The Investor Protection Act of 2009 Takes Aim at Strengthening Disclosure and Enforcement Under the Federal Securities Laws

On Friday July 10, 2009, the White House and the Treasury Department delivered to Capitol Hill proposed legislation known as the Investor Protection Act of 2009 (the "Proposed Legislation").[1] This comes nearly a month after the Treasury Department released the white paper on Financial Regulatory Reform (the "White Paper").[2] The White Paper broadly laid out numerous regulatory objectives of the President's plan to reform, modernize and protect the integrity of the financial system. These objectives include (i) promoting robust supervision and regulation of financial firms, (ii) establishing comprehensive regulation of financial markets, (iii) protecting consumers and investors from financial abuse, (iv) providing the government with the tools it needs to manage financial crises and (v) raising international regulatory standards and improving international cooperation. The Proposed Legislation addresses the first three objectives laid out in the White Paper by strengthening disclosure requirements and enforcement and remedies available under each of the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act"), the Investment Company Act of 1940 (the "Company Act") and the Investment Advisers Act of 1940 (the "Advisers Act" and, collectively, the "Acts").

The highlights of the Proposed Legislation are as follows:

I. Disclosure

Investor Advisory Committee

The boldest piece of the Proposed Legislation is to establish under the Exchange Act the Investor Advisory Committee. This committee will be asked to advise and consult with the Securities and Exchange Commission (the "Commission") on a broad range of topics including (i) regulatory priorities and issues regarding new products, trading strategies, fee structures and the effectiveness of disclosure, (ii) initiatives to protect investor interest and (iii) initiatives to promote investor confidence in the integrity of the market place. However, the findings or recommendations of the committee shall not be binding on the Commission.

The members of the Investment Advisory Committee will be appointed by the Chairman of the Commission and shall represent interests of both individual and institutional investors and use a wide range of investments and approaches. However, the number of members is not specified. The Investment Advisory Committee will be required to meet at least two times each year and the Commission will be appropriated sufficient funds to cover the costs of the Investment Advisory Committee, including compensation and travel expenses of all members.

Consumer Testing

The White Paper suggests that, in order for the Commission to be able to better evaluate the effectiveness of investor disclosures, the Commission needs the ability to meaningfully engage in consumer testing.[3] This would include field testing, consumer outreach and testing of disclosure to individual investors.[4] Prior to the

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1 Proposed Legislation, Title IX - Additional Improvements to the Financial Markets, available at http://www.treas.gov/press/releases/docs/tg205071009.pdf.

2 Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

3 *See* White Paper at 71.

4 *Id.*

Proposed Legislation, it was perhaps unclear whether the Commission had the authority to engage in such activities or if such activities would be receive budgetary support.

By amending each of the Acts, the Proposed Legislation would confirm that the Commission has the authority to engage in consumer testing for the purpose of evaluating current and proposed rules and programs. Specifically, the Commission will be authorized to gather information, communicate with investors and other members of the public and engage in temporary or experimental programs determined by the Commission in its discretion to be in the public interest or for the protection of investors.

Fiduciary Duty Owed by Brokers-Dealers and Investment Advisers

From the perspective of individual retail investors, investment advisers and broker-dealers are nearly indistinguishable. However, they are regulated under different legal frameworks; the investment adviser is legally its customer's fiduciary, while the broker-dealer, who gives "incidental advice" in the course of its business, does not have to comply with the same high standard.

The Proposed Legislation would amend the Exchange Act and the Advisers Act to even the playing field between investment advisers and broker-dealers. Specifically, the Commission will be authorized to promulgate rules to provide that brokers, dealers and investment advisers, when providing investment advice to retail customers, shall be required to act solely in the interest of such customers without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice. In addition, the Commission will be tasked with taking steps to simplify and clarify disclosure to investors regarding the terms of their relationships with investment professionals and to prohibit sales practices, conflicts of interests and compensation schemes for financial intermediaries that it deems contrary to the public interest or the interests of investors.

Purchasing Shares of an Investment Company

The timing of certain disclosures is also addressed by the Proposed Legislation. Currently, many prospectuses are not required to be delivered until *after* the sale has taken place. The Proposed Legislation specifically authorizes the Commission to require that delivery of certain documents or information precede a sale to a purchaser of securities issued by a registered investment company. Therefore, under the Proposed Legislation, a purchaser of shares in a mutual fund would have adequate information to make an informed investment decision prior to the confirmation of the sale.

