NSCP Currents

January / February 2011 Special Edition

When Does A Broker-Dealer Become an Investment Adviser?

by Paul B. Uhlenhop and Stephanie J. Gulizia

I. INTRODUCTION

The answer to this question is unclear as a result of the SEC interpretation of the statutory broker-dealer exemption from investment adviser registration and changed brokerage and investment adviser business practices in the securities industry.** Although the SEC has attempted to clarify the broker-dealer exemption through informal interpretations and a formal Rule 202(a)(11)-1 (the "Vacated Rule"),[2] this attempt at clarification was short circuited when the Circuit Court of the District of Columbia vacated the Vacated Rule in *Financial Planning Ass'n v. SEC*,[3] ("*Financial Planning*"). This decision also casts doubt on some of the SEC staff's past and current interpretations. After *Financial Planning*, the SEC issued a release for a new proposed Rule 202(a)(11)-1 (the "Proposed Interpretive Rule")[4] which was designated an "interpretive rule," and which, as discussed below, still contains some of the elements of the Vacated Rule that the Court of Appeals found violative of the statutory exemption for broker-dealers. The SEC has not acted to formalize the Proposed Interpretive Rule as a final rule.

Further complicating the question is Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[5] Section 913 mandated a study by the SEC to evaluate whether existing "retail" customers' standards of care applicable to broker-dealers, investment advisers and their associated persons are effective and whether there are problems in the protection of retail customers that can be traced to the standard of care provided to them. The SEC was mandated to take into account 14 enumerated factors. One factor mandated that the SEC consider the potential impact of eliminating the broker-dealer exemption[6] from the definition of "investment adviser" in the Investment Advisers Act ("IAA"). The study ("913 Study") was finished and delivered to Congress on January 21, 2011.[7] In the 913 Study, the SEC staff states that it "believes that eliminating the broker-dealer exemption would not provide the SEC with a flexible, practical approach to addressing what standard should apply to broker-dealers and investment advisers when they are performing the same functions for retail investors."[8] The 913 Study did not discuss expressly the scope of the broker-dealer exemption, although there are certain things that may be implied from the 913 Study which are discussed below.

Consequently, substantial confusion reigns as to the scope of the broker-dealer exemption. To qualify for a safe harbor a broker-dealer needs to understand the limitation of the broker-dealer exemption and when it must consider registration as an investment adviser.

II. THE STATUTORY BROKER-DEALER EXEMPTION

A. The Statute

The IAA exemption for broker-dealers from registration as an investment adviser is set forth as an exclusion from the term "investment adviser" as follows:

"Investment Adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include ... (C) 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; (emphasis added)[9]

To understand the broker-dealer exemption, it is important to first understand the definition of investment adviser (discussed below in Section II.B) and then the exemption for certain broker-dealers (discussed below in Section II.C).

B. The Scope of the Definition of Investment Adviser

The definition of investment adviser has three elements:
(1) receipt of compensation;
(2) in the business of advising others;
(3) advice regarding the value of securities or the advisability of investing in or purchasing or selling securities, or as a business issues or promulgates analysis or reports concerning securities.[10]

(Continued on page 2)

Paul Uhlenhop *is a member of the law firm of Lawrence, Kamin, Saunders & Uhlenhop, L.L.C., Chicago, Illinois. Mr. Uhlenhop is a member of the Illinois and New York bars as well as an esteemed member of the NSCP Board Alumni.* ***Stephanie Gulizia*** *is an associate at Lawrence, Kamin, Saunders & Uhlenhop, L.L.C., and a member of the Illinois and Michigan bars. The authors would like to thank* ***Suzanne Hennessey,*** *Legal Assistant at Lawrence, Kamin, Saunders & Uhlenhop, L.L.C., for her valuable contributions to this article.*

WHEN DOES A BD BECOME AN IA?
(Continued from page 1)

The first element, "compensation" is broadly construed by the SEC to include any kind of direct, indirect, economic or other benefits.[11] The fees or the compensation need not be received directly from the client and may be received indirectly from third parties.[12] The staff of the SEC appears to take the position that any "special compensation" for advisory services that is part of a bundled fee (e.g., brokerage and investment advice) would be included within the term "compensation."[13] See Section II.C.3 below for further discussion.

