Investment Advisers

Investor Protection Act of 2009

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On July 10, 2009, the Obama Administration proposed the Investor Protection Act of 2009 (Investor Protection Act).[1] The Investor Protection Act proposes to amend portions of all four main securities acts: the Securities Act of 1933 (Securities Act), the Securities Exchange Act of 1934 (Exchange Act), the Investment Company Act of 1940 (Investment Company Act), and the Investment Advisers Act of 1940 (Advisers Act).

Functioning almost as a grab-bag of items, the Investor Protection Act is an omnibus piece of legislation cobbling together 11 not-necessarily-related improvements to the securities laws. For the most part, it focuses on investment advisers and broker-dealers, rather than public companies or mutual funds. Some provisions are more controversial than others. We discuss each of the proposed amendments in more detail in this article, but in summary they:

- *Enhance investment adviser and broker-dealer fiduciary duties* — harmonize and expand fiduciary duties for broker-dealers and investment advisers;

- *Enhance investment adviser and broker-dealer disclosure* — give the Securities and Exchange Commission (SEC) authority to require disclosure by investment advisers and broker-dealers regarding the terms of investors' relationships with investment professionals;

- *Enhance registered investment company disclosure* — give the SEC authority to require point of sale disclosure by registered investment companies;

- *Further limit conflicts of interest* — permit the SEC by rule to expand current prohibitions on investment adviser and broker-dealer conflicts of interest;

- *Prohibit abusive sales practices and regulate financial intermediaries* — allow the SEC to promulgate rules prohibiting abusive sales practices and compensation of financial intermediaries where such practices are contrary to the public interest and the interests of investors;

- *Create "aiding and abetting" liability* — impose aiding and abetting liability for "knowingly or recklessly provid[ing] substantial assistance" to securities law violators;

- *Create a new Investor Advisory Committee* — establish an Investor Advisory Committee, which would consult with the SEC and would represent investors;

- *Expand whistleblowing protections* — enhance whistleblowing incentives and protection;

- *Establish consumer testing* — grant the SEC authority to engage in consumer testing;

- *Regulate arbitration clauses* — grant the SEC authority to prohibit or otherwise limit arbitration clauses; and

- *Expand collateral bars* — provide for collateral bars in the event persons associated with investment advisers, broker-dealers, municipal securities dealers or transfer agents engage in certain bad acts, which collateral bars would, for example, prohibit barred persons associated with broker-dealers from becoming associated with investment advisers.

Fiduciary Duties

The Investor Protection Act proposes to amend the Exchange Act and the Advisers Act so as to harmonize the fiduciary duties of investment advisers and broker-dealers. The SEC would be authorized to promulgate rules on the standard of conduct applicable to brokers, dealers and investment advisers providing investment advice about securities to retail customers or clients (and such other customers or clients as the SEC may by rule provide). Such rules would, in substance, require such brokers, dealers and investment advisers to act solely in the interest of customers or clients without regard to the financial or other interests of the broker, dealer or investment adviser providing advice.[2]

Investment Advisers

It is unclear whether the Investor Protection Act would expand investment adviser fiduciary duties. Although the Advisers Act never explicitly refers to fiduciary duties, the Supreme Court has stated that investment advisers are fiduciaries with "an affirmative duty of 'utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' … clients."[3] The SEC staff have taken the position that an investment adviser's fiduciary duty may entail five major responsibilities: (1) to put clients' interests first; (2) to act with utmost good faith; (3) to provide full and fair disclosure of all material facts; (4) not to mislead clients; and (5) to disclose all conflicts of interest to clients.[4] In addition, Section 206 of the Advisers Act is widely understood as imposing a fiduciary duty on investment advisers through its broad antifraud language. Nonetheless, many investment advisers currently are not aware of their fiduciary duties or attempt to disclaim fiduciary duties through exculpation provisions in fund documents, through adequate and appropriate disclosure of such exculpations, and through investor or, alternatively, advisory board approval. If the SEC plans to promulgate future rules regarding fiduciary duties, the SEC will need to address the ability of investment advisers to disclaim fiduciary duties in such circumstances.

Broker-Dealers

The Investor Protection Act clearly proposes to expand a broker-dealer's duty to ascertain suitability under NASD Rule 2310 and the Exchange Act. The concept of suitability appears in self-regulatory organization rules such as NASD Rule 2310. Suitability has also been interpreted as an obligation under the antifraud provisions of the Exchange Act. Under current suitability requirements, a broker-dealer must have an adequate and reasonable basis for any recommendation that such broker-dealer makes. NASD Rule 2310 requires that "[i]n recommending to a customer, the purchase, sale or exchange of any security, a member firm shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." In general, NASD Rule 2310 further obligates member firms making recommendations to a non-institutional customer to obtain information concerning (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member firm in making recommendations to such customer. There is no current requirement that a broker-dealer act in the best interest of a client or customer.

