



## The Wall Street Reform and Consumer Protection Act of 2009: Impact on Broker-Dealers and Investment Advisers

On December 11th, the House of Representatives narrowly passed “The Wall Street Reform and Consumer Protection Act of 2009” (the “Bill”). The Bill provides a comprehensive plan for financial regulatory reform, protection of consumers and investors, enhanced Federal understanding of insurance issues, regulation of the over-the-counter (“OTC”) derivatives markets, and numerous related matters. While the Bill represents the House’s view of how to regulate the financial markets, it must be resolved with whatever legislation finally is passed by the Senate, which currently is in the process of producing its own bill.

Nevertheless, the Bill provides a good indicator of the direction that Congress is likely to take in regulating the financial markets and providers of financial services. It covers a diverse array of such providers and services, dealing with matters such as prudential regulation of companies and activities for financial stability purposes; supervision and regulation of bank holding companies and depository institutions; improvements to the Federal deposit insurance fund, the asset-backed securitization process, and financial crisis management; regulation of OTC derivative products and markets; establishment of a Consumer Financial Protection Agency; registration of private fund investment advisers; regulation of rating agencies; and the establishment of a Federal Insurance Office to study and report on modernizing and improving insurance regulation in the United States. The Bill also calls for creation of a Financial Services Oversight Council, with voting members that include the Secretary of the Treasury (as Chairman) and the heads of the Board of Governors of the Federal Reserve System, the Office of Comptroller of the Currency (“OCC”), the Office of Thrift Supervision (until that person’s functions are transferred to the OCC in accordance with one of the provisions of the Bill), the Securities and Exchange Commission (“SEC”), the Commodity Futures Trading Commission (“CFTC”), the Federal Deposit Insurance Corporation (“FDIC”), the Federal Housing Finance Agency, and the National Credit Union Administration (“NCUA”).

Several parts of the Bill directly impact the activities, policies, and procedures of brokers, dealers and investment advisers. Most of these are found in Subtitle C of the Bill, the “Investor Protection Act of 2009” (the “Investor Protection Act”), which effects numerous changes to the Securities Act of 1933 (the “Securities Act”); the Securities Exchange Act of 1934 (the “Exchange Act”); the Investment Advisers Act of 1940 (the “Advisers Act”); and the Investment Company Act of 1940 (the “Investment Company Act”) (collectively, the “Acts”). The Bill’s changes to the Advisers Act are extensive. They include eliminating the de-minimis exemption that allowed advisers to private funds to avoid registration under the Advisers Act, while preserving an exemption for foreign private fund advisers that have fewer than 15 U.S. clients. In addition, the Bill enhances the role of state regulators in regulating and overseeing the activities of investment advisers. Because of the breadth and scope of the changes to the Advisers Act, these will be covered in a separate briefing.

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Some of the more significant aspects of the Bill (aside from those mentioned above affecting investment advisers) are outlined below.

### Broker, Dealer, and Investment Adviser Fiduciary Duty; Harmonized Regulations.

The Bill amends Exchange Act Section 15 to require the SEC to promulgate rules providing that a broker or dealer, when providing personalized investment advice about securities to retail customers, is subject to the same standard of conduct with respect to that customer as the standard that applies to an investment adviser under the Advisers Act. The Bill also amends Advisers Act Section 211 to require the SEC to promulgate rules providing that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized advice about securities to retail customers, is to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser. This standard must be no less stringent than the one applicable to investment advisers under Advisers Act Sections 206(1) and (2) when providing personalized investment advice about securities.<sup>1</sup> Any material conflicts of interest will have to be disclosed and consented to by the customer. The Exchange Act amendment also requires the SEC to promulgate rules requiring brokers and dealers that sell only proprietary or another limited range of products to provide notice to each retail customer and obtain the customer's consent or acknowledgment.<sup>2</sup>

