



Regulatory Update — SEC Adopts Rule Excluding Broker-Dealers Offering Fee-Based Accounts from the Investment Advisers Act of 1940

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Summary of SEC Release¹

I. Introduction

The Securities and Exchange Commission (“Commission” or “SEC”) on April 6, 2005 adopted a rule addressing the application of the Investment Advisers Act of 1940 (“Advisers Act”) to broker-dealers offering fee-based accounts.² The rule lists conditions under which a broker-dealer may retain its statutory exception from the definition of an “investment adviser” under the Advisers Act, even if it accepts special compensation such as an asset-based or fixed fee for its services. The rule also permits broker-dealers to offer execution-only brokerage services for reduced commission rates without triggering the application of the Advisers Act. In addition, the adopting release directs the SEC staff to report to the Commission within 90 days on any additional rulemaking that may be needed by either the SEC or SROs and on options and recommendations for a study comparing the levels of protection afforded retail customers of financial service providers under the Securities Exchange Act of 1934 (“Exchange Act”) and the Advisers Act. While this rule has a lengthy history, this memorandum focuses on the requirements in the final rule.³

Significantly, as described in more detail below, the rule categorizes financial planning as advisory activity. One of the consequences of this change is that a broker-dealer providing “free” financial plans or planning services as an inducement to sell securities for commissions would be required to register as an investment adviser and treat those customers as advisory clients.

II. Certain Broker-Dealers Deemed Not to be Investment Advisers

The SEC adopted new Rule 202(a)(11)-1 under the Advisers Act principally to address the application of the

Advisers Act to broker-dealers offering asset-based or fixed-fee accounts. Under the rule, a broker-dealer providing advice that is solely incidental to its brokerage services is excepted from the Advisers Act if it charges an asset-based or fixed fee for its services, provided it makes certain disclosures about the nature of its services. The rule has its roots in the 1995 “Tully Report” on compensation practices in the retail brokerage industry.⁴ The rule was first proposed by the Commission in 1999, and was repropose at the end of 2004.⁵

Section 202(a)(11) of the Advisers Act generally defines an “investment adviser” as a person who receives compensation for providing advice about securities as part of a regular business, but specifically excludes from this definition a broker-dealer “whose performance of [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor.” New Rule 202(a)(11)-1 interprets this provision to allow broker-dealers to continue to offer fee-based accounts provided they comply with the conditions in the rule.

A. Special Compensation

Under Rule 202(a)(11)-1(a), a broker-dealer providing investment advice to its brokerage customers is not required to treat those customers as advisory clients solely because of the form of the broker-dealer’s compensation. In particular, the rule exempts a broker-dealer registered under the Exchange Act from classification as an “investment adviser” for purposes of the Advisers Act provided: (i) any investment advice the broker-dealer provides to an account must be solely incidental to the brokerage services provided to the account (and thus the broker-dealer must not exercise “investment discretion” over the account as defined in the rule); and (ii) advertisements for and contracts, agreements, applications and other forms governing its accounts 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

¹ This publication has been prepared for general information of clients and friends of the firm as a brief description of recent SEC action. It is not meant to provide legal advice with respect to any specific matter.

² See Release Nos. 34-51523, IA-2376 (Apr. 12, 2005), 70 FR 20424 (Apr. 19, 2005).

³ The Financial Planning Association filed a petition on April 28, 2005 in the U.S. Court of Appeals for the District of Columbia Circuit challenging the rule (*Financial Planning Association v. SEC*, D.C. Cir., No. ___, 4/28/05).

⁴ Report of the Committee on Compensation Practices (Apr. 10, 1995) (“Tully Report”). The committee, which was formed in 1994 at the suggestion of then-Commission Chairman Arthur Levitt, addressed ways in which conflicts of interest arising from registered representative compensation practices in the brokerage industry could be minimized.

⁵ See Release Nos. 34-50980, IA-2340 (Jan. 6, 2005), 70 FR 2716 (Jan. 14, 2005); Release Nos. 34-42099; IA-1845 (Nov. 4, 1999), 64 FR 61226 (Nov. 10, 1999).

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.

The Rule also requires the broker-dealer to identify an appropriate person at the firm with whom the customer can discuss the differences between brokerage and advisory accounts. Significantly, the Rule does not prohibit broker-dealers from providing additional disclosure regarding the nature of the fee-based account, customers' rights, the broker-dealer's obligations, and the differences from an advisory account, so long as the additional disclosure does not interfere with the prominence of the required disclosure statement and contact information.

To keep a broker-dealer from being subject to the Advisers Act solely because it also offers electronic trading or some other form of discount brokerage, or more than one level of service, the Rule also provides that a broker-dealer will not be considered to have received special compensation solely because the broker-dealer charges one customer a commission, mark-up, mark-down or similar fee for brokerage services that is greater than or less than one it charges another customer. In the adopting release, the Commission explicitly notes that the rule supersedes prior staff interpretations under which a full-service broker-dealer would be subject to the Advisers Act with respect to accounts for which it provides advice incidental to its brokerage business merely because it offered electronic trading or other forms of discount brokerage.⁶

B. Solely Incidental

Rule 202(a)(11)-1(b) identifies three general circumstances under which the provision of advisory services by a broker-dealer would not be solely incidental to brokerage.⁷ These three circumstances are based on the Commission's interpretation that investment advice is "solely incidental to" the conduct of a broker-dealer's business within the meaning of Section 202(a)(11)(C) of the Advisers Act and to "brokerage services" provided to brokerage accounts under the Rule when the advisory services rendered are in connection with and reasonably related to the brokerage

services provided. In particular, a broker-dealer would not be able to rely on the rule's exemption from the Advisers Act with respect to an account if the broker-dealer charges a separate fee (or separately contracts) for advisory services, engages in financial planning, or exercises investment discretion as defined in the Rule.

