

FEE-BASED ACCOUNTS RULE FORUM
How Firms Are Adapting To The Rule
And A Look Towards The Future

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Fee-Based Accounts Rule Forum*

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I. Introduction.

A. Beginning January 31 of this year, the rules changed for broker-dealers offering investment advice, as the last provisions of SEC Rule 202(a)(11)-1 swung into effect. The rule, adopted in April 2005, remapped the regulation of broker-dealers offering investment advice in two respects: it casts certain discretionary brokerage and comprehensive financial planning services as “investment advice” subject to the Investment Advisers Act of 1940, and it carves out from regulation under the Advisers Act fee-based brokerage services that comply with specified conditions. Although according the SEC’s adopting release, the rule was designed to address “confusion regarding the differences between broker-dealers and investment advisers,”¹ the rule, as well as the related SEC staff guidance, arguably raise as many questions as they answer. In fact, Rule 202(a)(11)-1 and SEC staff guidance leave open a broad range of important issues that, depending on future interpretations by regulators and the courts, have the potential to limit the ability of broker-dealers to provide investment advice alongside principal or dealer-based execution services, which are effectively prohibited under the Advisers Act.

II. Overview of Rule 202(a)(11)-1

A. The SEC adopted Rule 202(a)(11)-1 to address the application of the Investment Advisers Act to certain types of advisory programs and services offered by broker-dealers. The rule was first proposed in 1999² to respond to perceived uncertainties under Section 202(a)(11)(C) of the Advisers Act, which provides an exception for broker-dealers from the definition of investment adviser. That proposal quickly became the focus of intense lobbying efforts by the securities, investment management, and financial planning industries. Financial planners rallied together in opposition to the proposal, launching a letter writing campaign that resulted in the submission of over 1,700 comment letters. The Financial Planning Association upped the ante by filing a petition for judicial review of the SEC proposal.³ This prompted the SEC to repropose the rule in January 2005,⁴ and to adopt the rule in final form two months later.⁵ In response, the FPA filed another suit on April 28, 2005. The briefing of that case just started in March

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¹ See SEC Release No. 34-51523 (Apr. 15, 2005), at 4, available at <www.sec.gov/rules/final/34-51523.htm>.

² See SEC Release No. 34-42099 (Nov. 4, 1999), available at <www.sec.gov/rules/proposed/34-42099.htm>.

³ Financial Planning Ass’n v. SEC, No. 04-1242 (D.C. Cir.) (case docketed on July 20, 2004).

⁴ See SEC Release No. 34-50980 (Jan. 6, 2005), available at <www.sec.gov/rules/proposed/34-50980.htm>.

⁵ SEC Release No. 34-51523, *supra* note 1.

2006. Consumer advocacy groups also have joined the industry in commenting on the rulemaking and submitted letters to the SEC that are sharply critical of both the rule and the SEC guidance.⁶

B. The final rule represents a surprising metamorphosis in the SEC’s regulation of broker-dealers providing investment advice. It allows a broker-dealer to charge asset-based or fixed fees without falling under the Advisers Act so long as the investment advice is “solely incidental” to the brokerage services provided and the customer receives (and all marketing around the fixed-fee brokerage accounts uses) standardized disclosure. However, as discussed below, under Rule 202(a)(11)-1, activities in which broker-dealers have routinely engaged and that have been widely understood to be a customary aspect of “full service brokerage” are now subject to regulation under the Advisers Act.

III. When Does a Broker-Dealer’s Advice Trigger Application of the Advisers Act?

A. Section 202(a)(11)(C) of the Advisers Act defines an “investment adviser” to exclude broker-dealers if the investment advice they provide is “incidental” to their brokerage business and they do not charge “special compensation” (*e.g.*, a clearly definable charge) for such advice. Thus, historically, the determination of whether a broker-dealer was offering an investment advisory service or a brokerage service has turned on the nature of the compensation. A broker-dealer receiving “special compensation” for providing services that included an element of investment advice was unable to rely on the broker-dealer exception from the definition of an investment adviser, and therefore was subject to investment adviser regulation.

B. The exclusion in Section 202(a)(11)(C) recognizes that broker-dealers “commonly give a certain amount of advice to their customers in the course of their regular business and that it would be inappropriate to bring them within the scope of the [Advisers Act] merely because of this aspect of their business.”⁷ Indeed, as the SEC has recognized, the advice provided by broker-dealers “is substantial in amount, variety, and importance to their customers” and was “well understood in 1940 when Congress passed the Advisers Act.”⁸

C. Following this statutory scheme, the SEC and its staff has historically drawn the line between broker-dealer and investment adviser activity primarily by focusing on the form of compensation rather than the substance of a broker-dealer’s activity. For at least two decades, the SEC and its staff have taken the stance that a broker-dealer may be viewed as receiving special compensation in the context of multi-tiered commission schedules if a higher commission rate is primarily attributable to investment advice provided, regardless of the character of that advice. As the staff commented in 1985,

⁶ *See, e.g.*, Letter from the Consumer Federation of America and Fund Democracy to Chairman Christopher Cox, February 15, 2006, *available at* www.funddemocracy.com/Letter%20re%2012.16.05%20Staff%20Interpretation.pdf.

⁷ *See* Opinion of the General Counsel Relating to Section 202(a)(11)(C) of the Advisers Act, Advisers Act Release No. 2 (Oct. 28, 1940), 11 Fed. Reg. 10996 (Sept. 27, 1946).

