Morgan Lewis
COUNSELORS AT LAW

Preparing for Regulatory Change in Private Client Services

Steven W. Stone
Morgan, Lewis & Bockius, LLP

SIFMA Private Client Conference
April 22-23, 2010
Grand Hyatt New York City

Morgan Lewis
COUNSELORS AT LAW

Preparing for Regulatory Change in Private Client Services

By Steven W. Stone*
Morgan, Lewis & Bockius LLP

I. Introduction

A. 2010 is shaping up to be a watershed year when it comes to regulatory changes affecting private client services, as Congress gears up to pass major financial reform legislation and the SEC, FINRA and the DOL pursue separate regulatory reform programs and step up their respective examination and enforcement efforts affecting private client services.

B. Although the broader agenda in many ways reflects the play book issued by the Obama Administration last summer in the Treasury's white paper on financial regulatory reform,[1] there has been a considerable evolution in many of the issues. Even while Congress deliberates over financial reform legislation, the SEC, FINRA and the DOL have each taken up a variety of the issues in advance of any legislative enactment.

C. The fundamental agenda for reshaping how broker-dealers are regulated when providing investment advice – a critical subject for private client services – advances as the U.S. Senate deliberates on a legislative proposal sponsored by Senator Christopher Dodd and approved by the Senate Banking Committee last month.

---

* Steven W. Stone is a partner in the Washington, DC office of Morgan, Lewis & Bockius LLP.

1 U.S. Department of the Treasury, Financial Regulatory Reform: A New Foundation, http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (2009).

On March 22, 2010, the Senate Banking Committee passed *The Restoring American Financial Stability Act of 2010* (RAFSA),[2] which, if passed by the Senate (presumably with changes debated on the floor), will be considered by Congressional conferees together with *The Wall Street Reform and Consumer Protection Act*, H.R. 4173 (WSRA). WSRA, sponsored by Representative Barney Frank, passed the U.S. House of Representatives on December 11, 2009 by a 223-202 vote.

1. RAFSA and WSRA build on the Obama Administration's proposals from last summer to establish consistent standards for all financial professionals who provide investment advice, improve disclosures, and, as stated by the Treasury last summer, require accountability from securities professionals. The two legislative proposals take different approaches – with the House seeking to establish a standard of care for broker-dealers providing investment advice and the Senate taking a study approach – as summarized in the "At a Glance" chart below and discussed in detail below.

2. Enactment of either proposal will prompt SEC action to reassess the obligations of broker-dealers giving recommendations, research and other investment advice, possibly by subjecting them to a standard of conduct comparable to that required of investment advisers. Either proposal, if enacted, will also prompt the SEC to further scrutinize broker-dealer sales practices, conflicts of interest, and compensation arrangements involving both retail and potentially institutional clients. In the retail context, this will intensify focus on mutual fund sales practices and related compensation arrangements (12b-1 fees, loads, and revenue-sharing and shelf-space payments) – already topics on the SEC's and FINRA's agenda.

3. All told, if the regulatory reforms envisioned by these proposals advance, this will require that firms closely review and revise offered products and services – including those involving investment advice and related conflicts, disclosures and compensation arrangements; make any needed changes to those products and services, related arrangements and client-facing documentation; and revamp related supervisory and back office systems.

[2] See http://banking.senate.gov/public/_files/TheRestoringAmericanFinancialStabilityActof2010AYO10732_xml0.pdf.

