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Client Alert

A report for clients and friends of the firm

June 2005

SEC Adopts Rule Addressing Scope of Investment Advisers Act's "Broker-Dealer Exception"

The Securities and Exchange Commission has adopted a new regulation, Rule 202(a)(11)-1 under the Investment Advisers Act, that addresses the Act's application to broker-dealers that offer fee-based brokerage programs or both full-service and discount brokerage services. The new rule affirms that a broker-dealer is not required to register with the SEC as an investment adviser solely because it offers such programs or services but, in the case of fee-based brokerage programs, imposes new disclosure requirements. For a firm that is registered with the SEC as both a broker-dealer and an investment adviser, the new rule will affect which of the firm's customer accounts must be treated as advisory accounts. The SEC has designated July 22, 2005, as the compliance date for the new rule's disclosure requirements. As discussed below, certain other provisions have later compliance dates.

This Client Alert highlights the key provisions of the new rule and significant statements in the SEC's adopting release. *As we discuss below, we strongly recommend that broker-dealers affected by the new rule promptly undertake the measures necessary to implement the rule's requirements by their respective compliance dates.*

Background

Fee-based brokerage programs provide customers with a package of services—typically including execution, investment advice, and custodial and recordkeeping services—for an asset-based or fixed fee. Discount brokerage programs, many of which are electronic trading programs, provide customers who do not want a broker's advice the ability to trade securities at a reduced commission rate.

Under the federal securities laws, broker-dealers are regulated primarily under the Securities Exchange Act, while investment advisers are regulated primarily under the Advisers Act. In order to avoid duplicative regulation of broker-dealers, the Advisers Act's so-called "broker-dealer exception" excludes from the Act's definition of "investment adviser," and thus from regulation under the Advisers Act, a broker-dealer whose provision of investment advice is "solely incidental" to its brokerage business, and for which the broker-dealer receives no "special compensation." However, under the Advisers Act, a broker-dealer that offers fee-based brokerage programs, or both full-service and discount brokerage services, could be deemed to receive special compensation and thus be ineligible for the "broker-dealer exception." Since 1999, the SEC has been engaged in a rulemaking proceeding, which has been controversial within some parts of the financial services industry, intended to clarify the application of the broker-dealer exception in such situations. The newly adopted Rule 202(a)(11)-1 is the product of the rulemaking proceeding.

Fee-Based Brokerage Programs

Under Rule 202(a)(11)-1, a registered broker-dealer will not be deemed to be an investment adviser based solely on its receipt of special compensation, provided that (i) any investment advice that the broker-dealer provides to an account is "solely incidental" to the brokerage services provided to the account, and (ii) advertisements for, and contracts, agreements, applications and other forms governing, accounts for which the broker-dealer receives special compensation include a prominent statement that the account is a brokerage account and not an advisory account, and that the broker-dealer's interests may not be the same as those of the customer. These two conditions are discussed below.

"Solely Incidental." Rule 202(a)(11)-1 incorporates, from the statutory broker-dealer exception, the requirement that advisory services provided in reliance on the rule must be solely incidental to the brokerage services provided. However, in a departure from the statutory exception, the rule provides that the advice a broker-dealer provides to an account must be solely incidental to brokerage services provided *to that account*, rather than to the overall operations of the broker-dealer. The adopting release states that, in general, investment advisory services are solely incidental to brokerage services rendered to an account if the advisory services are in connection with, and reasonably related to, the brokerage services. The release reaffirms the SEC's past position that the portfolio manager selection and asset allocation services involved in wrap fee programs are investment advisory services that are not deemed to be solely incidental to brokerage services.

Paragraph (b) of the rule identifies the following three non-exclusive circumstances under which investment advisory services are *not* solely incidental to brokerage services.

(i) Separate Fee or Contract. Under the rule, a broker-dealer's advisory services are not solely incidental to brokerage services if the broker-dealer charges a separate fee, or separately contracts for, the advisory services.

(ii) Financial Planning Provided by Broker-Dealers. The rule provides that advisory services provided by a broker-dealer to a customer are not solely incidental to brokerage services provided to that customer if the broker-dealer provides such advisory services as part of a financial plan or in connection with providing financial planning services and: (a) holds itself out generally to the public as a financial planner or as providing financial planning services; *or* (b) delivers to the customer a financial plan; *or* (c) represents to the customer that the advice is provided as part of a financial plan or financial planning services.

The adopting release states that under the rule, a broker-dealer is subject to the Advisers Act if it portrays itself as a financial planner or as providing financial planning services, whether or not it uses those particular terms, and must treat as advisory clients those customers to whom it delivers a financial plan or represents that its advice is part of a financial plan, regardless of what it calls the plan. While there are some elements common to both a financial plan and the advice of a broker-dealer based on its understanding of a customer's needs and objectives (which, the release notes, is incumbent in the broker-dealer's suitability analysis), the SEC does not consider this advice alone to constitute a financial plan.

(iii) Discretionary Accounts. The rule provides that a broker-dealer's advisory services to an account are not solely incidental to its brokerage services if it exercises investment discretion over the account, other than "on a temporary or limited basis." According to the adopting release, such temporary or limited discretion must be confined to a transaction or series of transactions and must not extend to setting investment objectives or policies for the customer.

