November 9, 2009

Investor Protection Act Passes House Financial Services Committee

Introduction

The Investor Protection Act passed the House Financial Services Committee (the "Committee") on November 4, 2009 on a party-line vote. The bill (the "Committee Bill") modified the draft originally introduced in the Committee by Rep. Paul Kanjorski (the "Kanjorski Draft"),[1] and was modeled on a July 2009 Administration Proposal. Consideration of the Committee Bill on the House floor has not yet been scheduled, and the Senate has not yet made public its version of the bill.

The Committee Bill maintains, and in some cases modifies, many of the key Kanjorski Draft provisions, including the harmonized fiduciary duty standard for broker-dealers and investment advisers and enhanced Securities and Exchange Commission ("SEC") enforcement powers. Specifically, the Committee Bill would:

- Modify the Kanjorski Draft's proposed uniform fiduciary standard for broker-dealers and investment advisers;
- Establish a limit on the value of client funds under the custody of an investment adviser;
- Exempt small issuers from Section 404(b) of the Sarbanes Oxley Act of 2002 ("Sarbanes-Oxley");
- Provide the SEC with explicit authority to impose proxy access standards;
- Authorize the SEC to provide the Financial Industry Regulatory Authority ("FINRA") enforcement authority over member broker-dealers and their associated persons and rulemaking under the Investment Advisers Act of 1940 (the "Advisers Act");
- Require SEC registration by municipal financial advisers;
- Establish a Capital Markets Safety Board within the SEC to conduct examinations of failed institutions;
- Authorize the formation of a joint advisory committee of the SEC and Commodities Futures Trading Commission ("CFTC"); and
- Establish a Financial Reporting Forum.

Changes to the Kanjorski Draft Provisions

Fiduciary Standard Applicable to Broker-Dealers and Investment Advisers

Both the Committee Bill and the Kanjorski Draft require the SEC to adopt rules providing that the standard of conduct for broker-dealers shall be the same as the standard of conduct for investment advisers when providing investment advice to a retail customer.

The Committee Bill clarifies that the prescribed standard would apply only when the advice is personalized and relates to securities, and when the customer is a natural person or legal representative of a natural person. The Committee Bill and the Kanjorski Draft both require the SEC to adopt rules requiring a broker-dealer or investment adviser "to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice." The Committee Bill requires that under the SEC rules any material conflicts of interest must be disclosed and

[1] As described in the October 6, 2009 Davis Polk memorandum.

may be consented to by the customer. This change recognizes that material conflicts of interest may still arise in the fiduciary relationship, and that the customer may consent to these conflicts. However, it does not address situations in which the broker-dealer or adviser believes that the customer's investment decisions are not consistent with the customer's best interest, such as concentrated holdings of the stock of the customer's employer.

The Committee Bill also states that the receipt of commissions, fees, or other standard compensation, and sale of proprietary or other limited range of products by a broker-dealer, shall not be considered a violation of the standard, although notice and consent or acknowledgement by the customer are required.

While the Committee Bill still maintains that the broker-dealer standard be "no less stringent" than the standard applicable to investment advisers under the Advisers Act, it limits the applicable standard to Sections 206(1) and 206(2) and does not include the principal trading and crossing restrictions of Section 206(3) of the Advisers Act.

In addition, the Committee Bill also authorizes the SEC to promulgate rules to require persons that sell "identified investment products or services" to provide retail customers with documents and information prior to the purchase of such products or services following a study of the issue. The Committee Bill does not define the term "identified products or services," presumably leaving it for the SEC to prescribe.

The Committee Bill responds to some, but not all, of the criticisms that were leveled against earlier formulations. For example, the new uniform standard covers personalized investment advice only with respect to securities, and not other financial products (such as foreign exchange, futures, or swaps). By contrast, it leaves unaddressed serious concerns about the possibility of inconsistencies between the proposed federal standard and those which may be imposed by state rules, thus perpetuating and perhaps worsening a situation where a financial intermediary providing comparable services on a national scale must provide those services in accordance with varying local standards.

The new provisions concerning firms that only provide proprietary or a limited range of products would, potentially, create uncertainties for firms that offer both proprietary and nonproprietary products with similar investment characteristics, and in some ways could create a disincentive to offering a broader range of products.

The provision permitting informed consent by customers concerning conflicts of interest also raises questions. Specifically, some industry participants may be concerned that the SEC's interpretation and implementation of the provision could require consent procedures that are impractical or extremely cumbersome, including consent on a trade-by-trade basis.