At a Glance Key Differences

Provision	House Bill	Senate Bill
1. Proposes Express Standard of Conduct	Yes	No, requires a broad-based study by the SEC of personalized investment advice provided by broker-dealers and investment advisers to retail customers about securities
a. Proposes Best Interest Standard (vs. Sole Interest Standard in Treasury Proposal)	Best Interest	
b. Incorporation of Advisers Act Obligations	Yes, but limited to anti-fraud concepts	
c. Focus on "personalized investment advice"	Yes	Yes
d. Focus on "retail customers"	Yes, but SEC can expand scope	Yes
e. Recognition of Disclosure to Manage Conflicts	Yes, impliedly	Not addressed
f. Clarification that Receipt of Commissions Does Not Violate Standard	Yes	Not addressed
g. Coverage of Principal Trading Issues	Not specifically, but provision mandating that SEC rules not be "less stringent" than Advisers Act antifraud provisions (Section 206(1)&(2)), leaves SEC with flexibility to provide such relief under Section 206(3) (governing principal trades)	Not addressed
h. Relation to State Law	Not addressed	Study to address state regulation
2. Mandates SEC Action to Facilitate Clear Disclosures to Investors About Brokerage and Advisory Relationships	Yes	Yes, but SEC is authorized but not mandated
3. Mandates SEC Action to Examine and, as Appropriate, Prohibit Sales Practices, Conflicts and Compensation Schemes	Yes	Not addressed
4. Restriction on Independent Custody	Yes, would require independent custodians $10M+ accounts	Mandates that investment advisers safeguard client assets in accordance with SEC rules
5. SEC Mandate to Restrict Arbitration	Yes	No, SEC authorized to restrict or re-affirm

II. House Bill – The Wall Street Reform and Consumer Protection Act (WSRA)

A. **Overview.** As mentioned, WSRA was approved by the House on December 11 by a narrow 223-202 vote. WSRA does five things in particular as relevant to broker-dealers offering investment advice.

1. First, it directs the SEC to mandate fiduciary based standards of conduct for broker-dealers and investment advisers when providing personalized investment advice to "retail" investors.

2. Second, it mandates that the SEC facilitate clear disclosures to investors about brokerage and advisory relationships and authorizes the SEC to require point of sale disclosure for mutual funds.

3. Third, it mandates the SEC to examine and, as appropriate, prohibit sales practices, conflicts and compensation schemes for broker-dealers and investment advisers that the SEC views as contrary to the public interest.

4. Fourth, it mandates the SEC to limit the ability of broker-dealers and investment advisers to require arbitration of customer disputes.

5. Fifth, it would, in effect, require an independent custodian for advised accounts of $10 million or more.

Each is discussed in turn below.

B. **Standard of Conduct.** WSRA directs the SEC to establish both rules under the Investment Advisers Act of 1940 ("Advisers Act") articulating the standard of conduct for investment advisers and rules under the Securities Exchange Act of 1934 ("Exchange Act") specifying that, in effect, the standard of conduct for broker-dealers is the same as for investment advisers under the Advisers Act. Specifically, WSRA directs the SEC to promulgate rules under the Advisers Act "to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice to retail customers (and such other customers as the Commission may by rule provide), shall be 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." WSRA, in turn, directs the SEC to promulgate rules under the Securities Exchange Act "to provide that, with respect to a broker or dealer, when providing personalized investment advice to a retail customer (and such other customers as the Commission may by rule provide), the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser under the Investment Advisers Act of 1940." So drafted, the provision is limited in several key respects.

1. First, the provision is limited to "personalized investment advice" to "retail customers."

2. Second, the standard is a "best interest" standard – requiring that a broker-dealer act in the client's "best interest" when giving investment advice – not the "sole interest" standard that was in the Administration's draft legislation and is comparable to the strict "exclusive benefit" rule under the Employee Retirement Income Security Act of 1974 ("ERISA").

3. Third, the provision tacitly recognizes that a broker-dealer may have a conflict of interest, but requires that any advice be made "without regard" to any conflicting interest.

