

Impact of Dodd-Frank Wall Street Reform and Consumer Protection Act on Broker-Dealers

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On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), bringing to a close the national debate over the appropriate regulation of the financial markets that began with former Treasury Secretary Henry Paulson's white paper in March 2008. We would like to share with you our thoughts on the likely impact of the Act on broker-dealers.

Impact on a Broker-Dealer's Relationship with Customers

Several provisions of the Act are likely to have a significant effect on the relationship between broker-dealers and their customers, particularly retail customers. However, all of these changes will first require rulemaking before they take effect. Firms interested in anticipating the impact may want to consider the following.

- **Who is a Retail Customer?** Critical to the new rules is a new definition of "retail customer." The Act defines a retail customer as a natural person who receives personalized investment advice about securities from a broker, dealer or investment adviser and uses such advice primarily for personal, family or household purposes. § 913(a).
- **New Standard of Care for Retail Customer Relationships.** The Act contains several, arguably overlapping, provisions focused on enhancing the standard of care for services provided to retail customers. The Act authorizes the Securities and Exchange Commission (SEC) to adopt rules to impose the same standard of conduct on broker-dealers and investment advisers. § 913. The Act provides the SEC with permissive rulemaking authority to require that broker-dealers and investment advisers act "in the best interest of the customer without regard to the financial or other interest" of the broker-dealer and investment adviser. At the same time, the Act requires the SEC to conduct a study to evaluate the effectiveness of existing legal and regulatory standards of care for brokers-dealers, investment advisers and associated persons to ascertain whether there are regulatory gaps or overlap. The study must be completed by January 21, 2011. SEC Chairman Mary Schapiro and others are on record that they are solidly in favor of increasing the standard of care for broker-dealers.
- **Expanded Disclosure Requirements.** The Act's provisions relating to the standard of care also authorize the SEC to adopt rules to facilitate "simple and clear disclosure" of broker-dealers' and investment advisers' relationships. § 913. The SEC can also require broker-dealers offering solely proprietary products or a limited range of products to provide disclosure of that limitation, and require written consent from customers acknowledging the limitation. § 913(g). The SEC will need to address a number of important questions in this area: What products, if sold by a

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1

broker-dealer, will fall within the “limited range of products” category so that broker-dealers will need to receive customer consent or acknowledgment? What form of consent will be required? Will broker-dealers be grandfathered with respect to their current business lines or will they need to obtain new written consents from all of their customers?

- **Customer Account Agreements.** The Act’s directives for the SEC could very well result in changes to standard provisions in customer account agreements. For example, the Act grants the SEC authority to limit or prohibit mandatory pre-dispute arbitration clauses in agreements. § 921.
- **CRD and IARD Access.** The Act requires the SEC to complete a study on ways to improve investor access to registration information and disciplinary information on broker-dealers and investment advisers, and consider whether to further centralize the two systems. § 919B.
- **Investor Qualification and Education.** The Act requires the SEC to conduct a study regarding the “financial literacy” of investors. § 917. The results of this study could influence the shape of future rulemaking. There may be increased focus on investor education initiatives such as generic investment product brochures. This study could call into question conventional practices for qualifying customers as experienced investors.
- **Securities Lending Notice.** The Act amends the Securities Exchange Act of 1934 (the 1934 Act) to require a broker-dealer to provide a notice to its customers that they may elect not to allow their securities to be used in connection with short sales and that if the broker-dealer uses their securities for lending purposes, it may receive compensation for doing so. The Act authorizes the SEC to adopt a rule to prescribe the form, content, time and manner of delivery of the notice. § 929X.

Impact on a Broker-Dealer’s Relationship with its Registered Persons

A few provisions of the Act may have an impact on broker-dealers’ relationships with their registered persons. Again, these provisions are not expected to have immediate effect.

- **Compensation Arrangements for Registered Persons.** The Act authorizes the SEC to examine and adopt rules prohibiting compensation schemes contrary to the public interest and protection of investors. § 913(g). For some time, since the publication of the 1995 Tully Committee Report¹ addressing the compensation practices of broker-dealers, securities regulators have expressed concerns about the potential conflicts created by conventional commission-based compensation arrangements as well as various types of incentive arrangements. Rulemaking to impose the same standard of conduct on broker dealers as applies to advisers could again cause a reconsideration of compensation arrangements for broker-dealer personnel.