Each provision includes a virtually identical definition of "retail customer" – "a natural person, or the legal representative of such natural person, who (a) receives personalized investment advice about securities from a broker or dealer [or investment adviser (Advisers Act only)]; and (b) uses such advice primarily for personal, family, or household purposes." Interestingly, this definition contains no exception for high net worth investors or others who are sometimes viewed as able to "fend for themselves," but otherwise it is narrower than the definition that is often applied to the term by financial industry participants, in that it applies only to "natural persons" and only those getting "personalized investment advice."<sup>3</sup>

### Whistleblower Protection.

The Bill allows the SEC, in any judicial or administrative action that results in monetary sanctions exceeding \$1 million, to pay an

award or awards not exceeding 30 percent of the sanctions to one or more "whistleblowers" who voluntarily provided information that led to the successful outcome. The amount of an award will be in the sole discretion of the SEC. No award will be made to any whistleblower who is convicted of a criminal violation related to the action; to any whistleblower that fails to submit information to the SEC in such form as the SEC may require; or to any whistleblower who is, or was at the time he or she acquired the information, a member, officer, or employee of any appropriate regulatory agency, the Department of Justice, the Public Company Accounting Oversight Board ("PCAOB"), or an SRO. The Bill also protects whistleblowers from discharge, demotion, suspension, threats, harassment, and any other manner of discrimination because of any lawful act in providing information to the SEC, or in assisting in any investigation or judicial or administrative action based on or related to such information. It also provides that the SEC, its officers and employees, shall not disclose any information that could reveal a whistleblower's identity, including information provided by a whistleblower to the SEC, unless and until required to be disclosed to a defendant or respondent in connection with a proceeding instituted by the SEC or certain designated agencies.

The "Securities and Exchange Commission Investor Protection Fund" will be established to provide for payment of whistleblowers and for funding investor education initiatives. By October 30 of each year, the SEC will be required to send to the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs (the "Congressional Committees") a report on the whistleblower program and investor education initiatives funded by the fund, and the balance and financial activity in the fund, during the fiscal year.

### Treatment of Certain Mid-Sized Investment Advisers.

The Bill enhances the role of state regulators by providing that investment advisers regulated and examined, or required to be regulated and examined, by a State, with assets under management less than \$100,000,000 (or such higher amount as the SEC deems appropriate), must register with and be subject to examination by such State. The Bill also calls for the SEC to publish a list of States that regulate and examine, or require regulation and examination of, investment advisers to which the requirements of this provision apply. Under a provision added by the Manager's

<sup>1</sup> An important clarification of the scope of this duty was added in an amendment by House Committee on Financial Services Chairman Barney Frank (the "Manager's Amendment"), which states that this section does not impose "a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities."

<sup>2</sup> This subsection also provides that the sale of only proprietary or other limited ranges of products by a broker or dealer is not, in and of itself, considered a violation of the new fiduciary standard.

<sup>3</sup> The SEC is not to ascribe a meaning to the term "customer" that includes an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.

Amendment, if no State in which such an adviser is registered conducts such examinations, the adviser will be required to register with the SEC. If an adviser would have to register with five or more States, then it may remain registered with the SEC.

### Registration of Municipal Financial Advisers.

The Bill would create a new category of registrant under the Exchange Act, requiring “municipal financial advisers” to register with the SEC. Municipal financial advisers would be defined as those persons engaged in the business of (i) providing advice to municipal securities issuers regarding the issuance or proposed issuance of securities (including remarketing municipal securities), investing proceeds from issuances, hedging associated risks (including advice as to swap agreements), or preparing disclosure documents; (ii) assisting municipal securities issuers in selecting or negotiating guaranteed investment contracts or other investment products; or (iii) assisting any municipal securities issuer in the primary offering of securities not involving a public offering.<sup>4</sup> Municipal financial advisers would be specifically prohibited from engaging in fraudulent, deceptive, or manipulative acts or practices, and from violating any regulations regarding conflicts of interest or fair practices, including rules and regulations related to political contributions. The SEC would be required to enact rules and regulations to define and prescribe means reasonably designed to prevent, fraudulent, deceptive, or manipulative acts and practices.

