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THE IMPACT OF THE DODD-FRANK ACT ON THE SECURITIES INDUSTRY: WHAT BROKER-DEALERS AND INVESTMENT ADVISERS NEED TO KNOW

BY K.SUSAN GRAFTON

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, the most comprehensive package of financial regulatory reforms since the Great Depression. Because only a limited number of provisions were effective upon enactment, the overall impact of the Act cannot be fully determined until regulators undertake required rulemaking and determine whether — and to what extent — to exercise delegated rulemaking authority.

This article highlights the potential federal securities law implications for broker-dealers with respect to their: (1) sales practices; (2) trading and investments; and (3) investment banking and advisory services. Also summarized are potential new Securities and Exchange Commission requirements related to broker-dealers' associated persons and a variety of new operational issues that broker-dealers are likely to face in connection with these activities, including substantial new disclosure and reporting obligations. Potentially, many broker-dealers will also see changes in their capital requirements flowing from new systemic risk regulations.

I. SALES PRACTICES

A. STANDARD OF CARE (SEC. 913)

The SEC is granted discretionary rulemaking authority under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to establish comparable standards of conduct for broker-dealers and investment advisers. Specifically, the SEC is authorized, but is not required, to promulgate rules, providing that the standard of conduct for broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers, and such other customers as the SEC may provide by rule, 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 providing the advice.

Within six months of enactment, the SEC must complete a study and submit a report to the banking committees comparing the legal and regulatory requirements for services offered by broker-dealers and investment advisers, and addressing any gaps in regulation and investor understanding. The study must also assess the potential impact to retail investors from changes in regulatory requirements.

A standard of conduct for broker-dealers based on the IAA's fiduciary duty standard raises a number of issues:

"Retail customer" is defined as a natural person, or his or her legal representative, who (a) receives personalized investment advice about securities from a broker-dealer or investment adviser; and (b) uses such advice primarily for personal, family, or household purposes. If the SEC adopts a standard of care, an "opt out" or similar provision recognizing the differing needs of individual investors based on sophistication and types of investments, could be one way to balance the new standard's benefits and costs.

Compensation. The Act provides that the receipt of commission or fee-based compensation "shall not, in and of itself, be considered a violation" of a broker-dealer or investment adviser's standard of care. If a standard of care is adopted, guidance will be needed on the circumstances, if any, when compensation, including sales incentives, can be a factor in determining whether the duty is violated.

No ongoing duty. The Act further provides that a broker-dealer will not be considered to have a continuing duty of care or loyalty to a customer after providing personalized investment advice. While this language is helpful, if a duty is adopted, guidance will be needed on a variety of issues, including whether there are any circumstances when a broker-dealer has an obligation to review customers' holdings in view of their financial profiles, and the application of the standard of care to clients who have multiple accounts at the broker-dealer.

Dually-registered individuals. There has been no suggestion that individual representatives will be prohibited from registering as both brokers and investment adviser representatives. Less clear is whether individuals will be allowed to wear two hats when dealing with the same client, such that the standard of care can reflect the level of service provided to a particular client on a particular transaction.

Disclosure. Both Congress and the SEC propose that investors receive enhanced disclosure from their financial services providers about the scope of their customer relationship. Disclosure requirements likely would encompass conflicts of interest, fees, descriptions of products and services offered, and the firm's obligations when providing particular services to the client.

Sale of proprietary and limited range of products. A broker-dealer's sale of only proprietary or other limited range of products (as determined by the SEC) will not, in and of itself, be considered a violation of the standard of care. If a new duty is adopted, clarification will be needed regarding whether there are any circumstances under which offering limited products will be deemed violative; whether non-proprietary products must be offered as an alternative, and, if so, the number and range of such products; and any requirement for customer disclosure or consent.

Impact on overall business. If a fiduciary duty or other standard of care is adopted, its impact on a broker-dealer's overall business will need to be considered, including any potential limitations on principal trading, market making, underwriting, and cash sweep activities.

STATUS

On July 27, 2010, the SEC issued a release requesting public comment on the 14 issues listed in Section 913 that it is required to consider as part of its study. The comment period expired on August 30, 2010.

The SEC's report to the banking committees is due on January 21, 2011, and there are no new requirements, unless the SEC exercises its rulemaking authority.