The second element, "in the business," requires that a broker-dealer provide the services on a continuum, or with regularity or frequency.[14] Also, if the broker-dealer represents to the public that it is providing investment advisory services, that would be considered "in the business."[15]

The third element is "advice" regarding the value of securities or the advisability of investing in or purchasing or selling securities, or the issuance or promulgation of analysis or reports. The other components of the third element, including "securities," are broadly construed by the SEC staff.[16] General advice about securities may or may not be considered advice regarding securities. If general advice is given regarding the benefits of investment in securities as opposed to commodities, real estate or insurance, the third element would be met.[17] The SEC has also taken the position that asset allocation and timing services as well as selection of investment advisers or evaluation of investment advisers may be considered indirectly giving advice about securities.[18] Advice as to securities markets or general advice such as analysis of specific securities or types of securities constitutes advice with respect to securities. On the other hand, the SEC has given no-action assurances to providers of computer software services offering calculations and pricing models that customers may use, but these interpretations are limited by a number of restrictions.[19] Web sites providing recommendations, trading strategies and analysis may also be considered investment advice.

Providing advice to a private equity fund may or may not be investment advice regarding securities and depends principally upon the facts and circumstances of each particular fund.[20]

It is not particularly clear whether advice regarding a company's financial or capital structure may be financial advisory services. Lempke in his treatise indicates that the general view is that the IAA was not intended to apply to activities such as general investment banking activities, although he warns that it is "difficult to generalize on this issue."[21] For example, recapitalization of securities would necessarily include advice regarding the securities and would be considered investment advisory activities.

Financial planning for compensation usually involves advice about securities or allocation of assets. For that reason, under certain circumstances financial planning may involve advice requiring registration under the IAA.[22] See Sections II.C and III.E for further discussion.

In summary, the SEC staff interprets the term "investment adviser" very broadly.

C.The Scope of the Broker-Dealer Exemption Prior to Rule 202(a)(11)-1

1. The Statutory Standard

The broker-dealer exemption from registration as an investment adviser has two broad elements as follows: (1) any advice given must be "solely incidental" to the conduct of its business as a broker or dealer; and (2) no "special compensation" may be received by the broker-dealer for the advice.

In 2005, the SEC codified many of its interpretations regarding the broker-dealer exemption into the Vacated Rule, discussed below.

2. Dual Broker-Dealer and Investment Adviser Registration and Dual Accounts

It is important to note that the SEC has taken the position that a broker-dealer may also be registered as an investment adviser and is not necessarily acting as an investment adviser to other accounts when it provides advisory service "solely" incidental to its brokerage or dealer business and with no special compensation.[23] Thus, a broker or dealer registered as an investment adviser may have investment advisory accounts, broker-dealer accounts and accounts for which it provides both investment advisory and broker-dealer services.[24]

3. "Special Compensation"

To understand "special compensation," one must understand the history of brokerage compensation.[25] Prior to 1975, stock exchange rules required that broker-dealers use a fixed schedule of brokerage fees for all transactions. In 1975, Congress enacted legislation unbundling brokerage fees and allowing a free market in brokerage compensation, resulting in new and different structures for brokerage compensation. Prior to 1975, if a broker-dealer gave advice as part of the services for which it received brokerage compensation, the SEC did not consider such special compensation since the brokerage compensation was a fixed amount. After the unbundling of commissions in 1975, questions arose as to whether part of a brokerage fee (or mark-up or mark-down for dealers) would be considered special compensation for broker-dealers who provided investment advice to their customers. Further, new and varied types of brokerage compensation developed, including brokerage fees based on a net asset value of the account over a period of time and a flat fee for a period of time with unlimited trades. Some brokers had one fee for brokerage and another fee for brokerage with advice. Other broker-dealers had discounted or negotiated fees for different clients. As a result, some customers pay more than other customers for similar or even identical services.[26] With the advent of fee-based brokerage accounts, the SEC's view was that a broker-dealer would not be an investment adviser solely because

of the receipt of special compensation as part of a fee-based customer account of a broker or dealer provided that the advice was solely incidental to transactions.[27] The SEC stated in the Vacated Rule its position that the fee difference between the two accounts would not necessarily be considered "special compensation" unless it includes a clearly definable fee for investment advice.[28] However, the SEC staff appears to take the position that special compensation includes:
(1) compensation for investment advice in a form other than brokerage commissions;
(2) brokerage commissions that include a clearly definable charge for investment advice;
(3) a receipt of a percentage of the total advisory fees charged to a broker-dealer's client by a separate investment adviser; and
(4) wrap fees.[29]

Any compensation other than brokerage fees (or mark-up or down) would be "special compensation."[30] This created a great deal of confusion as to what is "special compensation" and what advice was solely "incidental" to a brokerage transaction and what was not.