4. WSRA goes on to recognize three key principles.

   a. **New Standards Must Build on Existing Antifraud Concepts under the Advisers Act**. WSRA mandates that any standard of conduct set by the SEC must be "no less stringent than the standard applicable to" advisers under the antifraud provisions of the Advisers Act, Section 206(1) and (2). This provision was added in response to lobbying by advisers and consumer groups based on concerns that Congress would "water down" the standard for broker-dealers. (Earlier drafts of the provision would have mandated that the standard established by the SEC be "at least as high" as the "current standard applicable to investment advisers," which was troublesome given that it might have picked up *all* the regulatory requirements to which advisers are subject and might have limited the SEC's latitude in tailoring any standard for broker-dealers given the various and differing roles broker-dealers play.)

   b. **Recognition of Disclosure as a Way to Manage Conflicts**. WSRA tacitly recognizes disclosure as a way to manage conflicts, although this is done through the codification of an *affirmative obligation* of disclosure and customer consent. The provision states that "[i]n accordance with such rules [as the SEC shall promulgate], any material conflicts of interest shall be disclosed and may be consented to by the customer." The provision is helpful in that it is limited to "material" conflicts, but its reference to customer consent (while fortunately free of any reference to consent being in advance or in writing) will have to be narrowed in application.

   c. **Receipt of Commissions Does Not Violate Standard**. As applicable to broker-dealers, WSRA recognizes that "[t]he receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of such standard applied to a broker or dealer." However helpful the provision is, the key concept of "commission or other standard compensation" is unclear.

C. **Relationship Disclosure** – WSRA tracks the Treasury's draft legislation[3] and would require that the SEC "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest." This provision is not limited to retail investors. Any required disclosure would presumably be a consolidated disclosure brochure for both broker-dealers and advisers or, in the case of a broker-dealer, a brochure similar to the Form ADV Part II brochure for investment advisers (*i.e.*, a "Form BD, Part II" brochure). Just as with Form

[3] Treasury, Investor Protection Act of 2009, http://www.treas.gov/press/releases/docs/tg205071009.pdf (July 10, 2009).

ADV, any SEC-mandated or approved form for disclosure to investors may provide a positive shield for firms that provide disclosure to investors in accordance with the form's requirements (*i.e.*, if a firm discloses information on a matter in accordance with the criteria promulgated by the SEC, it is harder for the SEC and investors to argue that the firm's disclosure was lacking).

D. **Sales Practices and Conflicts** – WSRA would require that the SEC "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that it deems contrary to the public interest and the protection of investors." This provision is not limited to retail investors. It is unclear where this is heading and what the specific focal points of the proposed legislation are aside from the general subjects identified. One likely focus is sales practices and related compensation schemes involving mutual funds now regulated principally by FINRA, including mutual fund 12b-1 fees, sales loads, revenue sharing arrangements with mutual funds and their affiliates, and differential compensation to investment professionals based on firm revenue from mutual funds. Other possible areas of focus may include Inter-firm payments, rebates and credits, "pay to play" in the state or municipal pension plan context, and compensation arrangements involving retirement accounts and their service providers.

E. **Authority to Restrict Mandatory Pre-Dispute Arbitration** – WSRA proposes to amend the Exchange and Advisers Acts to mandate that the SEC initiate rulemaking to prohibit or restrict pre-dispute arbitration agreements with clients of broker-dealers and investment advisers.

F. **Independent Custodian Requirement** – Notably, Illinois Representative Bill Foster submitted an amendment, which was accepted subject to modification to address securities industry concerns, that would, in effect, mandate the use of independent custodians for advised accounts over $10 million.

III. Restoring American Financial Stability Act of 2010 (RAFSA)

A. **Overview** – RAFSA takes the far less radical and more deliberative approach of charging the SEC with studying how broker-dealers should be regulated when providing investment advice.[4]

B. **SEC Study** – RAFSA requires that the SEC conduct a study of the effectiveness of existing standards of care for broker-dealers, investment advisers and their associated persons when providing personalized investment advice and recommen-

[4] Earlier drafts of RAFSA would have repealed the provision of the Advisers Act that excepts broker-dealers from the definition of "investment adviser." This provision excepts broker-dealers when providing investment advice that is incidental to the brokerage business and for which they receive no "special compensation." While this change has the effect of making broker-dealers subject to the same fiduciary duty of investment advisers under the Advisers Act – because they would be deemed investment advisers – it creates many problems not contemplated by the drafters.