¹ See Report of the Committee on Compensation Practices, [1995 Decisions Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,614 (Apr. 10, 1995).

- **Use of Financial Planner and Similar Designations.** The Act requires the Government Accountability Office (GAO) to conduct a study on financial planners and the use of financial designations for the purpose of assessing current regulation and oversight and identifying any gaps. § 919C. This study could revive debate over practices entailing the use of “financial adviser” designations for registered persons.

Participation in Private Offerings

Broker-dealers participating in private offerings should be aware of a few changes affecting these offerings.

- **Change in Accredited Investor Net Worth Standard.** The Act changes the rules for determining an investor’s net worth in the case of an investor seeking to fall into the accredited investor category for a natural person with a net worth of at least \$1 million. § 412. The net worth calculation can no longer include the value of the investor’s primary residence (but per SEC staff guidance, should take into account any indebtedness against the primary residence if the outstanding indebtedness exceeds its value). Broker-dealers participating in private offerings should anticipate that issuers may be changing their subscription agreements or related instructions to take into account this change. Depending on the offering structure, some issuers may require that the new net worth calculation method be followed for subscriptions submitted prior to the Act’s effective date (on the theory that the subscriptions may have not been accepted, or their acceptance may be contingent upon a closing, in either case, events occurring after the Act’s effective date).
- **Regulation of Private Fund Advisers.** The Act imposes investment adviser registration requirements on certain advisers to private funds who previously qualified for an exemption. § 403. Broker-dealers participating in private fund offerings should consider these new requirements in connection with due diligence review of private funds.

Impact on Sales Activities and Marketing Materials

A few provisions of the Act are likely to affect sales and marketing activities.

- **Use of NRSRO Ratings.** The Act comes down hard on nationally recognized statistical rating organizations or NRSROs. Not only does the Act seek to impose more extensive controls over NRSROs, but also requires various agencies to review and report on the extent to which their rules are predicated on NRSRO status. § 932. Given the loss of confidence in the NRSRO rating system, broker-dealers may want to consider the extent to which they rely on NRSRO ratings in selecting and promoting securities and investments to their customers. For example, broker-dealers may want to consider revising their product due diligence processes to include a review of the annual internal control reports NRSROs will file with the SEC, NRSRO ethics policies, and conflict disclosures required by the SEC.

- **Mutual Fund Advertising.** The Act requires the GAO to conduct a study on mutual fund advertising. § 918. The study must be completed by January 21, 2012, and submitted to the House Financial Services Committee and the Senate Banking Committee. The study will focus on current practices with respect to performance among other things, and requires the GAO to provide recommendations that allow investors to make better informed decisions.
- **Timing of Delivery of Investment Information – Point of Sale.** The Act adds a new Section 15(n) to the 1934 Act, which grants authority to the SEC to issue rules that designate documents or information that must be provided by a broker-dealer to a retail investor *before* the purchase of an investment product or service. § 919. Any such rule must require documentation in a summary format, containing clear and concise information about investment objectives, strategies, costs, risks and compensation received by a broker-dealer or any other intermediary in connection with the purchase.

Operational Activities

A few provisions of the Act may have an impact on broker-dealers' operational activities.