The Bill would impose on municipal financial advisers, and their associated persons, a fiduciary duty to any municipal securities issuer for which they act. The Bill also would reorganize the Municipal Securities Rulemaking Board to ensure that a majority of its members are independent public representatives, with at least one representative of investors and one of issuers.

### Custodial Requirements.

The Bill requires the SEC to adopt a rule under Advisers Act Section 211(a) making it unlawful for a registered investment adviser to have custody of client funds or securities exceeding \$10,000,000 in value, per client, unless they are maintained with a qualified custodian in separate accounts under each client’s name, or in accounts that contain only client funds and securities under the name of the investment adviser as agent or trustee for each client, and the custodian does not directly or indirectly provide investment advice with respect to such funds or securities. Any exception provided in the rule must require that affected clients

receive, no less than once per year, a report from an independent entity with a fiduciary responsibility to the client verifying that the assets in the client’s account are in accord with those set forth on the client’s account statement.

### Short Sale Reforms.

The Manager’s Amendment amends several sections of the Exchange Act relating to short sales. A provision similar to SEC temporary Rule 10a-3T, which expired on August 1, 2009, would be added to Section 13(f), requiring every “institutional investment manager”<sup>5</sup> that effects a short sale of an equity security to file a daily report with the SEC disclosing information regarding each security sold short. While the reported information would be kept confidential, the SEC would be required to prescribe rules for public disclosure, at least monthly, of aggregate information regarding reported short sales.

Exchange Act Section 9 would be amended to make it unlawful for any person, alone or with others, to effect, directly or indirectly, manipulative short sales, and would require the SEC to issue rules to ensure that “appropriate enforcement options and remedies are available” to address violations.

Finally, Exchange Act Section 15 would be amended to require every registered broker or dealer to provide notice to its customers that they may elect not to allow their fully paid securities to be used in connection with short sales. Moreover, if a broker or dealer uses a customer’s securities in connection with short sales, it will be required to provide the customer with notice that the broker or dealer may receive compensation in connection with such lending.

### Increased SIPC Cash Limit; Study of Risk-Based Assessments.

The Bill amends the Securities Investor Protection Act of 1970 (“SIPA”) by replacing the amount of cash protected by the Securities Investor Protection Corporation (“SIPC”), currently set at \$100,000 per customer, with a provision that makes the cash limit “the standard maximum cash advance amount for each such customer.” This would be defined initially as \$250,000, but it could be adjusted no later than April 1, 2010, and every five years thereafter, to reflect inflation. The Bill also requires the Comptroller General of the United States (the “Comptroller General”), in consultation with the SEC, FDIC, SIPC, Financial Industry Regulatory Authority (“FINRA”), and any other appropriate

<sup>4</sup> Excluded from this definition are attorneys; nationally recognized statistical rating organizations, to the extent that they are involved in the process of developing credit ratings; registered broker-dealers acting as underwriters; and any State, or political subdivision thereof.

<sup>5</sup> An institutional investment manager is defined in Section 13(f)(5)(a) as “any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.”

public or private sector entity, to conduct a study regarding whether to require SIPC to impose risk-based assessments on members for the purpose of adequately maintaining the SIPC Fund, and to submit a report to the Congressional Committees no later than one year after the date of enactment of the Investor Protection Act.

### SIPC Protection for Futures in a Portfolio Margin Securities Account.

The Bill also amends the SIPA to add “futures contracts and options on futures contracts received, acquired, or held by or for the account of a debtor from or for such accounts, and the proceeds thereof,” to the definition of “customer property” in the case of portfolio margin accounts carried as securities accounts pursuant to an SEC-approved portfolio margining program. This would provide SIPC protection to futures and options on futures positions in such accounts.

