

ClientAlert

Financial Markets Developments

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[Dodd-Frank Wall Street Reform and Consumer Protection Act](#)

Provisions of The Dodd-Frank Act Impacting Broker-Dealers and Securities Trading

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act"), which was signed into law by President Obama July 21, 2010, contains numerous amendments to the Securities Exchange Act of 1934 (the "Exchange Act") that will impact broker-dealers and the trading of securities. Most of the provisions of Dodd-Frank that are directed in particular at broker-dealer and securities trading issues are set forth in Title IX of the Act, titled the Investor Protection and Securities Reform Act of 2010 (hereinafter "Title IX"). Several titles of Dodd-Frank other than Title IX enact a large number of amendments to the Exchange Act dealing with security-based swaps trading, clearing and market participants. These other provisions will clearly have an impact on broker-dealers trading and dealing in such instruments, but they are outside the scope of this Alert. Click [here](#) for a detailed discussion of the amendments to the Exchange Act dealing with swaps and derivatives.

1. How Does Title IX of Dodd-Frank Address the Different Standards of Conduct for Brokers-Dealers and Investment Advisers?

The issue of whether broker-dealers who provide investment advice to customers should be subject to the same standard of conduct as investment advisers providing advice to clients has been long debated within the securities industry. Financial planners and other investment advisers have argued that brokers providing incidental investment advice (such as securities recommendations) to brokerage customers, should be held to the same fiduciary standard of care to which investment advisers are subject when they provide investment advice to clients.

The US Investment Advisers Act of 1940 ("Advisers Act") excludes brokers and dealers from the definition of "investment adviser" with respect to the provision of investment advice that is "solely incidental" to the conduct of their business as brokers or dealers, provided they receive no special compensation for such advice.¹ This exclusion has meant that broker-dealers who provide securities recommendations or other investment advice to brokerage customers incidentally to their brokerage services are not investment advisers under the Advisers Act and thus not subject to the fiduciary standard of care imposed by Sections 206(1) and 206(2) of the Advisers Act. Rather, broker-dealers who are not also investment advisers are subject to the lower standard of suitability when selling investment products to customers, which requires only that the product or transaction be suitable for the customer. This suitability standard does not necessarily require a broker to avoid conflicts of interest when making recommendations to customers and would not



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require a broker to avoid considering its own financial interest in making a recommendation to a customer. An adviser subject to a fiduciary standard would have to place the interests of the client ahead of the adviser's and would need to act only in the best interest of the client. Applying a fiduciary standard to brokers could raise concerns that selling a proprietary product that pays the broker more than a non-proprietary product might not satisfy the fiduciary standard.

To address the issue of the different standards of conduct for broker-dealers and investment advisers, Chairman Frank's original version of the financial regulatory reform bill, which the House passed in December of 2009, would have mandated that broker-dealers be subject to a fiduciary standard of care when providing investment advice to retail customers and that brokers not take into account their own financial interest in making recommendations to retail customers. In contrast, the bill passed by the Senate in May of this year would have merely required the SEC to conduct a study of the differences between the standards of conduct for broker-dealers and investment advisers and then pass a rule if they found any gaps or meaningful differences. The Dodd-Frank Act, as signed into law by the President, settles on a compromise that requires the SEC to study the need for a unified standard of care for brokers, dealers and investment advisers when providing investment advice to "retail customers" while also simultaneously granting the SEC the express authority to commence a rulemaking immediately as necessary or appropriate in the public interest and for the protection of *retail customers and such other customers as the SEC provides* to address the legal or regulatory standards of care for broker-dealers and investment advisers and their associated persons for providing personalized securities investment advice to retail customers. In conducting this rulemaking, the SEC is ordered to consider the findings, conclusions and recommendations of the study required by the Act.

Retail Customer

Title IX of Dodd-Frank defines a "retail customer" to mean a natural person or his or her legal representative who receives "personalized" investment advice from a broker-dealer or investment adviser and uses the advice "primarily for personal, family or household purposes." It is not clear, however, exactly what "personalized" means, and it is presumably left up to the SEC to define or limit that term. Regardless, it does appear that this new standard of conduct will, with respect to retail customers, create a new duty for brokers and dealers that previously had only been subject to a general suitability standard when offering standardized investment products or advice to retail

customers. It should be noted that, while the authority granted to the SEC to pass rules relating to the standards of care for broker-dealers and advisers only specifically mentions "retail customers," it also grants the SEC the authority to pass rules governing the standard of conduct for broker-dealers dealing with "such other customers as the SEC provides" in its rule, if the SEC deems including such other customers within its rules necessary to protect such customers. This could in theory result in the SEC requiring in its new rules that institutional brokers, such as prime brokers and institutional executing brokers, be subject to a standard of conduct greater than mere suitability. Whether the SEC elects to impose any such higher standards on institutional brokers and dealers remains to be seen.

