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SEC Revisits Broker-Dealer/Investment Adviser Rules in Response to Circuit Court Decision

On September 24, 2007, the SEC issued two releases that provide new guidance to broker-dealers and investment advisers about their respective duties under the U.S. securities laws. The releases were issued in response to an adverse decision earlier this year by the Court of Appeals for the D.C. Circuit in *Financial Planning Association v. SEC*, which vacated a 2005 Commission rule exempting certain broker-dealers from regulation under the Investment Advisers Act of 1940.

The Commission has struggled in recent years to draw appropriate lines between the activities of broker-dealers, who are regulated under the Securities Exchange Act of 1934, and investment advisers, who are regulated under the Advisers Act and have fiduciary duties to their customers. The line-drawing has been especially difficult in the context of fee-based brokerage accounts, which, like traditional advisory accounts, charge a flat percentage fee based on the amount of assets in the account. This type of arrangement has grown increasingly prevalent (in 2007, the SEC estimated customers of broker-dealers held $300 billion in one million fee-based brokerage accounts). In 2005, the Commission adopted a rule exempting certain fee-based brokerage accounts from the Advisers Act – a move that was largely welcomed by the brokerage industry and strongly opposed by the financial planning industry. In March of this year, the D.C. Circuit overturned the rule on the grounds that the SEC had exceeded its authority. The latest Commission releases are an attempt to provide practical relief and clarity to the many broker-dealers who have found themselves subject to the Advisers Act as a result of the court decision.

The first release provides relief to certain investment advisers who are also registered as broker-dealers from a requirement under the Advisers Act that they obtain prior written consent each time they enter into a principal transaction with an advisory client. The SEC's new rule, adopted on an interim final basis, allows advisers to obtain consent orally before each principal transaction, as long as they provide certain written disclosures at the outset of the advisory relationship and in the transaction confirmation.

The second release reproposes for comment three interpretive provisions that were contained in the 2005 rule and vacated by the court in the *FPA* case (but which were not specifically held by the court to be invalid).

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The *FPA* Decision

Following the adoption of the SEC's 2005 rule governing fee-based brokerage accounts, the Financial Planning Association (FPA) filed suit in the D.C. Circuit challenging the rule on the grounds that the Commission had exceeded its authority under the Advisers Act. Under Section 202(a)(11) of the Advisers Act, a broker-dealer is exempted from the requirements of the Act if (i) its advice is "solely incidental" to the conduct of its business as a broker or dealer and (ii) the broker-dealer receives no "special compensation" for its advice. The Commission's 2005 rule provided an exemption for certain fee-based brokerage accounts, notwithstanding that broker-dealers offering such accounts were receiving "special compensation" for their advice. The FPA argued that this exemption was contrary to the language and intent of the statute and that the SEC had exceeded its authority.

On March 30, 2007, the D.C. Circuit issued an opinion in which it agreed with the FPA and vacated the Commission's 2005 rule. The Court subsequently granted the Commission's motion to stay the issuance of its mandate until October 1, 2007, to give the SEC and the industry time to address the implications of the decision.

The practical result of the court's decision was to force brokerage firms either to discontinue fee-based brokerage accounts or to convert those accounts to advisory accounts. One of the main impediments to converting to advisory accounts was Section 206(3) of the Advisers Act, which makes it unlawful for an investment adviser to enter into a principal transaction with a customer without obtaining prior written consent from the customer on a transaction-by-transaction basis. In seeking relief from this provision, the brokerage industry has contended that many of its fee-based customers rely on principal transactions and that, due to the speed and volume of such transactions, it would not be feasible to obtain prior written consent on a transaction-by-transaction basis.

Temporary Rule on Principal Trades with Advisory Clients

To address the concerns of broker-dealers affected by the *FPA* decision, the Commission's new rule provides investment advisers with an alternative means to comply with the requirements of Section 206(3) of the Advisers Act. Specifically, the rule permits an adviser, with respect to a non-discretionary advisory account, to comply with Section 206(3) by, among other things:

- Providing written prospective disclosure regarding the conflicts arising from principal transactions;
- Obtaining written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions;
- Making certain disclosures, either orally or in writing, and obtaining the client's consent before each principal transaction;
- Sending to the client confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction; and

- Delivering to the client an annual report itemizing the principal transactions.

The rule also requires that the investment adviser be registered as a broker-dealer under the Exchange Act and that each account for which the adviser relies on the rule be a brokerage account.

The new rule became effective on September 30, 2007 and will expire on December 31, 2009. The Commission adopted the rule on an interim final basis in order to provide the industry with some measure of certainty for the foreseeable future, while giving the Commission a 27-month period in which to consider public comments and develop a more permanent approach to regulation in this area. The Commission will also have time to consider a study being prepared by the RAND Corporation, at the direction of the SEC, comparing the impact on investors of the different regulatory regimes that apply to broker-dealers and investment advisers.

Comments on the interim final rule are due November 30, 2007. For a copy of the rule, see http://sec.gov/rules/final/2007/ia-2653.pdf.

Proposed Interpretive Rule Addressing the Application of the Advisers Act to Certain Activities of Broker-Dealers

The SEC's proposed interpretive rule would reinstate three interpretive provisions that were vacated by the court in the *FPA* decision. The first would clarify that a broker-dealer's advice to a client is not "solely incidental" to the conduct of its brokerage business, and thus would be subject to the Advisers Act, if the broker-dealer (i) exercises investment discretion over the client's account (except discretion granted on a temporary or limited basis), or (ii) charges a separate fee, or separately contracts, for advisory services. The Commission declined to repropose a more controversial part of the 2005 rule, which provided that a broker-dealer would not be exempt from the Advisers Act if it "holds itself out generally to the public" as a provider of financial planning services.

The second interpretive provision would clarify that a broker-dealer does not receive "special compensation" within the meaning of the Advisers Act solely because it charges some customers higher or lower commissions or mark-ups than it charges other customers. For example, a broker-dealer would not be subject to the Advisers Act if it had a higher fee schedule for full-service brokerage that included access to brokerage personnel.

The third provision would clarify that a registered broker-dealer is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subject it to the Advisers Act. This provision would codify a long-standing interpretation of the Advisers Act that permits a dually registered broker-dealer and investment adviser to distinguish its brokerage customers from its advisory clients.

Comments on the proposed interpretive rule are due November 2, 2007. For a copy of the proposed interpretive rule, see http://sec.gov/rules/proposed/2007/ia-2652.pdf.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum may be directed to any of the following:

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