K&L GATES

FINANCIAL PROFESSIONAL STANDARDS

**10 July 2019**

***Practice Groups:***

***Investment Management, Hedge Funds and Alternative Investments***

***Broker-Dealer***

# SEC Outlines Parameters of Permissible Broker-Dealer Advice to Customers

***By Richard F. Kerr, Pablo J. Man, C. Dirk Peterson, Eden L. Rohrer, and Andrew J. Shipe***

On June 5, 2019, the Securities and Exchange Commission ("SEC" or "Commission") issued a new interpretation ("Interpretation") of the "solely incidental" prong of Section 202(a)(11)(C) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which provides an exclusion from the definition of "investment adviser" for certain broker-dealers.[1] The Interpretation is part of a larger set of regulatory reforms meant to improve the quality and transparency of investors' relationships with investment advisers and broker-dealers.

Although the measures adopted by the SEC on June 5 are intended primarily to address the protection of retail investors, the new Interpretation has implications for all broker-dealers, including those that serve only institutional investors.

We have summarized the Interpretation and outlined certain of its implications for broker-dealers, below. In brief, the Interpretation provides examples to illustrate the extent to which a broker-dealer may provide discretionary trading and account monitoring services to customers without triggering investment adviser status and registration requirements. The Interpretation also describes the potential implications of account monitoring, including how monitoring practices may give rise to implied recommendations, and reminds broker-dealers of the importance of appropriate supervisory procedures in this area.

The Interpretation is effective immediately upon publication in the *Federal Register*.

## CONFIRMING PRIOR "SOLELY INCIDENTAL" INTERPRETATIONS

In brief, under the Advisers Act, a person who, for compensation, engages in the business of advising others as to investments in securities, or that issues or promulgates analyses or reports concerning securities, is defined as an "investment adviser." Investment advisers are generally required to register with the SEC or with one or more of the states. However, under Section 202(a)(11)(C) of the Act, a broker or dealer is excluded from the definition of "investment adviser" when (a) the broker-dealer's advice is "solely incidental" to the conduct of its business as a broker or a dealer, and (b) the broker-dealer does not receive any "special compensation" for advisory services.

The new Interpretation is intended to confirm and clarify the Commission's prior interpretations of the term "solely incidental." It reiterates the SEC's view that a broker-dealer's "[a]dvice need not be trivial, inconsequential, or infrequent" in order to be "solely incidental" to its securities business. Rather, a broker-dealer's advice will be deemed "solely incidental" if it "is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions," determined by reference to the totality of the facts and circumstances surrounding the firm's business, the services it offers, and its

[1] *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser*, SEC Rel. No. IA-5249 (Jun. 5, 2019).

relationships with its customers. Thus, for example, a broker-dealer, whether serving institutional or retail customers, could operate a robust research department and not be subject to the Advisers Act to the extent that the dissemination of research reports was a means of soliciting order flow for a sales and trading business or was pursuant to a commission-sharing arrangement in compliance with Section 28(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as discussed below.

The Interpretation explains how the "solely incidental" prong is applied in two contexts: (1) investment discretion over customer accounts and (2) account monitoring and account reviews.

### *Investment Discretion Over Customer Accounts*

The Commission has historically taken the position that the exercise of unlimited investment discretion over customer accounts is not "solely incidental" to a broker-dealer's securities business. The Commission reasoned that unlimited discretion gives a broker-dealer ongoing authority over a customer's account "indicating a relationship that is primarily advisory in nature" and "such a level of discretion by a broker-dealer is so comprehensive and continuous that the provision of advice in such a context is not incidental to effecting securities transactions."

Yet the Commission has also recognized that account discretion may not trigger investment adviser status in "situations where the discretion is limited in time, scope or other manner and lacks the comprehensive and continuous character of investment discretion that would suggest that the relationship is primarily advisory." Although the totality of the facts and circumstances would be relevant to a determination of whether temporary or limited discretion is consistent with the "solely incidental" prong, the Commission provided specific examples of discretion that, standing alone, would not fall outside the broker-dealer exclusion. Those examples include where a broker-dealer exercises discretion:

1. 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;
2. 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;
    - In a 2007 interpretation, the SEC stated that the limited period was "not to exceed a few months." However, in the new Interpretation, the SEC states that, depending on the circumstances, discretion that lasts for "a few months" may actually reflect an advisory relationship.
3. In a 2007 interpretation, the SEC stated that the limited period was "not to exceed a few months." However, in the new Interpretation, the SEC states that, depending on the circumstances, discretion that lasts for "a few months" may actually reflect an advisory relationship.
    - The SEC noted this form of discretion may present difficulties due to reforms in money market fund regulation that limited the availability of stable net asset value money market funds and imposed liquidity restrictions on others. Firms holding such discretion must be careful to ensure that exchanges are "like for like." The SEC stated that it anticipates that the Financial Industry Regulatory Authority, Inc. will review how its rules apply to such discretionary transactions.