4. Solely Incidental

The SEC staff considers the establishment of a separate advisory business or the advertisement and promotion of investment advisory services evidence that the services are not solely incidental to brokerage activity.[31] The SEC also advised in a no-action letter that the use of the internet to provide investment advice, such as a website providing day trading recommendations for a subscription fee would come within the definition of an investment adviser.[32]

Specific investment advice for a specific securities transaction is considered "solely incidental." The SEC staff considers advice not "solely incidental" if the broker-dealer holds itself out to a client as providing general account management services to the customers such as wrap fees or similar programs.[33] The SEC staff has also taken the position that "solely incidental" would not include providing long-term financial management services tailored to specific needs of an individual retail client of a broker-dealer.[34] However, as discussed below in Section III.E, the SEC's position with respect to financial planning services appears to be in abeyance.

It should also be noted that broker-dealers are required to comply with the suitability rules of the Financial Industry Regulatory Authority, Inc. ("FINRA")[35] and the SEC "shingle theory,"[36] which require that a broker-dealer, before recommending a security, obtain and analyze information from a customer regarding the customer's financial position, tax status, investment objectives and other information sufficient to be able to reasonably assess the suitability of a particular recommended security in view of the customer's financial and personal situation. The problem is that a broker or dealer necessarily must engage in some financial planning to meet its suitability obligations. Compliance with the suitability requirements should be considered solely incidental to the brokerage or dealer transaction and not financial planning because the suitability requirement is required by the SEC and by the rules of FINRA approved by the SEC. The SEC has stated that good suitability compliance is not deemed to be financial planning.[37] FINRA seems to follow the policy established by the SEC. Further, as explained in Section III.E., the SEC appears to be holding in abeyance the issue of whether financial planning is not solely incidental under Section 202(a)(11)(C).

5. Discretion

The SEC view of discretionary accounts is that generally such accounts would be considered advisory accounts since discretion inherently involves some investment advice to the account that is more than advice related to unique transactions and therefore not solely incidental.[38]

6. Associated Persons

Nothing in Section 202(a)(11)(C) exempts associated persons of broker-dealers from investment adviser registration.[39] However, the SEC has long taken the position that if a registered broker-dealer qualifies for the exemption, its associated persons would also qualify, so long as they act within the scope of the exemption.[40]

7. Foreign Broker-Dealers

Foreign broker-dealers are not covered by the broker-dealer exemption from the IAA. Only registered broker-dealers are covered by the exemption. However, the SEC has provided no-action letter exemptions for offshore broker-dealers where they are subject to a foreign regulatory regime that is similar to the IAA, provided they meet the limitations of Section 202(a)(11)(C) of the IAA.[41]

8. State Securities Law

Broker-dealer exemptions from state investment adviser registration are beyond the scope of this article. Many state securities laws have provisions the same as or very similar to the federal broker-dealer exemption from the IAA.[42] However, other states have more expansive or more restrictive wording in their broker-dealer exemption. In addition, some states having wording tracking the federal broker-dealer exemptions of Section 202(a)(11)(C) may also have interpretations different than the SEC. Accordingly, a broker-dealer may be exempt from federal investment adviser registration while still needing to register as an investment adviser in one or more states.

D. Rule 202(a)(11)-1 (2005)

Because these informal interpretations by the SEC are complex and in some cases confusing, in 2005, the SEC adopted the Vacated Rule in an attempt to clarify the broker-dealer exemption and to bring it up to date with current industry practices. The Rule in its entirety reads as follows:
Rule 202(a)(11)-1: Certain Broker-Dealers

(a) *Special Compensation*. A broker or dealer registered with the Commission under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) (the "Exchange Act"):

(1) Will not be deemed to be an

(Continued on page 4)

WHEN DOES A BD BECOME AN IA?
(Continued from page 3)

investment adviser based solely on its receipt of special compensation (except as provided in paragraph (b)(1) of this section), provided that:

(i) Any investment advice provided by the broker or dealer with respect to accounts from which it receives special compensation is solely incidental to the brokerage services provided to those accounts (including, in particular, that the broker or dealer does not exercise investment discretion as provided in paragraph (b)(3) and (d) of this section); and

(ii) Advertisements for, and contracts, agreements, applications and other forms governing, accounts for which the broker or dealer receives special compensation include a prominent statement that: "Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid by both you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons' compensation, may vary by product and over time." The prominent statement also must identify an appropriate person at the firm with whom the customer can discuss the differences.

