

PRESIDENT OBAMA'S PLAN FOR HARMONIZATION OF BROKER-DEALER AND INVESTMENT ADVISER REGULATION AND INCREASED FEDERAL RESERVE AUTHORITY OVER CLEARING AND SETTLEMENT SYSTEMS

On June 17, 2009, the Obama administration released a white paper outlining its proposals to reform significant aspects of the system of financial regulation in the United States.¹ Among its many proposals, the Obama administration seeks changes to the regulation of broker-dealers and investment advisers, as well as payment, clearing and settlement systems.

Harmonization of Broker-Dealer and Investment Adviser Regulation

The administration advocates for harmonization of the regulation of investment advisers and broker-dealers to address investor confusion about the roles these financial intermediaries play. To implement the regulatory harmonization, the administration proposes new legislation that would:

- require broker-dealers who provide investment advice about securities to have the same fiduciary obligations as registered investment advisers;
- provide simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals; and
- prohibit certain conflicts of interest and sales practices that could be construed as contrary to the interests of investors.²

The administration calls for legislation that would grant the Securities and Exchange Commission the necessary authority to carry out these proposals. The SEC also would be empowered to “examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the investors’ best interest.”

The white paper focuses on the retail investor’s view of broker-dealers and investment advisers.³ The paper notes that broker-dealers and investment advisers often offer to retail investors virtually identical products and services and, as a result, retail investors are confused about the distinctions

¹ *Financial Regulatory Reform: A New Foundation*, Department of the Treasury (June 17, 2009) (“Reform Proposal”), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

² See Reform Proposal, p. 71 et seq.

³ The proposed reforms would create a single federal agency, the Consumer Financial Protection Agency (“CFPA”), intended to protect consumers in the financial products and services markets. The CFPA’s jurisdiction would include “consumer financial services and products such as credit, savings and payment products and related services.” The paper makes clear, however, that the CFPA would not have jurisdiction over “investment products and services already regulated by the SEC or CFTC” and, therefore, would not appear to be involved in the regulation of broker-dealers’ and investment advisers’ securities-related activities.

between the two. According to the administration, “the distinction is no longer meaningful between a disinterested investment [adviser] and a broker who acts as agent for an investor.” From the perspective of the retail investor, “an investment adviser and a broker-dealer providing ‘incidental advice’ appear in all respects identical.”

Perhaps due to its breadth, the white paper does not offer details about how a fiduciary duty would apply to broker-dealers’ sales activities, and the SEC and its staff likely will be tasked with the difficult job of determining when a broker-dealer is providing “investment advice about securities” and therefore should be subject to a fiduciary duty, as compared to acting as a sales agent and therefore not acting as a fiduciary.⁴ In addition, the paper does not make clear whether the fiduciary duty would be applied to broker-dealers by applying the Investment Advisers Act of 1940 to their activities, or by applying a fiduciary duty to broker-dealers through other means. If the Advisers Act were to apply, the principal trade restrictions may prevent broker-dealers from conducting many of the services and activities investors have come to expect from them. Similar issues arise under the Employee Retirement Income Security Act (ERISA), which severely limit many of the activities of a “fiduciary” as defined under that Act.

One significant issue that the paper does not explicitly address is whether there should be a self-regulatory organization (SRO) for investment advisers akin to the Financial Industry Regulatory Authority, Inc. (FINRA) for broker-dealers. While it is not entirely clear that the lack of discussion of an SRO means that none is contemplated, it is generally understood that legislation would be necessary to establish an SRO for investment advisers.

Prohibition of Mandatory Arbitration

In another proposal aimed at investor protection, the administration recommends legislation that would empower the SEC “to prohibit mandatory arbitration clauses in broker-dealer investment advisory accounts.”⁵ The paper expresses concern that, while arbitration may be a reasonable option for resolving disputes between broker-dealers and their customers, mandatory arbitration could be seen as disadvantageous to customers in some cases. Before using its authority to prohibit mandatory arbitration clauses, the SEC would first need to conduct a study on the use of such clauses, with a focus on whether arbitration inhibits investors’ ability “to obtain effective redress of legitimate grievances” and on whether the arbitration system should be changed in some fashion.

The use of mandatory arbitration clauses in brokerage agreements has long been debated and, if the SEC receives and acts upon the authority to prohibit that practice, there could be unintended effects, for example lengthening the dispute resolution process and ultimately increasing the costs to customers involved in disputes. It may also burden broker-dealers with significant costs because they would need to amend all of their customer agreements. Prohibition of mandatory arbitration

⁴ Difficulty in making this distinction was highlighted in Rule 202(a)(11)-1 of the Advisers Act, which was vacated by the U.S. Court of Appeals for the District of Columbia Circuit in *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

⁵ Reform Proposal, p. 72.

clauses also would appear inconsistent with the public policy embodied in the Federal Arbitration Act, which “declared a national policy favoring arbitration.”⁶

Federal Reserve Oversight of Clearing and Settlement Systems

The Federal Reserve would gain oversight authority over all systemically important payment, clearing and settlement systems, including, for example, National Securities Clearing Corporation.⁷ The Federal Reserve’s authority would supplement that of existing regulators, such as the SEC.

The Federal Reserve would have the authority to assist in determining the scope of, and participate in, on-site examinations of payment, clearing and settlement systems by the primary regulators of those systems. The proposal also would grant the Federal Reserve the right to be consulted on all rule changes that affect such a system’s risk management. Finally, the Federal Reserve would have the power to force a system that did not meet applicable standards to take corrective action. Although it would first recommend the corrective action to the system’s market regulator, if the market regulator did not comply, the Federal Reserve could force such action on an emergency basis, after consultation with a proposed Financial Oversight Council.

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⁶ See *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995) (citing *Southland Corp. v. Keating*, 465 U.S. 1 (1984)).

⁷ Reform Proposal, p. 51.