

Impact on Broker-Dealers From the New SEC Rule Narrowing the Exemption for Broker-Dealers From The Investment Advisers Act

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I. INTRODUCTION

The SEC recently substantially narrowed the exemption from the Investment Advisers Act of 1940 for broker-dealer activity by adopting a new Rule 202(a)(11)-1.¹ Among the many changes is a requirement that any discretionary account will be considered an advisory account requiring a broker-dealer to register as an investment adviser. In addition, broker-dealers cannot hold themselves out as financial planners, prepare a financial plan or deliver a financial plan to a customer without becoming an investment adviser. There are a number of other provisions in the Rule that substantially impact broker-dealers as discussed below.

The Rule is effective April 15, 2005, except section (a)(1)(ii) which is effective May 23, 2005. Broker-dealers that are not registered as investment advisers must comply with disclosure requirements by July 22, 2005. All advertisements, contracts, agreements and applications, or other forms governing broker-dealer accounts opened after July 22, 2005 must include a disclosure required by the Rule if the broker-dealer intends to avoid investment adviser registration for such accounts. However, the July 22, 2005 date does not apply to fee-based brokerage accounts open prior to July 22, 2005. If a broker has commission-based discretionary accounts, investment adviser registration compliance is not required until October 24, 2005. Section V below contains a more detailed discussion of these compliance dates and their impact.

II. BASIC OUTLINE OF THE RULE

A. The Rule's Background

The Investment Advisers Act exempts from the definition of investment adviser contained in the Act a broker-

dealer "whose performance of [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore."² This provision has for many years permitted broker-dealers to avoid investment adviser registration as long as the advice given by a broker-dealer was "solely incidental" to its brokerage business and the broker-dealer received no "special compensation." With the advent of unbundling of commissions, broker-dealers began offering discount service and full service. A series of SEC staff no-action letters created a problem because the letters indicated that any compensation differential between accounts would make the higher fee accounts potentially advisory accounts because of the higher fee would be considered "special compensation." As a result, the SEC proposed in 1999 a safe harbor for discount brokerage programs and for asset fee-based brokerage programs.³ At that time, the SEC also granted a temporary no-action position if the proposed rule was followed. This proposed rule change lay dormant until early 2005 when the SEC, as a result of a petition, repropoed the rule.⁴

B. The New Rule

The newly adopted Rule 202(a)(11)-1 is short but complex and difficult to read. Subsection (a) of the new Rule 202(a)(11)-1 is entitled "Special Compensation." Subsection (a)-1 provides that a broker-dealer registered with the SEC will not be deemed an investment adviser based *solely* on receipt of special compensation (except if that compensation is for investment advisory services as provided in subsection (b)(1) of the Rule), provided the broker-dealer receiving special compensation meets the following criteria:

(1) any investment advice provided by the broker-dealer with respect to accounts from which it receives special

compensation is "*solely incidental to*" brokerage service provided to these accounts;

(2) no investment discretion is exercised as provided in paragraphs (b)(3) and (d) of this section; and

(3) all advertisements for contracts, agreements and applications, and other forms governing the account for which the broker-dealer receives special compensation include a prominent statement set forth in the Rule explaining that the account is a brokerage account and not an advisory account and certain other things, including a prominent statement identifying who at the firm the customer may call or contact to discuss these differences.

Subsection (a)(2) provides that a broker-dealer does not receive a "special compensation" *solely* because it charges a commission, mark-up, mark-down or similar fee for brokerage services that are greater or less than one it charges another customer. Thus, the existence of a discount brokerage fee at a broker-dealer that has full service or an asset-based fee structure will not *by itself* trigger investment adviser registration provided that the provisions of subsection (a) outlined above, which includes no discretion and the required disclosure, are met. However, to be exempt from investment adviser registration, the broker-dealer must also meet the tests that the advice is "solely incidental" to the brokerage. These tests are set forth in subsection (b) by defining what advice is *not* solely incidental to.

Subsection (b) entitled "Solely Incidental To" is particularly difficult to understand. It provides: a broker-dealer provides advice that is not solely incidental to the conduct of its business as a broker-dealer within the meaning of Section 202(a)(11)(C) of the Advisers Act or to the brokerage services provided

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BD EXEMPTION

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to accounts from which it receives special compensation within the meaning of paragraph (a)(1)(i) of this section if the broker-dealer (among other things and without limitation):

- (1) Charges a separate fee, or separately contracts, for advisory services;
- (2) Provides advice as part of a financial plan or in connection with providing financial planning services and:

- (i) holds itself out generally to the public as a financial planner or as providing financial planning services;

- (ii) delivers to the customer a financial plan; or

- (iii) represents to the customer that the advice is provided as part of a financial plan or in connection with financial planning services; or

- (3) Exercises investment discretion, as that term is defined in paragraph (d) of this section, over any customer accounts.