⁸ SEC Release No. 34-50980, *supra* note 4, Section II.A.1.

“[i]f two general fee schedules are in effect, either formally or informally, the lower without investment advice and the higher with investment advice, and the difference is primarily attributable to this factor[,] there is special compensation.”⁹ This conclusion was reached despite the fact, now conceded by the SEC, that “[a]t the time the Advisers Act was enacted, Congress understood ‘special compensation’ to mean compensation other than commissions.”¹⁰

D. The SEC’s approach to distinguishing between broker-dealer and investment adviser activity led to regulatory uncertainties in the early 1990s, as increasing numbers of broker-dealers launched non-traditional commission arrangements, including discount (and later electronic) and fee-based brokerage arrangements. To the extent the related brokerage services included an advice component, broker-dealers generally were careful to make clear that they intended to provide the same types of advice as they provided to customers paying traditional commissions in an effort to skirt the investment adviser status issue. These arrangements were already well established in the marketplace by the time the SEC proposed Rule 202(a)(11)-1.¹¹

IV. The New Status Quo: Functions to Which the Advisers Act May or May Not Apply. In the final rule, the SEC ultimately staked out a functional approach to deciding which brokerage activities may fall within the scope of the Advisers Act, but not without a few surprises. The approach is based on the SEC’s view that “broker-dealers and advisers should be held to similar standards depending not upon the statute under which they are registered, but upon the role they are playing.”¹²

The final rule also expressly precludes certain activities from being deemed solely incidental, including exercising investment discretion over an account, providing advice as part of a financial plan, or charging a separate fee or separately contracting for advisory services. As discussed below, the SEC’s new stance on the first two of these activities represents a remarkable change from its past interpretations.

A. Different and non-traditional commissions.

1. The final rule clarifies that offering both discount and full-service brokerage services does not bring a broker-dealer under the Advisers Act. In doing so, the SEC wisely backed away from its previous stance that firms offering multiple commission schedules, including higher commissions where investment advice was given as part of a “full service” offering, would create “special compensation.” In addition, a broker-dealer may charge asset- or fee-based commissions without triggering the Advisers Act so long as the investment advice is “solely incidental” to the brokerage services pro-

⁹ See Robert S. Strevell, SEC Staff No-Action Letter (Apr. 29, 1985).

¹⁰ See SEC Release No. 34-50980, *supra* note 4, at n. 45 (citing S. REP. NO. 76-1775, 76th Cong., 3d Sess. 22 (1940)).

¹¹ See SEC Release No. 34-42099, *supra* note 2, Section I.

¹² SEC Release No. 34-51523, *supra* note 1, Section III.A.2.

vided and the broker-dealer provides a standardized disclosure to customers in advertisements, contracts and applications, and other forms governing the program.¹³

2. The standard disclosure must recite, in a prominent statement, 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.

3. The prominent statement also must identify an appropriate person at the firm with whom the customer can discuss the differences between brokerage services and advisory services subject to regulation under the Advisers Act. The rule does not, however, specify what type of person would be an appropriate contact for customer questions. Accordingly, it would be permissible to designate a customer's broker or financial adviser as a person to whom a customer should address questions. Firms also are free to designate a help line or other centralized customer service resource to address these questions, assuming the help line staff has appropriate expertise.

B. Discretionary Brokerage Accounts.

1. Before Rule 202(a)(11)-1 was adopted, a broker-dealer was regarded as providing incidental investment advice, and was not treated as an investment adviser subject to the Advisers Act, when exercising discretionary authority over the accounts of a limited number of customers, so long as the customers did not pay special compensation for these services. However, if a broker-dealer's business consisted "almost exclusively of managing accounts on a discretionary basis," the SEC staff would not regard the broker-dealer as providing "incidental" investment advice for purposes of the exclusion in Advisers Act Section 202(a)(11)(C).¹⁴

2. The final rule reverses that approach and treats discretionary brokerage as an advisory service subject to the Advisers Act. Under the final rule, a broker-dealer is not excepted from the Advisers Act for any account over which it exercises investment discretion as that term is defined under the Securities Exchange Act of 1934,¹⁵

¹³ Rule 202(a)(11)-1(a)(1)(ii). This provision of the rule went into effect July 22, 2005.

¹⁴ See SEC Release No. 34-15215 (Oct. 5, 1978).

¹⁵ Under Section 3(a)(35) of the Exchange Act, a "person exercises 'investment discretion' with respect to an account if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines,

unless such discretion is exercised on a “temporary or limited basis.” Although the meaning of “temporary or limited basis” discretion does allow for some flexibility for broker-dealers to execute transactions without receiving specific trade-by-trade directions from the customer prior to execution, the language makes clear that this sort of limited discretion excludes broad management authority or discretionary grants “seeking to obtain discretionary supervisory services.”¹⁶

3. This reversal is remarkable given that discretionary brokerage existed before Congress enacted the Advisers Act (and chose to focus on a broker-dealer’s means of compensation as the primary factor in deciding applicability of the statute). In addition, SEC and self-regulatory organization (“SRO”) rules, in the SEC’s own words, “provide substantial protections for broker-dealer customers that in many cases are more extensive than those provided by the Advisers Act and the rules thereunder.”¹⁷ For example, both NYSE and NASD rules impose heightened supervisory requirements for transactions effected on behalf of discretionary brokerage accounts.¹⁸ Moreover, discretionary brokerage transactions are governed by the suitability and best execution standards for registered broker-dealers, which parallel those for registered investment advisers in many respects, as well as state and common law fiduciary standards. Indeed, when formulating proposed Rule 206(4)-5 under the Advisers Act, which would have created an express suitability obligation for investment advisers, the SEC looked primarily to interpretations of the scope of broker-dealer suitability obligations under the Exchange Act.¹⁹

in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.”