Custody Requirements

The Committee Bill requires the SEC to adopt a rule making it unlawful for registered investment advisers to have custody of more than $10 million worth of client funds or securities unless the funds are maintained with a qualified custodian that does not provide investment advice with respect to these securities. This provision would prevent dually-registered investment advisers/broker-dealers from holding more than $10 million in assets for a client in street name, requiring significant changes to existing client relationships.

Sarbanes-Oxley Exemptions

Through several uncoordinated amendments, the Committee Bill excepted from Section 404(b) of Sarbanes-Oxley: (1) issuers whose market capitalization is less than $75 million, and (2) issuers whose market capitalization is less than $700 million until the SEC adopts rules proactively applying Section 404(b) to these issuers after studying the costs and impacts of Section 404(b) on these issuers.

New SEC Authority to Issue Rules on Proxy Access

In an attempt to address questions about the SEC's authority to adopt prescriptive proxy access rules, the Committee Bill gives the SEC explicit statutory powers by amending Section 14(a) of the Securities Exchange Act of 1934. The SEC proposed rules this summer that would permit shareholders meeting

certain ownership and holding requirements to nominate directors to a company's board of directors through the company's proxy statement and proxy card. The proposed rules are described in Davis Polk's June 18, 2009 memorandum. Chairwoman Mary Schapiro recently reiterated that the SEC intends to adopt the rules in early 2010. The provision in the Committee Bill makes clear that the SEC has the authority to prescribe rules and regulations, including procedures, relating to the inclusion of shareholder nominees for the board of directors in a company's proxy solicitation.

SEC Permitted to Grant Enforcement Authority to FINRA

The Committee Bill would permit the SEC to grant to FINRA enforcement authority under the Advisers Act with respect to FINRA's members or persons associated with its members.[2] This provision is a direct response to FINRA's justification for failing to detect Madoff's Ponzi scheme. It also grants the SEC authority to delegate to FINRA rulemaking authority under the Advisers Act. This section has encountered strong opposition from investment advisers and state securities regulators, and Committee Chairman Barney Frank stated that he will attempt to delete the provision when the Committee Bill moves to the House floor.

A less controversial provision of the Committee Bill requires the SEC to conduct a study of examination and enforcement resources concerning investment advisers, including whether a self-regulatory organization should be involved in investment adviser oversight as well as the role of self-regulatory organizations in enforcement generally.

Regulation of Municipal Financial Advisers

Responding to numerous instances over recent years of municipal issuers having entered into dubious transactions, and allegations of flawed investment advice, the Committee Bill requires broad SEC regulation of municipal financial advisors ("MFAs"), including requirements relating to registration, training, experience, competence and other qualifications of associated persons. These provisions are based on comparable broker-dealer requirements, but do not include membership in a self-regulatory organization. Under current law, MFAs generally are not subject to regulations that apply to registered investment advisers or broker-dealers unless they are otherwise registered as such (although they may be subject to regulation as municipal securities brokers and dealers in some instances).

The Committee Bill would apply a fiduciary duty, to be defined by the SEC, to an MFA and any person associated with an MFA with respect to their advice to any municipal securities issuer. In addition, MFAs would be prohibited from engaging in fraudulent, deceptive, or manipulative acts or practices. The SEC would have enforcement authority over MFA activities.

A "municipal financial adviser" is defined broadly to include a person who provides advice for compensation to a municipal securities issuer with respect to the issuance of securities, the investment of proceeds or the selection or negotiation of investment products generally, hedging activities and the preparation of disclosure documents. It would also include any person that assists a recipient of municipal issuance proceeds in selecting investment products. There are explicit carve-outs for lawyers and credit rating agencies acting in their capacity as such and for registered broker-dealers acting as underwriters. "Municipal securities issuer" includes recipients of proceeds from a municipal offering, which can include many corporations, and nonprofits raising funds through a municipal development authority. There is no exception from registration for banks. Registered broker-dealers would only benefit from an exception to the extent that many act as underwriters for municipal issuers.

The proposed MFA provisions would not in all instances capture advisers involved in advising on or arranging loans, but would cover swaps and other hedge products, even those that are not "securities."

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[2] An "associated person" of a broker-dealer includes ". . . any partner, officer, director, or branch manager of such broker or dealer . . . any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial . . . ." Thus, FINRA would acquire jurisdiction over nonmember affiliates of member broker-dealers, among others.

