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A legal update from Dechert's Financial Services Group

SEC Not to Appeal Decision Vacating Broker-Dealer Exemption Rule

Summary

On May 14, 2007, the SEC announced that it would not appeal a decision of the Court of Appeals for the District of Columbia ("Court") that vacated an SEC rule. That rule would have exempted broker-dealers[1] receiving asset-based fees for brokerage services from registration as investment advisers.[2] This legal update explores the implications of the Court's opinion as well as the SEC's reaction.

Background

Treatment of Broker-Dealers Providing Investment Advice Under Investment Advisers Act of 1940 (the "Advisers Act")

Broker-dealers and investment advisers have different obligations under the federal securities laws. Investment advisers act as fiduciaries to their clients, owing them a duty to act in good faith, with reasonable care, and with full and fair disclosure of all material facts. Broker-dealers have different and often more specific obligations to their customers under the Securities Exchange Act of 1934 ("Exchange Act"), and, as discussed in greater detail in this update, they render services to their customers that are similar to those of investment advisers. Two leading observers describe the distinction as follows: Nicholas Nicorette, President of the Financial Planning Association ("FPA") says that "a financial planner or investment adviser has a clear legal duty to put the client's interest first. It's called a fiduciary duty." Marc E. Lackritz, CEO of the Securities Industry and Financial Markets Association ("SIFMA") says investors in fee-based advisory accounts "receive equally robust regulatory protection, simply under different laws and regulations."[3]

Historically and to the present day, broker-dealers have provided investment advice in connection with brokerage services. First, broker-dealers provided investment advice as an auxiliary part of a package of services for which their customers paid a fixed fee or commission. Beginning in the 1920s, broker-dealers began to provide investment advice as a specific service for which their customers paid a separate fee.

In response to the latter development, Congress determined that, in situations where broker-dealers were specifically and separately compensated for providing investment advice, they should be subject to regulation as investment advisers. At the same time, Congress did not wish to subject those brokers that were already regulated under the Exchange Act and provided investment advice that was merely incidental to their brokerage services to regulation under the Advisers Act.

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1 The Court's opinion refers to brokers and dealers as "broker-dealers" because in the Court's view, the differences between the two were irrelevant for the purposes of the appeal. This legal update will follow that convention.

2 *See Financial Planning Association v. Securities and Exchange Commission*, No. 04-1242 (D.C. Cir., March 30, 2007).

3 *Brokers' Liability for Advice, The Wall Street Journal*, (May 7, 2007) at R6.

Reflecting the balance between these competing goals, the Advisers Act defines an investment adviser as:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[4]

However, an investment adviser does not include "any broker or dealer (1) whose performance of [such advisory services] is solely incidental to the conduct of his business as a broker or dealer and (2) who receives no special compensation therefor." (the "Broker-Dealer Exemption").[5]

Shortly after the enactment of the Advisers Act, the General Counsel of the SEC issued an opinion stating that "special compensation" meant brokerage charges "directly related to the giving of advice."[6] Since that time, special compensation generally has been considered to be any "non-commission" compensation (i.e., compensation other than brokerage commissions and dealer compensation). Broker-dealers charging non-commission compensation for providing investment advice were regarded as receiving special compensation and could not benefit from the Broker-Dealer Exemption.

However, broker-dealers charging only transaction-based compensation (i.e., commissions) were exempt from the Advisers Act. Prior to the unfixing of commission rates in 1975, it was easy to identify when broker-dealers were receiving "special compensation" (i.e., special compensation amounted to any fees charged in addition to the fixed rate for commissions). However, when commission rates became negotiable, the receipt of special compensation became more difficult to identify.

Adoption of Rule 202(a)(11)-1 Under the Advisers Act

Beginning in the late 1990s, the SEC began to reconsider its approach to the regulation of broker-dealers under the Advisers Act in response to the development of two new types of brokerage programs: fee-based brokerage programs and discount brokerage programs. Fee-based brokerage programs provide customers with a package of services, including advice incidental to brokerage, for a fixed fee or a fee based upon the assets on account with the broker-dealer.

