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SEC Adopts Interim Rule to Provide Limited Principal Trading Relief and Proposes Interpretive Rule Clarifying the Application of the Advisers Act to Broker-Dealers

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At an open meeting yesterday, the Securities and Exchange Commission (SEC) addressed questions raised by the securities industry in the aftermath of *Financial Planning Association v. SEC*. As expected, in anticipation of the vacature of Rule 202(a)(11)-1 (Old Rule) on October 1, the SEC adopted Temporary Rule 206(3)-3T (Interim Rule), which provides limited relief from the principal trading restrictions of Section 206(3) of the Investment Advisers Act of 1940 (Advisers Act). The SEC also proposed new Rule 202(a)(11)-1 (Interpretive Rule), which reinstates guidance from the Old Rule that: (i) advisory status should be determined on an account-by-account basis; (ii) a broker-dealer does not receive "special compensation" simply because it charges different commissions for different brokerage services; and (iii) a broker-dealer exercising investment discretion, other than limited or temporary discretion, is subject to the Advisers Act. Notably, the SEC did not address financial planning services and its view, expressed in the Old Rule, that a broker-dealer becomes subject to the Advisers Act by providing comprehensive financial planning services.

Background

The SEC adopted the Old Rule in April 2005 primarily to address the application of the Advisers Act to broker-dealers offering fee-based brokerage accounts. In the Old Rule, the SEC also addressed interpretive issues relating to the application of the Advisers Act to a broker-dealer that provides investment advice.[1] The Financial Planners Association (FPA) challenged the Old Rule, arguing that the SEC had overstepped its authority in excluding broker-dealers from the definition of "investment adviser" when offering fee-based brokerage accounts. The Court of Appeals for the D.C. Circuit held that the Old Rule should be vacated in its entirety. The SEC applied for and received a 120-day extension for entry of the court's order. The court is expected to enter its order on October 1, 2007, at which time the Old Rule will be vacated.

Principal Trading Relief for Nondiscretionary Advisory Accounts

Although the D.C. Circuit's decision did not address the permissibility of fee-based brokerage accounts per se, dicta in both the majority and the dissenting opinions, as well as language in the SEC's adopting release for the Old Rule, suggests that receipt of fee-based compensation by a broker-dealer for services that include investment advice is "special compensation." If this interpretation is correct, firms offering fee-based brokerage will not be

1. The Old Rule included interpretive guidance that (i) a broker-dealer's advisory status should be determined on an account-by-account basis; (ii) investment advice provided in connection with financial planning services or by a broker-dealer that is holding itself out as providing financial planning services is not "solely incidental to" the conduct of a broker-dealer business; (iii) the exercise of investment discretion by a broker-dealer, subject to limited exceptions, is not "solely incidental to" the conduct of a broker-dealer's business; (iv) a full-service broker-dealer would not be subject to the Advisers Act simply because it also offered discount brokerage services for a lower fee (i.e., the differential in charges would not be presumed to be a separate fee for "investment advice"); and (v) portfolio manager selection and asset allocation services provided by a broker-dealer in the context of a wrap fee program is not "solely incidental to" brokerage.

able to rely on the "Brokers' Exception" to the definition of investment adviser and arguably will not be able to offer these accounts as "pure" brokerage accounts after the Old Rule is vacated.[2]

Many broker-dealers have taken steps to transition their fee-based brokerage customers to another type of account prior to October 1. One of those account alternatives is a nondiscretionary advisory account (or NDA). Like fee-based brokerage accounts, these accounts allow clients to make their own trading decisions and pay an asset-based fee rather than trade-by-trade commissions. Unlike the fee-based brokerage accounts, however, nondiscretionary advisory accounts are subject to the Advisers Act. As a result, absent relief, the restrictions on principal trading in Section 206(3) of the Advisers Act would apply to these accounts.

The Interim Rule, which goes into effect on September 30, 2007 and remains in effect until December 31, 2009, allows firms that are dually registered with the SEC to engage in principal transactions in securities with their nondiscretionary advisory clients, subject to the following conditions:

- *Blanket Client Consent and Disclosure by the Dual Registrant.* The dual registrant must provide written notice to its clients regarding its intent to rely on the Interim Rule and obtain written consent from each client to do so. Although not addressed at the open meeting, the SEC previously indicated that the Interim Rule would allow firms to rely on the relief as of October 1 so long as the required written client consents and ADV disclosure is in place by January 1, 2008. It was not clear from the open meeting whether this grace period will be included in the actual Interim Rule.

- *Disclosure.* Firm representatives must orally inform the client each time the firm trades with the client that it may do so on a principal basis and the client must agree. Client confirmations must disclose when the firm acts as principal. Similar to the current requirement for agency cross-trades under Advisers Act Rule 206(3)-2, firms executing principal trades under the Interim Rule must provide clients with a list of all principal trades effected for the client's account during the prior year as well as the transaction-based compensation charged on such transactions.

- *Excludes Proprietary Securities and Syndicate Offerings.* The relief would 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. In discussing the proposal at the open meeting, the SEC staff did not specifically mention that the relief would apply to investment-grade, nonconvertible debt underwritten by affiliates of the dual registrant, although SIFMA's summary of the proposed Interim Rule and its recent press release suggest that it will.

The Interim Rule makes clear that it does not relieve an adviser from its fiduciary duties under Sections 206(1) and 206(2) of the Advisers Act to act in the best interest of clients and to provide full, fair, and current disclosure to clients about material conflicts of interest.

Interpretive Guidance on Adviser Status, Commission Differentials and Discretionary Brokerage

The Interpretive Rule reaffirms that a firm may have both a brokerage relationship and an investment advisory relationship with the same client. This guidance will be helpful to firms that have multiple account relationships with the same client, including firms that provide asset allocation services covering both advisory and brokerage accounts. The guidance clarifies that the firm's status as an investment adviser should be determined on an account- and service-specific basis rather than presuming that the firm is an adviser for all purposes simply because it acts as adviser to the client in one context.

The Interpretive Rule reinstates action taken by the SEC under the Old Rule to override prior interpretations suggesting that a broker-dealer using different commission schedules may be receiving "special compensation" in the higher commission schedule within the meaning of the Brokers' Exception. This relief should mitigate recharacterization risk for firms offering both full service and discount brokerage programs.

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2. The "Brokers' Exception" in Section 202(a)(11)(C) of the Advisers Act excludes from the definition of an investment adviser "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."

The Interpretive Rule also affirms the staff 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 the broker-dealer to the Advisers Act.

Open Question: Status of Financial Planning

As noted, the proposed Interpretive Rule does not address comprehensive financial planning. Given that the SEC has not reestablished its position on financial planning in the proposed Interpretive Rule, it is an open question for firms as to whether or not they should revert to the prior practice of providing these services on a brokerage basis.

Both the staff and the commissioners emphasized the importance of the current Rand study of broker vs. adviser regulation. The staff indicated that when the Rand study results are received, which is anticipated to be the end of this year, the Division of Investment Management would work closely with the Division of Market Regulation to provide recommendations to the Commission in light of the data about how best to address issues raised in regulating brokerage and advisory activities. The release(s) announcing the Interim Rule and the Interpretive Rule are expected to be issued shortly, in advance of their effectiveness.

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