4. To purchase or sell securities to satisfy margin requirements or other customer obligations that the customer has specified (such as a sale to satisfy a collateral call);
5. To sell specific bonds or other securities and purchase similar bonds or other securities in order to permit a customer to realize a tax loss on the original position;
    - A previous SEC statement to this effect was limited to bonds, but the new Interpretation notes that, for these purposes, there is no reason to distinguish between bonds and other securities.
6. To purchase a bond with a specified credit rating and maturity; and
7. To purchase or sell a security or type of security limited by specific parameters established by the customer.

### *Account Monitoring And Account Reviews*

The Interpretation also discusses account monitoring and account review practices by broker-dealers. Curiously, and without explanation, this portion of the Interpretation appears to be focused on retail customer accounts. It does not address whether the principles that it describes would (or would not) apply to the accounts of institutional investors. We anticipate further guidance from the Commission in order to clarify this point.

In any case, ongoing account monitoring and account review, for compensation, are generally considered investment adviser activities. However, the Commission rejected the view that *any* amount of account monitoring must fall outside the "solely incidental" prong of the broker-dealer exclusion.

The Interpretation provides that when a broker-dealer agrees to monitor a *retail* customer's account on a periodic basis for purposes of providing buy, sell, or hold recommendations, it may still be considered to provide advice that is "in connection with and reasonably related to effecting securities transactions" — thus not triggering investment adviser registration. In addition, if a broker-dealer agrees to monitor a retail customer's account, then such monitoring "would result in a recommendation to purchase, sell, or hold a security each time the agreed-to monitoring occurs," and those recommendations would be subject to the new Regulation Best Interest.

The Commission also explained that when a broker-dealer, on its own initiative, and without agreeing with the customer, reviews a retail customer's account in order to decide whether to provide a recommendation, and then acts upon the decision by providing a recommendation, "the broker-dealer's actions are in connection with and reasonably related to the broker-dealer's primary business of effecting securities transactions," and that such activity would not rise to the level of "account monitoring."

Although the Interpretation is focused on the "solely incidental" prong of the broker-dealer exclusion, the Commission cautioned (in a footnote) about the potential advisory nature of monitoring services that charge a separate fee. If a broker-dealer separately contracts and charges a separate fee for advisory services, it is providing investment advice that is inconsistent with the broker-dealer exclusion. Even where monitoring is consistent with the "solely incidental" prong, the broker-dealer may not receive "special compensation" for the service and rely on the broker-dealer exclusion. Finally, the Commission explained that broker-dealers receive special compensation where there is a clearly definable charge for investment advice.

## OBSERVATIONS FOR BROKER-DEALERS AND INVESTMENT ADVISERS

### *Compliance Policies And Procedures*

The Commission was attentive to the implications of its statements regarding account monitoring and account review practices. It suggested that broker-dealers may wish to create account monitoring policies and procedures for personnel that, if followed, would help to demonstrate that any account monitoring was reasonably related to the broker-dealer's securities business. In suggesting the adoption of such policies and procedures, the Commission cautioned that they should be drafted in a way that would permit a broker-dealer's personnel to monitor accounts without straying too far into the realm of providing non-incidental investment advice.

The details of such arrangements must be considered by each firm in light of its business. However, the Commission suggested by way of examples that broker-dealers relying on the exclusion could include in their policies and procedures that a registered representative may agree to monitor a customer's account at specific time frames (e.g., quarterly) for the purpose of determining whether to provide a buy, sell, or hold recommendation to the customer, however, those policies and procedures should not permit a broker-dealer to agree to monitor customer accounts in a manner that results in the provision of advisory services such as providing continuous monitoring. A firm dually registered as a broker-dealer and an investment adviser (a dual registrant) could adopt policies and procedures that distinguish the level and type of monitoring in advisory and brokerage accounts.

All broker-dealers should identify explicit or implicit agreements to monitor accounts and implement controls with respect to the frequency and purpose of account monitoring or account reviews. Broker-dealers, in particular, should confirm that policies and procedures that govern account monitoring are incorporated into their Regulation Best Interest compliance programs due to the SEC's statement that monitoring gives rise to recommendations under Regulation Best Interest. Dual registrants should also confirm that monitoring is tailored to the type of account service being provided and is conducted in accordance with appropriate regulatory requirements.