(2) Will not be deemed to have received special compensation solely because the broker or dealer charges a commission, mark-up, mark-down or similar fee for brokerage services that is greater than or less than one it charges another customer.

(b) *Solely Incidental To*. A broker or dealer provides advice that is not solely incidental to the conduct of its business as a broker or dealer within the meaning of section 202(a)(11)(C) of the Advisers Act or to the brokerage services provided to accounts from which it receives special compensation within the meaning of paragraph (a)(1)(i) of this section if the broker or 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.

(c) *Special Rule*. A broker or dealer registered with the Commission under section 15 of the Exchange Act is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subject the broker or dealer to the Advisers Act.

(d) *Investment Discretion*. For purpose of this section, the term investment discretion has the same meaning as given in section 3(a)(35) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(1)(35)), except that it does not include investment discretion granted by a customer on a temporary or limited basis. (emphasis added) [43]

In the rule, one sees a summary of interpretive positions taken by the SEC and its staff in previous years. The SEC attempted to provide that "special compensation" would not be deemed to be "special compensation" under certain circumstances as set forth in subsections (a)(1) and (2) quoted above. Subsection (a)(1) provides that a broker-dealer adviser will not be deemed to have received "special compensation" under subsection (1) if the broker-dealer receives special compensation and:

(x) the advice to the customer is solely incidental to brokerage or dealer transaction services,

(y) the broker-dealer does not have discretion, and

(z) the broker-dealer complies with the provisions of subsection (a)(1)(ii) providing for warnings in the broker-dealer's advertisements, contracts or similar statements to the public as follows:

Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid by both you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons' compensation, may vary by product and over time.[44]

Subsection (a)(2) reiterates the SEC's position that a broker-dealer who receives "special compensation" will not be deemed to receive "special compensation" solely because the broker-dealer charges a commission, mark-up, mark-down or similar fee for brokerage service that is greater than one it charges another customer for brokerage services.

Subsection (b) provides a definition of "solely incidental to" and states that certain activities are not solely incidental to the conduct of its business as a broker or dealer for services provided to accounts for which it receives special compensation within the meaning of paragraph (a)(1)(i), including but not limited to

(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;…

It is interesting to note the SEC view of financial planning in subsection (b)(2) is in line with its past interpretive positions, but as explained below is being held in abeyance at the present time. In the adopting release for the Vacated Rule, the SEC went out of its way to stress that suitability compliance does not constitute financial planning although in the real world they are indistinguishable, leaving open a serious conflict.[45]

In subsection (c) of the Vacated Rule, the SEC reiterated its long-standing interpretation that a broker-dealer also registered as an investment adviser may have some accounts that are investment advisory accounts and other accounts that are not.

E. Rule 202(a)(11)-1 Vacated by the Court of Appeals of the District of Columbia

In *Financial Planning*, the Court of Appeals of the District of Columbia vacated in its entirety the Vacated Rule primarily because the SEC exceeded its authority by interpreting the statutory exemption for broker-dealers to permit "special compensation" to a broker-dealer in certain limited circumstances. The Court of Appeals focused on the definition of "special compensation" quoted above in subsection (a) of the Rule and held it was beyond the statutory language because the rule expanded the statutory exemption in that the rule permitted a broker-dealer to receive "special compensation" for advisory services under certain circumstances without being registered as an investment adviser. The Court of Appeals found that the statute itself contains no provision permitting the SEC to broaden the statutory definition of "special compensation." The Court appears to have also concluded that the SEC did not have authority to exclude from special compensation the provisions in (a)(2) providing that a broker-dealer would be deemed not to have received special compensation solely because the broker-dealer charges a commission, mark-up, mark-down or similar fee for brokerage services that is greater than or less than one it charges another customer. This, in the opinion of the Court of Appeals, also expanded the exemption because it went beyond the provision prohibiting "special compensation" contained in the Act.

