News Bulletin

July 23, 2009

The Investor Protection Act of 2009

On July 10, 2009, the Treasury released draft legislation,[1] the Investor Protection Act of 2009 (the "Proposed IPA"), intended to provide new tools to the Securities and Exchange Commission to protect investors. The proposed legislation would implement some of the broad consumer protection recommendations contained in the Obama Administration's White Paper on regulatory reform (the "White Paper").[2] The draft legislation, which has not yet been introduced in Congress, would amend various federal securities laws to, among other things, establish consistent standards for those who provide investment advice about securities, enhance whistleblower incentives, expand the scope of enforcement action for aiding and abetting violations and other violations of the securities laws, improve the timing and quality of disclosure and make permanent the SEC's Investor Advisory Committee. Many legislative provisions will require the SEC to promulgate implementing regulations, so the full impact of this proposed legislation will not be felt for some time, even after its enactment.

Harmonizing Conduct Requirements; Limitations on Certain Sales Practices, Compensation Schemes and Other Arrangements, and Mandatory Pre-Dispute Arbitration

Broker-dealers and investment advisers are currently subject to different regulatory standards. The Investment Advisers Act of 1940 (the "Advisers Act") subjects investment advisers to common law fiduciary and anti-fraud obligations, subject to certain exceptions. Broker-dealers, which are regulated by the Securities Act of 1934 (the "Exchange Act"), are subject to the general anti-fraud provisions of the Exchange Act, as well as the standards imposed by the Financial Industry Regulatory Authority ("FINRA") and other self-regulatory organizations ("SROs"), with respect to, among other things, "suitability" of an investment for clients, but are not held to be "fiduciaries" in respect of their clients. The Administration believes that investors do not distinguish between the recommendations of broker-dealers and investment advisers and these differing legal standards "are no longer meaningful."[3] The Administration seeks to harmonize these differing standards of conduct. The Proposed IPA would amend both the Advisers Act and the Exchange Act to authorize the SEC to issue rules that require broker-dealers and investment advisers to be held to a fiduciary standard "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," when providing investment advice to retail customers or clients (or such other customers or clients as the SEC may determine).

The Proposed IPA would also require the SEC to issue rules to facilitate the delivery of "simple and clear" disclosures regarding the investor's relationship with these investment professionals. In addition, it would require the SEC to "examine, and where appropriate," promulgate rules prohibiting sales practices, conflicts of

[1] http://www.treas.gov/press/releases/tg205.htm
[2] http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. See also, our Alert, "Newton's Third Law and the White Paper," http://www.mofo.com/news/updates/files/090618WhitePaper.pdf (June 18, 2009).
[3] *See* the discussion in the Fact Sheet announcing the draft legislation, *supra*, note 1.

interest and compensation schemes for financial intermediaries, such as broker-dealers and investment advisers that the SEC "deems contrary to the public interest and the interest of investors." The potential prohibition of compensation schemes is unusual as it is not mentioned in the White Paper and is directed solely at these investment professionals. Further, the SEC typically focuses on disclosure, not prohibition, of a particular practice. One particular sales practice is targeted. The Proposed IPA would amend the Investment Company Act of 1940 (the "Investment Company Act") to authorize the SEC to promulgate rules that would mandate that certain documents or information be provided to purchasers before a sale of securities issued by a registered investment company, such as a mutual fund. This is not current market practice and could be opposed by the mutual fund industry.

Another area of concern is the mandatory pre-dispute arbitration provision that appears in nearly all retail investor account agreements, which has been extensively and generally fruitlessly attacked in the courts.[4] The Proposed IPA would authorize the SEC to prohibit or restrict use of such agreements relating to disputes with broker-dealers, municipal securities dealers and investment advisers arising under the federal securities laws or SRO rules if it finds that such prohibition or limitation is "in the public interest and for the protection of investors."

Whistleblower Incentives and Protections

The Proposed IPA would allow the SEC to compensate whistleblowers who voluntarily provide "original information" in connection with successful enforcement actions resulting in monetary sanctions exceeding $1 million with up to 30% of the monetary sanctions imposed. The legislation would also create a new SEC Investor Protection Fund funded by monies collected in SEC enforcement actions other than, in most cases, disgorgement actions under Section 308 of the Sarbanes-Oxley Act of 2002. The legislation would also provide for whistleblower confidentiality protection and prohibitions on retaliation. Under the proposed legislation, the SEC would have sole discretion to make whistleblower determinations, which determinations would be final and not subject to judicial review.

Enforcement Enhancements – Aiding and Abetting Authority and Investment Adviser Bars

Current law grants the SEC authority to pursue aiding and abetting claims under only the Exchange Act. The Proposed IPA would extend its authority to such claims under the Securities Act of 1933, the Advisers Act and the Investment Company Act. It should be noted that the proposed legislation would not give individuals the right to pursue aiding and abetting claims.[5]

In addition, consistent with the goal of establishing consistent standards, the legislation would extend the bar from being affiliated with broker-dealers to investment advisers who have been suspended or barred for securities law violations.

Enhanced Community Involvement

The SEC currently has an Investment Advisory Committee. The Proposed IPA would make such Committee permanent and establish membership, procedural and payment guidelines. As indicated by its title, the Committee would advise the SEC on "regulatory priorities and issues regarding new products, trading strategies, fees structures and the effectiveness of disclsosures," but would have no ability to bind the SEC.

[4] "Although arbitration may be a reasonable option for many consumers to accept after a dispute arises, mandating a particular venue and up-front method of adjudicating disputes – and eliminating access to courts – may unjustifiably undermine investor interests." The White Paper, *supra*, note 2 at 72.

[5] The U.S. Supreme Court determined in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), that private parties may not pursue claims of aiding and abetting of federal securities fraud in civil actions.

The legislation also is intended to clarify that the SEC can engage in consumer communications and testing, including engaging in temporary and experimental programs, for the purposes of evaluating its rules and programs and for "considering, proposing, adopting, or engaging in rules and programs."

Conclusion

The White Paper set forth an ambitious program that is intended to protect investors. Treasury has begun to issue actual draft legislation to implement the White Paper's recommendations, including the Consumer Financial Protection Agency Act and, now, the Proposed IPA. Many of the provisions of the Proposed IPA, if adopted, would result in significant changes in the practices and procedures routinely followed by broker-dealers and, as a result, require that financial institutions undertake a careful review of all of their internal procedures, documentation, standard agreements and business practices. Of course, it is not possible to predict which provisions of the Proposed IPA will undergo revision. Further, many of the provisions would require SEC implementation, and their ultimate form and impact, are currently unknowable.

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