¹⁶ SEC Release No. 34-51523, *supra* note 1, Section III.E.4.

¹⁷ SEC Release No. 34-50980, *supra* note 4, n. 52.

¹⁸ *See, e.g.*, NYSE Rule 408 and NASD Rule 2510 (requiring heightened supervision of discretionary brokerage accounts); NYSE Rules 722 and 724 and NASD Rule 2860(b) (requiring supervision of discretionary options accounts); and NYSE Rule 414(i) and NASD Rule 2845 (stating that the rules governing supervision of discretionary accounts in options govern discretionary accounts in currency warrants, currency index warrants, and stock index warrants).

¹⁹ *See* Investment Advisers Act Release No. 1406 (Mar. 16, 1994). The SEC staff tacitly recognized the comparability of broker regulation in this area by granting an exemption treating broker discretionary trades the same as adviser discretionary trades for purposes of allowing suppression of trade-by-trade confirmations. *See, e.g.*, Goldman, Sachs & Co., SEC Staff No-Action Letter (Aug. 14, 2003), *available at* <www.sec.gov/divisions/marketreg/mr-noaction/goldman081403.htm>. Regardless of whether a broker-dealer is treated as an investment adviser in connection with its exercise of discretion, it also must comply with Section 11(a) of the Exchange Act and NASD Rule 2720(l). Exchange Act Section 11(a) prohibits a member of a national securities exchange from effecting transactions on the exchange for an account in which it or an associated person exercises investment discretion (and certain other covered accounts), unless an exception applies. Section 11(a)(1) provides that the prohibition on principal transactions does not apply to transactions by a dealer acting in the capacity of a market maker; *bona fide* arbitrage, risk arbitrage, or hedge transactions; transactions by an odd lot dealer; and transactions made to offset errors. In addition to the statutory exceptions to Section 11(a), Rule 11a2-2(T) permits an exchange member to effect transactions for covered accounts by arranging for an unaffiliated exchange member to execute the transactions directly on the exchange floor where, among other conditions, neither the member nor any of its asso-

C. “Temporary or limited” discretionary authority

1. As noted above, the final rule does not classify all discretionary activity as investment advisory services. The SEC carved out the exercise of discretion on a “temporary or limited basis.” This carve-out provides flexibility to broker-dealers by allowing them to exercise discretion for execution purposes so long as the discretion is “limited to a transaction or series of transactions and [does] not extend to setting investment objectives or policies for the customer.” Responding to industry comments,²⁰ the SEC listed the following examples as instances in which it would treat a broker-dealer’s discretion as temporary or limited:

- When the broker-dealer is given discretion as to the price or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security;
- When the broker-dealer is given discretion on an isolated or infrequent basis to purchase or sell a security or type of security when a customer is unavailable for a limited period of time not to exceed a few months;
- When the broker-dealer is given discretion as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent;
- When the broker-dealer is given discretion to purchase or sell securities to satisfy margin requirements;
- When the broker-dealer is given discretion to sell specific bonds and purchase similar bonds in order to permit a customer to take a tax loss on the original position;
- When the broker-dealer is given discretion to purchase a bond with a specified credit rating and maturity; and
- When the broker-dealer is given discretion to purchase or sell a security or type of security limited by specific parameters established by the customer.

ciated persons retains any compensation in connection with effecting the transaction without express written consent from the person authorized to transact business for the account in accordance with the rule.

NASD Rule 2720(I) prohibits a broker-dealer from executing, on a discretionary basis, any transaction in securities issued by the broker-dealer, one of its affiliates, or an issuer with which the broker-dealer has a conflict of interest without the customer’s prior specific written approval, although exemptive relief may be available in limited circumstances. *See, e.g.*, NASD Exemptive Letter to Goldman, Sachs & Co. (June 14, 1999), *available at*

www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002617.

²⁰ *See* Comment Letter of Securities Industry Association (Feb. 7, 2005), *available at* www.sec.gov/rules/proposed/s72599/sia020705.pdf; Comment Letter of Morgan, Lewis & Bockius LLP (Feb 7, 2005), *available at* www.sec.gov/rules/proposed/s72599/morganlewis020705.pdf.