Title IX of Dodd-Frank expressly authorizes the SEC in its rulemaking to impose a standard of conduct on brokers providing investment advice to retail customers that is "the same as the standard of conduct applicable to an investment adviser under Section 211 of the Advisers Act." Notably, Title IX provides in new Section 15(k) of the Exchange Act that the receipt of compensation based on commissions or other standard brokerage compensation for the sale of securities shall not, in and of itself, be considered a violation of any standard of conduct that the SEC may apply to a broker-dealer, and states that a broker-dealer will not be required to have a continuing duty of care or loyalty to the customer after providing personalized investment advice regarding securities. Also, new Section 15(k) also provides that the sale of only proprietary or a limited range of products will not, in and of itself, be considered a violation of any conduct standard that the SEC may establish pursuant to the rulemaking authorized by Dodd-Frank.

Study Required Regarding the Standard of Conduct for Broker-Dealers and Advisers

Title IX of Dodd-Frank requires the SEC to conduct a study regarding the respective standards of care of broker-dealers and investment advisers to evaluate the need for a new standard of conduct for brokers and to determine to what degree the standards should be uniform for broker-dealers and investment advisers providing investment advice to retail customers. The SEC must consider a number of specific questions designed to evaluate the effectiveness of the legal and regulatory standards applicable to broker-dealers and investment advisers, including the sufficiency of current SRO rules (e.g., FINRA and NYSE rules), state laws, and the costs and benefits of adopting a uniform standard. The study must also consider retail investors' ability to understand regulatory differences between the current standards of conduct for broker-dealers and investment advisers. The SEC must report to the House and Senate's respective banking committees within six months after the enactment of Dodd-Frank

and seek public comment on these matters in order to prepare the report to Congress, and the SEC must take the findings of the study into account in either passing any new rule after the study is complete or amending any rule that it passes after the enactment of the Dodd-Frank Act but prior to the completion of the study.

2. Will There Be Any New Disclosure Requirements for Broker-Dealers?

Title IX of the Act adds new Section 15(1) to the Exchange Act, which directs the SEC to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest, and to examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest and compensation schemes for broker-dealers and investment advisers that the SEC deems contrary to the public interest and the protection of investors.

Pre-Sale Disclosures to Retail Investors

Most notably, Section 919 of Title IX expressly provides the SEC with authority to promulgate rules that specify the information and disclosures that a broker-dealer must provide to a “retail investor” before the purchase of an investment product of service and requires that any rules the SEC promulgates pursuant to this authority must (a) be in a summary format, (b) contain clear and concise information about investment objectives, strategies, costs and risks, and (c) contain clear and concise information about any compensation or other financial incentive received by a broker, dealer or other intermediary in connection with the purchase of retail investment products. This is a very significant development for the retail brokerage industry as it had fought previous attempts by the SEC to require point of sale disclosure to investors of the amount and type of compensation that a broker would receive in connection with the sale of an investment product (most notably mutual funds) to retail customers. The SEC had long felt that such information should be disclosed to investors, particularly retail investors, but the SEC’s authority to pass a rule requiring such disclosure had been challenged by the industry. Section 919 of Dodd-Frank makes it abundantly clear that the SEC now has authority to require disclosures regarding broker compensation and any other disclosures that SEC can justify as promoting investor protection, efficiency and capital formation. However, this express authority is limited to requiring disclosure to retail investors only.

Disclosures Regarding Sale of Proprietary Products

Title IX of the Dodd-Frank Act adds new Section 15(k)(2) to the Exchange Act, which provides the SEC with express authority to pass rules requiring broker-dealers that only sell proprietary or “other limited range of products” provide notice of such to each retail customer and obtain the consent or acknowledgement of the customer. This new Section 15(k)(2) provides that the sale of only proprietary or a limited range of products does not, per se, violate the standard of conduct that the SEC may require in any new rule setting the standard of care for brokers providing advice to retail customers, but it also does not define what would be considered a “limited range of products,” which leaves a good deal of discretion in the hands of the SEC to interpret this important condition for requiring enhanced disclosure to retail investors.

3. How Will The SEC Enforce These New Standards of Conduct With Respect to Broker-Dealers?

Title IX of Dodd-Frank adds new Section 15(m) to the Exchange Act, which requires the SEC to harmonize enforcement of violations of the standards of conduct applicable to broker-dealers and investment advisers. This new section also provides the SEC with enforcement authority under the Advisers Act to bring actions against broker-dealers for violations of any new Exchange Act standard of conduct applicable to a broker-dealer providing personalized investment advice about securities to a retail customer and requires the SEC to prosecute and sanction violators of the two standards of conduct to the same extent.

4. How Does the Dodd-Frank Act Impact Short-Selling?

Section 929X of Title IX of the Dodd-Frank contains several short-sale reform provisions.