III. SEC Proposed Interpretive Rule 202(a)(11)-1 and the Current Status of the Broker-Dealer Exemption

A. Proposed Interpretive Rule 202(a)(11)-1

Shortly after the Court of Appeals decision in 2007, the SEC promulgated a proposed Rule 202(a)(11)-1 which "…would reinstate three interpretive provisions of the Rule that was vacated by a recent Court opinion."[46] The SEC in its Proposing Release stated:

(1) "The first provision would clarify that a broker-dealer that exercises investment discretion with respect to an account or charges a separate fee or separately contracts for advisory services, provides investment advice that is not 'solely incidental to' its business as a broker-dealer."

(2) The second provision of the interpretive release would "clarify that a broker-dealer does not receive special compensation within the meaning of Section 202(a)(11)(C) of the Advisers Act solely because it charges a commission for discount brokerage services that is less than it charges for full service brokerage."

(3) The third provision would clarify that a registered broker-dealer is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subjects it to the Act."[47]

As discussed below in Sections III.C, III.D and III.E, parts of the Proposed Interpretative Rule appear to fly in the face of the decision of the Court in *Financial Planning* vacating the Vacated Rule. It should be noted that the SEC stated in the proposing release that it was holding in abeyance its position in subsection (b) of the Vacated Rule regarding financial planning until it had completed a study of customer perceptions of the different services offered by broker-dealers and by investment advisers. The study was completed in 2008 but the SEC still has not released its position on subsection (b). Presumably, the SEC has held in abeyance this critical position because of the financial crisis and Section 913 of Dodd-Frank Act, which required the SEC to again study customer perceptions.

B. The Current SEC Position

Because of the confusion, it is difficult to advise clients, but generally the best advice is to stay out of the way of the SEC by registering if there is a serious question as to whether the broker-dealer falls outside the broker-dealer exemption as interpreted by the SEC. Likewise, if a broker-dealer is also an investment adviser, it needs to carefully examine which accounts are investment advisory accounts. In either case, there are three critical areas of analysis and assessment:

1. Is there discretion?
2. Is there special compensation?
3. Is the advice solely incidental to a brokerage transaction?

Except as modified by the Proposed Interpretive Rule, the SEC staff positions discussed in Section II above regarding the definitions of "investment adviser" and the broker-dealer exemption remain applicable.

C. Discretion

Both the Vacated Rule and the Proposed Interpretive Rule provide, in essence, that a broker-dealer may not rely on the broker-dealer exemptive provision of Section 202(a)(11)(C) if it exercises discretion other than on a limited or temporary basis with respect to any account. The current position of the SEC is that full discretion inherently carries with it a continuing duty to advise the accounts because it would necessarily include managing the account and providing advisory services beyond those solely incidental to the conduct of the business of a broker or dealer.

The Court of Appeals did not focus precisely on the discretionary provision in the Vacated Rule. Furthermore, the addition of discretion as a disqualifying factor narrows the broker-dealer

(Continued on page 6)

WHEN DOES A BD BECOME AN IA?
(Continued from page 5)

exemption, unlike the other provisions of the Vacated Rule which expanded the exemption and upon which the Court of Appeals relied to vacate the rule. Since discretion narrows the exemption, it is unclear how the Court of Appeals would approach the issue of discretion, but it is very possible that it would disagree with the SEC's position because the express language of Section 202(a)(11)(C) does not mention discretion and the SEC does not have authority to interpret Section 202(a)(11)(C) beyond its plain wording.

Section 913(g) of the Dodd-Frank Act further complicates the law. Section 913(g), in part, states that: "…Nothing in this section requires a broker-dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized individual advice about securities to a retail customer."[48] Does Section 913 undercut the SEC's rationale for discretion having inherently a continuing duty of care and loyalty? Nevertheless, the SEC's current position is that if a broker-dealer exercises discretion except on a temporary or limited basis over an advisory account, the account would be considered an investment advisory account and require registration of the broker-dealer.

