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A legal update from Dechert's Financial Services Group

Temporary Rule Regarding Principal Trades with Certain Advisory Clients and Proposed Interpretive Rule Under the Advisers Act Affecting Broker-Dealers

Background

Investment advisers registered as broker-dealers with the Securities and Exchange Commission ("SEC") now have an alternative means to meet the requirements of Section 206(3) of the Investment Advisers Act of 1940 ("Advisers Act") when acting in a principal capacity in transactions with certain advisory clients. This alternative is set forth in Rule 206(3)-3T, a final temporary rule under the Advisers Act ("Temporary Rule").[1] The SEC has also proposed reinstating three interpretive positions formerly set forth in Rule 202(a)(11)-1 under the Advisers Act ("Proposed Rule").[2] The SEC has taken these actions in response to a recent court decision[3] invalidating Rule 202(a)(11)-1 under the Advisers Act.

The Temporary Rule

The Temporary Rule became effective on September 30, 2007. Absent any further action by the SEC, the Temporary Rule will expire on December 31, 2009. The SEC is also requesting comments on the Temporary Rule. The comment period will end on November 30, 2007.

The SEC adopted the Temporary Rule in response to the *Financial Planning Association v. SEC* ("*FPA*") decision invalidating Rule 202(a)(11)-1 under the Advisers Act, which provided that certain types of fee-based brokerage accounts were not advisory accounts and thus were not subject to the Advisers Act.[4] The Temporary Rule would enable investors to make an informed choice between fee-based brokerage accounts that are subject to the Advisers Act or commission-based brokerage accounts. It would also provide them access to securities held in

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1 *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2653 (September 24, 2007).

2 *Interpretive Rule Under the Advisers Act Affecting Broker-Dealers*, Investment Advisers Act Release No. 2652 (September 24, 2007).

3 *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007) ("*FPA*"). On March 30, 2007, the Court of Appeals for the District of Columbia vacated Rule 202(a)(11)-1 under the Advisers Act. Rule 202(a)(11)-1 provided, among other things, that fee-based brokerage accounts were not advisory accounts and thus were not subject to the Advisers Act. The *FPA* court did not question the validity of the SEC's interpretive positions contained in the rule, but it vacated the entire rule, calling into question the SEC's interpretations. As a result of the decision, broker-dealers offering fee-based brokerage accounts became subject to the Advisers Act with respect to those accounts, and the client relationship became fully subject to the Advisers Act. Broker-dealers would need to register as investment advisers and fully comply with the Advisers Act. The SEC filed a motion with the court requesting that the court temporarily stay the effectiveness of its decision. The court granted the SEC's motion and stayed the issuance of its mandate until October 1, 2007.

4 *See Dechert OnPoint*, May 2007 (Issue 14) for a discussion of the implications of the court's ruling and the SEC's reaction. *See also Certain Broker-Dealers Deemed Not to be Investment Advisers*, Investment Advisers Act Release No. 2376 (April 12, 2005).

principal accounts of a firm registered as a broker-dealer under Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act") and as an investment adviser under Section 203 of the Advisers Act (a "Dual Registrant") while maintaining an asset-based fee structure. Such a structure provides greater certainty and, potentially, less exposure to certain conflicts of interest, such as churning, that have traditionally been associated with commission based accounts. A Dual Registrant offering such accounts would be a fiduciary. The accounts themselves would be subject to and enjoy the full protections of both the Advisers Act and the Exchange Act and the rules under each.

The Temporary Rule permits a Dual Registrant to engage in principal transactions on behalf of a non-discretionary advisory account (i.e., accounts for which the client has not granted investment discretion, except on a temporary or limited basis), without violating Section 206(3) of the Advisers Act, if the Dual Registrant, among other things:

- obtains written revocable consent from the client prospectively authorizing the Dual Registrant directly or indirectly acting as principal, for its own account, to sell any security to or purchase any security from such client;
- discloses to the client the capacity in which the Dual Registrant may act with respect to the transaction, either orally or in writing, and obtains the client's oral or written consent, prior to the execution of each principal transaction;
- sends to the client confirmation statements at or before the completion of each such transaction (i.e., settlement) disclosing the capacity in which the Dual Registrant has acted and disclosing that the Dual Registrant informed the client that it may act in a principal capacity and that the client authorized the transaction; and
- delivers an annual report to the client itemizing all principal transactions executed on behalf of the client in reliance on the Temporary Rule.