The adopting release states that the SEC would view a broker-dealer's discretion to be temporary or limited within the meaning of the rule when, for example, the broker-dealer is given discretion: (i) as to the price or time at which to execute a customer order for the purchase or sale of a definite amount or quantity of a specified security; (ii) on an isolated or infrequent basis, to purchase or sell a specific security or type of security while a customer is unavailable for a limited period of time not to exceed a few months; (iii) as to cash management, such as to exchanging a position in a money market fund for another money market fund or cash equivalent; (iv) to purchase or sell securities to satisfy margin requirements; (v) to sell specific bonds and purchase similar bonds in order to permit a customer to take a tax loss; (vi) to purchase a bond having a specified credit rating and maturity; or (vii) to purchase or sell a security or type of security within specific parameters regarding all material characteristics (e.g., type of issuer, amount, maturity and yield).

The SEC notes that the rule's treatment of investment discretion represents a departure from previous positions, under which a broker-dealer's exercise of investment discretion subjected it to the Advisers Act only if the broker-dealer had a significant number of discretionary accounts. Under the new rule, the broker-dealer exception is unavailable to a broker-dealer who exercises investment discretion over any account.

Disclosure to Customers Paying Special Compensation. As the second condition to the availability of the broker-dealer exception for fee-based brokerage programs, Rule 202(a)(11)-1 requires that advertisements for, and contracts, agreements, applications and other forms governing, accounts for which a broker-dealer receives special compensation must include a "prominent statement" that:

> Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons' compensation, may vary by product and over time.

As this disclosure suggests, and in the words of the adopting release, "if a broker-dealer were to choose to treat an account

as an advisory account, the disclosure described above would not be required." However, when the disclosure is required, the SEC intends that the foregoing "standard language" (to quote the adopting release) be used without material alteration. The rule does not prohibit broker-dealers from providing additional disclosure discussing such matters as the nature of the fee-based account, customers' rights, the broker-dealer's obligations, and the differences between brokerage and advisory accounts, so long as such additional disclosure does not interfere with the prominence of the required disclosure.

Under the rule, a broker-dealer's disclosure must identify an appropriate person at the firm with whom the customer can discuss the differences between fee-based brokerage accounts and advisory accounts. The rule does not require a contact person to be specifically named; it is sufficient to disclose a designated contact point that allows the customer to speak to a person within the firm. The adopting release states that additional disclosure, interactive websites or multimedia presentations cannot be used to substitute for disclosure of such a contact.

Discount Brokerage Services

Paragraph (a)(2) of Rule 202(a)(11)-1 provides that a broker-dealer will not be deemed to receive special compensation solely because the broker-dealer charges a customer, in consideration for brokerage services, a commission, mark-up, mark-down or similar fee that is greater or less than that charged to another brokerage customer. The adopting release states that this provision supersedes SEC staff positions under which a broker-dealer was deemed to be subject to the Advisers Act if it provided incidental investment advice to full-service brokerage accounts, solely because it also offered discount brokerage services.

Scope of the Broker-Dealer Exception

Paragraph (c) of Rule 202(a)(11)-1 provides that a broker-dealer registered under both the Securities Exchange Act and the Advisers Act is an investment adviser solely with respect to those accounts from which it receives compensation, or to which it provides services, that subject the broker-dealer to the Advisers Act. According to the adopting release, this provision codifies prior interpretative positions permitting a broker-dealer registered under the Advisers Act to distinguish its advisory clients from its brokerage customers.

Compliance Dates

Broker-dealers relying on Rule 202(a)(11)-1 to provide investment advice to fee-based brokerage accounts must comply with the disclosure requirements discussed above under *"Disclosure to Customers Paying Special Compensation"* no later than July 22, 2005. Accordingly, all advertisements for, and contracts, agreements, applications and other forms governing, such accounts opened on or after July 22, 2005 must include the required disclosure. The adopting release states that broker-dealers relying on the rule with respect to fee-based brokerage accounts opened prior to that date are encouraged, but not required, to amend existing agreements governing those accounts.

No later than October 24, 2005, broker-dealers must treat as advisory accounts those accounts over which they exercise investment discretion, or to which they provide financial planning services, or advisory services under separate contracts or for separate fees.

Further SEC Exploration of Certain Issues

In the adopting release, the SEC indicates that the rulemaking proceeding resulting in Rule 202(a)(11)-1 has also identified other important investor protection issues "implicating policy concerns well beyond the scope of this rulemaking." Accordingly, the SEC staff has been directed to report within 90 days on ways in which such issues could be addressed, including any rulemaking action that the staff would be prepared to recommend be taken by the SEC or any self-regulatory organization in the near term. The staff has also been directed to report on options and recommendations for a study comparing the levels of protection afforded to retail customers of financial service providers under the Securities Exchange Act and the Advisers Act, and recommending ways of addressing, through legislation or regulation, any investor protection concerns arising from material differences between the two regulatory regimes.

Recommended Compliance Measures

In view of the requirements of Rule 202(a)(11)-1 and the compliance dates discussed above, we recommend that broker-dealers affected by the rule take the following actions as soon as practicable:

1. Identify, and revise as required by the rule, those documents to which the rule's disclosure provisions apply (*i.e.*, advertisements for, and contracts, agreements, applications and other forms governing, accounts for which special compensation is received). As discussed above, the compliance date for the rule's disclosure provisions is July 22, 2005.

2. Identify those of its customer accounts that involve investment discretion, or separate contracts or fees for advisory services, or advice provided as part of financial planning services, and are thus excluded by the rule from the broker-dealer exception. As discussed above, all such accounts must be treated as advisory accounts no later than October 24, 2005.

3. Adopt and implement those revisions to written supervisory and compliance procedures that are

appropriate to ensure full compliance with the rule's requirements by the dates indicated above.

4. Institute appropriate education and training of registered representatives, and associated supervisory and operational personnel.

We would be happy to discuss with you any of the matters addressed in this Client Alert or the SEC's adopting release. If we can be of assistance, please contact the lawyers listed below.

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