2. Since the rule was adopted, the SEC staff has issued two letters interpreting the scope of the concept of temporary or limited discretion. First, in *UBS Financial Services, Inc.*,²¹ the SEC staff confirmed that it would deem a cash management program to involve “temporary or limited” discretion where, among other things, UBS agreed to:

- Provide cash management services only for institutional accounts (as defined by NASD Rule 3110(c)(4));
- Obtain from each customer a written grant of discretion limited to compliance with written guidelines set and provided by the customer;
- Exercise discretion in accordance with such written guidelines and any subsequent customer instructions;
- Disclose to each such customer that UBS may act as principal in transactions effected for the customer’s account;
- Exercise discretion only for those customers that require, pursuant to the customer’s written guidelines, that the weighted average maturity of the customer’s account not exceed 18 months;
- Limit discretionary trading in each such customer’s account to fixed-income and similar instruments, such as U.S. Treasury securities, municipal securities, debt obligations issued by U.S. federal agencies or U.S. government-sponsored enterprises, interests in money market funds, investment grade corporate debt, commercial paper, variable rate demand obligations, auction rate certificates, auction preferred stock, repurchase and reverse repurchase transactions, and certificates of deposit;
- With respect to fixed-income instruments and auction preferred shares, exercise discretion only for such customers that limit the grant of discretion, according to the customer’s written guidelines, to instruments (a) bearing credit ratings of A1/P1 or higher for short-term investments and A2/A or higher for long-term investments and (b) with maturities of three years or less;
- Treat the accounts of such customers as discretionary brokerage accounts under applicable SRO rules; and
- Clearly inform each such customer that the account is a brokerage account.

UBS is interesting in that it is by no means clear that this relief was legally needed given the SEC’s guidance in the adopting release for Rule 202(a)(11)-1 and because several of the conditions—such as the limitation to institutional accounts—may not be legally rele-

²¹ SEC Staff Interpretive Letter (Sept. 29, 2005), *available at* <www.sec.gov/divisions/investment/noaction/ubs092905.htm>.

vant to whether a broker-dealer is deemed an investment adviser by virtue of its exercise of discretion. Accordingly, although the *UBS* letter is a helpful illustration of the kinds of discretion that may be exercised consistent with the notion of temporary or limited discretion, its conditions should not be read as modifying the guidance provided by the SEC or as necessarily limiting other arrangements.

3. The second SEC staff letter interpreting the scope of the concept of “temporary or limited discretion” addressed whether a broker-dealer would be deemed exercising investment discretion over client accounts if employees of the broker-dealer exercised discretion over “friends and family” accounts. In *Morgan, Lewis & Bockius LLP*,²² the SEC staff confirmed that a broker-dealer would not be deemed to exercise investment discretion for purposes of the Advisers Act if an associated person exercises investment discretion over an account due to his or her position as executor, conservator, trustee, attorney-in-fact, or other agent as a result of a family or personal relationship, and not due to his or her employment with the broker-dealer.

D. Financial Planning Services

1. The aspect of Rule 202(a)(11)-1 generating the most controversy and consternation in the securities industry is the classification of financial planning as investment advice subject to the Advisers Act. In the past, the SEC said that a broker-dealer would not be acting as an investment adviser for Advisers Act purposes when the broker-dealer provides financial planning advice without charging a separate fee for the services. In other words, the activity was considered to be “solely incidental” to the brokerage services if a broker-dealer provided financial planning advice to brokerage customers but charged only transaction-based compensation for executing transactions. The rule reversed this earlier stance. Specifically, the rule states that advice is not considered solely incidental to brokerage services if it is provided as part of a financial plan or in connection with providing financial planning services, and the broker-dealer:

- Holds itself out as a financial planner or as providing financial planning services to the general public;
- Delivers a financial plan to the customer; or
- Represents to the customer that the advice is part of a financial plan or provided in connection with financial planning services.

2. Neither the rule nor the adopting release seeks to define “financial planning services” or “financial plan” except in purely conceptual terms. As described in the release, financial planning services typically involve assisting clients in identifying long-term economic goals, analyzing their current financial situation, and preparing a comprehensive financial plan to achieve those goals. Whether a particular document is a financial plan, according to the SEC, turns on whether it bears the “characteristics” of a

²² SEC Staff Interpretive Letter (Nov. 17, 2005), *available at* www.sec.gov/divisions/investment/noaction/morganlewis111705.htm.

financial plan. Specifically, a financial plan generally seeks to address a wide spectrum of a client's long-term financial needs, including insurance, savings, tax and estate planning, and investments, taking into consideration the client's goals and situation, including anticipated retirement or other employee benefits.²³

3. The adopting release cites a 1987 release jointly issued by the SEC and the North American Securities Administrators Association²⁴ that similarly describes financial planning services as involving a financial program prepared for a client based on the client's financial circumstances and objectives, normally covering present and anticipated assets and liabilities, including insurance, savings, investments, and anticipated retirement or other employee benefits. The program developed for the client also would usually include general recommendations for a course of activity, or specific actions, to be taken. For example, the plan may recommend that the client obtain insurance or revise existing coverage, establish an individual retirement account, increase or decrease funds held in savings accounts, or invest funds in securities. A financial planner also may develop tax or estate plans or refer clients to an accountant or attorney for these services.

4. After months of discussions between industry representatives and the SEC staff, the staff issued a letter to the Securities Industry Association in December 2005 addressing four issues in connection with the implementation and operation of the portion of Rule 202(a)(11)-1 relating to financial planning activities of broker-dealers.²⁵

a. Holding out

The SEC staff made clear that “[h]olding itself out as providing advisory services does not by itself require a broker-dealer to register under the Advisers Act. Under rule 202(a)(11)-1(b), a broker-dealer is an investment adviser subject to the Advisers Act if it portrays itself, in advertisements or otherwise, to the public (*i.e.*, holds itself out) as a financial planner *and* also provides investment advice as part of a financial plan or in connection with providing financial planning services.”²⁶

b. *Differentiated from brokerage tools.*

The SEC staff also explained its views of the ways in which a financial plan differs from financial tools offered by broker-dealers as part of their brokerage services:

[A financial plan] is distinct from a financial tool that is used to provide guidance to a customer with respect to a particular transaction or

²³ SEC Release No. 34-51523, *supra* note 1, at 58.

