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Financial regulatory reform: anticipating the compliance challenges for broker-dealers

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As the Administration's framework for financial regulatory reform begins to take shape, we can start to identify the potential compliance implications for broker-dealers. Set forth below is a preliminary list of compliance issues to consider when reviewing the proposals, draft Investor Protection Act of 2009 (PDF) (IPA) and the subsequent rule proposals to effect the Administration's regulatory reform framework.

1. Fiduciary duty standard of care

The Administration proposes to authorize the SEC to align intermediaries' duties across financial products. In particular, broker-dealers would be subject to the same standard of care as registered investment advisers when providing investment advice about securities to retail investors, even if such advice is "incidental to brokerage." As drafted, the IPA would give the SEC rulemaking authority to extend the conduct standards to customers and clients other than retail investors.

Compliance considerations

The IPA would amend section 15 of the Securities Exchange Act of 1934 to authorize the SEC to promulgate rules to provide for the standard of conduct for broker-dealers providing investment advice about securities to customers or clients. Accordingly, it does not appear that the Administration proposes to eliminate the "incidental to brokerage" exception from the definition of "investment adviser" in section 202(a)(11) of the Investment Advisers Act of 1940 (Advisers Act), which would require broker-dealers providing advisory services to register as investment advisers. It remains to be seen, however, whether "comparable standards of conduct" will result in extension of the Advisers Act restriction on principal trading activities to broker-dealers providing advisory services, notwithstanding the Advisers Act exception. Other potential compliance issues include:

- distinguishing between a broker who provides investment advice and a broker who acts as agent;
- defining "retail investors";
- harmonizing the different regulatory requirements for broker-dealers and investments advisers, particularly with respect to record retention, communications with the public and advertisements;
- rationalizing the different exam and licensing requirements; and
- determining the Financial Industry Regulatory Authority's jurisdiction when a broker-dealer is providing investment advice.

2. Conflicts of interest

The proposals include a number of recommendations directed at eliminating conflicts of interest. In the case of broker-dealers, new legislation is sought that would prohibit certain, (unspecified) conflicts of interests and sales practices that are contrary to investors' interests, and possibly limit cold calling of potential clients. Specific reference is made to compensation arrangements that incentivize financial intermediaries to sell products at the expense of their investing customers, and new authority is sought for the SEC to examine and prohibit such compensation arrangements.

Compliance considerations

Financial services firms may want to update their prior conflicts of interest reviews to reflect their current business activities and take remedial action where appropriate. If not already included in the review, compensation practices and other sales incentives for particular products may need to be evaluated, and sales people should receive training where appropriate, including with respect to cold calling activities.

3. Increased disclosure obligations

The proposals include several recommendations intended to enhance the quality and timing of disclosures to investors. Among other things, the IPA would amend section 24 of the Investment Company Act of 1940 to authorize the SEC to promulgate rules requiring pre–sale disclosure for sales of securities of registered investment companies.

The Administration also seeks to require investment professionals to make plain-English disclosure to investors regarding the scope of the terms of their relationships. This proposal responds to concerns that investors do not understand the differences between brokers and investment advisers. In addition, the proposals include recommendations for budgetary increases to enhance the SEC's ability to field test the effectiveness of and to gather information about investor disclosures. Along these lines, the SEC and the Commodity Futures Trading Commission are already considering imposing additional disclosure requirements in connection with the marketing of derivatives to less sophisticated counterparties, such as small municipalities. Moreover, the SEC would be required to issue new regulations to improve the standardization and transparency of legal documentation and the disclosure practices of underwriters of asset-backed securities and other participants in the securitization industry.

Compliance considerations

The Administration's recommendations relating to disclosures should be evaluated in terms of potential new burdens that could be imposed, and steps that might be taken now to control risks. With respect to the former, the potential costs and burdens of point-of-sale disclosure are extremely high unless web-based point-of-sale disclosure is permitted, particularly in the case of mutual fund sales.

With respect to the latter, although disclosures of risks and conflicts may not be a "cure all," firms may wish to review standard disclaimers and disclosures in their sales literature and other marketing materials in light of regulatory concerns that have come to light as a result of disciplinary actions and enforcement proceedings. Although much of the discussion around disclosure has been in the context of retail investors, the new SEC Investor Advisory Committee, which will meet for the first time on July 27, 2009, will also be charged with representing the interests of institutional investors.

4. Use of pre-dispute arbitration clauses in certain agreements

The IPA would authorize the SEC to prohibit or limit the use of mandatory pre–dispute arbitration clauses in broker-dealer and investment adviser client agreements. The draft legislation does not include the proposals' limited context of retail and investment advisory account agreements with retail investors. The proposals call for the SEC to conduct a study of pre-dispute arbitration provisions before banning their use. The SEC's review would be required to assess whether investors obtain effective redress through arbitration and consider whether any other changes should be made to the arbitration process.

Compliance considerations

Several consequences could occur if the SEC bans mandatory arbitration. First, the dispute resolution process could be extended, which would increase costs for broker-dealers that potentially could be passed on to their customers. Second, there will be practical implications for broker–dealers who will need to take inventory and revise their standard form agreements and to distribute them for use in accordance with the compliance deadline. In the case of existing customers, broker-dealers will need to develop a systemic approach for re-documenting the affected clients or for amending their existing agreements.

