

*Coping with New SEC Rules Extending  
Adviser Regulation to Brokers  
Providing Advice*

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# *Coping with New SEC Rules*

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- Background
- Rule 202(a)(11)-1 Overview
- “Special Compensation”
- “Solely Incidental” - Financial Planning
- “Solely Incidental” - Discretion
- Transition - Objectives
- Alternative Models
- Transition Process

# *Background*

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- Definition of investment adviser
- Broker exclusion
  - Incidental advice
  - Special compensation
- Wrap accounts
- Enter fee based brokerage accounts
  - And SEC's 1999 proposal

# *Rule 202(a)(11)-1 Overview*

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- “Special compensation”
  - Fee based brokerage exception
- “Solely Incidental” – Advice by broker-dealer is not “solely incidental” if the broker-dealer
  - Charges a separate fee or separately contracts for advisory services
  - Provides advice as part of a financial plan
  - Exercises investment discretion
- Registered broker-dealers are deemed advisers only for accounts for which they provide advisory services

# *“Special Compensation”*

- A registered broker-dealer will not be deemed an adviser based on its receipt of “special compensation” if
  - Advice provided to accounts from which it receives special compensation is solely incidental to brokerage services provided
  - Ads, agreements, applications and other forms governing accounts for which the broker-dealer receives special compensation disclose
    - Your account is a brokerage (not advisory) account
    - Our interest may not always be the same as yours
    - Ask questions to ensure you understand your rights & our obligations to you, including to disclose conflicts and to act in your best interest
    - We are paid both by you and others who pay based on what you buy
    - Our profits and our reps’ compensation may vary by product & over time
  - The disclosure must identify an appropriate person at the firm with whom the customer can discuss the differences

# *“Solely Incidental” - Financial Plans*

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- Advice is not incidental to brokerage if the broker-dealer provides advice as part of a financial plan or in connection with providing financial planning services and
  - Holds itself out as a financial planner or as providing financial planning services
  - Delivers a financial plan to the customer
  - Represents to the customer that the advice is provided as part of a financial plan or in connection with financial planning services
- The concept of financial planning is not clearly defined
  - Focus on comprehensiveness
  - Input versus output

# *“Solely Incidental” - Discretion*

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- Exercising investment discretion is not incidental to brokerage
- Not covered – Discretion granted “on a temporary or limited basis”
  - As to price or time to trade a definite quantity of a specified security
  - On an isolated or infrequent basis, to trade a security or type when customer is unavailable for a limited time (up to few months)
  - As to cash management, such as to exchange sweep vehicles
  - To purchase or sell securities to satisfy margin requirements
  - Tax loss harvesting trades
  - To purchase a bond with a specified credit rating and maturity
  - To trade a security or type of security limited by specific parameters
- Employee trading

# *Transition - Objectives*

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- Restructure current brokerage and advisory services to minimize the extent to which your firm may be deemed acting as
  - An adviser when Rule 202(a)(11)-1 goes into effect
  - A fiduciary for ERISA and other retirement accounts

# *Alternative Models*

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1. Preserve full service model by continuing to offer brokerage and advisory services on an integrated basis
2. Acknowledge your firm's investment advisory services – or at least some of them – result in it being an adviser for other purposes across its brokerage business
3. Push out to a separate (though affiliated) adviser current advisory business – or the advisory business for those advisory services that are the least susceptible to containment – and seek to maintain sufficient separateness from this advisory business so that regulators should not “collapse” your firm with the adviser

# *Transition Process*

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- Catalog Advisory Services
- Analyze Advisory Services
- Limit Financial Planning Services
- Limit Exercise of Discretion
- Shift Advisory Business to Affiliates?
- Update Policies and Procedures
- Policies and Procedures
- Establish Tracking Systems
- Consider “Defensive” Authorizations
- Review Marketing Materials
- Customer Disclosures
- Consider RR Issues
- Train Representative

# *Catalog Advisory Services*

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- Catalog the services your firm provides that may be viewed as advisory services under Rule 202(a)(11)-1
  - Financial planning
  - Discretionary brokerage, including pursuant to trading authorization
  - Sale of research for separate price
  - Other

# *Analyze Advisory Services*

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- Scope of the advisory relationship
  - Whether it extends to
    - Affiliates
    - Other accounts maintained by the customer at the firm
    - Other dealings with the customer
- Ability to limit the advisory relationship
  - Ways to interpose another adviser or hand off customer questions involving non-incident advice
  - Take off “adviser hat”
- Steps that could be taken if the advisory relationship mistakenly bleeds into other brokerage relationships or dealings with the customer

# *Limit Financial Planning Services*

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- Limit financial planning and related services
  - Consider if they can be limited to take them outside the concept of being financial planning services (i.e., advice) for purposes of the Rule
  - Even if they involve advice, consider limiting the scope of financial planning services
    - Exclude brokerage accounts
    - Exclude implementation assistance
    - Conclude advisory relationship on delivery of financial plan
  - Means to limit?