Public Short-Sale Reporting by Institutional Managers

Most notably, Section 929X amends Section 13(f) of the Exchange Act to require the SEC to adopt rules providing for the public disclosure of certain information regarding short sales by institutional investment managers (i.e., persons who own or manage US\$100 million or more in publicly traded securities) who are currently required to file Form 13F beneficial ownership reports quarterly with the SEC. The information that the SEC must require to be disclosed regarding such short sales includes: (a) the name of the issuer of the security sold short, (b) the title, class, CUSIP and aggregate amount of the number of short sales of each security sold short, and (c) “any additional information determined by the SEC following the end of the reporting period.” Title IX further requires that these public disclosures required by the mandated

SEC rules shall occur no less than monthly. This is significant development for institutional managers (including brokers, dealers, investment advisers, banks and others) who currently file Forms 13F with the SEC because the required disclosures must be public, as per the express language of Title IX. Previously, the SEC has passed a temporary rule that required such institutional managers to file weekly short position and transaction reports on Form SH with the SEC, but that rule (which expired last summer) did not make the reports public. At the time that Form SH was implemented, many market participants expressed concern that short positions and transactions should not be made public because (1) such information is proprietary and could make a hedge fund or dealer's proprietary trading strategy known to the market, and (2) such disclosure could encourage short squeeze schemes and copycat short-selling by the larger market. With the apparently mandated public disclosure of short sale information, as specified in the SEC's rules required under Title IX, many of those same concerns will undoubtedly arise, particularly for active short sellers.

Securities Lending Restrictions and Impact on Short-Selling

Section 929X of Title IX amends the Exchange Act by adding new Section 15(e), which provides that all registered broker-dealers must provide notice to all of its customers (not just retail customers) that they may elect not to allow their fully paid securities to be used in connection with short-sales. New Section 15(e) also provides that, if a broker-dealer uses a customer's securities in connection with short sales, the broker-dealer must provide the customer with notice that the broker-dealer may receive compensation in connection with lending the customer's securities. These two new provisions are significant in that they make clear that any customer, including prime brokerage customers and other nonretail customers, can expressly preclude the lending of their fully paid securities (margin securities would still be subject to lending without customer consent). Of course, a prime broker does not have to accept a customer who refuses to allow their fully paid securities to be lent out by the prime broker, and until now most prime brokerage agreements have provided that the prime broker can lend out the customer's full paid securities. New Section 15(e) could change this dynamic by giving prime brokerage customers more leverage to negotiate lending restrictions regarding their fully paid securities, although it is difficult to predict. If large numbers of prime brokerage and institutional customers were to restrict the lending of their fully paid securities, this could reduce the number of shares available for borrowing to deliver on short-sales, which could have an impact on the number and frequency of fails-to-deliver in the market and could increase borrowing costs for traders that must borrow shares to ensure delivery on their short-sales.

5. How Are Associated Persons of Broker-Dealers and Investment Advisers Impacted by Provisions of the Dodd-Frank Act?

Collateral Industry Bars for Associated Persons

Section 925 of Title IX amends the Exchange Act and the Advisers Act to grant the SEC authority to bar individuals who violate the Exchange Act or the Advisers Act from being associated with essentially any securities firm or intermediary, including broker-dealers, investment advisers, investment companies, municipal securities dealers, transfer agents and securities rating organizations. Previously, the Exchange Act and the Advisers Act only allowed for bars from association with the specific type of registered securities entity that was involved in the particular violation.

Authority With Respect to Formerly Associated Persons

Title IX amends several provisions of the federal securities laws to make clear that the SEC may bring enforcement proceedings against persons who were formerly associated with a regulated entity (including broker-dealers, government securities brokers or dealers, public accounting firms and investment companies). This provision of Dodd-Frank was designed to prevent an individual from avoiding a penalty or collateral bar simply because he or she is no longer associated with that regulated entity at the time that the SEC seeks to institute administrative or enforcement proceedings.

6. How Does the Dodd-Frank Act Reform SIPC and the SIPA?

With the large scale losses that brokerage customers suffered as a result of the failures of Lehman Brothers and Bear Stearns and the much publicized fraud that Bernie Madoff committed through his brokerage firm, it became clear that the fund used by the Securities Investor Protection Corporation ("SIPC") to pay back brokerage customers' claims of lost securities and cash in the event of broker-dealer failures was inadequately funded. In response to this realization, Congress in Section 929C of Title IX has increased SIPC's authority to borrow from the Treasury Department, from US\$1 billion to US\$2.5 billion and, more importantly, has in Section 929V of Dodd-Frank amended the Securities Investor Protection Act of 1970 (the "SIPA") to increase the annual assessment that SIPC members must pay to fund the SIPC fund from the current US\$150 annual fee to a new annual assessment equal to 0.02 percent of the gross revenues from the securities business of such member. This should greatly enhance the refunding of the SIPC fund when depleted in times of numerous broker-dealer failures and insolvencies, such as has occurred during the current financial crisis.

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In addition, Section 929H of Title IX amends the SIPA to increase the standard maximum cash advance a customer can receive per account capacity from the previous US\$100,000 cash limit to US\$250,000 and includes an inflation adjustment for the standard maximum cash advance that must be made no later than January 1, 2011 and every five years thereafter.

Finally, Section 929V amends the SIPA to provide that any person who falsely represents by any means, with actual knowledge of the falsity of the representation and with an intent to deceive or cause injury to another, that such person or another person is a SIPC member or that any person or account is protected or eligible for protection under SIPA or by SIPC, will be liable for any damages caused and will be fined up to US\$250,000 or imprisoned for up to five years.

1. See Section 202(a)(11)(c) of the Advisers Act.

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