1. Separate Contract or Fee

Rule 202(a)(11)-1(b)(1) provides that a broker-dealer that separately contracts with a customer for investment advisory services (including financial planning services) would not be considered to be providing advice that is solely incidental to its brokerage services. The Rule also provides that a broker-dealer charging a separate fee for advisory services would not be considered to be providing advice that is solely incidental to its brokerage services.

2. Financial Planning

Under Rule 202(a)(11)-1(b)(2), a broker-dealer would not be providing advice solely incidental to brokerage if it provides advice as part of a financial plan or in connection with providing planning services and: (i) holds itself out generally to the public as a financial planner or as providing financial planning services; (ii) delivers to its customer a financial plan; or (iii) represents to the customer that the advice is provided as part of a financial plan or financial planning services.

According to the Commission, what typically distinguishes financial planning from other types of advisory services is the breadth and scope of the advisory services provided.⁸ Under the new Rule, a broker-dealer would be subject to registration under the Advisers Act if it portrays itself to the public as a financial planner or as providing financial planning services, whether it uses those particular terms or not. In addition, a broker-dealer must treat as advisory clients all those customers to whom it delivers a financial plan, regardless of what it chooses to call the plan. While there are some common elements in a financial plan and a broker-dealer's advice based on its understanding of a customer's needs and objectives (which is a necessary element of its suitability analysis), the Commission does not consider this broker-dealer advice alone as constituting a financial plan.⁹ Whether a particular document or representation will be viewed as a financial plan will turn on whether it has the characteristics of a financial plan.

⁶ 70 FR at 20436.

⁷ In the adopting release, the Commission also reaffirmed its long-held view that advisory services provided by certain brokers in connection with wrap fee programs are not solely incidental to brokerage. 70 FR at 20437.

⁸ 70 FR at 20438.

⁹ The Commission concluded that it would be unwise for the Commission to attempt to distinguish when a suitability analysis ends and financial planning begins, and it did not want to interfere in any way with a broker-dealer's fulfillment of its suitability obligations. 70 FR at 20439.

Whether a communication represents that the services provided are financial planning services will depend on how a reasonable investor would understand the services described in the communication.¹⁰

3. Investment Discretion

Rule 202(a)(11)-1(b)(3) provides that a broker-dealer that exercises “investment discretion” as defined in the rule would not be considered to be providing advice that is solely incidental to its brokerage services. As the Commission notes in the adopting release, the rule terminates the existing staff approach under which a discretionary account is subject to the Advisers Act only if the broker-dealer has enough other discretionary accounts to trigger the Act.¹¹ Rather, under the new Rule, the exception provided by Section 202(a)(11)(C) of the Advisers Act is not available for any account over which a broker-dealer exercises investment discretion, regardless of the form of compensation and without regard to how the broker-dealer handles other accounts.

The definition of the term “investment discretion” adopted in the Rule is a modified version of the definition of the term in Section 3(a)(35) of the Exchange Act that does not include investment discretion granted by a customer on a temporary or limited basis.¹² Where such temporary or limited authority has been given to the broker-dealer, the Commission agrees that the customer is granting discretion primarily for execution purposes rather than seeking to obtain discretionary supervisory services.¹³ The

¹⁰ The Commission observed that including a disclaimer that comprehensive advisory services offered to customers would not constitute “financial planning services” or is “not comprehensive” would not permit a broker-dealer to avoid application of the Advisers Act under the rule. Id.

¹¹ 70 FR at 20440.

¹² Section 3(a)(35) of the Exchange Act provides that:

A person exercises “investment discretion” with respect to an account if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.

¹³ The Commission further noted that, to fall within the exception, such discretion must be limited to a transaction or series of transactions and not

Commission would regard a broker-dealer’s discretion to be temporary or limited within the meaning of Rule 202(a)(11)-1(d) when a broker-dealer is given discretion:

- As to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security;
- On an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time not to exceed a few months;
- As to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent;
- To purchase or sell securities to satisfy margin requirements;
- To sell specific bonds and purchase similar bonds in order to permit a customer to take a tax loss on the original position;
- To purchase a bond with a specified credit rating and maturity; and
- To purchase or sell a security or type of security limited by specific parameters established by the customer.¹⁴

III. Additional Study

As noted above, the adopting release directs the SEC staff to report to the Commission within 90 days on any additional rulemaking that may be needed by either the SEC or SROs. In addition, the staff was directed to report on options and recommendations for a study to compare the levels of protection afforded retail customers under the Exchange Act and the Advisers Act, and to recommend ways to address any investor protection concerns arising from material differences between the two regulatory regimes. The study would include such questions as:

- Whether the Commission should seek legislation that would integrate the existing regulatory schemes applicable to broker-dealers and investment advisers that provide services to retail clients?
- Should sales practice standards and advertising rules applicable to advice provided by broker-dealers be enhanced?

extend to setting investment objectives or policies for the customer. 70 FR at 20441.

¹⁴ Id.

- Should broker-dealers who provide investment advice but who are excepted from the Advisers Act nonetheless be subject to the fiduciary obligations imposed by that Act on investment advisers?
- Whether obligations under the Advisers Act applicable to dually registered broker-dealers (*i.e.*, those broker-dealers that are also registered as investment advisers) should be modified or streamlined to eliminate regulatory overlap and reduce regulatory burdens?

For Further Information

If you have any questions concerning this memorandum or the Commission's new Rule, please contact any of the following members of our Securities and Futures Market Regulation Group:

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