B. PRODUCT-SPECIFIC SALES REQUIREMENTS

1. Retail Investment Products and Services (Sec. 919)

The SEC is granted discretionary authority under the 1934 Act section 15(n) to promulgate rules designating documents and information that broker-dealers must provide to retail investors prior to the purchase of an investment product or service.

Any information or documents required to be provided must be in summary format; contain clear and concise information about investment objectives, strategies, costs, and risks; and provide information about any compensation or other financial incentive received by a broker-dealer or other intermediary in connection with the purchase of a retail investment product.

If the SEC adopts rules, guidance will be needed on a number of issues:

Information requirements. If broker-dealers are required to prepare summaries and cannot use materials prepared by the issuer, or a wholesaler, potential 1933 Act liability will need to be evaluated, particularly in the case of investment company securities, exchange-traded funds, and structured products. Guidance will also be needed as to whether the document must be filed in advance with FINRA.

Disclosure of compensation. The definition of "other intermediary" will need to be defined. If rules are adopted, guidance will be needed on, among other things, whether the retail broker-dealer will be required to, and can, provide information regarding compensation received by wholesalers and credit rating agencies.

STATUS

No new requirements, unless the SEC exercises its rulemaking authority.

2. Mutual Fund Shares (Sec. 918 and Sec. 919)

The Government Accountability Office is required to conduct a study and report to the banking committees by January 21, 2012 on mutual fund advertising to identify:

- existing and proposed regulatory requirements for open-end investment company advertisements;
- current marketing practices for the sale of open-end investment company shares, including the use of past performance data, funds that have merged, and incubator funds;
- the impact of such advertising on consumers; and
- recommendations to improve investor protections in mutual fund advertising and additional information needed to ensure that investors can make informed financial decisions when purchasing shares.

The impact for broker-dealers will need to be assessed after GAO publishes its findings.

STATUS

On July 21, 2010, the SEC published rule amendments that, among other things, would rescind 1934 Act Rule 12b-1 and require clearer disclosure about all sales charges in fund prospectuses, annual and semi-annual reports to shareholders, and in investor confirmation statements. The SEC stated that it is considering recommendations for future consideration regarding simplification of cost information prior to sale, and that Section 919 of the Act grants the SEC authority to "issue rules designating documents or information that shall be provided by a broker or dealer to a retail investor before the purchase of an investment to enhance the information provided at the point of sale, as opposed to the completion of the sale."

3. Sales of Proprietary Products or A Limited Range of Products (Sec. 913(g))

The Act provides that a broker-dealer's sale of only proprietary or other limited range of products (as determined by the SEC) will not, in and of itself, be considered a violation of the standard of care.

STATUS

No new requirements, unless the SEC exercises its rulemaking authority.

4. ABS Risk Retention (Sec. 941)

Risk retention. The SEC, the banking agencies and, in the case of residential mortgages, the housing agencies, must jointly promulgate rules that require securitizers of ABS to maintain five per cent of the credit risk in assets transferred, sold, or conveyed through the issuance of ABS; except that less than five per cent of the risk will need be retained if high standards for underwriting are satisfied by the securitizers and originators of the relevant assets.

The new rules must allocate the risk retention obligation between securitizers and originators. The retained risk may not be hedged.

Specific risk standards are to be set forth in the rules.

"Securitizer" means an issuer of an ABS; or a person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.

"Originator" means any person who, through the extension of credit or otherwise, creates a financial asset that collateralizes an ABS; and sells an asset directly or indirectly to a securitizer.

The potential impact of the new ABS-related requirements cannot be determined until the relevant rules are proposed. At a minimum, however, broker-dealers will want to review their due diligence and valuation processes.

STATUS

Rulemaking is required within 270 days of enactment.

The rules will take effect one year, for securitizations of residential mortgages, and two years, for all other securitizations, after publication in the Federal Register.

The SEC is currently accepting public comment regarding asset backed securities as well as other regulatory initiatives under Titles II-IV, VI - IX and XV of the Act.

5. Securities-Based Swaps (Sec. 764)

Security-based swap dealers and major security-based swap participants will be required to comply with SEC-prescribed business conduct standards. Among other things, broker-dealers who are deemed to be swap dealers or major security-based swap participants will have a duty to communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith and other standards and requirements prescribed by the SEC.

Security-based swap dealers will also have to comply with any SEC prescribed duties regarding their dealings with Special Entities as counterparties, including any duty to have a reasonable basis to believe that the counterparty has an independent representative with sufficient knowledge to evaluate the transaction and risks.

