Capital Markets Regulatory Reform: Strengthening Investor Protection,
Enhancing Oversight of Private Pools of Capital, and
Creating a National Insurance Office

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Chairman Frank, Ranking Member Bachus, and members of the Committee, thank you for the opportunity to appear before you to discuss the protection of investors. It is an honor and a privilege to appear before the Committee today.

This testimony briefly discusses certain provisions of the October 1 draft of the Investor Protection Act of 2009 (the "Act").

Statutory Fiduciary Duty for Brokers

Section 103 of the Act establishes a federal fiduciary duty for brokers, dealers and investment advisers who provide investment advice about securities to retail investors. It amends the Exchange Act to require the SEC to impose the same "standard of conduct" for brokers who provide investment advice to retail clients that is applicable to an investment adviser under the Advisers Act. It requires a parallel rulemaking under the Advisers Act to establish that the "standard of conduct" for brokers, dealers, and investment advisers as to investment advice provided to retail investors is to "act in the best interest of the customer." The provision defines "retail customer" as an individual or individual's representative who receives "personalized investment advice . . . and uses such advice primarily for personal, family or household purposes."

Section 103 will substantially enhance the protection of investors. Currently, brokers are held to a fiduciary duty with respect to retail investment advice only to the extent that the client can demonstrate a relationship of trust and confidence or the broker is an investment adviser under the Advisers Act. In contrast, Section 103 establishes that the providing of retail investment advice is alone sufficient to create a fiduciary duty for all brokers.

The current fiduciary standard under the Advisers Act, as set forth by the Supreme Court in *Capital Gains*[1] and in numerous federal judicial and administrative precedents, applies only to brokers who are subject to the Advisers Act. Brokers whose investment advice is solely incidental and who receive only commission-based compensation are excluded from the definition of "investment adviser" under and therefore not subject to the Advisers Act. The SEC's overbroad interpretation of the term "solely incidental" has allowed a class of brokers who provide a significant amount of personalized investment advice to avoid regulation under the Advisers Act and thereby the automatic application of the federal fiduciary standard under the Act when they provide investment advice. These brokers are subject to a fiduciary duty only when their advisory arrangements with clients create a relationship of trust and confidence. Section 103 harmonizes the federal fiduciary standard as applied to retail investment advice by establishing that brokers who provide retail investment advice are subject to a fiduciary duty under the Advisers Act, regardless of whether they are otherwise regulated under the Act.

It is unclear, however, whether the same fiduciary standard needs to applied to investment advisers through an amendment to the Advisers Act. Investment advisers already are subject to a fiduciary duty under the Advisers Act with respect to investment advice provided to all clients, whether or not it is retail in nature. There is a risk that creating a statutory fiduciary duty under the Act could be

[1] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

interpreted to narrow the scope of the existing Advisers Act fiduciary duty under *Capital Gains* and other federal court and administrative precedent. By amending Section 102 to leave the Advisers Act unchanged, the Committee could remove any possible doubt that the fiduciary applicable to investment advisers has been narrowed.

If there is a concern that fiduciary standards might be applied differently to brokers and advisers without a parallel amendment to the Advisers Act, then the amendment to the Exchange Act could simply be revised to state that, with respect to retail investment advice, brokers shall be subject to the fiduciary duty that applies to investment advisers under the Advisers Act. This approach would establish that the source of law in applying a fiduciary duty to brokers and advisers regarding retail investment advice was the same for both, without potentially affecting an adviser's fiduciary duty in other, non-retail contexts.

<u>Restrictions on Mandatory Arbitration</u>

Section 201 of the Act amends the Exchange Act and Advisers Act to authorize the SEC to regulate mandatory arbitration clauses in brokerage and advisory agreements. Arbitration can provide a fair and efficient means of resolving disputes that benefits brokers, advisers, and their clients. There are persuasive arguments, however, that mandatory arbitration does not serve this purpose. Many commentators have pointed to: the lack of guidance provided to arbitrators regarding applicable law; the lack of written, public decisions; the process by which panels are selected; the procedural rules governing arbitration and a host of other concerns as showing bias against brokers' customers (virtually all of the commentary has involved broker arbitration, not adviser arbitration).