²⁴ Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 8, 1987).

²⁵ Securities Industry Association, SEC Staff Letter (Dec. 16, 2005), *available at* <www.sec.gov/divisions/investment/noaction/sia121605.htm>.

²⁶ *Id.* (emphasis in original).

an allocation of customer funds and securities based upon the long-term needs of a client, but that is not applied in the context of the more comprehensive plan described above. When used in this more limited way, a financial tool would be viewed as part of a broker-dealer's brokerage relationship with its customer. Where the financial tool is used with, or made available to, a brokerage customer, the fact that a broker-dealer discloses to the customer that the financial tool is a brokerage service and not a financial plan can be helpful in determining whether the broker-dealer is providing brokerage services. How a reasonable investor would perceive the services would also be an important consideration.²⁷

In this context, a "financial tool" may include questionnaires, financial calculators, or tools that generate asset allocation and cash flow analyses.

c. Moving from "adviser" to broker.

(i) Critically, the SEC staff provided guidance and some credence to the principle that a broker-dealer could, having previously acted as an investment adviser, resign from the "advisory" role and act only as a broker-dealer in the implementation of a customer's financial plan. According to the SEC staff:

As a general matter, a broker-dealer/investment adviser may discontinue its advisory relationship with its client and then assume a brokerage relationship. An advisory contract, for example, may contain a provision under which both parties agree to terminate the advisory relationship, or either party may initiate the termination of the advisory relationship. The parties may agree that the advisory relationship terminates with the delivery of a financial plan. The extent to which the broker-dealer/investment adviser would thereby limit the scope of its fiduciary obligations to the client would turn, in our view, on whether the broker-dealer/investment adviser has provided the client full disclosure about the change in the relationship and any consequent change in the obligations assumed by the broker-dealer. Disclosure by a broker to a customer should be sufficient to enable the client to reasonably understand that the broker-dealer/investment adviser is removing itself from a position of trust and confidence with its client. In our view, a mere statement of a change in the capacity in which the firm is acting would be inadequate ordinarily to effectively alter the fundamental nature of the relationship.²⁸

(ii) Although the SEC staff commented that the client disclosure should address whether the broker-dealer was removing itself from a position of trust and confidence with its client, the staff conceded that "there are circumstances

²⁷ *Id.*

²⁸ *Id.*

under which broker-dealers have been held to fiduciary standards similar to advisers,”²⁹ leading many to believe that such stark disclosure should only be necessary or appropriate where no comparable fiduciary obligations would apply to the broker-dealer’s continued dealings with the client.

d. Use of CFP or similar credentials.

The SEC staff explained that the use of “Certified Financial Planner” (CFP) or similar professional credentials will not alone be deemed to create an investment advisory relationship.³⁰

E. Sponsoring a wrap program

1. Wrap sponsors generally are subject to investment adviser registration, although the SEC briefly held out the possibility that there could be circumstances in which such registration ought not to be required. For the most part, past SEC statements on the subject point to the need for registration. For instance, in a 1995 release, the SEC stated that a broker-dealer sponsoring a wrap fee program “generally cannot rely” on the broker-dealer exception from the definition of investment adviser in Advisers Act Section 202(a)(11)(C) because “the staff is of the view that a [wrap fee program] generally is not incidental to a sponsor’s broker-dealer business and . . . the sponsor’s portion of the wrap fee is special compensation.”³¹

2. This principle was left undisturbed in the SEC’s 1997 release adopting Rule 3a-4,³² and in the SEC’s 1999 release proposing Rule 202(a)(11)-1. In the 1999 proposing release, the SEC stated that, even if broker-dealer sponsors do not have discretionary authority, the advice the sponsor provides on asset allocation or selection of portfolio managers could not be viewed as incidental to its brokerage services.³³

3. By contrast, a prior SEC staff interpretation merely suggested that sponsors of a wrap fee program are, in most cases, viewed as providing investment advice, without ruling out the possibility that a wrap fee program could be structured so that the sponsor played a non-investment advisory role.³⁴

²⁹ *Id.* n. 9.

³⁰ *Securities Industry Association, supra* note 25.

³¹ Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release 21260 (July 27, 1995).

³² Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release No. 22579 (Mar. 24, 1997).

³³ SEC Release No. 34-42099, *supra* note 2, Section II.A.1.

³⁴ See Disclosure by Investment Advisers Regarding Wrap Fee Programs, Advisers Act Release No. 1401 (Jan. 13, 1994) (*citing* National Regulatory Services, Inc., SEC Staff No-Action Letter (Dec. 2, 1992) (noting that “[i]n almost all cases, the sponsor of a wrap fee program will be providing investment advisory services to the wrap fee client”).

4. Most recently, in the 2005 re-proposal of Rule 202(a)(11), the SEC acknowledged that although a wrap fee involves the receipt of “special compensation,” sponsoring broker-dealers “may have available the exception provided by [proposed] rule 202(a)(11)-1 if, among other things, the portfolio manager selection and asset allocation services typically provided by the broker-dealer sponsor could be viewed as solely incidental to the business of brokerage.”³⁵ However, the SEC noted that it has “not viewed the asset allocation or portfolio manager selection advice as incidental to the brokerage transactions initiated by the portfolio manager,”³⁶ and requested comment on whether it should reexamine its past approach to wrap fee program sponsors.