D. Special Compensation

The second provision of the Proposed Interpretive Rule is designed to clarify that a broker-dealer has not received "special compensation" within the meaning of the broker-dealer exemption solely because it charges a commission for discount brokerage services to one customer that is more or less than it charges for full service to another customer. The SEC's position makes sense in today's changed market and from a customer standpoint. However, this long-time position of the SEC staff appears to fly in the face of the Court of Appeals decision which vacated Rule 202(a)(11)-1 because subsection (a)(2) of the Vacated Rule provided in slightly different wording that the broker or dealer would not be deemed to receive special compensation solely because the broker-dealer charges "a commission, mark-up, mark-down or similar fee for transactional services that is greater than or less than one it charges another customer." The SEC seems to be defining special compensation which the Court of Appeals concluded it did not have the authority to define. Nevertheless, interpretation in the proposed Rule as to when and whether special compensation is not received by a broker-dealer remains the SEC's position. This position receives some support under Section 913 of Dodd-Frank and the 913 Study which provides as follows:

The Staff notes that Section 913 explicitly provides that the receipt of commission-based compensation, or other standard compensation, <u>for the sale of securities does not, in and of itself, violate the uniform fiduciary standard of conduct applied to a broker-dealer</u> (emphasis added).[49]

However, does this impact the broker-dealer registration exemption?

E. Solely Incidental to a Transaction

If a broker-dealer regularly provides investment advice to retail customers in connection with specific transactions as explained above, it probably need not register as an investment adviser. Broker-dealers in the financial services industry have for many years implied or expressly offered financial planning services to their customers in their advertisements, and publicity. If the broker-dealer holds itself out as providing continuing advice or does significant financial planning, the SEC's position in the Vacated Rule was that a broker-dealer would need to be registered as an investment adviser for those accounts. As explained in Section II.C.4 above, broker-dealer compliance with suitability rules of FINRA and the SEC could also constitute financial planning.

The staff of the SEC in the release for the Proposed Interpretive Rule stated that it "decided not to propose the part of the vacated Rule [regarding financial planning] which many financial services firms found difficult to apply."[50] The SEC stated that it would reconsider the financial planning issue after it had completed a study by Rand Corporation. The Rand study was finished in 2008. So far the SEC has not acted, presumably because of the financial crisis and the 913 Study. In the 913 Study, the staff of the SEC did not explicitly address the issue of financial planning. The 913 Study does discuss broker-dealer suitability requirements and as in the past seems to be saying that suitability, even if it involves financial planning, does not presently require registration.

It appears that the SEC is continuing to hold in abeyance its decision as to whether financial planning or holding out financial planning services would not be incidental to brokerage transactions.

F. Dual Registration.

Although the Court of Appeals vacated the entire rule, it did not discuss subsection (c) of the Vacated Rule which stated the SEC's long-time position that a broker-dealer registered with the SEC is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subjects the broker or dealer to the IAA. Nevertheless, the Court of Appeals stated the SEC did not have authority to define special compensation by enlarging the exemption. Thus, it remains to be seen as to whether this long-standing interpretation of the SEC remains valid. The staff of FINRA and the SEC, however, seem to be following the interpretation in all of its exams of broker-dealers that are also investment advisers. Further, in the 913 Study, the staff reiterated its position approving dual registration.[51]

IV. CHECKLIST FOR COMPLIANCE AND SUPERVISION

A. General

Although a full discussion of compliance and supervisory procedures is beyond the scope of this article, set forth below is checklist of some areas of compliance and supervision that a compliance officer of a broker-

dealer should consider in monitoring the broker-dealer exemption from investment adviser registration or exemption of accounts from investment adviser treatment if the firm is dually registered. The list is not inclusive and as with any list must be adapted to the business of the individual broker-dealer.

B. Review of Brokerage and Compensation Structure

The firm's brokerage and compensation structure should be reviewed on an on-going basis to determine if there is "special compensation" for advisers being received from clients in connection with securities transactions. Direct and indirect compensation received by the firm should also be reviewed on an on-going basis to determine if compensation includes paying up by customers for investment advice. The firm should have procedures to review from time to time (such as every 6 months) all compensation received by the firm to determine if it involves customers paying up for investment advice, either directly or indirectly by third parties.