Regardless of the merits of these criticisms, there can be no question that subjecting arbitration to SEC oversight will enhance the accountability of arbitration systems and increase the likelihood that FINRA and other arbitration sponsors will be

responsive to investors' concerns. The presence of an outside perspective with the authority to require change alone should encourage arbitration reform and improve public confidence in alternative dispute resolution mechanisms.

It should also be noted that the SEC previously has taken the position that a mandatory arbitration clauses in advisory agreements may violate an adviser's fiduciary duty to his client. I am not aware of that position having been expressly reversed, but it is my understanding that advisory agreements commonly include mandatory arbitration agreements (although not necessarily requiring FINRA arbitration as is the case with broker arbitration agreements). This suggests that the advisory community believes that the SEC has informally rescinded that position. In any case, Section 201's amendment of the Advisers Act to authorize the SEC to restrict the use of mandatory arbitration would implicitly overrule the SEC's position because the amendment expressly recognizes the use and implicitly the propriety of adviser arbitration clauses.

Interested Person Definition

Section 412 of the Act would amend the Investment Company Act to include in the definition of an interested person of investment company any person whom the SEC finds would be unlikely to exercise an appropriate degree of independence because of: (1) a material business or professional relationship with the company or any affiliated person of the company, or (2) a close familial relationship with any affiliated person of the company.

These provisions would provide the SEC with the flexibility that it needs to plug significant gaps in the definition of interested persons of investment companies. Noninterested directors of investment companies play an important role in protecting the interests of investors. The current definition of interested person is overbroad and allows conflicted persons to act as independent directors. For example, a former executive of an investment company's investment adviser can

join the board of the company and be considered a noninterested director, as can certain close relatives of current executives of the investment adviser. These persons cannot be expected to exercise impartial oversight of investment company operations or act as strong advocates for investment company shareholders when their interests may conflict with those of the company's adviser. Section 412 would provide the SEC with the authority it needs to ensure that these and other conflicted persons cannot claim to act as independent watchdogs for fund shareholders.

Illiquid Investments

Section 413 would provide the SEC with express authority limit mutual funds' investments in illiquid securities. Mutual funds have not been immune the current liquidity crisis. The illiquidity of short-term debt threatened to cause the per share net asset values of many money market funds ("MMFs") to drop below a dollar when they were unable to sell previously liquid securities at their carrying value. This catastrophe was narrowly averted only by government intervention. Illiquid investments held by other types of funds pose a threat to the integrity of the price at which the fund executes purchasers and redemptions. When market liquidity tightens, shareholders who are late movers in a flood of redemptions can be saddled with a disproportionate share of the fund's losses. While the SEC's longstanding 10% and 15% illiquid investment limits on MMFs and non-MMFs, respectively, have worked reasonably well, any doubt regarding its authority to impose such restrictions should be removed.

Whistleblowers

Section 605 of the Act would amend the whistleblower provision of the Sarbanes-Oxley Act of 2002 to extend coverage to subsidiaries or other affiliates whose financial information is included in the relevant public company's consolidated financial statements. This provision would ensure that the purpose of the whistleblower protections are not frustrated by organizational structures that are

irrelevant to the appropriate application of the provision. The importance of ensuring the integrity of public company reporting is in no way diminished when the information reported is that of a subsidiary or other affiliate.

Similarly, the whistleblower provision should be amended to ensure that employees of a public investment company's investment adviser are also covered. Certain investment advisers have taken the position that the whistleblower provisions do not apply to their employees because the advisers are not public companies, notwithstanding that, with respect to an investment company, the investment adviser is the entity responsible for investment company securities law compliance. An investment company's compliance functions rarely are carried out by the company's employees because investment companies generally have no employees other than persons who are also employees of the adviser. In practice, the only way for the whistleblower provisions to operate in the investment company context would be for them to apply to employees of the company's adviser.[2] Section 605 should also amend the whistleblower provision by inserting after "agent of such company," "or any officer, employee, contractor, subcontractor, or agent of an investment or principal underwriter of a registered investment company,".

[2] *See generally* Letter from Fund Democracy, Consumer Federation of America, Consumer Action and the North American Securities Administrators Association to the SEC (Mar. 28, 2008) *available at* http://www.funddemocracy.com/whistleblower%20letter%20final.pdf.