5. After reviewing the comments generated in response to this question, the SEC appears to have foreclosed the possibility of a wrap sponsor not being deemed an investment adviser after all. The adopting release for Rule 202(a)(11) “reaffirms” the Commission’s interpretation “that portfolio manager selection and asset allocation services involved in wrap fee programs are advisory services that are not solely incidental to brokerage services.”³⁷

F. Soliciting advisory accounts

1. The SEC staff has taken the position that broker-dealers receiving cash fees for referring clients to investment advisers are not receiving “special compensation” for purposes of the exclusion from the term “investment adviser” in Advisers Act Section 202(a)(11)(C).³⁸ However, this stance may not apply if the broker-dealer gets so involved in the advice provided by the investment advisers that any advice provided by the broker-dealers is no longer incidental to the brokerage business.³⁹

2. Broker-dealer representatives who solicit clients for an investment adviser may be subject to state investment adviser registration requirements because, unlike the broker-dealers that employ them, they may not enjoy federal preemption from state licensing or qualification requirements. However, the SEC has stated it would interpret the broker-dealer exception as available not only to a broker-dealer, but also to any of its registered representatives whose investment advisory activities are subject to the control and supervision of the broker-dealer⁴⁰—finessing what may have been a tricky state registration issue.

V. **When Does a Broker’s Advice Create Fiduciary Status?**

³⁵ SEC Release No. 34-50980, *supra* note 4, Section III.C.

³⁶ *Id.*

³⁷ SEC Release No. 34-51523, *supra* note 1, Section III.E.5.

³⁸ *See, e.g.*, Townsend and Associates, Inc. (Sept. 21, 1994); Koyen, Clarke & Associates, Inc. (Nov. 10, 1986).

³⁹ *See, e.g.*, Constellation Financial Management LLC, SEC Staff No-Action Letter (Jan. 9, 2003), at n. 14, available at <www.sec.gov/divisions/investment/noaction/constellation010903.htm>.

⁴⁰ SEC Release No. 34-50980, *supra* note 4, Section II.E.

Both investment advisers and broker-dealers are subject to extensive legal and regulatory requirements that obligate them to act for the benefit of their clients rather than in their own self-interest. These fiduciary (or fiduciary-like) obligations vary depending on the client relationship and may apply broadly or be limited only to specific aspects of the relationship. Specifically, broker-dealers and advisers alike may be deemed fiduciaries where they take on positions of trust and confidence *vis-à-vis* their customers.

The courts have held that broker-dealers that exercise discretion or control over client assets owe clients a broad fiduciary duty similar to that imposed on advisers.⁴¹ But the typical broker-dealer has a principal/agent relationship with clients that does not involve discretion or control of client assets. The courts and the SEC have observed that, in these situations, a non-discretionary broker-dealer is subject to limited, specific fiduciary obligations under common law. These obligations are transaction-related, are limited in scope and nature, and cease upon completion of a transaction. The courts and the SEC generally have concluded that the broker-dealer does not owe clients a broad fiduciary duty in such situations, even when the broker-dealer provides investment advice incidental to its broker-dealer activities.⁴²

A. For purposes of SRO suitability obligations?

Making a recommendation is a form of investment advice that triggers suitability obligations under specific NASD and other SRO suitability rules. However, these fiduciary-like obligations do not signify that a broker-dealer necessarily is a common law fiduciary when making recommendations.

B. If a Broker-Dealer's Activity Triggers Fiduciary or Adviser Regulation, How Far Does It Reach?

1. *The Advisers Act does not extend to purely brokerage activity*

A broker-dealer registered as an investment adviser is not, because of that registration, automatically an investment adviser to customers to whom the broker-dealer provides advisory services on a solely incidental basis and without special compensation. The SEC has long recognized that “[t]he relationship of a broker or dealer to his brokerage customers does not become an investment advisory relationship merely because the broker or dealer is a registered investment adviser.”⁴³ In keeping with its functional approach, the SEC plainly acknowledged in the adopting release for Rule 202(a)(11) that it

⁴¹ See, e.g., Arleen W. Hughes, 27 S.E.C. 629 (1948), *aff'd sub nom.* Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949); see also SEC v. Ridenour, 913 F.2d 515 (8th Cir. 1990); MidAmerica Federal Savings & Loan v. Shearson/American Express, 886 F.2d 1249 (10th Cir. 1989); Paine Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508 (Colo. 1986); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981); C. Weiss, “A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty,” 23 IOWA J. CORP. LAW 65 (1997).

⁴² See authorities cited in note 41, *supra*.

⁴³ Advisers Act Release No. 626 (Apr. 27, 1978); see, e.g., Goldman, Sachs & Co., SEC No-Action Letter (Feb. 22, 1999) (pertaining to the applicability of Advisers Act restrictions on principal trades to transactions effected for clients of the broker-dealer's prime brokerage services).

has “viewed the Advisers Act, and the protections afforded by the Act, as applying only to those accounts to which the broker-dealer provides investment advice that is not solely incidental to brokerage services or for which the firm receives special compensation.”⁴⁴ The final rule specifically provides that a broker-dealer registered under both the Exchange Act and the Advisers Act is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subject the broker-dealer to the Advisers Act.