5. Potential impact on broker-dealers from the CFPA

The current version of the draft Consumer Financial Protection Agency Act of 2009 (PDF) provides that the CFPA will have no authority over a broker-dealer or any other person regulated by the SEC (or the CFTC). The SEC, however, is required to consult and coordinate in advance with the CFPA regarding any SEC rule relating to an investment product or service that is of the same type as, or that competes directly with, a product or service regulated by the CFPA.

Compliance considerations

The Administration's version of draft authorizing legislation for the CFPA specifically disallows the new agency any jurisdiction over broker-dealers. Accordingly, it appears that broker-dealers may avoid duplicative regulatory requirements that would arise if the CFPA's jurisdiction was applied to broker-dealers based on the particular product or service and not whether they are regulated by the SEC. The requirement that the SEC consult with the CFPA regarding proposed SEC rules may help address concerns about regulatory arbitrage with comparable products and services. Given the CFPA's proposed authority to adopt rules and issue orders and guidance regarding sales practices, an open issue is the extent of potential FINRA/CFPA consultation that would occur.

6. Restrictions on affiliate transactions

The Administration proposes to require stronger firewalls between banks and their affiliates. Among other things, there are proposed to be greater limits on banks' OTC derivative and securities financing transactions with affiliates. Those limitations could potentially include requirements for full collateralization of OTC derivative, securities financing, and other "covered" transactions with affiliates for the transaction's life, and the expansion of existing restrictions to transactions between a bank and all private investment vehicles sponsored or advised by the bank.

Compliance considerations

Bank-affiliated broker-dealers may need to review their policies and procedures for compliance with restrictions on bank affiliate transactions. In addition, compliance and supervisory procedures generally should be reviewed to address potential conflicts of interest between affiliated banks, which may require restrictions on transactions between the broker-dealer's proprietary trading desks and affiliated banks.

7. Over-the-counter derivatives

The Administration's plan is expected to create regulatory incentives (e.g., lower capital requirements) for the trading of standardized OTC derivatives, which would be required to be cleared through central counterparties, rather than customized instruments. Customized OTC derivatives could still be traded, but they could not be used solely to avoid a CCP.

SEC chairman Schapiro and CFTC chairman Gensler have generally agreed that the swaps exemption from the Commodity Futures Modernization Act should be eliminated. Based on the chairmen's plan, the SEC would have jurisdiction over all securities derivatives, and SEC chairman Schapiro has already called for extending the beneficial ownership reporting requirements of sections 13 and 16 of the Securities Exchange Act of 1934 to security-based derivatives. (The CFTC would have jurisdiction over derivatives based on currencies or interest rates as well as non-financial derivatives.)

The SEC and CFTC would be authorized to impose recordkeeping and reporting requirements, including an audit trail, on all OTC derivatives. Both agencies would also have authority to police market abuses involving OTC derivatives, and the CFTC would have authority to set position limits.

Compliance considerations

The specific regulatory requirements are still to be determined, but it is expected that broker-dealers who trade OTC derivatives will have additional recordkeeping requirements, trade reporting requirements, and possibly increased capital and margin requirements. In addition, if Exchange Act reporting of ownership of and transactions in security-based derivatives is required, broker-dealers will need to review their existing procedures to capture and report the requisite information.

8. Risk-management processes

Although one of the primary goals of the Administration's plan is to reduce system risk, several of the proposals have the potential for increasing the risks of individual market participants. For example, the Administration calls for originators and sponsors of asset-backed securities to be required to retain five percent of the credit risk of securitized exposures. Originators would be prohibited from direct or indirect hedging or transferring of that risk, although authority may be given to the bank regulators to modify the five percent requirement and to provide hedging exemptions. Also under consideration is a requirement that gains may need to be recognized over time rather than immediately upon sale.

Moreover, in the event of a "systemic risk" the Department of the Treasury could exercise resolution authority over bank holding companies and Tier 1 financial holding companies, and supplant normal bankruptcy procedures.

Compliance considerations

Broker-dealers will want to assess the impact to their risk management procedures and revise them as appropriate to reflect any restrictions on hedging activities, accounting changes regarding the recognition of gains, and the exposure to entities that might become subject to the proposed Treasury Department resolution process rather than a bankruptcy proceeding.

9. Whistleblowers

The Administration's plan would encourage increased whistleblower activity by calling for authorization of the SEC to establish, pursuant to new Exchange Act section 21F, whistleblower incentives, including the Securities and Exchange Commission Investor Protection Fund.

Compliance considerations

Generally, SEC investigations and examinations that are prompted by whistleblower claims can be particularly difficult to close out. Broker-dealers who are subject to Sarbanes-Oxley Act requirements may already have robust policies and procedures to deal with employee complaints and to prohibit retaliation against whistleblowers. Firms who have not been subject to those requirements may want to review their compliance and supervisory policies and procedures to help mitigate against whistleblower claims, including making sure that they (a) provide for alternative "reporting up" protocols; (b) reflect the firm's current activities, personnel, and practices; and (c) are being followed, enforced, and documented.

10. Additional books and records requirements

Generally, additional books and records requirements accompany any new regulation and, as mentioned above, several specific requirements are included in the Administration's plan. Among other things, additional recordkeeping and retention requirements are expected in connection with sales practices, compensation arrangements, new customer and counterparty documentation, and securitization and derivative transactions.

Compliance considerations

The full impact on broker-dealers as a result of additional books and records requirements will only be known once we see the full set of final rules. At the moment, the increased burden looks substantial.

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