These conditions are designed to require a Dual Registrant to fully apprise the client of the conflicts of interest associated with principal transactions, inform the client of the circumstances in which the Dual Registrant may effect a trade on a principal basis, and provide the client with meaningful opportunities to revoke consent or refuse to authorize a particular transaction.

The Temporary Rule is not available for principal trades of securities issued or underwritten by the Dual Registrant or a person who controls, is controlled by, or is under common control ("control person") with the Dual Registrant, except that the Temporary Rule does apply to non-convertible investment grade debt securities underwritten by the Dual Registrant or a control person.

Written Revocable Consent

To rely on the Temporary Rule, Dual Registrants must secure written revocable consent from the client prospectively authorizing the Dual Registrant to engage in principal trades with the client. Such consent must be informed; thus, a Dual Registrant is required to disclose, in writing:

- the circumstances under which the Dual Registrant may engage in principal transactions with the client;
- the nature and significance of the conflicts of interest associated with principal transactions; and
- how the Dual Registrant addresses those conflicts.

The SEC expects that consent would generally be obtained upon the establishment of an advisory account. The SEC, however, has not required that this consent be set forth in the client's advisory agreement.[5] To allow orderly transition for clients who convert (or have already converted) fee-based brokerage accounts to non-discretionary advisory accounts, the SEC has

[5] Because the Advisers Act does not specify any particular means by which a client must execute a new advisory contract or agree to changes in an existing contract, such contracts are governed by various state laws. The SEC cautioned advisers that they should consider the terms of their existing contracts, and applicable state law, to determine the manner by which such brokerage accounts would be converted to non-discretionary advisory accounts. *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2653 (September 24, 2007).

permitted Dual Registrants who obtain consents prior to January 1, 2008, to rely on the Temporary Rule upon its effectiveness—provided that the Dual Registrant complies with the remaining provisions of the Temporary Rule.[6]

Each written disclosure, confirmation, request for written prospective consent, and annual summary statement must include a plain English statement clarifying that the prospective general consent may be revoked at any time. Advisers who are not Dual Registrants, and Dual Registrants who are unable to obtain prospective consent to principal transactions in accordance with the Temporary Rule (or who have such consent revoked), must continue to comply with the terms of Section 206(3) of the Advisers Act when trading as principal with a client.

The SEC requests comments as to whether:

- these provisions adequately ensure that client consent is voluntary;
- advisers will make a client's consent a condition to participation in non-discretionary advisory accounts they offer; and
- whether there should be a requirement that the client's consent be renewed annually.

Trade-by-Trade Disclosure and Consent

Dual Registrants seeking to rely on the Temporary Rule must, prior to executing a principal transaction: (i) inform the client of the capacity in which the Dual Registrant may act with respect to the transaction; and (ii) obtain the client's consent to act as principal in effecting the transaction. This trade-by-trade disclosure and consent may be written or oral. Because the Temporary Rule is available only in the context of a non-discretionary account, Dual Registrants who would rely on the Temporary Rule must obtain, by virtue of the non-discretionary nature of the account, the client's consent to the trade itself. The SEC does not expect the additional disclosure requirement that the trade *may* be on a principal basis to be particularly burdensome and noted that the trade-by-trade disclosure and consent requirement serves an important function in that it alerts clients to the potential conflicts associated with principal trades.[7]

The SEC wants to learn from investors whether this consent requirement is informative and whether advisers intend to document receipt of the oral consent, and if so, whether they will be able to do so efficiently. The SEC is also requesting comment on whether investment advisers find useful the flexibility to provide oral instead of written disclosure on a trade-by-trade basis.