Refinements to Enforcement Authorities

The Committee Bill makes a few alterations to the enforcement authority sections of the Kanjorski Draft. Certain significant provisions of the bill, those dealing with aiding and abetting liability, collateral bars, and whistleblower protections, are virtually unchanged.

The Committee Bill adds a provision that prevents a whistleblower from receiving an award if the whistleblower knowingly and willfully made a false, fictitious, or fraudulent statement or representation.

The Kanjorski Draft required the SEC to complete all enforcement actions within 180 days. The Committee Bill has dropped this deadline and now requires that an action must be filed no later than 180 days after the SEC staff has provided any person with a written "Wells" notification. In addition, the Committee Bill requires the SEC staff, within 180 days from the date on which it completes the on-site portion of its compliance examination or inspection, to inform the subject in writing that the examination has concluded without findings or request the entity undertake corrective action. In both instances there is a 180 day extension for complex matters.

The Committee Bill adds the Public Company Accounting Oversight Board ("PCAOB") and any self-regulatory organization to the list of entities with whom sharing information would not waive privilege. In the Kanjorski Draft, the privilege was only preserved when information was shared with a foreign securities authority, foreign law enforcement authority, state securities or law enforcement authority or any federal agency.

The Committee Bill would alter the conduct test that governs when extraterritorial jurisdiction exists under the antifraud provision of the Advisers Act. The Committee Bill has deleted language which specified that jurisdiction exists over transactions occurring outside of the United States, and replaced it with language that clarifies that jurisdiction exists even if the violation is committed by a foreign adviser involving foreign investors. This is an attempt to tailor the conduct test for the Advisers Act to the type of conduct covered by the Advisers Act. This language may bolster the SEC's ability to exercise jurisdiction over a foreign adviser if it simply engages in investment transactions involving securities traded in the United States.

The Committee Bill has made the standard for the mandatory production of audit information by a foreign public accounting firm to the SEC and PCAOB slightly stricter. It requires production where there has been work performed "upon which a registered public accounting firm relies in the conduct of an audit or interim review" as opposed to simply where work was performed and provided to any issuer or its subsidiary. It also limits the production to "work papers" as opposed to "documentation."

Other Changes

The Committee Bill makes a variety of other changes that would affect advisers and broker-dealers.

Advisers in a state that regulates and examines investment advisers with investment assets under management of $25 million or more but less than $100 million appear to be required to register with and be subject to examination by the state. The intent of the legislation seems to be that registration of such investment advisers with the state is in lieu of registration with the SEC, although the bill is somewhat unclear. Furthermore, the Committee Bill lessens the SEC's authority to demand heightened fidelity bonds as compared to the Kanjorski Draft.

The Committee Bill would establish a Financial Reporting Forum comprised of a number of agency heads and industry representatives to discuss immediate and long-term issues critical to financial reporting, reducing the independence of the SEC and potentially the FASB regarding accounting issues.

The Committee Bill would authorize the formation of a Joint Advisory Committee of the SEC and CFTC to, among other things, consider emerging issues of common interest in the futures and securities markets, and require a Capital Markets Safety Board within the SEC to conduct examinations of failed institutions and publicly release its findings.

The Committee Bill codifies the existing Securities Investor Protection Corporation ("SIPC") practice of treating as "customers" protected by SIPC investors whose assets were sold or converted by their broker-dealer.

The Committee Bill contains a number of provisions aimed at investment protection for seniors. It provides grants to states contingent on their limiting use of misleading designations for persons selling securities and insurance, and adopting suitability rules for recommendations of securities and insurance, including annuities.

The Committee Bill would require the SEC to appoint an Ombudsman.

Studies

The Committee Bill also deferred action on a wide range of issues by requiring studies (to be conducted by the Government Accountability Office ("GAO") and the SEC) of:

- Sales of investment products and services and the effectiveness of disclosures at the point of sale (SEC);
- The need for enhanced resources for adviser exams including the role of self-regulatory organizations (SEC);
- Financial planning (GAO);
- The FINRA arbitration system (GAO);
- High frequency trading (SEC);
- The implementation of Madoff reforms (SEC);
- The SEC "revolving door" (GAO);
- The impact of Section 404 of Sarbanes-Oxley (in addition to an outright exemption for small issuers in regard to Section 404 reporting) (GAO); and
- Risk-based assessments for SIPC members (GAO).

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

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