- **Hunt for Missing Security Holders.** The Act directs the SEC to adopt new rules requiring broker-dealers to hunt for missing security holders. The new rule(s) must be in place no later than July 21, 2011 (one year after enactment of the Act). The rule(s) that the SEC must adopt in this area will require broker-dealers (as well as issuers, transfer agents, investment advisers and others) to communicate in writing with customers who have not negotiated a check before the earlier of the paying agent next sending out a regularly scheduled check, or the elapsing of six months after the sending of the non-negotiated check. The Act also stipulates that SEC rules in this area will have no effect on state escheatment laws. § 929W.
- **Broker Voting of Proxies.** The Act effectively requires a national securities exchange to adopt rules prohibiting a member from voting securities registered under Section 12 of the 1934 Act, unless the beneficial owners of the securities have instructed the member to vote the proxy in accordance with the voting instructions of the beneficial owner. § 957. Shareholder votes subject to this prohibition are those that relate to the election of a member of the board of directors of an issuer; executive compensation; or any other significant matter as determined by the SEC. There is an exclusion for votes for uncontested board seats of registered investment companies.
- **PCAOB Authority over Broker-Dealer Financial Audits.** The Act extends the Public Company Accounting Oversight Board's authority to expand its rules and standards to cover audits of broker-dealers. § 982. On July 15, 2010, the PCAOB held a meeting with its Standing Advisory Group to discuss broker-dealer audit considerations.
- **Volcker Rule.** Broker-dealers that are affiliated with a banking entity or a nonbank financial company supervised by the Federal Reserve Board may face restrictions on their proprietary trading activities and relationships with hedge funds and private equity funds. § 619.

What's In, What's Out?

The Act appears to have the effect of changing the status of certain financial and investment products and financial professionals under the federal securities laws.

- **Asset-Backed Securities.** These securities, which previously enjoyed significant exemptions from the securities laws, have lost much of that favored status. The Act authorizes the SEC and other agencies to adopt risk retention requirements for securitizers. In addition, the Act adds provisions to the federal securities laws authorizing the SEC to adopt rules to implement a registration framework for these securities. § 941 et seq.
- **Equity-Indexed Annuities Out?** In the final weeks, a provision was added to the Act, sometimes referred to as the “Harkin Amendment,” which provides that the SEC shall treat as an exempt security any insurance contract (including life insurance or annuities) that meets three requirements related to: use of a separate account; nonforfeiture status, and compliance with National Association of Insurance Commissioners (NAIC) and/or state-specific suitability requirements. § 989J.
- **Municipal Advisors In.** The Act requires the registration of a new category of municipal securities professional – the municipal securities advisor. § 975. The Act authorizes the Municipal Securities Rulemaking Board (MSRB) to adopt rules to cover municipal securities advisors. At this point, it is unclear who is subject to this requirement, and whether persons consulting with municipalities in connection with retirement plans will be subject to this registration requirement.

Impact on Regulators

The Act authorizes changes in the operations and authority of a number of securities regulators. Some of the noteworthy changes are noted below.

SEC

- **Closure on SEC Examinations.** Amendments to the 1934 Act will for the most part force the SEC staff to fish or cut bait with respect to exams, within 180 days of obtaining requested records. § 929U.
- **Expanded Authority for Enforcement Actions.** Various provisions of the federal securities laws have been amended to provide expanded or additional bases for liability. For example, a recklessness standard has been added to the aiding and abetting provisions of the 1934 Act, and the SEC has been given penalty authority for aiding and abetting violations of the Investment Company Act of 1940 (the 1940 Act). § 929M.

- **Manipulation Prohibition Extended to OTC Securities.** The Act amends the 1934 Act to extend its prohibition on price manipulation to cover securities traded in the over-the-counter markets. § 929L.
- **New Approach for SEC Rulemaking.** The Act authorizes the SEC to use investor testing to develop rules and provides for the formation of an “Investor Advisory Committee,” which the SEC is directed to consult on, among other things, “issues relating to the regulation of securities products, trading strategies, and fee structures, and the effectiveness of disclosure.” §§ 911 and 912.
- **More Resources.** The Act provides for increased resources, and requires the SEC to hire an independent consultant to assess, among other things, the SEC’s hiring and workplace policies and practices, including an assessment of the “diversity of skill sets of SEC employees.” § 967.

FINRA

- **Streamlined Rulemaking Proceedings.** The Act revises the rulemaking process for self-regulatory organizations to require the SEC to act within 45 days after publishing a notice of a proposed rule change unless it has taken action to delay the proceeding. It also deems a rule proposal approved if the SEC does not take any of the permissible courses of action by the end of the 45-day period. § 916.

MSRB

- **Rules for Municipal Advisors.** As noted above, the Act recognizes a new category of registrants – the municipal advisor. MSRB is authorized to adopt rules to apply to “municipal advisors.” § 975.