Trade-by-Trade Confirmations

At or before the completion of each principal transaction effected in reliance on the Temporary Rule, the Dual Registrant must provide the client with a written confirmation.[8] In addition to all information required by Exchange Act Rule 10b-10, this confirmation must include a plain English statement informing the client that the Dual Registrant disclosed to the client, prior to the execution of the transaction, that:

- the Dual Registrant may act in a principal capacity in connection with the transaction;
- the client authorized the transaction; and
- the Dual Registrant sold the security to, or bought the security from, the client for its own account.

Confirmations must be provided on a trade-by-trade basis, and Dual Registrants cannot currently rely on the alternative periodic reporting provisions of Ex-

6 Additionally, the SEC provided the same transition period for Dual Registrants to meet their Rule 204-3 brochure delivery requirements with respect to such clients. *Id.*

7 In allowing Dual Registrants to inform clients that a trade *may* rather than *would* proceed on a principal basis, the SEC recognized that, in many circumstances, a Dual Registrant may be uncertain, at the time consent would be most appropriately sought in the context of a non-discretionary trade, whether additional consent to the principal aspect of the transaction would be required. As noted below, the confirmation and annual summary requirements will serve to identify, to clients, those trades actually executed on a principal basis.

8 The SEC has consistently interpreted "the completion of the transaction" for purposes of Section 206(3) to be settlement. *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2653 (September 24, 2007) (citing *Commission Interpretation of Section 206(3) of the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 1732 (July 17,1998).)

change Act Rule 10b-10(b) when executing principal trades in reliance on the Temporary Rule. However, the SEC has sought comment as to whether the Temporary Rule should be modified to allow Dual Registrants to satisfy the confirmation requirements of the Temporary Rule by providing periodic reporting in accordance with those provisions of Rule 10b-10(b).The SEC also solicited comments as to whether additional information should be included in the confirmation.

Annual Summary Statement

The investment adviser must deliver to each client, no less frequently than once a year, an annual summary statement including a list of all transactions that were executed in reliance on the Temporary Rule, disclosing the date and price of each such transaction.

The Proposed Rule

The Proposed Rule is intended to restore certain interpretations set forth in prior Rule 202(a)(11)-1. Although the *FPA* court did not directly criticize these interpretations, its decision to vacate that rule called into question the ability for broker-dealers and Dual Registrants to rely on the interpretive guidance. The first provision of the Proposed Rule would make it clear that a broker-dealer that exercises investment discretion with respect to an account or charges a separate fee, or separately contracts, for advisory services provides investment advice that is not "solely incidental to" its business as a broker-dealer. The second provision would make it clear that a broker-dealer does not receive "special compensation" within the meaning of Section 202(a)(11)(C) of the Advisers Act solely because it charges a commission for full service brokerage that is more than it charges for discount brokerage services. The last 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 subjects it to the Advisers Act. The comment period on the Proposed Rule ends on November 2, 2007.

"Solely Incidental"

The Proposed Rule would recodify two interpretations regarding activity that is not "solely incidental" to brokerage services for purposes of Section 202(a)(11)(C).

Separate Contract or Fee for Advisory Services

The Proposed Rule would provide that a broker-dealer that separately contracts with a customer for, or separately charges a fee for, investment advisory services cannot be considered to be providing advice that is solely incidental to its brokerage. The SEC has long held the view that "when a broker-dealer charges its customers a fee for investment advice, it clearly is providing advisory services and is subject to the Advisers Act."[9]

Discretionary Investment Advice

The Proposed Rule would also make it clear that discretionary investment advice is not solely incidental to the business of a broker-dealer within the meaning of Section 202(a)(11)(C) and, therefore, brokers and dealers are not exempted from the Advisers Act for any accounts over which they exercise investment discretion. The SEC believes that this approach is appropriate because the Proposed Rule:

- would apply the Advisers Act to the type of relationship with a broker-dealer that the Advisers Act intended to cover;
- is consistent with the interpretation that a broker-dealer is an investment adviser only with respect to those accounts for which the broker-dealer provides services or receives compensation that subject the broker-dealer to the Advisers Act; and
- would provide a workable, bright-line test for the availability of the Section 202(a)(11)(C) exception.

