

## Implications of the D.C. Circuit's Decision Vacating Rule 202(a)(11)-1

April 6, 2007

As widely reported, on March 30, 2007, a divided panel of the U.S. Court of Appeals for the D.C. Circuit vacated Rule 202(a)(11)-1 under the Investment Advisers Act of 1940 (Advisers Act). The Financial Planning Association (FPA) had challenged the rule, arguing that the SEC had overstepped its authority in exempting broker-dealers from the definition of "investment adviser" when offering fee-based brokerage accounts. The court vacated the rule in its entirety, including provisions clarifying when a broker-dealer would and would not be deemed to be an investment adviser, even though these other provisions of the rule were not challenged by the FPA.<sup>1</sup>

### Background

The SEC adopted the rule in April 2005 primarily to address the application of the Advisers Act to broker-dealers offering fee-based brokerage accounts. In adopting the rule, the SEC acted on general exclusionary powers of the Advisers Act, rather than the specific exclusion provided for broker-dealers in Section 202(a)(11)(C).

Section 202(a)(11)(C) 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 Section is one of five specific exclusions from the definition of "investment adviser." Section 202(a)(11)(F) is a catch-all provision that authorizes the SEC to exclude from the definition "such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order."

The court disagreed with the SEC's reliance on the catch-all exclusion in Section 202(a)(11)(F) and held that the legislative intent underlying the provision does not support an exemption for broker-dealers that is broader than the specific exemption in Section 202(a)(11)(C). The court determined that, because broker-dealers are addressed in the exclusion provided in Section 202(a)(11)(C), they are not "other persons," for purposes of Section 202(a)(11)(F) and "the SEC cannot use the authority provided in Section 202(a)(11)(F) to establish new, broader exemptions for broker-dealers."

### What Does this Mean for the SEC?

The SEC has 45 days (until May 14) to ask for a rehearing (from the panel or *en banc*). If the SEC does not ask for rehearing within that time period, the court will then have seven days to issue a final order officially striking down the rule. If the SEC does ask for rehearing, the court's order will not issue until seven days after denial of

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<sup>1</sup> The 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.

the rehearing (assuming that the request is denied) or from the date on which the court affirms the ruling. The SEC may also file a discretionary appeal for review of the ruling by the U.S. Supreme Court. This filing would not stay issuance of the appellate court's ruling, although the SEC could separately seek to stay the order. The SEC has 90 days from the date of the decision (or, if they ask for a rehearing, from the date that the request is denied) to appeal to the U.S. Supreme Court, which may be extended for up to another 60 days.

The fact that the panel was divided may give the SEC an opening to seek a rehearing or to appeal the decision. However, the SEC may factor into its decision both the decisive tone of the majority ruling in the FPA decision and the outcome of other recent challenges to SEC rules before the D.C. Circuit.<sup>2</sup>

Regardless of whether the SEC elects to seek a rehearing or appeal the ruling, we expect the SEC will take action to provide legal clarity regarding the scope of the Section 202(a)(11)(C) exclusion and to provide some protection to broker-dealers offering fee-based brokerage accounts. One possibility would be for the SEC to initiate rulemaking under Section 206A of the Advisers Act, which provides broader authority to the SEC than its exemptive authority under Section 202(a)(11)(F). Relief under Section 206A could closely track the relief and guidance sought to have been implemented under Rule 202(a)(11)-1.

Alternatively, the SEC could opt for a more limited approach through rulemaking that exempts broker-dealers from the registration provisions of the Advisers Act as well as, perhaps, most critically, the restrictions on principal transactions under Section 206(3) (e.g., to allow blanket consent to principal trades). Under this approach, the SEC would retain jurisdiction over broker-dealers under the anti-fraud provisions of the Advisers Act. The implications of the SEC taking this approach are two-fold. First, broker-dealers would be deemed investment advisers when offering fee-based brokerage accounts and, thereby, presumptively be subject to fiduciary obligations. Second, broker-dealers that are not also registered under the Advisers Act would find themselves subject to state registration and substantive regulation as advisers with respect to any investment advice they provide, since they would be operating outside of the state law preemption provided by the National Securities Markets Improvement Act of 1996. The fact that the National Association of State Securities Administrators submitted an *amicus* brief in support of the FPA's challenge of Rule 202(a)(11)-1 suggests that the states might not readily cooperate with the SEC in formulating relief that would exempt broker-dealers from state investment advisory regulation.

The SEC might also look to interpret the language of Section 202(a)(11)(C) in a way that provides helpful guidance to broker-dealers offering fee-based accounts. As a practical matter, however, it might be difficult for the SEC to provide any sort of safe-harbor or interpretive protection for fee-based accounts as being exempt from regulation under the Advisers Act relying on this exemption. One of the important questions relating to the status of fee-based accounts is whether the fee would constitute "special compensation." The SEC's release adopting Rule 202(a)(11)-1 suggests that the staff's view is that fee-based compensation, by definition, constitutes "special compensation" within the meaning of the broker-dealer exemption.<sup>3</sup> The court, in both the majority opinion and the dissenting opinion, appeared to echo this view.

