

October 15, 2007

SEC Proposes Interpretive Rule Regarding Application of the Investment Advisers Act to Certain Activities of Broker-Dealers

The Securities and Exchange Commission (SEC) has proposed and published for public comment new Rule 202(a)(11)-1 under the Investment Advisers Act of 1940 (Advisers Act). New Rule 202(a)(11)-1 (Proposed Rule) would reinstate three interpretive provisions that previously were contained in the original version of that rule, but were struck down by the U.S. Court of Appeals for the D.C. Circuit. If adopted, the Proposed Rule would:

- a. identify circumstances under which a broker-dealer is providing investment advice that is not “solely incidental” to its business as a broker-dealer;
- b. permit a broker-dealer to provide both full-service and less expensive discount brokerage services without being deemed to charge “special compensation;” and
- c. take the position that a broker-dealer that is dually registered as an investment adviser is deemed to be an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subjects it to the Advisers Act.

The comment period for the Proposed Rule closes after November 2, 2007.

General Background

Section 202(a)(11)(C) of the Advisers Act excludes broker-dealers from the definition of “investment adviser” provided that:

- the broker-dealer’s “performance of such [investment advisory] services is solely incidental to the conduct of his business as a broker or dealer;” and
- the broker-dealer “receives no special compensation” for those advisory services.

The original version of Rule 202(a)(11)-1 – although primarily intended to remove certain broker-dealers from the scope of the Advisers Act – included several interpretations that clarified the application of Section 202(a)(11)(C). When the U.S. Court of Appeals for the D.C. Circuit vacated the original version of Rule 202(a)(11)-1, it struck down the entire rulemaking, thus placing the interpretive positions into question – even though the court did not explicitly question their validity.

In the aftermath of the decision, the SEC received requests from broker-dealers that it clarify the status of the interpretive provisions. In light of the D.C. Circuit’s decision, the SEC determined that it would re-propose the interpretive positions and seek public comment on the Proposed Rule.

Overview of Proposed Rule 202(a)(11)-1

The Proposed Rule would codify three interpretive positions:

1. **Proposed Rule 202(a)(11)-1(a): “Solely Incidental”**

Rule 202(a)(11)-1(a) would define “solely incidental” in the negative by stating what is **not** solely incidental to the conduct of a broker-dealer’s business. A broker-dealer’s investment advice is **not** solely incidental to the conduct of its business as a broker-dealer if the broker-dealer:

- charges a separate fee, or separately contracts, for advisory services; or
- exercises investment discretion over the account, as defined in Section 3(a)(35) under the Securities Exchange Act of 1934,* except investment discretion that is granted by a customer on a temporary or limited basis.

The SEC stated its understanding that “investment advice is ‘solely incidental to’ the conduct of a broker-dealer’s business within the meaning of section 202(a)(11)(C) when the advisory services rendered to an account are in connection with and reasonably related to the brokerage services provided to that account.” A separate contract providing for investment advisory services “reflect[s] a recognition that the advisory services are provided independent of brokerage services, and therefore, cannot be considered solely incidental to the brokerage services.” Similarly, “when a broker-dealer charges its customers a separate fee for investment advice, it is clearly providing advisory services....” Furthermore, the SEC stated that the exercise of investment discretion – the ability to trade without first consulting a customer “is qualitatively distinct from simply providing investment advice as part of a package of brokerage services.”

The SEC noted that the scope of proposed Rule 202(a)(11)-1(a) is not intended to be exclusive; there could be other ways in which a broker-dealer provides investment advice that is not “solely incidental.”

Proposed Rule 202(a)(11)-1(a) has a narrower scope compared to the original rule. The original version of Rule 202(a)(11)-1 provided that a broker-dealer was not providing incidental services if it: (a) held itself out as a financial planner or as providing financial planning services; (b) delivered a financial plan to its clients; or (c) represented to a customer that advice was provided as part of financial plan or in connection with financial planning services. In contrast, the Proposed Rule does not re-propose those interpretive positions. Instead, the SEC will consider these issues later, after the receipt of a study by the RAND Corporation that will compare levels of protection afforded customers of broker-dealers and clients of investment advisers under the federal securities laws.

* Section 2(a)(35) states that:

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 by 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, 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.

2. **Proposed Rule 202(a)(11)-1(b): “Special Compensation”**

Rule 202(a)(11)-1(b) provides that a broker-dealer will not be deemed to receive special compensation solely because it charges a commission, mark-up, mark-down, or similar fee for brokerage services that is higher or lower than one it charges another customer.

This interpretive position is designed to recognize that a broker-dealer could provide some of its customers with “full-service” brokerage, but offer others “discount” brokerage services (or internet brokerage services) at a lower price. The Proposed Rule addresses the concern that the additional price charged to full-service customers could be deemed to be the receipt of special compensation by the broker-dealer in return for the provision of investment advice to those customers. The Proposed Rule takes the position that such a price differential, standing on its own, is not special compensation for purposes of Section 202(a)(11).

3. **Proposed Rule 202(a)(11)-1(c): Dual Registrants**

Rule 202(a)(11)-1(c) states that a registered broker-dealer that also is registered as an investment adviser under the Advisers Act is deemed to be an investment adviser solely with respect to the accounts for which it provides services or special compensation that subject it to the coverage of the Advisers Act.

This rule would codify a long-standing interpretation of the Advisers Act that recognizes that a broker-dealer that also is registered as an investment adviser can distinguish between its brokerage customers and its advisory clients. In other words, a broker-dealer that is registered as an investment adviser would owe the fiduciary and other special obligations that arise under the Advisers Act only to its advisory clients, and not to its broker-dealer clients.

Request for Comment

The proposing release requests comments on the Proposed Rule no later than November 2, 2007. The full text of the proposing release is available online at <http://www.sec.gov/rules/proposed/2007/ia-2652.pdf>. If you are interested in commenting on any aspect of the Proposed Rule, we are available to assist you with the preparation and submission of your comment letter.

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