2. *Reach of advisory capacity may be unclear*

If a broker-dealer is deemed to be acting as an investment adviser to a customer with respect to one or more accounts, there are complicated and unresolved issues surrounding the reach of the broker-dealer’s adviser capacity, including:

- Does the broker-dealer’s advisory capacity extend to its affiliates?
- Does the broker-dealer’s advisory capacity extend to unrelated dealings?
- Does the broker-dealer’s advisory capacity reach other brokerage accounts of the customer—even those accounts with respect to which the broker-dealer gives no advice?
- How does a broker-dealer distinguish a non-discretionary advisory account from a “full service” brokerage account where the broker-dealer provides investment advice “solely incidental” to brokerage services?

C. Can an Advisory Relationship be Limited or Confined?

1. The ordinary broker-dealer executing a non-discretionary order is viewed as having a relationship that is transactional in nature and ceases when the transaction is completed. Correspondingly, any fiduciary or fiduciary-like obligations are transaction-related, are limited in scope and nature, and cease on completion of a transaction. As one court has observed: “The agency relationship between customer and broker normally terminates with the execution of the order because the broker’s duties, unlike those of an investment advisor or those of a manager of a discretionary account, are only to fulfill the mechanical, ministerial requirements of the purchase and sale of the security or future contract on the market.”⁴⁵

2. Consistent with this notion, broker-dealers have argued that, regardless of the capacity in which they may be acting when providing financial planning services, in the implementation phase of a financial plan, they execute specific investment ideas stemming from the financial plan in the customer’s brokerage account and are acting as broker-dealers (not investment advisers or fiduciaries), unless the customer expressly elects to execute the plan through a discretionary or other type of advisory ac-

⁴⁴ SEC Release No. 34-51523, *supra* note 1, Section II.A.

⁴⁵ *Walston & Co. v. Miller*, 100 Ariz. 48, 410 P.2d 658 (1966).

count. While there is growing acceptance of the principle that a broker-dealer and its customers should be able to consensually define their relationship in this manner,⁴⁶ the ultimate effectiveness of an approach where a broker-dealer is an “adviser” when providing financial planning services but a “broker” when implementing the plan is unclear. At the very least, a broker-dealer’s agreements and Form ADVs would have to be clear on the point and the broker-dealer’s course of dealing with the customer would have to be consistent with the different roles played by the broker-dealer during the different phases. In addition, given the SEC’s concern about dispelling customer confusion about the nature of the relationship, broker-dealers need to be prepared to explain the different roles they play in this process to their customers. Even with clear disclosures and a course of dealing consistent with a broker-dealer acting as “adviser” during the financial planning phase but a “broker” during implementation, the relationship between the customer and the broker-dealer could easily be misunderstood, and may be undermined if the conduct of a registered representative or other broker-dealer employee suggests, perhaps inadvertently, the continuation of an advisory relationship.

D. Inconsistencies in Regulation

1. Being deemed an investment adviser means more than just being presumptively deemed a fiduciary, even though that may mischaracterize the customer relationship (and will complicate the defense of customer disputes). It means being subject to an additional regulatory scheme that in some respects conflicts with the regulatory scheme for broker-dealers and the practical realities of carrying on a brokerage business. Both broker-dealers and investment advisers are subject to extensive regulation, but in many, if not most, respects, the regulation of broker-dealers is more robust than that covering investment advisers. This disparity has prompted regulatory arbitrage, as registered representatives have given up their brokerage licenses for adviser licenses. Indeed, the SEC has recognized that, “[a]though . . . the Advisers Act contains some restrictions, and thus imposes some costs on investment advisers that are not a part of broker-dealer regulation, broker-dealer regulation is much more detailed and involves significantly more regulatory costs than investment adviser regulation.”⁴⁷

⁴⁶ See Securities Industry Association, *supra* note 25; see, e.g., *Safer v. Nelson Financial Group, Inc.*, No. 04-31092 (5th Cir. Oct. 14, 2005) (rejecting plaintiffs’ contentions that their claims were not governed by a pre-dispute arbitration clause in a brokerage agreement where the claims related to the implementation of a financial plan and the financial planning agreement disclosed that the defendant would be acting as broker-dealer, not adviser, when assisting in the implementation of the financial plan), *available at* <<http://caselaw.lp.findlaw.com/data2/circs/5th/0431092cv0p.pdf>>.; In the Matter of IFG Network Securities, Inc., Initial Decision Release No. 273 (Feb. 10, 2005) (stating that “[t]here is no case precedent that holds that an associated person of an investment adviser cannot change hats, to use [defendant’s] metaphor, and act in the capacity of an associated person of a broker-dealer without the higher obligations of an adviser,” and rejecting contentions by the SEC’s Division of Enforcement that the Advisers Act antifraud provision applied to the defendant’s execution of transactions to implement customer financial plans where the agreements with customers stated that the defendant would be acting as broker when doing so), *available at* <www.sec.gov/litigation/aljdec/id273cff.pdf>.

⁴⁷ SEC Release No. 34-50980, *supra* note 4, Section II.A.4.

