Review of Recent Regulatory Developments

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As the regulatory organizations charged with overseeing the financial services industry struggle to carry out recent legislative mandates, industry participants are left to figure out what the new requirements mean for their businesses and how they can best comply with the provisions. While industry regulators have been busy this past year, next year promises to be even busier as certain initiatives reach the implementation stage. This article focuses on the recent regulatory and legal developments that are most germane to the investment consulting industry.

Form ADV Amendments

Several recent developments enhance disclosure provided to prospective and existing investment advisory and brokerage clients. For example, the Securities and Exchange Commission (SEC) has amended Form ADV to require a narrative brochure that describes the registrant’s advisory services. To comply with this new requirement, many investment advisers have needed to prepare descriptions of the services they provide and how they tailor those services to meet individual client needs. Investment advisers previously were obligated to disclose potentially material conflicts of interest, but now they must specifically address potential conflicts of interest raised by performance-based fees and side-by-side management of accounts with and without performance-based fees, advisers’ participation in client transactions such as through agency cross and principal transactions, and the use of soft dollars. The Form ADV amendments also required that investment advisers’ brochures be made public by filing them with the SEC via the Investment Adviser Registration Depository (IARD). Time will tell whether publicizing the details of investment advisers’ business and fee arrangements will lead to increased competitive pressure.

Form ADV, Part 2B requires investment advisers to prepare a brochure supplement for each supervised person “who formulates investment advice for a client and has direct client contact,” or “who has discretionary authority over a client’s assets,” even absent direct client contact.” At many firms the preparation of the brochure supplement raised as many—if not more—questions than the brochure. Many firms realized that the population of such supervised persons could be extensive and tried to define a more manageable universe. The next challenge was determining which legal or disciplinary events for individual supervised persons were “material to a client’s or prospective client’s evaluation of the supervised person’s integrity” and warranted disclosure. For example, does the fact that one of a supervised person’s professional designations lapsed due to his or her failure to complete required continuing education bear materially on the person’s integrity? Lastly, investment advisers have been challenged to briefly explain in the brochure supplement how each person is supervised and by whom. To alleviate some of the stress experienced by investment advisers and provide “additional time to design, test, and implement systems and controls to satisfy their obligations to prepare and deliver brochure supplements,” the SEC extended the compliance date of Part 2B by four months for those investment advisers with fiscal year ends between December 31, 2010, and April 30, 2011.

In a few short months, investment advisers will revisit their brochures as they prepare for their first annual updating amendments. As they do so, they will need to consider whether they must prepare a summary of material changes, which also must be filed with the SEC. Investment advisers that do need to update their brochures to correct material inaccuracies or reflect information filed in interim amendments will have the option of delivering only the summary of material changes together with an offer to provide the brochure to clients electronically. Investment advisers also should be aware that Form ADV, Part 1A has been amended and updated to request a variety of new information, including information related to exempt reporting advisers.

FINRA Point of Sale Disclosure Proposal

In May 2011 the Financial Industry Regulatory Authority (FINRA) submitted Proposed Rule 2341 to the SEC for approval. This proposal would have provided mutual fund investors with information on the cash compensation that broker-dealers receive from mutual funds and their affiliates, in addition to the sales charges and service fees disclosed in the mutual funds’ prospectuses. The SEC has promoted its own point-of-sale disclosure requirement in the past and appears to be considering reviving and enhancing its initiative in light of authority clarified by Section 919 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The seemingly duplicative initiatives have caused some in the industry to scratch their heads. The Independent Directors Council, among others, commented: “We are unclear, however, why the SEC and FINRA are pursuing this narrow change at this time, when broader point-of-sale initiatives that could provide more comprehensive and meaningful information to investors are underway.” FINRA withdrew its rule proposal in August, but expects to repropose it in the coming months. We expect some form of point-of-sale disclosure to become a reality in 2012, but whether
such disclosure is mandated by FINRA, the SEC, or a combination of the two regulators remains to be seen.

FINRA Disclosure Statement for Retail Investors

In October 2010, FINRA published Regulatory Notice 10-54, in which it sought comment on a potential proposal to require broker–dealers to provide retail investors with disclosure statements similar to investment advisers’ brochures at or before commencing business relationships with such investors. As contemplated, any required point-of-sale disclosure would be included in the disclosure statement. Many of the questions raised in the Regulatory Notice are closely related to or overlap with those raised in the SEC’s Study on Investment Advisers and Broker–Dealers. We should start to see answers to these questions in the new year as the SEC begins to take its next steps in response to the various Dodd-Frank initiatives and FINRA follows suit. In addition, we would not be surprised to see the contours of a disclosure statement for broker–dealers begin to take shape in the first half of 2012.