Subsection (b)(3) quoted above provides that advice is not "solely incidental to" if the broker-dealer exercises discretion as that term is defined in subsection (d) (i.e., the same as under section 3(a)(35) of the Securities Exchange Act of 1934, as amended),⁵ in which case adviser registration is required. Also, if a broker-dealer engages in any of the activities in subsection (b), the broker-dealer may not rely on the exemption and must register as an investment adviser.

Subsection (c) of the Rule provides that if a broker-dealer is also registered as an investment adviser, the provisions of the Investment Advisers Act will apply only to those accounts for which it provides services or receives compensation that subject the broker-dealer to the Advisers Act. All of these provisions are discussed in more detail below.

III. ADVICE THAT IS NOT "SOLELY INCIDENTAL TO"

A. Discretionary Accounts

Any discretionary account at a broker-dealer with full discretion now subjects the broker-dealer to investment adviser registration. This means that

broker-dealers with discretionary accounts will need to cease discretionary activity by October 24, 2005 or register as an investment adviser. It is important to note that the SEC does grant in the Adopting Release some relief providing that the final rule "permits broker-dealers to exercise investment discretion on a temporary or limited basis without becoming ineligible for the rule (emphasis added)."⁶ The SEC further states that any such discretion must be limited to "a transaction or series of transactions not extending to the extent that they set investment objectives or policies."⁷ Importantly, the SEC states that the following described type of discretion will be considered temporary or limited:

- As to the price at which 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;
- 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;
- As to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent;
- To purchase or sell securities to satisfy margin requirements;
- To sell specific bonds and purchase similar bonds in order to permit a

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customer to take a tax loss on the original position;

- To purchase a bond with a specified credit rating and maturity; and
- To purchase or sell a security or type of security limited by specific parameters established by the customer.⁸

B. Separate Fee or Contract

If a broker-dealer provides advice to its accounts as part of its conduct of a business as a broker-dealer, or to brokerage services provided to accounts from which it receives special compensation as defined within the rule, such advice will not be considered "solely incidental" if the broker-dealer charges a separate fee or separately contracts for advisory services. Thus, if a broker-dealer has a separate contract to provide investment advice separate from its normal account agreement for certain customers, it would fall within the prohibition. Likewise, if there is a separate fee designated for advisory services, then the broker-dealer would fall within the prohibition. However, if the broker-dealer has a full service commission for both brokerage and incidental advice, it would not fall within the prohibition absent the other limitations, such as having discretion or holding itself out or providing a financial plan as provided in subsection (b)(2) of the Rule.

C. Financial Planning Prohibition

Advice also would not be "solely incidental to" if a broker-dealer provides advice as part of a financial plan or in connection with financial plan services and:

- (1) holds itself out generally to the public as a financial planner or providing financial planning services; or
- (2) delivers to a customer a financial plan; or
- (3) represents to a customer that the advice is part of a financial plan or in connection with financial plan services.

If a broker-dealer does any holding out with respect to a financial plan, it must register as an investment adviser. This obviously creates a conflict with the broker-dealer's suitability obligation. Most broker-dealers today obtain

financial information from and develop a financial plan for each account taking into consideration all of the account's various objectives, including tax planning, insurance needs and a variety of other financial considerations that are necessary for a suitability determination. The SEC acknowledges that "elements of financial planning have been, are, and should be part of every broker-dealer's consideration as to suitability of the recommendations."⁹ The Commission goes on to say "We have concluded that it would be unwise for us to attempt to distinguish when a suitability analysis ends and financial planning begins and we do not want to interfere in any way with a broker-dealer's fulfillment of its suitability obligation."¹⁰ Thus, it appears that if a broker-dealer creates a *de facto* financial plan for a customer for use by the broker-dealer in determining suitability, it would be permissible and would not trigger adviser registration of the broker-dealer. However, if the broker-dealer "delivers" the financial plan to the customer, the broker-dealer would be subject to registration as an investment adviser. It would seem under the literal language of Rule 202(a)(11)-1(b), that if a broker-dealer delivers a document with all of the financial information provided by the customer, it comes very close to a financial plan. Likewise, it would appear that an account executive might be prohibited from orally discussing the client's overall own financial plan as opposed to the client's financial circumstances. This would also seem on its face to prohibit a broker-dealer from providing a summary of all of the financial information provided by the customer to the customer for verification which is required by SEC, self-regulatory organizations and states. However, as long as a summary of financial circumstances does not have specific recommendations for the customer to make changes with respect to non-securities activities such as insurance, it should not be considered a financial plan. This will be a real problem for compliance departments and will subject broker-dealers to second-guessing and resulting in penalties for failure to register as an investment adviser.