dations about securities to retail customers. The topics to be addressed include, among others:

1. The regulatory, examination, and enforcement resources devoted to, and activities of, the Commission and FINRA to enforce these standards of care, including the frequency and length of time of examinations;

2. Substantive differences, "compared and contrasted in detail," in the regulation of brokers, dealers, and investment advisers, when providing personalized investment advice and recommendations;

3. Specific instances in which the regulation and oversight of broker-dealers provide greater protection relative to investment advisers and vice versa;

4. Potential impact on retail customers (including on access to a range of products and services) of imposing upon broker-dealers the standard of care applied under the Advisers Act and other requirements under that Act;

5. Potential impact of authorizing the SEC to designate one or more self-regulatory organizations to augment the efforts of the Commission to oversee investment advisers;

6. Potential impact of eliminating the broker-dealer exclusion from the definition of ''investment adviser'' under Section 202(a)(11)(C) of the Advisers Act;

7. Ability of investors to understand the differences in terms of regulatory oversight and examinations between brokers-dealers and investment advisers; and

8. Varying level of services provided by broker-dealers and investment advisers and the varying scope and terms of retail customer relationships.

The SEC would be required to seek and consider public input, comments and data. If the SEC concludes that gaps or overlaps exist, the SEC would be required to commence rulemaking to promulgate rules under its existing statutory authority within two years of the enactment of the bill.

C. **New Disclosure Requirements** – RAFSA would amend the Exchange Act to provide that the SEC may issue rules designating documents or information that shall be provided by a broker-dealer to a retail investor before the purchase of an investment product or service by the retail investor. Such documents or information are to be in "summary format" and include "clear and concise" information about investment objectives, strategies, costs, and risks, and any compensation or financial incentive received by a broker-dealer or other intermediary in connection with the purchase of retail investment products.

D. **Authority to Restrict or Reaffirm Mandatory Pre-Dispute Arbitration** – RAFSA proposes to amend the Exchange and Advisers Acts to provide that the SEC may conduct a rulemaking to reaffirm or prohibit, or impose or not impose conditions or limitations on the use of agreements that require customers or clients of any broker-dealer or investment adviser to arbitrate any dispute between them that arises under the securities laws or the rules of a self-regulatory organization.

E. **Independent Custodian Requirement** – RAFSA would amend the Advisers Act to require that registered investment advisers take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the SEC may prescribe by rule.

F. **Other Studies**. The Manager's Amendments to RAFSA added a handful of new studies, including:

1. **GAO Study on Conflicts of Interest**. RAFSA requires the GAO to conduct a study within 18 months after the enactment of the Act regarding the potential conflicts of interest between securities underwriting and securities analyst functions within the same firms.

2. **SEC Study on Investor Access to Information About Advisers and Broker-Dealers**. RAFSA requires the SEC to conduct a study within 6 months after the date of enactment of the Act regarding ways to improve access of investors to registration information (including disciplinary actions, regulatory, judicial, and arbitration proceedings, and other information) about investment advisers, broker-dealers and their associated persons, and requires the SEC to implement any recommendations of the study. The SEC would be required to take action to address any study recommendations within 18 months of the issuance of the study.

3. **GAO Study on Financial Planners and Financial Planning Designations**. RAFSA requires the GAO to conduct a study within 180 days after the enactment of the Act to evaluate the effectiveness of state and federal regulations to protect consumers from misleading financial advisor designations, oversight structure and regulations for financial planners and gaps in the regulation of financial planners.

IV. **Current Regulatory Initiatives Affecting Private Client Services** – As noted at the outset, the SEC, FINRA and the DOL are each pursuing separate regulatory reform programs and stepping up their respective examination and enforcement efforts affecting private client services.

