC would need to review and potentially investigate, increasing both compliance and defense costs for the financial services industry.

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The proposed legislation incorporates additional features, including allowing the SEC to bar violators from all segments of the securities industry (not just the segment in which the person previously was engaged), giving the SEC authority to conduct consumer testing and making permanent the recently created Investment Advisory Committee to the SEC. No doubt many of these provisions will engender spirited discussion, both as the legislation wends its way through Congress and then, if necessary, when proposed rules are issued for comment.

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