SIPC

- **Increased SIPC Coverage.** The Act amends the Securities Investor Protection Act of 1970 (SIPA) by increasing the amount of cash protection for each customer to \$250,000, and by providing that the \$250,000 figure can be adjusted for inflation in future years. § 929H.
- **Increased SIPC Assessments.** The Act also amends SIPA by increasing the minimum assessment paid by SIPC members to 0.02% of the member’s gross revenues from the securities business. Persons who falsely misrepresent SIPC membership or protection can be fined or imprisoned. § 929V.

State Regulators

- **Expect More State-Registered Investment Advisers.** In order to reduce the SEC’s roster of registered investment advisers, the Act raises the threshold to qualify for SEC rather than state registration. This threshold will be increased to \$100 million. § 410. Firms that relied on the \$25 million test to qualify for SEC registration may now find themselves disqualified, and required to convert their registration to state registration.

- **Focus on Senior Issues.** The Act authorizes grants to state regulators for enforcing senior protection regulations. States that have adopted model North American Securities Administrators Association (NASAA) and/or NAIC regulations on the use of senior designations and NAIC Model regulations on annuity suitability are eligible to receive grants up to \$500,000 a year for up to three years to be used to fund a variety of education and enforcement initiatives. § 989A.

What Changes Today vs. What Requires Rulemaking

Many of the changes contemplated by the Act will not become effective until studies have been completed and implementing rules have been adopted and take effect. For now, the only changes discussed above with immediate effect are those relating to the change in the accredited investor net worth calculation and in SEC operations and authority.

Appendix A below provides a countdown of rulemakings and studies that may be of interest to broker-dealers.



If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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Appendix A

Deadline for Rule Changes

7-22-10 (the Effective Date)

- Change in net worth calculation for accredited investor definition

10-1-10

- Effective date for application of MSRB rules to municipal advisors

180 days after the Enactment Date (1-17-11)

- SEC rules implementing streamlined proceedings for self-regulatory organization rulemakings

1 year after the Enactment Date (7-21-11)

- SEC exemptive rule for venture capital advisers
- SEC rules revising notice requirement for missing security holders
- SEC rules disqualifying felons and other bad actors from Reg D Offerings
- SEC rules revised to remove references to credit ratings
- Increase in assets-under-management threshold for investment adviser registration with SEC
- Qualified client thresholds adjusted for inflation

2 years/24 months after the Enactment Date (7-21-12)

- Implement recommendations from Study on Investor Access to Information on Advisers and Broker-Dealers

No Deadline

- SEC rules prescribing customer notice for securities lending practices and compensation

SEC Study Due

150 days after the Enactment Date (12-18-10)

- SEC Organizational Study and Reform

180 days after the Enactment Date (1-17-11)

- Study on Enhanced Investment Adviser Exams

6 months after the Enactment Date (1-21-11)

- Study on Standard of Care and Related Matters for Broker-Dealers and Investment Advisers
- Study on Improved Investor Access to Information on Advisers and Broker-Dealers

1 year after the Enactment Date (7-21-11)

- Study and Report on Real - Time Reporting for Short Sales

18 months after the Enactment Date (1-21-12)

- Study on Extraterritorial Private Rights of Action

2 years/24 months after the Enactment Date (7-21-12)

- Study Regarding Financial Literacy Among Investors
- Study on Short Selling

GAO Study Due

180 Days after the Enactment Date (1-17-11)

- Study on Financial Planners and Use of Financial Designations

1 year after the Enactment Date (7-21-11)

- Study on Securities Litigation (private rights of action)
- Study on SEC Revolving Door
- Study of Person-to-Person Lending
- Study on Self-Regulatory Organization for Private Funds

15 months after the Enactment Date (10-21-11)

- Study on Proprietary Trading

18 months after the Enactment Date (1-21-12)

- Study Regarding Mutual Fund Advertising
- Study on Conflicts of Interest (between investment banking and analyst functions)
- Study of Municipal Markets

2 years/24 months after the Enactment Date (7-21-12)

- Study on Creation of Independent Professional Analyst Organization
- Study of Increased Disclosure to Municipal Securities Investors

3 years after the Enactment Date (7-21-13)

- Study on Custody Rule Costs
- Study and Report on Accredited Investors