### *Soft-Dollar Research Services*

The Commission (in a footnote) was careful not to disrupt certain accepted soft-dollar practices in compliance with Section 28(e) of the Exchange Act. Section 28(e) prescribes a safe harbor from claims of a breach of fiduciary duty if a discretionary money manager uses client commissions (and possibly "pays up") to obtain brokerage and research services. Over the years, the Commission has interpreted Section 28(e) to permit reliance on the safe harbor where one broker-dealer provides eligible research services and another broker-dealer "effects" the securities transactions generating the commissions used to purchase research.[2] In this environment, a broker-dealer's sole business may be to produce and provide research pursuant to a commission-sharing arrangement whereby it is paid for its research by a separate broker-dealer effecting or executing the trade. The Commission emphasized that the Interpretation, which requires a nexus of advice (e.g., research) with a business of effecting securities transactions, does not apply in the discrete case of

[2] *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, 71 FR 41978, 41994–41995 (July 24, 2006).

commission-sharing arrangements in compliance with Section 28(e), thus preserving the broker-dealer exclusion for research-only firms participating in compliant soft-dollar programs.

### *What About "Special Compensation"?*

The Interpretation does not generally speak to the other prong of the broker-dealer exclusion from the investment adviser definition: the requirement that a broker-dealer not receive "special compensation" for advisory services. As noted above, in connection with a discussion about account monitoring, the Commission explained that "broker-dealers receive special compensation where there is a clearly definable charge for investment advice.[3]" Therefore, prior SEC statements that describe the special compensation prong have not otherwise been affected or elaborated upon by the Interpretation.[4]

In contrast to soft dollar practices permitted in the U.S. under Section 28(e) of the Exchange Act, since the implementation of MiFID II[5], many investment managers in the EU have been required to "unbundle" payments for research services from payments for trade executions. This essentially means that broker-dealers must separately price research services in "hard dollars" that heretofore had been paid for with commissions generated from securities execution. The separation of research from execution, and the separate pricing, not surprisingly implicates the "special compensation" prong, and the availability, of the broker-dealer exclusion where a U.S. broker-dealer's research is disseminated to investment managers in the EU and/or to managers in other jurisdictions that have contractually agreed with their client to adhere to the MiFID II framework. On October 26, 2017, the SEC staff issued temporary and conditional no-action relief, set to expire in July 2020, to permit a broker-dealer to receive payments in "hard dollars" (i.e., separately priced) from an investment manager subject to MiFID, or through MiFID-governed research payment accounts from MiFID-affected clients, without being considered an investment adviser[6]. Although market practices in this area continue to evolve, we would expect that the SEC or SEC staff will, in the near future, either take some action to provide a more permanent solution, extend the temporary no-action relief, or confirm that no further relief will be provided.

---

[3] Interpretation at 20, n. 68; citing *Final Extension of Temporary Exemption from the Investment Advisers Act for Certain Brokers and Dealers*, SEC Rel. No. IA-626 (Apr. 27, 1978); see also *Opinion of General Counsel Relating to Section 202(a)(11)(C) of the Investment Advisers Act of 1940*, SEC Rel. No. 2 (Oct. 28, 1940) (describing this interpretation as the SEC's "longstanding view").

[4] See, e.g., *Interpretive Rule Under the Advisers Act Affecting Broker-Dealers*, 72 FR 55126 (Sept. 28, 2007); *Certain Broker-Dealers Deemed Not to Be Investment Advisers*, 70 FR 2716 (Jan. 14, 2005).

[5] Directive 2014/65 of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments and Amending Commission Directive 2002/92 and Directive 2011/61/EU.

[6] *Securities Industry and Financial Markets Association*, SEC Staff No-Action Letter (pub. avail. Oct. 26, 2017). The relief applies only where (1) the money manager makes payments to the executing broker-dealer out of client assets for research alongside payments to that executing broker-dealer for execution; (2) research payments are for research services that are eligible for the safe harbor under Section 28(e); (3) the executing broker-dealer effects the securities transaction for purposes of Section 28(e), and (4) the executing broker-dealer is legally obligated by contract with the money manager to pay for research through the use of a research payment account in connection with a client commission arrangement.

# SEC Outlines Parameters of Permissible Broker-Dealer Advice to Customers


## Authors:

**Richard Kerr**
rkerr@klgates.com
+1.617.261.3166

**Pablo J. Man**
pablo.man@klgates.com
+1.617.951.9209

**C. Dirk Peterson**
dirk.peterson@klgates.com
+1.202.778.9324

**Eden L. Rohrer**
eden.rohrer@klgates.com
+1.212.536.4022

**Andrew J. Shipe**
andrew.shipe@klgates.com
+1.202.778.9327