Under the traditional interpretation of the Broker-Dealer Exemption, the fixed or asset-based fees associated with fee-based brokerage programs could be considered to be non-commission compensation and thus "special compensation." Similarly, discount brokerage programs, which offer customers the opportunity to trade at a lower commission rate without the obligation to obtain investment advice, could cause broker-dealers offering both discount and full service brokerage accounts, which generally include the provision of incidental investment advice, to be regarded as receiving "special compensation" for the advice provided to customers electing "full service" brokerage accounts.

The SEC regarded fee-based and discount brokerage programs as providing the same services as traditional brokerage programs, only with a different pricing mechanism. The SEC did not perceive fee based brokerage programs or full service brokerage accounts to be primarily advisory in nature. Yet, under prior interpretations of the Broker-Dealer Exemption, such programs or accounts could be treated as advisory, and broker-dealers offering them could be subject to regulation as investment advisers. In addition, the SEC viewed fee-based brokerage programs as potentially mitigating long held concerns about the incentives that commission-based compensation creates for broker-dealers to "churn" accounts.[7] The SEC did not wish to discourage the development of fee-based brokerage programs by subjecting such programs to the Advisers Act.

To address these concerns, the SEC proposed Rule 202(a)(11)-1 under the Advisers Act to bring fee-based brokerage within the scope of the Broker-Dealer

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4 Section 202(a)(11) of the Advisers Act.

5 Section 202(a)(11)(C) of the Advisers Act.

6 Opinion of the General Counsel Relating to Section 202(a)(11)(C) of the Investment Advisers of 1940, SEC Release No. 2 (October 28, 1940) ("General Counsel's 1940 Opinion").

7 In 1994 the SEC formed a Committee to study brokerage compensation practices that found that fee-based compensation better aligned the interests of broker-dealers and their clients. Report of the Committee on Compensation Practices (April 10, 1995) (the "Tully Report").

Exemption. First proposed in November 1999, the Commission re-proposed Rule 202(a)(11)-1 in January 2005 and then adopted the rule, in final form, in April 2005 ("Final Rule"). Paragraph (a)(1) of the Final Rule addressed fee-based brokerage programs by providing that a broker-dealer registered under the Exchange Act would "not be deemed to be an investment adviser based solely on its receipt of special compensation" if:

- any investment advice provided is "solely incidental to the brokerage services," and
- certain disclosures are made to the customer.[8]

Paragraph (a)(2) of the Final Rule covered discount brokerage programs by providing that a broker-dealer that provided both discount brokerage programs and full service brokerage services would not be deemed to have received special compensation merely because one customer is charged more or less for brokerage services than another.[9]

In the adopting release for the Final Rule, the SEC stated that Congress' intent with respect to the "special compensation" requirement was to "provid[e] an easy way of accomplishing the underlying goal of excepting only advice that was provided as part of the package of traditional brokerage services" and *not* advice offered "through separate advisory departments for which customers separately contracted and paid a fee."[10] By its adoption of the Final Rule, the SEC intended to cause the application of the Advisers Act to "turn more on the nature of the services provided by the broker-dealer than on the compensation."[11]

Financial Planning Association v. SEC

On July 20, 2004, the FPA, an industry organization for financial planners,[12] challenged proposed Rule

[8] The Final Rule required a broker-dealer to include a prominent statement in advertisements for, and contracts, agreements, applications and other forms governing accounts for which the broker or dealer receives special compensation 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.' The prominent statement also must identify an appropriate person at the firm with whom the customer can discuss the differences." Rule 202(a)(11)-1(a)(1)(ii).