The provisions of the Investor Protection Act that expand aiding and abetting liability could make investment advisers and fund sponsors liable for unsuitable broker-dealer recommendations if such investment advisers and fund sponsors recklessly provide substantial assistance. Investment advisers who use broker-dealers to solicit clients or investors would be well advised to undertake an appropriate due diligence program to ensure that the broker-dealers have not engaged in unsuitable recommendations. Counsel should be consulted regarding the implementation of such a program.

If the SEC were to promulgate rules regarding a broker-dealer's obligation to act in the best interest of clients, the SEC would need to specify what information gathering requirements should apply to broker-dealers when they deal with different types of investors. Currently, NASD Rule 2310 provides relief on information gathering requirements with respect to non-institutional investors.

Disclosure Requirements

The Investor Protection Act contemplates giving the SEC authority under the Exchange Act and the Advisers Act to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals.[5] It is unclear what kind of disclosure is contemplated. Most likely, SEC rules under the Investor Protection Act would require disclosure regarding the investors' relationships with investment advisers and broker-dealers.

Registered Investment Company Disclosure

The Investor Protection Act contemplates allowing 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] The SEC has been considering point of sale disclosure by mutual funds since 2004.[7] Any such point of sale disclosure rules could affect funds that are currently exempt to the extent such exempt funds may, in the future, be required to register under the proposed Private Fund Investment Advisers Registration Act of 2009 or the proposed Hedge Fund Transparency Act.

Conflicts of Interest

The Investor Protection Act proposes giving the SEC authority under the Exchange Act and the Advisers Act to examine and, where appropriate, promulgate rules prohibiting investment adviser and broker-dealer conflicts of interest that it deems contrary to the public interest and the interests of investors.[8] Currently, Section 206 of the Advisers Act, which applies only to investment advisers, requires disclosure and investor or advisory board approval of conflicts of interest. Absent disclosure, a broker-dealer currently violates his duty to a client when there is a conflict of interest.[9]

The Investor Protection Act could allow the SEC to promulgate rules that entirely prohibit certain conflicts of interest, even with disclosure and/or investor or advisory board approval. If the SEC were to promulgate such rules, it should consider whether to allow fund sponsors and broker-dealers to engage in conflicts of interest where there has been disclosure and investor approval by very large investors that have the expertise, wealth and sophistication to properly evaluate and approve such conflicts of interest. However, such approval may be insufficient with respect to improper pay to play schemes that may benefit investors, but which are not in the public interest, such as what happened in the recent Carlyle scandal (discussed below).

Abusive Sales Practices and Compensation of Financial Intermediaries

The Investor Protection Act contemplates giving the SEC authority under the Exchange Act and the Advisers Act to examine and, where appropriate, promulgate rules prohibiting sales practices 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.[10] Currently, abusive practices by investment advisers and broker-dealers can be dealt with under Section 206 of the Advisers Act and Rule 10b-5 under the Exchange Act.

The Investor Protection Act would give the SEC the authority to promulgate rules to clarify which sales practices are abusive. Currently, abusive practices are subsumed under broad, antifraud remedial provisions that do not necessarily provide guidance. Case law in respect of the foregoing provides some guidance, but may not be illustrative of new issues. In addition, presently, many abusive practices can potentially be cured through disclosure and investor or advisory board approval. The Investor Protection Act could allow the SEC to promulgate rules that prohibit certain abusive practices, despite disclosure and investor or advisory board approval. The SEC should consider whether any type of investor carve-out is appropriate, such as for large institutional investors with the wealth and sophistication to evaluate and approve disclosed sales practices, at least where the harm of the abusive practice is on the investor side.

Recently, the compensation of financial intermediaries has been a subject of considerable debate. For example, Carlyle recently agreed to sign on to New York's Public Pension Fund Reform Code of Conduct when Carlyle was accused of improperly paying placement agents that had insider relationships with public pension plans. Such "improper" relationships would not necessarily give rise to a conflict of interest from the perspective of investors and therefore, may not be illegal under the Advisers Act or broker-dealer law. The Investor Protection Act could now give the SEC the authority to promulgate rules prohibiting such practices by investment advisers and broker-dealers on the basis that they are contrary to the public interest, even though they may actually benefit certain investors.