### Extraterritorial Jurisdiction of Federal Securities Law Antifraud Provisions.

The Bill amends the Securities Act, the Exchange Act and the Advisers Act to provide that the jurisdiction of the U.S. district courts, and the U.S. courts of any Territory or other place subject to U.S. jurisdiction, includes jurisdiction over violations of each Act’s antifraud provisions, and all suits in equity and actions at law under those provisions, involving (i) significant steps within the United States in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; and (ii) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

### Authority to Restrict Mandatory Pre-Dispute Arbitration.

The Bill gives the SEC authority to prohibit or impose conditions or limitations on the use of agreements requiring customers to arbitrate future disputes. It also requires the Comptroller General to compare the costs of litigation to arbitration proceedings using the FINRA arbitration system; the average percentage of the total claim amount recovered in FINRA arbitrations; and other issues. The Comptroller General must, within one year of enactment of the Investor Protection Act, submit a report to the Congressional Committees.

### Time Limits on Regulatory Actions and Examinations.

The Bill contains a provision that would require SEC staff either to file an action or to provide notice to the SEC Division of Enforcement of its intent to not file an action, with respect to any person that receives a written Wells Notice, no later than 180 days

after the date of such notice (except for certain complex actions). It also contains a provision that would require the staff, within 180 days after the later of the date on which it completes the on-site portion of a compliance examination or inspection, or it receives all records requested from the examined or inspected entity, to provide the entity with written notification that the examination or inspection has concluded without findings, or that the staff requests corrective action (again except for certain complex actions).

### Committees.

The Bill calls for several committees to advise the SEC, including:

**Investor Advisory Committee.** The Bill calls for an Investor Advisory Committee, to meet at least twice each year, to advise and consult with the SEC on regulatory priorities and issues regarding new products, trading strategies, fee structures, and effective disclosures, as well as initiatives to protect investors and promote investor confidence. Its role will be advisory; the SEC is not required to accept or act upon any of its findings or recommendations. The SEC Chairman will appoint members, who must represent individual and institutional investors.

**SEC/CFTC Joint Advisory Committee.** The Bill permits (but does not require) the SEC and CFTC to form a joint advisory committee composed of members of each commission, as well as industry experts and participants, to consider and develop solutions to issues of common interest in the futures and securities markets; to identify emerging regulatory risks, assess and quantify their implications for investors and other market participants, and recommend solutions; and to facilitate discussion and communication on regulatory issues. This committee would report regularly to each commission and to Congress.

**Financial Reporting Forum.** The Bill establishes a Financial Reporting Forum (the “Forum”), to consist of the SEC Chairman; the Secretary of the Treasury; the heads of the Financial Accounting Standards Board, PCAOB, the NCUA, and each appropriate Federal banking agency; and representatives of a non-financial institution, a financial institution, auditors, and investors, each to be appointed by the SEC. The Forum must meet at least quarterly to discuss issues critical to financial reporting, and issue an annual report to Congress detailing its determinations or findings, and any legislative recommendations.

### Studies.

The Bill mandates several studies relating to regulation of markets, market participants, and the structure and operation of the SEC itself, including:

**Organizational Study and Reform.** The Bill requires the SEC to hire an independent consultant to examine the SEC's internal operations, structure, funding, and the need for its comprehensive reform, as well as the SEC's relationship with and reliance on SROs and other entities. Within 150 days after being retained, the consultant must issue a detailed report and recommendations to the SEC and to Congress. No later than six months after the consultant issues its report, and every six months thereafter for two years, the SEC must report to the Congressional Committees on implementation of the consultant's recommendations.

**Enhancing Investment Adviser Examinations Process.**

The Bill requires the SEC to review and analyze the need for enhanced examination and enforcement resources for investment advisers, focusing on the number and frequency of examinations of advisers by the SEC over the preceding five years; the extent to which authorizing the SEC to designate one or more SROs to augment its oversight of investment advisers would improve the frequency of examinations; and current and potential approaches to examining the advisory activities of dually registered broker-dealers and investment advisers, or affiliated broker-dealers and investment advisers. The SEC must report its findings to the Congressional Committees.

**Study on Disclosure to Retail Customers.** The Bill requires the SEC to publish a study examining the nature of a "retail customer" (in accordance with the definition above), the range of products and services sold or provided to retail customers, the ways in which they are sold or provided, and who provides or sells them. The study must also include the fees charged and conflicts of interest that may arise, information that retail customers should receive and who should provide it, and ways to ensure that reasonably similar products and services are subject to similar regulatory treatment. The SEC is authorized to promulgate rules relating to providing designated documents or information to retail customers.