A. **Reconsideration of Rule 12b-1 (SEC)** – The SEC staff has stated that the SEC will propose substantial changes to Rule 12b-1 governing the use of mutual fund assets to finance distribution expenses. The SEC staff has been concerned that the

rule has led to complicated fee structures that have made it harder for investors to evaluate overall mutual fund costs. Specifically, the SEC staff has suggested that, although 12b-1 fees have evolved as a substitute for sales loads, they are not treated or disclosed in the same way as sales loads. Although the contours of the SEC's intended proposals remain unclear, SEC staff comments suggest the SEC will propose that 12b-l fees used as a substitute for front end sales charges be treated and disclosed on trade confirmations as "asset based sales charges."

B. **Point of Sale Disclosure (SEC & FINRA)** – SEC Chairman Mary Schapiro has publicly stated that the SEC will focus on point of sale issues for retail investors.[5] FINRA has a pending (and controversial) rule proposal from last summer to require point of sale disclosure concerning compensation received by broker-dealers distributing mutual funds.

C. **Pay to Play Restrictions (SEC)** – Last summer the SEC proposed – and has now signaled it will proceed to adopt – new Rule 206(4)-5 under the Advisers Act aimed at curtailing "pay to play" practices by investment advisers that seek to manage assets of state and local governments. The proposed rule would substantially restrict contribution and solicitation practices of investment advisers and certain of their related persons, restrict the use of placement agents for private funds (although FINRA may step in to regulate this in lieu of the SEC), and poses possibly draconian consequences for slip-ups. If adopted, the proposed rule will significantly affect investment advisers' compliance policies and procedures as well as recordkeeping requirements.

D. **Custody by Investment Advisers (SEC)** – The SEC recently adopted substantial amendments to its custody rule under the Advisers Act, which went into effect March 12, 2010. The amendments, which have generated considerable interpretive questions, restrict advisers from having omnibus accounts to hold or acting as trustee for client funds or securities unless they are qualified custodians (with limited exceptions), deem advisers to have custody of client funds and securities held by related person qualified custodians (with limited exceptions), and impose new surprise examination and internal control review requirements on advisers and related person qualified custodians.

E. **Form ADV, Part 2 (SEC)** – The SEC had proposed several years ago – and the SEC staff has signaled that it hopes to adopt – amendments to Form ADV Part 2, possibly including a proposed brochure supplement to disclose the background (including disciplinary information) and experience of each investment professional giving investment advice to clients.

F. **Current Initiatives Affecting Retirement Accounts** – We are also seeing an increased interest by the federal government in retirement plans and the regulation of persons who are fiduciaries and service providers to retirement plans, which

---

[5] *See* SEC Chairman Mary L. Schapiro, "Looking Ahead and Moving Forward," Speech at the SEC Speaks Conference (February 5, 2010), http://www.sec.gov/news/speech/2010/spch020510mls.htm.

could affect broker-dealers, investment advisers and mutual fund companies. This interest is reflected in several government initiatives.

1. **Fee Disclosures by Fiduciaries** – As part of a larger disclosure project, the DOL is working on finalizing a regulation that would require more detailed disclosure to plan sponsors by plan fiduciaries and service providers of the fees and other compensation they receive in connection with providing services to plans. (DOL previously adopted requirements for detailed service provider fee disclosure in the annual reports filed by plans with the government, which became effective for reports required to be filed in 2010.) Congress has been considering legislation that would impose similar disclosure requirements, which has been reported out of one House committee and is pending in another committee.

2. **Participant Advice** – DOL also recently proposed rules that would implement a prohibited transaction exemption for the provision of investment advice to participants in participant-directed plans (a matter that is also the subject of pending legislation).

3. **Definition of "Fiduciary**" – In addition, the DOL staff has indicated that it is considering revisions to a regulation on the definition of an ERISA fiduciary that would likely expand the scope of what constitutes "investment advice" that makes a person an ERISA fiduciary, possibly to include pension consultants. Action on all of these regulatory projects is expected in 2010.