Full Service and Discount Brokerage Programs

The Proposed Rule also makes it clear that a broker-dealer would not be considered to have received "special compensation" for purposes of Section 202(a)(11)(C) of the Advisers Act solely because the broker-dealer charges a commission, mark-up, mark-down, or similar fee for brokerage services that is greater or less than what it charges another customer. As such, the SEC would not conclude that the customer being charged the higher fee is paying "special

[9] *Interpretive Rule Under the Advisers Act Affecting Broker-Dealers*, Investment Advisers Act Release No. 2652 (September 24, 2007).

compensation" for investment advice based solely on differences in charges.

The SEC says that it would not look outside the fee structure of a given firm to determine whether "special compensation" exists. For example, the SEC would not consider a "full service" firm's charges "special compensation" when there is a "discount" firm offering lower rates.

Dual Registrants

The Proposed Rule provides that a Dual Registrant is an investment adviser solely with respect to those accounts for which it provides advice or receives compensation that subjects the broker-dealer to the Advisers Act.

Conclusion

Following the *FPA* case, many in the industry were concerned about the continued viability of non-discretionary fee-based accounts given, in particular, the difficulties associated with principal transactions under the Advisers Act. The Temporary Rule may serve to alleviate these concerns by providing Dual Registrants an alternative means to comply with Section 206(3) of the Advisers Act while maintaining client protection through the transaction-by-transaction disclosure and consent and confirmation and annual summary requirements of the Temporary Rule.

Similarly, the Proposed Rule, if adopted, would allow for the continued use and development of brokerage fee schedules and activities which allow brokers and brokerage customers to provide and utilize services on terms appropriate to the relationship while assuring that those activities which are advisory in nature are subject to necessary protections set forth in the Advisers Act. Importantly, the Proposed Rule would assure that (i) a broker may provide execution-only service to those customers that do not desire enhanced service, such as research, while continuing to serve full service customers, and (ii) Dual Registrants can continue to operate both advisory and brokerage businesses without subjecting traditional brokerage accounts to a regulatory regime that was not designed and may be ill-suited for such accounts.

As such, both the Temporary Rule and the Proposed Rule appear to embody reasonable approaches to clarify the status of broker-dealers and investment advisers without significant adverse impact on the industry or existing client and customer relationships.

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This update was authored by Keith T. Robinson (+1 202 261 3386; keith.robinson@dechert.com); Alan Rosenblat (+1 202 261 3332; alan.rosenblat@dechert.com); Jules G. Baughns (+1 202 261 3445; jules.baughns@dechert.com); Michael L. Sherman (+1 202 261 3449; michael.sherman@dechert.com).

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Sander M. Bieber
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Daphne T. Chisolm
Charlotte
+1 704 339 3153
daphne.chisolm@dechert.com

Allison R. Beakley
Boston
+1 617 728 7124
allison.beakley@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick
Washington, D.C.
+1 202 261 3305
douglas.dick@dechert.com

Steven S. Drachman
New York
+1 212 698 5627
steven.drachman@dechert.com

Ruth S. Epstein
Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

Susan C. Ervin
Washington, D.C.
+1 202 261 3325
susan.ervin@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Wendy Robbins Fox
Washington, D.C.
+1 202 261 3390
wendy.fox@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Robert W. Helm
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Stuart J. Kaswell
Washington, D.C.
+1 202 261 3314
stuart.kaswell@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Fran Pollack-Matz
Washington, D.C.
+1 202 261 3442
fran.pollack-matz@dechert.com

Jeffrey S. Puretz
Washington, D.C.
+1 202 261 3358
jeffrey.puretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson
Newport Beach
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson
Washington, D.C.
+1 202 261 3386
keith.robinson@dechert.com

Alan Rosenblat
Washington, D.C.
+1 202 261 3332
alan.rosenblat@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Patrick W. D. Turley
Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

David A. Vaughan
Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Anthony H. Zacharski
Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

Dechert LLP

www.dechert.com

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