[9] Rule 202(a)(11)-1(a)(2). Paragraphs (b) through (d) of the Rule (1) gave guidance as to when investment advice is not "solely incidental" to the provision of brokerage services; (2) provided that a broker-dealer registered as such under the Exchange Act is only an investment adviser with respect to those accounts for which the compensation it receives would subject it to the Advisers Act; and (3) excepted from the definition of "investment discretion" (for the purposes of the Rule) investment discretion that is provided "on a temporary or limited basis."

[10] *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, SEC Release No. 2376 at *10 (April 15, 2005) ("Adopting Release"). The SEC further stated that "neither the legislative history of section 202(a)(11)(C) nor the broader legislative history of the Advisers Act as a whole suggests that, in 1940, Congress viewed the form of compensation for the services at issue—commission versus fee-based compensation—as having any independent relevance in terms of the advisory services the Act was intended to reach."

[11] *Id.* at *4. Rule 202(a)(11)-1 also made other changes. For example, subsection (b)(3) of the Rule provided that a broker-dealer that exercises investment discretion would not qualify for the "solely incidental" exception. Accordingly, broker-dealers having discretionary brokerage accounts would be subject to the Advisers Act, regardless of the nature of the fees charged to such accounts. Prior to the adoption of the Rule, a staff no-action position provided that discretionary accounts would be covered by the Advisers Act "only if the broker-dealer has enough other discretionary accounts to trigger the Act." The Rule would have required that any discretionary account be subject to the Advisers Act, regardless of the broker-dealer's other accounts and the nature of the fees paid by the discretionary accounts. Thus, absent the rule, it is arguable that the provision of discretionary advice to brokerage accounts which are subject to traditional commissions may, again, be considered "solely incidental" and not for "special compensation" depending upon the particular facts and circumstances. In this respect, the Adopting Release, itself, notes that (i) "[t]he Advisers Act does not address directly whether a broker-dealer exercising investment discretion over a commission based account must comply with the Act" and (ii) "[w]hether the exercise of investment discretion meets the requirements of the exception depends on the sort of analysis and judgment that we have made in this rulemaking."

[12] Financial planners typically provide a variety of services, primarily advisory in nature, to individuals or families regarding the management of their financial resources based upon an analysis of their financial circumstances and objectives. A financial planner's compensation may take the form of an overall fee, an hourly fee, or commissions on the sale of securities products to their customers. Financial planners are generally registered as investment advisers under the Advisers Act.

In the Adopting Release, the SEC sought to distinguish financial planning from suitability analyses and "other types of investment advice, such as transaction-specific

202(a)(11)-1 on the ground that in exempting fee-based brokerage programs from the application of the Advisers Act, the SEC had exceeded its authority.[13]

The Court focused most of its attention on Section 202(a)(11)(F) of the Advisers Act, which authorizes the SEC to exempt "such other persons not within the intent of this paragraph, as the [SEC] may designate by rules and regulations or order."[14] The FPA argued that when Congress enacted the Advisers Act, it had identified in the Broker-Dealer Exemption the group of broker-dealers that it intended to exempt from regulation under the Advisers Act, and that Section 202(a)(11)(F) was only intended to be used by the SEC to exempt "other persons" from the Advisers Act.

The Court agreed. It held that in expanding the exemption for broker-dealers under the Broker-Dealer Exemption, the SEC violated the plain meaning of Section 202(a)(11)(F), which authorizes the SEC to exempt only "*other* persons" (emphasis added) from the Advisers Act. The Court reasoned that the text of the Broker-Dealer Exemption created a "precise exemption for broker-dealers"[15] and that the SEC had exceeded its authority by broadening that exemption. The Court also found that the SEC had failed to meet its statutory obligation in Section 202(a)(11)(F) that exemptions be consistent with the "intent" of Section 202(a)(11).[16]

The Court also discussed the legislative history of the Advisers Act, stating that Congress intended to "establish a federal fiduciary standard to govern the conduct of investment advisers, broadly defined."[17] The Court rejected the SEC's assertion that when the Advisers Act was enacted, Congress had been concerned about subjecting broker-dealers to dual regulation under both the Advisers Act and the Exchange Act, instead noting that "in the [Advisers Act], Congress expressly acknowledged that the broker-dealers it covered could also be subject to other regulation."[18]