The SEC is authorized, but not required, to exempt from designation as a "security-based swap dealer" any person that engages in a de minimis quantity of security-based swap dealings in connection with transactions with or on behalf of its customers. (Sec. 761)

STATUS

The SEC must issue rules by July 21, 2011.

The SEC's general request for comments asks for comments regarding: (a) definitions (including "swap," "security-based swap," "security-based swap agreement," "mixed swap," "security-based swap dealer," and "major security-based swap participant"); (b) security-based swap dealers and major security-based swap participants; (c) mandatory clearing of security-based swaps, end-user exception and security-based swap clearing agencies; (d) mandatory exchange trading and swap execution facilities (e) governance and conflict of interest controls for clearing agencies, swap execution facilities and exchanges; (f) swap data repositories: (g) real-time reporting; and (h) anti-manipulation protections.

On August 13, 2010, the SEC and CFTC jointly issued a concept release seeking public comment to assist with defining key terms relating to swaps (i.e., "swap", "security-based swap", "swap dealer", "security-based swap dealer", "major swap participant", "major security-based swap participant", "eligible contract participant", and "security-based swap agreement").

The comment period will expire on September 20, 2010.

C. INVESTOR ELIGIBILITY

1. Accredited Investors (Sec. 413)

The net worth standard for an "accredited investor" under the 1933 Act is set at more than $1m of net worth, excluding the value of an individual's primary residence, for a natural person, or joint net worth with spouse, at the time of purchase. During the first four years following enactment, the net worth standard is set at $1m, excluding the person's primary residence.

Every four years, the SEC must review the definition of "accredited investor" to determine if adjustments should be made to other eligibility criteria for natural persons.

STATUS

Effective upon enactment.

On July 23, 2010, Corp. Fin. Issued interpretative guidance providing that, pending SEC rulemaking to adjust the accredited investor standard:

1. the related amount of indebtedness secured by a primary residence up to its fair market value may be excluded, in addition to the market value of the house; and

2. any indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth.

2. Eligibility for Accredited Investor Status and to Invest in Private Funds (Sec. 415)

GAO is required to conduct a study on the appropriate criteria for determining financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds. The report is due to the banking committees within three years of enactment.

STATUS

No immediate changes, however, this issue is among those included in the SEC's general request for comment regarding issues under the Act.

3. Qualified Client Standard (Sec. 418)

All dollar amount tests employed with respect to any factor used in any SEC rule or regulation promulgated with respect to IAA section 205(e), including the net asset threshold test, must be adjusted one year after enactment, and every five years thereafter for the effects of inflation.

STATUS

The SEC must adjust the thresholds one year after enactment and every five years thereafter.

4. Security-Based Swap Counterparties (Sec. 764)

Broker-dealers that are security-based swap dealers or major security-based swap participants will be required to verify that any counterparty meets the eligibility standards for an eligible contract participant.

STATUS

Rules must be prescribed within one year of enactment.

II. TRADING & INVESTMENTS

A. PRINCIPAL TRADING

The Act does not include any limitation on principal trading by a broker-dealer that provides advice to retail investors. If the SEC does exercise its discretionary authority and imposes the same duty of conduct on broker-dealers as on investment advisers, exemptive or other relief will be needed to allow principal trading with clients without written trade-by-trade disclosure and consent.

STATUS

If the SEC eliminates the broker exception from the IAA, or otherwise subjects broker-dealers to a fiduciary duty, relief from principal transactions will be required.

Note also that the SEC staff has determined to allow temporary IAA Rule 206(3)-3T, which provides an alternative means for dually-registered broker-dealers and investment advisers to comply with the consent requirement of section 206(3) for principal transactions, to expire on December 31, 2010.

B. RESTRICTIONS ON PROPRIETARY TRADING AND INVESTMENTS IN CERTAIN PRIVATE FUNDS (SEC. 619)

1. Proprietary Trading

The Volcker Rule will apply to broker-dealers that are affiliates of a banking entity, including a bank holding company or any insured bank or thrift, or a company that controls an insured bank or thrift, or is deemed to be systemically important nonbank financial companies.

Market making, hedging to mitigate risks, and transactions on behalf of customers are all permitted. Transactions would be prohibited if they were found to be high risk, pose a threat to US financial stability or the entity's safety and soundness, or involve or result in a material conflict of interest between the entity and its customers, clients and counterparties.