New FINRA Know Your Customer and Suitability Rules

FINRA’s continued efforts to consolidate its rules have produced changes aimed in part at improving the services broker–dealers and their personnel provide to prospective and existing clients. FINRA’s recent Know Your Customer and Suitability Rule changes demonstrate this intent.¹ The rules were scheduled to go into effect on October 7, 2011, but were later delayed until July 9, 2012. New FINRA Rule 2090, largely based on NYSE Rule 405(1), generally requires broker–dealers and their personnel to use reasonable due diligence to learn the “essential facts” concerning customers.² The reasonable due diligence obligation commences when the broker-customer relationship is formed, not when a broker–dealer makes the first recommendation to the client. The rule defines “essential facts” as “those required to (a) effectively service the customer’s account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules.” FINRA has yet to address how best to handle a customer that does not want to provide essential facts as requested.

Similar to new FINRA Rule 2090, new FINRA Rule 2111 retains much of its predecessor’s rule text. It codifies the following three core suitability obligations: (i) “Reasonable basis” suitability (a reasonable basis to believe, based on adequate due diligence, that a recommendation is suitable for at least some investors); (ii) “Customer specific” suitability (reasonable grounds to believe a recommendation is suitable for the particular investor at issue); and (iii) “Quantitative” suitability (a reasonable basis to believe the number of recommended transactions within a certain period is not excessive). However, new FINRA Rule 2111 explicitly incorporates an obligation for broker–dealers and their associated persons to have a reasonable basis to believe that a recommended investment strategy involving securities is suitable for a customer, including recommendations to “hold” a security. Previously, suitability obligations applied only to recommended transactions, not investment strategies. This change promises to raise questions about how to collect, share, and monitor information needed to make investment strategy suitability determinations and the appropriate scope of an investment strategy suitability analysis.

FINRA states that the reasonableness determination should be based on “the customer’s investment profile,” which is described to include the following data points of the customer:

- Age
- Financial situation and needs
- Investment objectives
- Investment time horizon
- Risk tolerance
- Other investments
- Tax status
- Investment experience
- Liquidity needs
- Any other information the customer may disclose to the member or associated person in connection with such recommendation

Broker–dealers and their personnel will have to take care that these and other relevant data points are collected during the customer intake process. A review of Rule 17a-3 under the Securities Exchange Act of 1934 and Investment Advisers Act Release No. 1406 (March 16, 1994) also may provide some guidance in determining the types of information to collect to carry out the suitability obligations applicable to recommended investment strategies.

New FINRA Rule 2111 also modifies the institutional customer exemption, in part, by incorporating concepts previously introduced via National Association of Securities Dealers (NASD) interpretive guidance. Broker–dealers and their associated persons must now have “a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies, and is exercising independent judgment in evaluating recommendations.” Compliance includes obtaining an affirmative indication from the customer that he or she is indeed exercising independent judgment.

Broker–dealer personnel should be on the lookout for revised policies and procedures, and they should carefully review any accompanying guidance or statements of operation, to ensure that they do not inadvertently run afoul of the new FINRA Rules or internal guidelines.

ERISA Disclosure Requirements

In July 2010, the U.S. Department of Labor (DOL) adopted an interim final regulation under Section 408(b)(2) of
ERISA, requiring service providers to ERISA pension plans to provide more detailed disclosure about their services, their direct compensation (paid by the plan), and their indirect compensation (paid by parties other than the plan and plan sponsor). These rules, when they take effect next year, will require compensation disclosures to be provided by service providers who are plan fiduciaries or registered investment advisers, as well as by persons who receive “indirect” compensation in connection with providing certain types of services typically used by benefit plans, such as banking, consulting, custody, legal, or brokerage. The disclosures must be given to a plan’s “responsible plan fiduciary”—the plan fiduciary with the authority to cause the plan to contract for the services (typically the plan sponsor or a plan committee)—at the outset of the service arrangement, or by the regulation’s effective date for existing arrangements. The service provider must then notify the responsible plan fiduciary of any changes as soon as practicable, but not later than 60 days after the service provider learns of the change.

DOL is working on a final regulation that it aims to publish before the effective date of the new rules, recently extended to April 1, 2012. However, the final regulation likely will not be published before mid-November 2011. Given that substantive changes are expected, including as to the form in which the disclosures are to be made, time may be short to figure out how to comply with the new requirements.