It is unclear to what extent the SEC would use such authority to prohibit other types of placement agent and introductory services arrangements, notwithstanding Rule 206(4)-3 under the Advisers Act. For example, the SEC could take the position that the Investor Protection Act empowers the SEC to prohibit all placement agent and introductory services arrangements, even when non-public plans are involved, since such arrangements may involve pay to play schemes. However, extending the rule too broadly could significantly impair the private capital markets as placement agent and introductory services arrangements are often necessary tools in the capital raising process, and pre-existing business relationships can be used to stay within Securities Act Rule 506 private placement limitations. We note that the current SEC proposed rule regarding placement agents would only limit pay to play schemes and the use of placement agents with respect to public plans.[11] Since granting the SEC power to regulate financial intermediaries would have a significant impact on current legal activities within the capital markets, we think that Congress should address the question squarely in proposed legislation, rather than through an empowering clause in an omnibus act where its consequences might be over-looked. For example, proposed Advisers Act Rule 206(4)-5 is a single purpose rule that would prohibit financial intermediaries when public plans or other governmental entities are involved. This can be discussed — and passed or not passed — on its merits.

Aiding and Abetting Liability

The Investor Protection Act proposes to amend the Securities Act, the Investment Company Act and the Advisers Act to add liability for aiding and abetting violators, which would expand secondary liability beyond control persons.[12] Control persons under the Securities Act currently include persons who, by or through an agreement or understanding with one or more parties or by or through stock ownership, agency, or otherwise, controls a person liable under Sections 11 or 12 of the Securities Act. Control person liability is read into the Advisers Act and the Investment Company Act through Section 48 of the Investment Company Act and Section 208 of the Advisers Act, each of which prohibit doing illegal acts indirectly through affiliates.

The Investor Protection Act contemplates expanding secondary liability to cover situations where a person knowingly or recklessly provides substantial assistance to another person in violation of the applicable act or rule. Aiding and abetting liability would make the person liable to the same extent as the primary violator.

Thus, under either the Securities Act, the Investment Company Act or the Advisers Act, a fund sponsor or other issuer (as the case may be) could be liable where they recklessly provide assistance to sellers of their securities, regardless of whether they are control persons. In addition, other persons providing substantial assistance in the violations could be liable, such as lawyers and accountants. Due to the fact that liability can be established by recklessness, fund sponsors, issuers, lawyers, accountants and other persons that could be involved in securities violations would be well advised to adopt due diligence plans in respect of the foregoing, since due diligence in other securities law contexts is often a defense against reckless conduct. Counsel should be consulted regarding implementation of such due diligence plans.

Investor Advisory Committee

The Investor Protection Act proposes to add a new Section 38 to the Exchange Act. Section 38 would create an Investor Advisory Committee, which would advise and consult the SEC on several matters, including regulation, investor protection and the integrity of the market place.[13] The Investor Advisory Committee would be appointed by the Chairman of the SEC, and would represent the interests of individual investors and institutional investors. One concern of having an Investor Advisory Committee is that it could provide advice and counsel to the SEC that is too one-sided. The SEC, as an independent governmental agency, even if charged with protecting investors, may be in a better position to balance investor protection with the needs of issuers and fund sponsors.

Whistleblowing

The Investor Protection Act contemplates amending the Exchange Act to incentivize and protect whistleblowing.[14] The Investor Protection Act would authorize the SEC to pay whistleblowers an award up to 30 percent of monetary sanctions imposed in any judicial or administrative action brought by the SEC under the securities laws. Certain persons are ineligible for such whistleblowing incentives.

The Investor Protection Act would also entitle employees who are discharged or discriminated against due to lawful SEC whistleblowing, to all relief necessary to make the employees whole. Such whistleblowing actions would be subject to a statute of limitations. An action could not be brought more than six years after the date on which the violation reported is committed, or more than three years after the date when facts material to the right of action are known or reasonably should have been known by the whistleblower, but in no event later than 10 years after the date on which the violation is committed. Information provided by whistleblowers would be treated as confidential unless required to be disclosed to a defendant or respondent in connection with a public proceeding instituted by the SEC and certain other governmental agencies and self-regulatory organizations.