STATUS

By October 21, 2011, the SEC, CFTC and Banking agencies must adopt coordinated rulemaking.

The rules will be effective the earlier of 12 months after the issuance of final rules, or two years after enactment. The Federal Reserve may extend this period for one year, three times, for an aggregate of five years from enactment.

The SEC included prohibitions on proprietary trading in its general request for comment.

2. Investments In or Sponsorships of Hedge Funds or Private Equity Funds

This restriction of the Volcker Rule applies to the same types of entities that are subject to the proprietary trading restriction.

Subject to certain exceptions, a banking entity or systemically important nonbank financial company is prohibited from acquiring or retaining any ownership interest in or sponsoring a hedge fund or private equity fund.

Organizing and offering a hedge fund or private equity fund, including serving as a general partner, managing member, or trustee of the fund, and selecting the management or directors of the fund, among other things, is permitted when done in connection with bona fide trust, fiduciary or investment advisory services; only a de minimis investment is made; the investment does not present material conflicts of interest or pose a threat to US financial stability or the entity's safety and soundness; the entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the hedge fund or private equity fund or any fund in which such fund invests; there is no shared name; and written disclosure is made to prospective and actual investors that they, and not the banking entity or nonbank financial institution, bear sole responsibility for any losses.

STATUS

Generally, the above timeframes apply, except that the Federal Reserve may, upon application, extend the transition period for five years to fulfill a contractual obligation that was in effect on May 1, 2010.

The SEC included "prohibitions on certain relationships with hedge funds and private equity funds" in its general request for comment.

C. SECURITY-BASED SWAP (SEC. 763)

1. Accredited Investors (Sec. 413)

All security-based swaps must be traded on a securities exchange or through a swap execution facility unless no such entity is available for the particular swap. Limited exemptions are available from this requirement, including for trades with non-financial entities.

The SEC is authorized, but not required, to adopt business conduct standards

applicable to registered security-based swap dealers and major security-based swap participants concerning: (1) fraud, manipulation, and other abusive practices involving swaps; (2) diligent supervision of the business of the registered entity; and (3) adherence to all applicable position limits; and such other matters as the SEC determines to be appropriate. (Sec. 764).

STATUS

Rules must be prescribed within one year of enactment.

D. SHORT SELLING

1. Real-Time Short Position Reporting (Sec. 417)

ORSFI is required to conduct a study on the feasibility, benefits, and costs of requiring real-time reporting of short sale positions either publicly or to the SEC and FINRA and of conducting a voluntary pilot program by public companies in which the companies agree to have all trades in their shares reported real-time to the Consolidated Tape marked "short", "market maker short", "buy", "buy-to-cover", or "long." The report on the results of the study is due to the banking committees by July 21, 2011.

STATUS

No new requirements at this time.

2. Short Selling, Including Fails (Sec. 417)

ORSFI is required to conduct a study on the state of short selling on national securities exchanges and in the over-the-counter markets, including the incidence of the failure to deliver shares sold short. The report, together with any recommendations for market improvements, is due to the banking committee by July 21, 2012.

STATUS

No new requirements at this time.

3. Short Sales Reforms (Sec. 929X)

1934 Act section 15(d) requires that (a) broker-dealers notify customers that they may elect not to allow their fully-paid for securities to be used in connection with short sales; and (b) if a broker-dealer uses a customer's securities in connection with short sales, the broker or dealer must notify the customer that the broker or dealer may receive compensation in connection with lending the customer's securities.

The SEC has discretionary authority to prescribe the form, content, time, and manner of delivery of the notice.

STATUS

Effective upon enactment.

4. Additional Enforcement Authority (Sec. 929X)

The SEC is required to issue any additional rules that are necessary to ensure that the appropriate enforcement options and remedies are available to prevent manipulative short selling.

STATUS

No new requirements at this time.

5. Short Sale Disclosure (Sec. 929X)

1934 Act section 13(f) is amended to require the SEC to prescribe rules providing for the public disclosure of the name of the issuer and the title, class, CUSIP number, aggregate amount of the number of short sales of each security, and any additional information determined by the SEC following the end of the reporting period. At a minimum, monthly public disclosure is required.

STATUS

No new requirements until the SEC prescribe rules. ■