If the SEC elects not to carry out new rulemaking or appeal the decision or ask for a rehearing, there will be considerable—and entirely legitimate—pressure on the SEC and its staff to issue interim relief and guidance, particularly to broker-dealers carrying fee-based brokerage accounts. We expect that the SEC will consider providing temporary relief to broker-dealers offering fee-based brokerage accounts to give them time for an orderly transition. We also expect that the SEC and its staff will pursue other types of relief to restore other clarifying provisions of the rule, including those relating to financial planning, broker-dealer exercise of investment discretion, and the principle that a broker-dealer's advisory status should be determined on an account-by-account basis.

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<sup>2</sup> *Chamber of Commerce of the United States of America v. SEC*, No. 05-1240 (D.C. Cir. 2006); *Goldstein et al. v. SEC*, N. 04-1434 (D.C. Cir. 2006).

<sup>3</sup> See *Certain Broker-Dealers Deemed Not to Be Investment Advisers*, Rel. Nos. 34-51523; IA-2376 (April 15, 2005) at p. 28 ("... the Advisers Act was written in such a way that it covers fee-based programs because the fee would constitute "special compensation . . .").

## What Does this Mean for Broker-Dealers?

Depending on the steps taken by the SEC, as discussed above, broker-dealers should reexamine their fee-based brokerage programs, as well as their financial planning business, discretionary practices, and discount brokerage lines in light of the court's ruling.

An argument may be made that broker-dealers offering fee-based brokerage accounts are essentially in the same position as they were prior to the SEC's adoption of the rule. At that time, many firms had reasoned that adoption of the rule was unnecessary to provide clarity because there were strong arguments that the fee was a commission or a fee "in lieu of commission" and, thus, neither a fee for investment advice nor "special compensation." The risk with this approach, however, is that language in the rule's adopting release, as well as *dicta* in the court's decision, suggests that fee-based compensation paid to a broker may constitute "special compensation" regardless of the context. The combination of the views expressed in the adopting release and the media focus on these accounts may expose broker-dealers to heightened litigation risk for fee-based accounts if they elect to continue to offer these accounts absent additional regulatory relief.

In addition, without the rule, it is no longer clear that the relationship between a broker-dealer and its customer will necessarily be determined on an account-by-account basis. As a result, when a customer has both an advisory account and a brokerage account with the same representative, it could be the case that the advisory relationship will be determinative of the entire relationship between the two, and the broker may be considered to be a "fiduciary" with respect to all of the customer's accounts at the broker. This could be particularly difficult for full-service broker-dealers that execute principal transactions with their customers or sell proprietary products to the customers. Such a determination might also affect whether a broker-dealer could be deemed a "fiduciary" for purposes of other laws, such as the Employee Retirement Income Security Act of 1974.

The impact of the court's decision on firms offering side-by-side brokerage and full-service brokerage, financial planning, and discretionary services, arguably, is less problematic. The decision did not substantively address those aspects of the rule, and the provisions of the rule addressing those topics were in the nature of interpretive guidance. In respect to the areas where the advice is not otherwise codified (e.g., financial planning and discretionary brokerage), firms could end up in exactly the same position as they were before the adoption of the rule—a result that would be welcomed by large segments of the securities industry. With respect to whether firms offering side-by-side discount brokerage and full-service brokerage would be deemed to be taking a separate "fee" for investment advice by virtue of the higher charge on full-service brokerage, the interpretive guidance provided by the rule, albeit vacated, suggests that the intent of the SEC was to modify its prior interpretations in this area. Similarly, the rule's adopting release clarified the status of sponsor firms that provide assistance with portfolio manager selection and asset allocation advice in the context of wrap fee programs by stating that, consistent with prior SEC interpretations, such investment advice is subject to the Advisers Act.

## Next Steps

We recommend that broker-dealers not make any major changes to their business until the SEC has clarified what action it might take with respect to the ruling or provide additional relief to broker-dealers. In the meantime, firms should take stock of their businesses and consult with counsel regarding the implications of the decision for themselves in light of their particular circumstances. In addition, it may be helpful for firms that currently offer fee-based brokerage accounts, financial planning services, and discretionary services to begin to take steps to inventory modifications that would need to be made (e.g., in customer disclosures and account documentation) to address possible changes to their businesses, assuming the decision remains intact and no additional regulatory relief is forthcoming.

For a copy of the court's decision, please visit

<http://pacer.cadc.uscourts.gov/docs/common/opinions/200703/04-1242a.pdf>

For background information on the rule and recent developments since its adoption, please see:

Article: "New Rules of the Road for Brokers Offering Investment Advice"

[http://www.morganlewis.com/pubs/Stone\\_article\\_NewRulesoftheRoad\\_Apr2006.pdf](http://www.morganlewis.com/pubs/Stone_article_NewRulesoftheRoad_Apr2006.pdf)

Outline: "Investment Adviser Issues for Broker-Dealers"

[http://www.morganlewis.com/pubs/Stone\\_InvestmentAdviserIssues\\_25mar07.pdf](http://www.morganlewis.com/pubs/Stone_InvestmentAdviserIssues_25mar07.pdf)

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