The SEC would have rulemaking authority in respect of whistleblowing incentives and protections, and would be required to issue final regulations implementing the provisions of proposed Section 21F of the Exchange Act no later than 270 days after the date of enactment of the Investor Protection Act.[15]

Authority of the SEC to Engage in Consumer Testing

For purposes of considering or evaluating the SEC's rules and programs, the SEC would be authorized to gather information, communicate with investors or other members of the public and engage in such temporary or experimental programs as it determines is in the public interest or for the protection of investors.[16] This change would apply to all four main bodies of federal securities laws. It is unclear how consumer testing authority would interact with the Paperwork Reduction Act, which places limitations on a federal agency's ability to gather public information.

In addition, it is possible that the SEC could use consumer testing to investigate without probable cause, at least with respect to the Advisers Act and the Securities Act. Currently, Section 209(a) of the Advisers Act and Section 20(a) of the Securities Act give the SEC authority to investigate only when it appears that federal securities laws are being violated.[17] Under the Investor Protection Act, the SEC could potentially investigate by "gather[ing information" if the SEC determines that it is in the public interest to do so. Thus, consumer testing could expand the SEC's authority to investigate under the Advisers Act and the Securities Act.

Arbitration Clauses

The Investor Protection Act proposes to amend the Exchange Act and the Advisers Act to provide that the SEC, by rule, may prohibit, or impose limitations on the use of agreements that require customers or clients of any broker-dealer to arbitrate disputes arising under the federal securities laws or the rules of a self-regulatory organization if such prohibition or limitations are in the public interest and for the protection of investors.[18]

Currently, arbitration clauses may violate Section 206 of the Advisers Act, particularly if they do not prominently disclose that rights under the Advisers Act and federal securities laws are non-waivable.[19] Under the Exchange Act, we note that the SEC has implied (in the context of an arbitration clause) that a "hedge clause" may be acceptable in an agreement so long as such clause also clearly discloses that investors are not precluded from recourse under the law.[20] However, certain exchanges impose other limitations on the use of arbitration clauses by broker-dealers.[21] Nonetheless, the Investor Protection Act would allow the SEC to promulgate rules that more clearly define the limitations on arbitration clauses.

Collateral Bars

The Exchange Act and the Advisers Act currently bar certain persons from associating, or seeking to become associated, with broker-dealers, investment advisers, municipal securities dealers and transfers agents if the SEC determines that such persons have committed certain bad acts.[22] For example, persons associated with broker-dealers can presently be banned from associating with broker-dealers, but not transfer agents, investment advisers or municipal securities dealers. The Investor Protection Act would provide for collateral bars where persons barred from being associated with broker-dealers would also be barred from being associated with investment advisers, municipal securities dealers, transfer agents or nationally recognized statistical rating organizations.[23]

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[1] The proposed amendments embodied in the Investor Protection Act are only some of the proposed legislation that has been introduced or published this year. For a discussion of some of the other proposals, please see our article entitled "Open Issues in the Hedge Fund Transparency Act" in Bloomberg Law Reports®—Securities Law (Mar. 23, 2009) and "Private Fund Investment Registration Act of 2009" in Bloomberg Law Reports®—Securities Law (Aug. 17, 2009).
[2] Investor Protection Act Section 913.
[3] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).
[4] Lori A. Richards, Speech by SEC Staff: *Fiduciary Duty: Return to First Principles* (Feb. 27, 2006).
[5] Investor Protection Act Section 913.
[6] Investor Protection Act Section 914.
[7] *See* SEC Release No. IC-26341 (Jan. 29, 2004).
[8] *Id.*
[9] In the Matter of Arleen W. Hughes, SEC Release No. 34-4048 (Feb. 20, 1948), *aff'd*, 174 F.2d 969 (D.C. Cir. 1949) (cited by In the Matter of G. Bradley Taylor, Administrative Proceeding File No. 3-9955 (Sep. 24, 2002)).
[10] Investor Protection Act Section 913.
[11] SEC Release No. IA-2910 (Aug. 3, 2009).
[12] Investor Protection Act Sections 926 and 927.
[13] Investor Protection Act Section 911.
[14] Investor Protection Act Section 922.
[15] Investor Protection Act Section 924.
[16] Investor Protection Act Section 912.
[17] *See* Advisers Act Section 209(a); Securities Act Section 20(a).
[18] Investor Protection Act Section 921.
[19] SEC No-Action Letter to McEldowney Financial Services (Oct. 17, 1986).
[20] *See* SEC Release No. 34-19813 (May 26, 1983).
[21] *See, e.g.*, SEC Release No. 34-27187 (Aug. 25, 1989).
[22] Exchange Act Sections 15(b)(6)(A), 15B(c)(4), and 17A(c)(4)(C); Advisers Act Section 203(f).
[23] Investor Protection Act Section 925.