In promulgating the Final Rule, the SEC had also relied on Section 211(a) of the Advisers Act, which grants the SEC the authority "from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the functions and powers conferred upon [the SEC] elsewhere in this title." Using similar reasoning as for Section 202(a)(11)(F), the Court held that the SEC's reliance on its general rulemaking authority under this provision did not justify the Final Rule because Section 211(a) did not enable the SEC to "ignore either of the two requirements in [the Broker-Dealer Exemption] for broker-dealers to be exempt from the [Advisers Act.]" Throughout its opinion, the Court characterized the SEC as redefining or avoiding specific and explicit statutory limitations provided in the Broker-Dealer Exemption when it adopted the Final Rule.

Section 206A of the Advisers Act affords the SEC broader exemptive authority than Sections 202(A)(11)(F) and 211(a). Section 206A provides:

> [The SEC], by rules and regulations, upon its own motion or by order upon application, may conditionally or unconditionally exempt any . . . class or classes or persons, or trans-

advice, which may be solely incidental to brokerage." In doing so, however, the SEC acknowledged that "elements of financial planning have been, are, and should be a part of every broker-dealer's considerations as to the suitability of their recommendations." As such, the rule looked to whether the broker-dealer held itself out in a manner that suggested its willingness to provide financial planning services, without making clear the precise services that would constitute financial planning. The SEC justified this approach by noting that "it would be unwise for us to attempt to distinguish when a suitability analysis ends and financial planning begins, and we do not want to interfere in any way with a broker-dealer's fulfillment of its suitability obligations." Since the court vacated the rule, it is arguable that broker-dealers may have increased flexibility to provide more extensive financial planning services to brokerage clients without the need for registration under the Advisers Act.

13 Prior to its complaint, the FPA had also filed several comment letters to the proposed rule on behalf of its members that argued that the SEC's failure to impose Advisers Act restrictions on fee-based brokerage programs would deny investors the important protections of the Advisers Act, and would have "competitive implications" for financial planners. Adopting Release at *5.

14 Section 202(a)(11)(F) of the Advisers Act.

15 *Financial Planning Association*, slip op. at 15.

16 *Id.* at 12-13.

17 *Id.* at 16. The Court acknowledged (albeit in a footnote) that shortly after the enactment of the Advisers Act, the General Counsel's 1940 Opinion had stated that the Broker-Dealer Exemption "amounts to a recognition that . . . it would be inappropriate to bring [broker-dealers] within the scope of the Investment Advisers Act" merely because "brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business." *Id.* at fn. 17, citing the General Counsel's 1940 Opinion.

18 *Id.* at 17, citing Section 208(b) of the Advisers Act.

> actions, from any provision or provisions of this title or of any rule or regulation thereunder if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.[19]

Apparently, the SEC elected not to rely on Section 206A in promulgating the Final Rule because, by invoking its authority under Section 202(a)(11)(F), broker-dealers relying on the Final Rule would also be protected from regulation under state adviser statutes.[20] Nevertheless, the SEC did (albeit in a footnote) identify Section 206A as a possible "alternative ground" of authority for the Final Rule because the rule was "in the public interest and consistent with the purposes intended in the [Advisers] Act."[21]

With respect to Section 206A, the Court stated that it "ha[d] no occasion to express an opinion on the SEC's authority under it . . . but the broader language found in [Section] 206A supports the conclusion that subsection (F) must be read more narrowly."[22] This suggests that the Court could well have reached a different conclusion if the SEC had relied on Section 206A in adopting the Final Rule rather than Section 202(a)(11)(F). By identifying Section 202(a)(11)(F) as providing narrower rulemaking authority than Section 206A, the Court implied that relying on a broader grant of authority might have served the SEC in better stead.