Service providers covered by the new rules must provide the required disclosures to ERISA pension plan clients by the April 1, 2012, effective date, and to new clients on and after the effective date. They should plan accordingly, by taking inventory of their ERISA pension plan business that may be affected and planning how to make the necessary disclosures. In addition, they should develop a process for alerting clients to any change in the disclosed information within the timeframe required by the regulation. If the service provider disclosure rule is violated, the plan sponsor or fiduciary that retained the noncomplying service provider potentially could be liable for having engaged in a prohibited transaction. Therefore, plan sponsors should consider developing a process for determining which plan service providers will be obligated to make the required disclosures, and for reviewing the information received to confirm that disclosures have been provided by all the plan’s covered service providers and contain all the necessary information. To qualify for a special rule that relieves plan sponsors but not service providers from liability in the event disclosures are not received or are incomplete, there should be a process for requesting the missing information from a noncomplying service provider and for notifying DOL if the service provider still fails to comply. In addition, to help demonstrate compliance with their general fiduciary responsibilities under ERISA, plan sponsors and other plan fiduciaries should plan to utilize the information obtained as part of their process for selecting and monitoring plan service providers, in particular for evaluating whether the plan is paying, or the service provider is receiving, in excess of “reasonable compensation” for its services. This can be accomplished by integrating the review of the disclosed information into the selection and monitoring process and appropriately documenting that review.

DOL also recently adopted disclosure rules for participant-directed individual account plans, requiring that participants in these plans be provided with detailed information about the plans, plan investments, and fees and expenses that may be charged to their plan accounts. These rules, like the service provider disclosure rules, are scheduled to take effect in early 2012 (initial disclosures for calendar-year plans are due by May 31, 2012).

While the disclosure may be the legal responsibility of the plan sponsor in its role as plan administrator, plan sponsors will expect the details to be handled by their service providers who provide plan administration or investment consulting services. In anticipation of the upcoming compliance deadline, some of the large plan recordkeeping firms already have prepared disclosure templates and been making them available to their clients.

**Proposed Changes to Fiduciary Definitions and Standards**

The SEC and DOL have undertaken initiatives that would make significant changes to the fiduciary rules that apply to broker–dealers and investment advisers. While both initiatives are still in their early stages, further activity is expected over the next year. Because the SEC activity was prompted by recent legislation, and the DOL activity has caught the attention of Congress, it can be expected that both projects will be subject to ongoing congressional scrutiny.

**SEC Proposed Uniform Fiduciary Standard**

Perhaps the most important regulatory and legal development to have emerged recently is the SEC staff’s recommendation. In the SEC’s Study on Investment Advisers and Broker–Dealers (the Study), which was required by Section 913 of the Dodd-Frank Act, the SEC staff recommended the creation, through rulemaking, of a uniform fiduciary standard for investment advisers and broker–dealers that is consistent with the standard that applies to investment advisers under the Investment Advisers Act of 1940 (the Advisers Act). Specifically, the SEC staff recommended adoption of the following uniform fiduciary standard based on the statutory language in the Dodd-Frank Act:

[T]he standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail
customers (and such other customers as the Commission may by rule provide), shall be 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.”

The Study generally frames the issues for the remapping of the regulation of investment advisers and broker–dealers and could significantly impact the business models of and services offered by investment advisers and broker–dealers and their personnel. Arguably, it has the potential to affect registered investment advisers to a much greater extent, especially if a self–regulatory organization for investment advisers emerges from the fray. In addition to the recommended uniform fiduciary standard, the SEC staff made several other recommendations that would help to harmonize the broker–dealer and investment adviser regulatory regimes. Of particular relevance are the SEC staff’s recommendations to: (i) clarify the duty of loyalty and care owed to retail customers; (ii) develop consistent and substantive customer communication rules to facilitate the provision of uniform, simple, and clear disclosures to retail investors about the terms of their relationship with broker–dealers and their associated persons; (iii) address how broker–dealers and their associated persons should abide by the uniform fiduciary standard when engaging in principal transactions; (iv) address what it means to provide personalized investment advice; (v) review supervisory requirements for investment advisers and broker–dealers with an eye toward harmonization; (vi) consider requiring investment adviser representatives to be subject to federal licensing and continuing education requirements; and (vii) consider harmonizing broker–dealer and investment adviser registration processes, including, notably, subjecting investment advisers to a substantive review prior to registration.

While the Study was well considered and comprehensive, it provided little in the way of direction as to how the SEC might address or implement the staff’s recommendations. Some believe the proposed uniform fiduciary standard should borrow the fiduciary duty standard that has developed under Section 206 of the Advisers Act, while others believe it should ultimately resemble something altogether different.