II. Enforcement and Remedies

Limitation on Mandatory Arbitration Clauses

Pursuant to industry-wide practice, when opening an investment account with a broker-dealer, customers are generally required to agree to arbitration of all disputes arising from matters related to the account. The White Paper states that, while it may be reasonable to accept arbitration *after* a particular dispute arises, so-called "pre-dispute" arbitration clauses may unfairly undermine investors by mandating the venue and method of adjudicating disputes and eliminating access to courts.[5] The Proposed Legislation would amend the Exchange Act and the Advisers Act to allow the Commission to prohibit, or impose limitations or conditions on the use of, agreements that require customers of broker-dealers to arbitrate any future dispute arising under the federal securities laws or the rules of a self-regulatory organization.

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[5] *Id*. at 72.

Whistleblower Incentives and Protections

In many cases, the Commission relies on information from private individuals, so-called "whistleblowers," to provide information that leads to enforcement actions. Currently, the Commission has the authority to compensate, and thus create incentives for, whistleblowers who bring forward information in insider trading cases. The Proposed Legislation would amend the Acts to expand the scheme to compensate whistleblowers that bring forward well-documented evidence of any fraudulent activity.

The Proposed Legislation would create the Investor Protection Fund which will include in its deposits any monetary sanction collected by the Commission in any proceeding brought by the Commission under the securities laws.[6] Any whistleblower who voluntarily provides original information[7] to the Commission that leads to the successful enforcement of an action under the securities laws which includes monetary sanctions exceeding $1,000,000 will be eligible to receive an award, to be paid out of the Investor Protection Fund, in an amount not exceeding 30 percent of such sanctions. The amount of the award shall be determined by the Commission in its sole discretion. Such determination may include, among other things, the degree of assistance provided by the whistleblower and any legal representative and the Commission's programmatic interest in deterring the type of violation at issue. Regardless, no award shall be made if the whistleblower (i) is a member, officer or employee of any appropriate regulatory agency, the Department of Justice or a self-regulatory organization, (ii) is convicted of a criminal violation relating to the subject matter of the information provided or (iii) fails to submit the information in such form as the Commission may require by rule.

The Proposed Legislation also includes certain protections for whistleblowers. Any employee, contractor or agent who is discharged, demoted, suspended, threatened, harassed or otherwise discriminated against in the terms or conditions of their employment because of any lawful act done in connection with providing information to the Commission as a whistleblower shall be entitled to full relief. This relief shall include full reinstatement, two times back pay, with interest and compensation for any special damages, including litigation expenses. In addition, the Commission shall keep all information provided by whistleblowers confidential and such information shall be privileged as an evidentiary matter, not subject to civil discovery or other legal process. However, such information may be used in connection with the proceeding for which it was provided and certain government agencies may use such information subject to the continuing maintenance of such information as confidential and privileged.

Collateral Bars

Under the current framework of both the Exchange Act and the Advisers Act, any violation of the securities laws by an individual acting as a broker-dealer, municipal securities dealer, transfer agent or investment adviser could result in sanctions barring such person from acting in such capacity. However, the various provisions are mutually exclusive and do not provide the Commission with explicit authority to bar an individual from all aspects of the securities industry, but only from that area of the industry specifically related to the violation. The Proposed Legislation would amend the Exchange Act and the Advisers Act to allow the Commission, in the case of a violation by an individual acting in any of the above capacities, to bar such person

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[6] These deposits will exclude any monies added to the disgorgement fund pursuant to Section 308 of the Sarbanes-Oxley Act of 2002 to the extent such monies are distributed to victims of a violation of the securities laws or any monies otherwise distributed to such victims. The fund will be capped at $100,000,000.

[7] Under the Proposed Legislation, "original information" includes any information that is based on direct and independent knowledge or analysis of a whistleblower, is not already known to the Commission, and is not based on allegations in a hearing, report, audit or from the news media.

across the board from being associated with any transfer agent, broker-dealer, investment adviser, municipal securities dealer or nationally recognized statistical rating organization.

Aiding and Abetting Liability under the Federal Securities Laws

In a move that expands the classes of defendants for violations of each of the Securities Act, Company Act and Advisers Act, the Proposed Legislation would amend each of the foregoing to provide that aiding and abetting, defined to mean knowingly or recklessly providing substantial assistance to, another person in violation of any provision shall be a violation of such provision to the same extent as the person to whom such assistance was provided. This change mirrors the standard already found in Section 20 of the Exchange Act.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Banks Bruce at 212.701.3052 or bbruce@cahill.com.