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Current Concerns for Investment Advisory Compliance

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Agenda

- D.C. Circuit's decision vacating Rule 202(a)(11)-1
- Recent regulatory actions and guidance
 - [Temporary Rule 206\(3\)-3T – Limited Principal Trade Relief](#)
 - [New Rule 202\(a\)\(11\)-1](#)
- Next steps
 - [Rand Study](#)
 - [Impact on Regulation of Financial Planning Services](#)
- Compliance concerns for nondiscretionary advisers

Regulatory Background

- Old Rule 202(a)(11)-1 Overview (Approved on April 12, 2005)
 - “Special compensation” – asset based fees for brokerage services
 - “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
- Commission differentials ≠ special compensation

Regulatory Background

- DC Circuit Court of Appeals Vacates SEC Rule 202(a)(11)-1 (March 30, 2007)
 - Court determined that Section 202(a)(11)(C) of the Advisers Act was the only exemption from the Advisers Act available to broker-dealers who provide advice to clients
 - “Fee-in-lieu of” commission brokerage accounts were deemed to be “special compensation” and not excluded from the Advisers Act
 - Court decision effective on October 1, 2007
 - The entire Rule
 - Including provisions related to Account by Account Status, Financial Planning, Discretionary Brokerage, and Commission Differentials

What now?

- Fee-based brokerage accounts are a thing of the past
- Firms have transitioned fee-based brokerage accounts either to:
 - nondiscretionary advisory accounts subject to the Advisers Act; or
 - commission-based brokerage subject to the Exchange Act and FINRA rules

Recent regulatory actions and guidance

- Rule 206(3)-3T – Temporary Rule Regarding Principal Trade Relief for Certain Advisory Accounts
- Relief available for nondiscretionary advisory accounts of firms dually registered as BD/IA
- Conditions
 - **Client Global Written Consent** – authorizing the adviser to engage in principal trades (which may be revoked by the client at any time) and disclosing conflicts
 - **Trade-by-Trade Disclosures** – written or oral before each trade is executed
 - **Trade-by-Trade Consent** – written or oral before each trade is executed
 - **Confirm Disclosures** – capacity in which adviser acted and a reminder that adviser had informed the client that it might act as principal and that the client authorized the transaction
 - **Annual Report** – itemizing principal trades

Recent regulatory actions and guidance

- Rule 206(3)-3T (cont'd)
 - In effect as of September 30 and will expire on December 31, 2009, unless the SEC takes action to adopt it as a permanent rule
 - The Rule allows firms to rely on the relief now, so long as the required global written client consents and ADV disclosure are in place by January 1, 2008
 - The relief does not apply to principal trades involving (i) securities issued by the dual registrant or an affiliate or (ii) securities (other than investment grade, nonconvertible debt) underwritten by the dual registrant
 - The relief applies to investment grade, nonconvertible debt underwritten by the dual registrant or an affiliate

Recent regulatory actions and guidance

- New Rule 202(a)11-1
 - SEC proposed rule amendments designed to reinstate certain provisions that were part of the vacated Old Rule
- Account by Account Status
 - SEC reaffirmed that a firm may have both a brokerage relationship and an investment advisory relationship with the same client
- Commission Differentials
 - SEC reinstates position that a broker-dealer using different commission schedule for full service and discount brokerage would not be receiving “special compensation” for full service brokerage

Recent regulatory actions and guidance

- New Rule 202(a)11-1 (cont'd)
 - **Discretionary Brokerage**
 - The New Rule reaffirms the SEC position that the exercise of investment discretion is not “solely incidental to” brokerage, even if compensated through ordinary commissions
 - The staff reiterated its view set forth in the Old Rule that the exercise of limited or temporary discretion should not be deemed to involve the exercise of investment discretion so as to subject a broker-dealer to the Advisers Act

What About Financial Planning Services?

- Provision in Old Rule vacated (even though not at issue in the FPA decision)
- SEC did not address provision of comprehensive financial planning services
- Open question for firms as to whether or not to revert back to the prior practice of providing these services on a brokerage basis
- Possible return to former paradigm that looked to whether financial planning was for free or for a fee (“special compensation”)
- Stay tuned for outcome of Rand Study

Compliance concerns for nondiscretionary advisers

- What are the SEC's hot areas in exams?
- Advertising, adherence to compliance procedures, disclosure of conflicts
- Read the SEC's exam request letters – how well could you respond?
- ERISA is a trap for the unwary
- How do these affect nondiscretionary advisers?

Key Compliance Areas for Nondiscretionary Advisers - Advertising

- “How does the firm ensure that performance and other information used in advertisements and other marketing materials is calculated accurately and fairly and is used in ways that are not misleading?”
- Advertising – can’t advertise performance unless:
 - The firm is running a model
 - The firm discloses whether it has any clients that actually follow the model and have achieved these results
 - Or the firm discloses that no clients have results as good as the model
 - The firm has backup documentation that demonstrates how performance was calculated

Key Compliance Areas for Nondiscretionary Advisers – Making Recommendations

- “How does the firm ensure that portfolio management decisions are consistent with client mandates, regulatory requirements, disclosures and fiduciary obligations?”
- Document the advice given, the client’s instructions, and any follow-up.
- What is the firm’s procedure for formulating advice? Recommended lists, approved research.
- How does the firm ensure the advice is suitable? Manager review, comparison to benchmarks.

Key Compliance Areas for Nondiscretionary Advisers - Conflicts

- “How does the firm ensure that personal trading activities of access persons and investment decisions for proprietary accounts of Registrant are consistent with codes of ethics, regulatory requirements, disclosures and fiduciary obligations?”
- Receipt of additional compensation— does the firm or an affiliate get 12b-1, placement, revenue sharing or referral fees for recommending certain investments to clients?
- Interests in issuers – does the firm recommend issuers (e.g. private funds) in which it or its personnel have significant ownership?
- Affiliated brokers – does the firm use or recommend affiliated brokers or placement agents?
- Principal and agency cross trades – Advisers Act rules govern the disclosures of conflicts.

ERISA

- A nondiscretionary adviser can still be an ERISA fiduciary
- Fiduciary status arises with discretion OR giving advice that is “a” primary basis for the client’s investment decisions
- Possible to disclaim fiduciary status in account documents, but if in fact the client relies exclusively on the adviser, a trier of fact may find the adviser is a fiduciary
- Many practices permitted under the Advisers Act are prohibited or restricted under ERISA, such as principal trades and taking dual fees

Questions