The path forward has been further called into question by Congress’ reaction to the Study. The possible adoption of a uniform fiduciary standard was squarely addressed on September 13, 2011, in a hearing before the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises entitled "Ensuring Appropriate Regulatory Oversight of Broker–Dealers and Legislative Proposals to Improve Investment Adviser Oversight.” In Representative Steve Garrett’s (R–NJ) opening remarks, he made clear that he did not think the SEC had sufficiently justified the need for rulemaking to implement a uniform fiduciary standard. Chairman Spencer Bachus too expressed doubt as to the prudence of proceeding with rulemaking in this area at the expense of rulemaking in other areas in need of reform and in the absence of additional empirical data and economic analysis demonstrating the need for a uniform fiduciary standard.

The SEC’s ultimate action on the recommendations is likely to be affected, in part, by divisions within the SEC. The extent of these divisions was emphasized by the dissents submitted by two of the SEC commissioners, Commissioner Casey and Commissioner Paredes. Commissioner Casey’s term has since expired, which may affect the dynamic of the remaining commissioners. The SEC’s next steps are also likely to be affected by continued congressional attention, competing demands on the SEC and its staff, and the strained SEC budget.

**ERISA Fiduciary Status Regulation**

In October 2010, DOL proposed changes to its long–standing regulation defining the type of “investment advice” that can make a person a fiduciary under ERISA. The proposal would replace the current five–part test with a two–part analysis. Under this analysis, investment consultants who either acknowledge fiduciary status or are investment advisers as defined in the Advisers Act (whether or not registered) would be treated as “investment advice” fiduciaries under ERISA once they make investment recommendations, without regard to, for example, whether their recommendations are individualized to the needs of the particular plan. Recommendations by those who are not acknowledged fiduciaries or investment advisers would need to be individualized to the needs of the plan, but only would have to be “considered” by the recipient of the advice in connection with an investment or management decision to trigger “investment advice” fiduciary status.

The proposed changes have been controversial, generating many comments. Congress also has shown interest; several members submitted comments and a House subcommittee held a hearing in July. The financial services industry, concerned about the potential impact on long–standing business practices (particularly in the brokerage and valuation industries), has mounted a lobbying effort to convince DOL to scale back the proposal in several respects.

DOL’s reaction has been to continue to emphasize the need for a new rule, the first change in this area in 36 years. However, in September 2011, DOL announced that instead of proceeding directly to a final rule, it intends to repropose the regulation with changes for further comment. The reproposal likely will appear in early 2012. DOL has indicated that it will make some changes, including applying the condition that the

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advice be “individualized” more broadly under the rule, and clarifying the scope of an exception for persons engaging in purchases and sales with plans that the financial services industry views as too limited. In addition, responding to industry concerns that the DOL rule would, in conjunction with the new rules for derivatives under the Dodd-Frank Act, prevent plans from being able to enter into swap transactions, DOL has written a letter to the financial regulators indicating its intent that plans not be prevented from engaging in swaps. However, until the reproposed rule is released, it will not be clear to what extent the industry’s concerns are being addressed.

The issue raised for investment consultants is the extent to which their firms, if they become (or are at risk of becoming) ERISA fiduciaries, may have to modify the way they do business. They may have to revise their compensation structures to avoid prohibited transactions, or they may need to limit the scope of the advice they provide. The DOL staff has said that it intends to address these concerns through prohibited transaction exemptions, and has indicated that it anticipates issuing proposed exemptions at the same time the rule is reproposed. In addition, because the DOL proposal and the planned SEC uniform fiduciary standard would apply to many of the same firms, the financial services industry has requested that DOL coordinate its proposal with the SEC to avoid conflicting obligations. The DOL staff has indicated that it will do so, although the staff also has said that it does not intend this coordination to lead to compromising ERISA’s fiduciary standards. Given the considerable uncertainty about the outcome of this process, DOL activity in this area should be closely monitored.

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Endnotes
1 Amendments to Form ADV, Investment Advisers Act of 1940 Release No. 3060 (July 28, 2010).
2 Item 4 of Form ADV, Part 2A.
3 Items 6, 11, and 12 of Form ADV, Part 2A.
4 Instruction 1 to Form ADV, Part 2B.
5 Item 3 of Form ADV, Part 2B.
6 Amendments to Form ADV; Extension of Compliance Date, Investment Advisers Act of 1940 Release No. 3129 (December 28, 2010).
7 Rule 204-1 under the Investment Advisers Act of 1940 requires a registered adviser to annually revise its Form ADV, including its brochure, within 90 days of its fiscal year end. Investment advisers must make their annual delivery of their brochures no later than 120 days after the end of their fiscal years.
11 In a departure from NYSE Rule 405(1), new Rule 2090 does not require that a broker–dealer learn the essential facts of every order.
13 Id.
14 Reasonable Contract or Arrangement under Section 408(b)(2) – Fee Disclosure; Interim final rule with request for comments, 75 Fed. Reg. 41,600 (July 16, 2010).
15 75 Fed. Reg. 31,544 (June 1, 2011).