19 Section 206A of the Advisers Act.

20 *Financial Planning Association*, slip op. at fn. 284. Section 203A(b)(1)(B) of the Advisers Act provides that the states may not regulate as investment advisers "any person . . . that is not registered under [the Advisers Act] because that person is excepted from the definition of an investment adviser under Section 202(a)(11)"—which would include broker-dealers relying on the Final Rule.

21 *Id.*

22 *Id.* at 20-21.

Minority Opinion by Judge Garland

Judge Garland dissented in the case, finding the text of Section 202(a)(11)(F)—in particular, the phrases "such other persons" and "within the intent of this paragraph"—sufficiently ambiguous to justify deference to the SEC's reasonable interpretation of the statute.[23] Garland noted that the majority had chosen to analyze the plain meaning of the Broker-Dealer Exemption when the real question at issue was whether Section 202(a)(11)(F) allowed the SEC to exempt broker-dealers beyond those already exempt.

In Judge Garland's view, nothing in Section 202(a)(11)(F) (or elsewhere in Section 202(a)(11)) suggested that Congress had spoken to this issue. Therefore, Judge Garland concluded that under *Chevron*,[24] the statutory text of Section 202(a)(11)(F) was ambiguous, and deference to the SEC's reasonable interpretation was appropriate. He also noted that the legislative history of the Advisers Act did not make clear Congress's intentions with respect to the SEC's ability to delineate further exceptions through rulemaking. Therefore, he maintained that the Court should have relied upon the SEC's judgment in interpreting its own authority under Section 202(a)(11)(F).[25]

Judge Garland also stated that the SEC had presented a reasonable case that extending the Broker-Dealer Exemption to fee-based brokerage programs was consistent with Congress's intent. He noted that the SEC had reasonably concluded that such programs were not substantially different from traditional brokerage programs, and that they should be treated the same way under the Advisers Act by allowing them the benefit of the Broker-Dealer Exemption.

Legal and Practical Implications for Fee-Based Brokerage Programs

We believe that, as written, the decision seems to suggest that the term "special compensation" should be broadly construed. Broker-dealers receiving any compensation other than brokerage commissions or dealer compensation could be regarded as receiving special compensation, and could be required to register as investment advisers under the Advisers Act.

23 Dissent by Garland, J. at 1.

24 *Chevron, USA, Inc. v. Natural Res. Def. Counsel, Inc.*, 467 U.S. 837, 842 (1984).

25 *Financial Planning Association*, slip op. at 5.

This interpretation could have drastic consequences for the broker-dealer industry, which administers approximately $300 million in fee-based brokerage programs. However, we believe that, despite the decision, broker-dealers dually-registered under both the Exchange Act and the Advisers Act may continue to rely on the prior Staff no-action position that the standards of the Advisers Act will not apply where they provide investment advice that is incidental to brokerage services.[26]

Conclusion

On May 14, 2007, the SEC asked the Court for a 120-day stay of its ruling to allow broker-dealers that offer fee-based brokerage accounts an opportunity to respond to the decision, as the ruling is likely to cause substantial changes in the manner that broker-dealers conduct their businesses, since it is estimated that the ruling will affect more than a million fee-based brokerage accounts. On May 14, the SEC also announced that it will not to seek further review of the Court's decision, but plans to consider whether further rulemaking or interpretations are necessary as a result of the decision.[27] We understand that the SIFMA has suggested that a 120-day stay is inadequate for broker-dealers to respond to the Court's ruling. While we have no first hand knowledge of any action that might be taken by affected brokerage firms, it seems reasonable to assume that pressure will be put on the SEC and the Solicitor General's office to seek certification to the Supreme Court in order to effectively enable broker-dealers to have more time to adjust to the ruling.

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[26] *See* E.F. Hutton & Co., Inc. (pub. avail. February 2, 1979).

[27] *See also* SIFMA statement "SEC Leaves Investors in the Lurch by Not Asking for Rehearing" (May 14, 2007) http://www.sifma.org/news/44596414.shtml.

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