The most critical area is whether oral discussions with a client concerning the totality of the client's financial position, including recommendations with respect to securities transactions, will constitute "delivering a financial plan." Hopefully the SROs and the SEC will provide further guidance.

D. The Titles "Financial Adviser" and "Financial Consultant"

The SEC notes in its Adopting Release that the use of the term "financial adviser" and "financial consultant" would not be considered a holding out of financial planning by a broker-dealer.¹¹ The Adopting Release also noted that if a broker-dealer is also registered as an investment adviser, the broker-dealer may make known to its broker-dealer clients that financial planning services or advisory services are available without treating such broker-dealer clients as investment advisory clients unless a client avails himself of the firm's advisory services.¹²

IV. WRAP FEES

The SEC in the Adopting Release makes clear that broker-dealers offering wrap fees must be registered as investment advisers because they are selecting investment advisers.¹³

V. COMPLIANCE EFFECTIVE DATES

As noted above, there are a number of compliance effective dates for the Rule, all of which appear to be remarkably short and may be unrealistic for many broker-dealers. The Rule is going to have its biggest impact on smaller broker-dealers, but it certainly will also effect larger broker-dealers.

The Rule is effective on April 15, 2005, except that paragraph (a)(1)(ii) dealing with advertisements, contracts, agreements and applications disclosure, is not effective until May 23. This permits broker-dealers to rely on Rule 202(a)(11)-1(a)(2) when they offer discount brokerage excluded under the Rule. Also, the April 15th date permits broker-dealers to provide non-discretionary investment advice in connection with fee-based brokerage accounts without having to immediately register as an investment adviser.

The disclosures that are required by subsection (a)(1)(ii) (accounts for

which a broker-dealer receives special compensation solely incidental to brokerage services) will be effective on July 22, 2005. Advertisements, contracts, agreements, applications and other forms governing accounts opened after July 22, 2005, must include the disclosure statement required by subsection (a)(1)(ii). It is important to note that the Adopting Release provides that fee-based brokerage accounts *opened prior to July 22, 2005, are not required to amend* their existing contacts and agreements with those accounts, although the SEC in a footnote recommends strongly that they do so.¹⁴

A broker-dealer that has commission-based discretionary accounts and is not registered as an investment adviser must register as investment adviser by October 24, 2005. If a broker-dealer has accounts for which (1) it charges a separate fee or separate contracts for advisory services or (2) provides advice as part of a financial plan as further provided in subsection (b)(2), these accounts must be treated as advisory accounts no later than October 24, 2005, which also would require investment adviser registration. If the broker-dealer is already registered as an investment adviser falling within subsection (b), any account must be treated as an advisory account subject to all provisions of the Advisers Act no later than October 24, 2005.

These compliance dates are particularly tight for firms of any size. Broker-dealers that have not registered as investment advisers will have to proceed expeditiously to become registered as an investment adviser and to implement all the required investment adviser forms and compliance by October 24, 2005. Compliance with all of the effective dates is made particularly difficult in view of the numerous compliance rules that have been adopted by the SEC and the SROs within the last year.

VI. SUMMARY

The SEC should be congratulated for being willing to tackle a clarification in the public's mind of the difference between investment advisers and broker-dealers. Rule 202(a)(11)-1 is a reasonable first attempt to make this

differentiation. Although as noted in the Adopting Release, the SEC is constrained by the specific wording of the Act as to how far it might go. Nevertheless, there will still be confusion in the public's mind as to the respective roles of broker-dealers and investment advisers. The Rule does not go to the heart of the issue in that broker-dealers manage money for investors and broker-dealers execute brokerage or dealer transactions which may or may not be recommended. The Rule's disclosures emphasize legal issues but they do not emphasize the difference between management of money, which is principally the function of an investment adviser. All in all, however, the Rule is a substantial improvement and over a period of time should greatly assist in educating the public with respect to the differences between broker-dealers and investment advisers.

1. SEC Release No. 34-51523; IA-2376 (April 12, 2005) (the "Adopting Release") adopting Rule 202(a)(11)-1; 17CFR 275.202(a)(11)-1.
2. §202(a)(11)(c), 15 USC 80b.
3. Certain broker-dealers deemed not to be investment advisers, IA Release No. 1845 (Nov. 4, 1999), 64 F.R. 61226 (Nov. 10, 1999) proposing Release.
4. Certain broker-dealers not deemed to be investment advisers, IA Release No. 2340 (Jan. 6, 2005); 70 F.R. 2716 (Jan. 14, 2005) repropounding the Release.
5. 15 U.S.C. 78c(a)(35).
6. Adopting Release, p. 64.
7. *Id.*
8. Adopting Release, pp. 64 and 65.
9. Adopting Release, p. 56.
10. *Id.*
11. Adopting Release, p. 59.
12. Adopting Release, fn 159.
13. Adopting Release, p. 65.
14. Adopting Release, fn 187.

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