**Study of Financial Planning.** The Bill requires the Comptroller General to study regulation and oversight of financial planning, considering the role of financial planners in providing advice in investment, income tax, education, retirement, and estate planning; other areas with respect to managing of financial resources; and gaps in the regulation of financial planners. The Comptroller General must submit a report to Congress of findings, determinations, and recommendations regarding appropriate regulation of, or standards for, financial planners.

**Study of the Revolving Door.** The Bill also requires the Comptroller General to review and analyze issues relating to employees who leave the SEC to work for SEC-regulated financial institutions, including the number of such employees

and the average length of their employment, how many worked on cases involving regulated financial institutions, whether SEC employees who later work for financial institutions have engaged in information sharing or assisted institutions in circumventing Federal rules and regulations while employed by the SEC, and whether greater post-employment restrictions are necessary. The Comptroller General must make recommendations for strengthening internal controls and submit a report to the Congressional Committees.

**Other Provisions.**

In addition to the foregoing, the Investor Protection Act portion of the Bill contains a number of additional provisions, including provisions that:

- Give the SEC the authority to impose civil penalties in cease and desist proceedings.
- Enhance aiding and abetting liability under the Securities and Investment Company Acts.
- Provide for nationwide service of subpoenas in any SEC action or proceeding.
- Provide for sharing privileged information obtained by the SEC with any agency, SRO, foreign securities authority or law enforcement authority, the PCAOB, or State securities or law enforcement authority, and protect the confidentiality of that information.
- Expand the universe of audit information to be exchanged with foreign regulators.
- Establish an SEC "Capital Markets Safety Board" to investigate failed institutions registered with the SEC, determine the cause of the failure, and publish on the SEC web site a report that includes recommendations for avoiding similar failures.
- Require the SEC Chairman to appoint an Ombudsman to act as a liaison between the SEC and any person with respect to any problem that such person may have in dealing with the SEC as a result of the SEC's regulatory activities.
- Authorize the SEC to gather information, communicate with investors and the public, and engage in temporary or experimental programs, for the purposes of evaluating rules and programs, and considering, proposing or adopting rules or programs.

- Amend the Exchange Act, Investment Company Act and Advisers Act to provide the SEC with the ability to make reasonable periodic, special, or other information and document requests in order to conduct surveillance or risk assessments of the securities markets, registered persons, or otherwise, in furtherance of the purposes of each Act.
- Provide for protection of confidentiality of certain materials submitted to the SEC.
- Authorize the SEC to require registered management companies to provide and maintain a fidelity bond against certain losses.
- Provide for PCAOB oversight of auditors of brokers and dealers.
- Provide enhanced protections for seniors who are targeted by salespersons and advisers using misleading certifications and professional designations, including purported certifications, professional designations, or other credentials that indicate or imply that a salesperson or adviser has special certification or training in advising or servicing seniors.
- Revise the recordkeeping rules under the Investment Company Act relating to persons with custody or use of a registered investment company's securities, deposits, or credits.
- Require the SEC, within six months of enactment of the Investor Protection Act, to provide the Congressional Committees with a report on the implementation of reforms outlined by the SEC in the wake of the Madoff fraud, including an analysis of how many, and to what extent, reforms have been implemented; and whether there is overlap between the SEC's reform proposals and those of the SEC Inspector General. The SEC and the Congressional Committees will publish the report on their web sites.

As noted above, the Bill must still be resolved with whatever proposals emerge from the Senate, which is still in the drafting stages of its legislation. We will continue to monitor this critical area as the final form of Congress' financial regulatory reform takes shape.

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The Financial Services Practice Group of Winston & Strawn represents a broad range of financial institutions on all aspects of their businesses, including regulatory matters, legislative developments and proposals affecting the financial industry. If you have any questions regarding the matters discussed in this briefing, or if you need advice or assistance in determining how to respond to those matters, please contact any of the Winston & Strawn attorneys listed below or your usual Winston & Strawn contact:

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