2. Because the framework for investment adviser regulation is less robust than that for broker-dealers, it sometimes takes a more blunt or restrictive approach. As a result, if a broker-dealer is deemed an investment adviser with regard to an account or activity, it has to ensure that it is complying with the regulatory provisions of the Advisers Act and its policies and procedures and related internal controls to promote compliance with the Advisers Act, including allocation of investment opportunities and burdensome requirements under Advisers Act Section 206(3) with regard to principal and agency cross transactions (the non-compliance with which creates a “put” right in the hands of the customer). Moreover, there are important differences in the regulatory schemes for broker-dealers and investment advisers in other respects, and these are reflected in inconsistent approaches on certain issues, including:

- Personal securities trading and code of ethics issues;
- Performance fees;
- Compensation;
- Advertising and communications with the public, including reference in ads to past specific recommendations, testimonials and related performance, and use of investment analysis tools;
- Supervision rules;
- Records and e-mail;
- Custody;
- Gift and gratuities; and
- Political contributions.

3. Arguably broker-dealer regulation provides more comprehensive disclosure requirements than the Advisers Act. Broker-dealers are, in a number of situations, required to provide specific disclosure to customers at the point of sale as compared to the Advisers Act, which relies, in large part, on an adviser’s Form ADV for important disclosures. The ADV is required to be delivered to customers only at inception of the advisory relationship and, thereafter, only upon customer request. Examples of point of sale disclosure requirements applicable to broker-dealers but not to investment advisers include:

- Confirmation Disclosure, including specific disclosure of compensation, conflicts, and capacity;
- Statement Disclosure, including updated information regarding customer holdings, past transactions, and position values; and

- Special disclosures regarding conflicts relating to equity research.

VI. Recent Developments

A. “The Study”.

1. The SEC recognized that there are important issues raised by the different regimes regulating investment advice that need to be addressed. In the adopting release, the SEC asked the SEC staff to provide suggestions for a study to “compare the levels of protection afforded retail customers of financial service providers under the Securities Exchange Act and the Investment Advisers Act, and to recommend ways to address any investor protection concerns arising from material differences between the two regulatory regimes.”⁴⁸ On the heels of the new rule’s full effectiveness, the SEC announced in March 2006 that, based on the SEC staff’s input, it will conduct a broad-based study of the framework for regulation of broker-dealers and investment advisers for the purpose of determining, among other things, whether requirements on dual registrants should be modified to eliminate regulatory overlap and reduce regulatory burdens.⁴⁹

2. The SEC recently published a detailed RFP about the Study, which focuses on the impact on investors of the different regulatory structures governing broker-dealers and investment advisers.⁵⁰ The following points are particularly noteworthy:

- The SEC lists as objectives for the Study evaluation of (1) “individual investors’ expectations regarding the obligations owed to them” by investment professionals; and (2) “individual investors’ understanding of the marketing and other information provided to them regarding financial products, accounts, programs and services.”
- The consultant selected by the SEC would be directed to work closely with the SEC staff in conducting the Study.
- The consultant will be expected to compare product offerings, marketing materials and fees for services and products offered by broker-dealers and investment advisers, respectively, by reviewing a wide variety of written materials, including marketing materials.
- The SEC indicated that it anticipates that the consultant will conduct extensive interviews of investors as well as of the market participants themselves in developing the report.

⁴⁸ SEC Release No. 34-51523, *supra* note 1, Section V.

⁴⁹ See SEC Release No. 34-53406 (Mar. 3, 2006), available at <www.sec.gov/rules/other/34-53406.pdf>; Cynthia A. Glassman, Remarks at the Financial Service Institute’s 2006 Broker-Dealer Conference (Jan. 25, 2006), available at <www.sec.gov/news/speech/spch012506cag.htm>.

⁵⁰ See Proposed Study to Compare Roles of Investment Advisers, Broker-Dealers, <http://www.sec.gov/news/press/2006/2006-129.htm> (Aug. 1, 2006).

Taken as a whole, this may suggest that the Study is designed to build on the “focus group” interviews conducted by the SEC prior to adopting new Rule 202(a)(11)-1⁵¹ and to flesh out concerns expressed by the SEC that individual investors are confused about the nature of the services they receive. As a result, we would recommend that firms focus on the disclosure they currently provide to customers to ensure that it clearly delineates their roles and responsibilities when acting as broker and as adviser. In addition, firms may want to review the internal training materials to confirm that the internal sales force is familiar with the marketing materials and distinctions in roles and responsibilities they have in connection with different products and services.

B. Proposed CFP Board Code of Ethics. In July 2006, the Certified Financial Planner Board of Standards published a proposed Code of Ethics and Professional Responsibility and Financial Planning Practice Standards.⁵² The proposed standards are intended to provide guidance regarding the role of a CFP providing financial planning services, but did not explain that the CFP could also act in a brokerage capacity when implementing a financial plan (such as where he or she complied with the SEC’s no-action position taken in December 2005), in which case the Code standards should not apply. We are concerned that this omission could increase investor confusion. Thus, to the extent the CFP Board proceeds to adopt the Code of Ethics, we would suggest that brokers using the CFP designation may want to consider adding disclosures to their financial planning materials explaining that the principals articulated in the Code apply exclusively when they provide financial planning services.

⁵¹ See <http://www.sec.gov/rules/proposed/s72599/focusgrp031005.pdf>.

⁵² See CFP Board, *Exposure Draft Revision Of Ethical Standards Released For Comment*, <http://www.cfp.net/media/release.asp?id=142> (July 24, 2006).