# *Limit Exercise of Discretion*

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- Revise trading authorizations to fit within the SEC's concept of "temporary or limited" discretion
  - Consider adding disclosures mandated for fee based accounts under Rule 202(a)(11)-1
- Terminate or transition existing relationships involving the exercise of broad investment discretion
  - Arrangements in which your firm exercises discretion that is not temporary or limited, or susceptible to being so limited, should be recast as full-fledged advisory relationships
- Update WSPs and establish a surveillance systems to ensure only limited discretion is exercised

# *Shift Advisory Business to Affiliates?*

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- If an advisory business will be conducted through a separate adviser that the firm does not wish to be “collapsed” with the firm for regulatory purposes
- Firm and its affiliated advisers should adopt policies and procedures to maintain the separateness of those organizations
  - Corporate organization
  - Corporate “housekeeping”
  - Information barriers
  - Separate compensation systems

# *Update Policies and Procedures*

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- Update P&P to reflect transition plan
- Note where broker-dealer and adviser regulatory requirements differ
  - Agency and agency-cross transactions governed by Advisers Act Section 206(3) and Rule 206(3)-2
  - Principal transactions governed by Advisers Act Section 206(3);
  - Personal securities trading/code of ethics issues governed by Advisers Act Rule 204A-1
  - Performance-based fees under Advisers Act Section 205 and Rules 205-1 through 205-3
  - Advertising and communications with the public, specifically including the bars on reference to past specific recommendations and use of testimonials in investment adviser advertisements under Advisers Act Rule 206(4)-1

# *Policies and Procedures*

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- Consider if P&P for advisory business comply, as need, with SEC and SRO requirements governing broker-dealers
  - Especially where the adviser and brokerage businesses are performed
    - By common personnel or
    - Where such businesses could be “collapsed” for regulatory purposes
- Examples
  - “Selling away” requirements under NASD Rule 3040
  - SRO rules concerning identification of individual representatives authorized to exercise discretion over customer accounts
  - Books and records requirements under SEC Rule 17a-3 and 17a-4, including relating to the preservation and maintenance of email
  - MSRB rule relating to political contributions

# *Establish Tracking Systems*

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- Establish systems that track and record the kind of relationship (brokerage or investment advisory) the firm has with each customer
  - To ensure generally that services actually provided to a customer are rendered in accordance with allocable law and the firm's P&P
  - To ensure that advisory services are not inadvertently provided to a customer when the relationship with that customer must be limited to a brokerage relationship
  - For surveillance purposes

# *Consider “Defensive” Authorizations*

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- Consider augmenting current customer documentation to include authorizations and conflict disclosures that would be required were those services characterized as advisory services subject to the Advisers Act
  - Authorization to engage in agency-cross transactions (so as to comply with Advisers Act Rule 206(3)-2, were it applicable)
  - Authorization to act as principal in customer transactions
    - Note trade-by-trade requirement under Section 206(3)

# *Review Marketing Materials*

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- “Holding Out” issue
- Take inventory of and analyze sales marketing materials
  - Determine whether services need to be re-characterized so that the advisory and brokerage components are separately delineated
  - Especially important in dual use materials
    - Stationery and business cards that may contain reference to both brokerage and advisory services

# *Customer Disclosures*

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- Build on fee-based brokerage disclosures to provide more detailed information about
  - Specific services in which
    - The firm is acting as a broker-dealer
    - The firm or (its affiliates) are acting as adviser
  - The scope and duration of any advisory relationships
  - Brokerage as default capacity?
- Where?
  - Firm website
  - Customer education document
  - Ads, agreements, applications and other forms

# *Consider RR Issues*

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- Consider how the restructuring of your firm's advisory business affects
  - RR compensation and any related conflicts
  - Your firm's posture in any overtime litigation to which your firm may be subject

# *Train Representative*

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- Supplement “Firm Element” Continuing Education program
  - Programs and services in which the firm is providing brokerage *versus* advisory services
  - Differences in the role and responsibilities of the firm when acting in these different capacities
  - Information available to customers
- Scripts for answering customer questions