C. Discretion

The firm's customer accounts should be reviewed on an on-going basis to determine if any accounts are fully discretionary accounts. If they are, the accounts should be treated as advisory accounts. If the firm is not dually registered, the firm should have account opening procedures that monitor for discretionary accounts and for de facto discretion.[52]

D. Review of Financial Planning Activity

Even though the SEC's position on financial planning is in abeyance, the supervisory procedures should provide for on-going review by one or more supervisors of all advertisements, promotional material, web sites and similar materials to determine if they present the broker-dealer as holding itself out as a financial planner or investment adviser. Customer correspondence should be reviewed for language that focuses on long-term financial planning. The firm's suitability procedures should be reviewed to determine if they go beyond bona fide compliance with suitability and the SEC's shingle theory. In this area, as noted above, the SEC and FINRA seem to provide the firm with plenty of space and have not been questioning suitability analysis (no matter how thorough) as constituting financial planning presumably because the issue is on hold as noted in the Proposed Interpretive Rule. Nevertheless, if the broker-dealer holds itself out expressly or implicitly as offering financial planning services or in fact engages in financial planning, the firm needs to carefully consider whether it should register as an investment adviser or rely on the SEC's de facto suspension of its position on financial planning. To avoid holding out in advertisements, contracts, agreements, applications and other customer forms and similar statements to the public, the SEC's warning that was set forth in the Vacated Rule as follows:

Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid by both you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons' compensation, may vary by product and over time.[53]

By inserting this language in customer advertisements, promotional material, customer agreements and contracts, customers are on notice that the broker-dealer is operating as a broker-dealer and not an investment adviser. It would serve the broker-dealer well to have such SEC inspired disclosures. The 913 Study recommends disclosure of the role of a broker-dealer as a means to educate customers.[54]

E. Research Department

If the broker-dealer has a research department, there should be supervisory procedures for a continuing review of research and for what it is used. If research is provided to third parties who compensate the firm either directly or indirectly, the firm may be an investment adviser. The firm's procedures should provide for review from time-to-time whether the firm or account executives recommend investment advisers or consultants that evaluate investment advisers. The procedures should monitor whether the firm is recommending or suggesting wrap fee programs. As explained above, any activities in these areas will generally require investment adviser registration for the firm.

F. Review of Analytical Materials for Customer Use

Many firms have analytical, computer-driven resources for clients to determine allocation of assets and allocation of securities by area or by types. Procedures should require prior approval of those programs. Someone should be designated as responsible for on-going analysis and approval or non-approval of such programs. If the firm's analytical programs for use by customers result in recommending specific securities or even specific types of securities such as mutual funds, equity mutual funds, investment adviser registration may be required. It is suggested that the firm, if there is any doubt, attempt to obtain a no-action letter from the SEC staff.

V. CONCLUSION

Because of the confusion with respect to the broker-dealer exemption, broker-dealers need to proceed very carefully in this area. Broker-dealers should carefully analyze the facts regarding their operations to determine whether they need to be registered as an investment adviser. For those broker-dealers that are already registered as an investment adviser, they need to carefully analyze their customer accounts to determine which accounts are advisory accounts and which are not. Failure to so register as an investment adviser or failure to properly classify an account as an advisory account or a brokerage account may have disastrous consequences. Because

(Continued on page 8)

WHEN DOES A BD BECOME AN IA?
(Continued from page 7)

of the consequences, it is advisable for broker-dealers to stay well within the various interpretations discussed above.

It is unfortunate that the 913 Study by the staff did not discuss in more detail the confusion caused by the Court of Appeals decision in *Financial Planning* and its impact on and confusion with respect to the scope of the broker-dealer exemption from investment adviser registration. The SEC should clarify the broker-dealer exemption from investment adviser registration. To do so, based on the Court of Appeals decision in *Financial Planning*, the SEC would need specific authorization from Congress to interpret or broaden the statutory broker-dealer exemption provision. Alternatively, the SEC should ask Congress to legislate clarification. The changes should take into consideration the changes in the market for brokerage services since the unbundling in 1975, including the evolution of a number of arrangements for brokerage fees that may raise a question as to whether a higher brokerage fee for some customers is in fact special compensation. Congress should authorize the SEC to define special compensation as the SEC tried to do in the Vacated Rule. Congress should also address the SEC's position on discretion so that it is clear whether discretion does or does not require IAA registration. If the SEC's view is that financial planning services are outside the scope of the broker-dealer exemption and require investment adviser registration, Congress should explicitly state this position. However, as the SEC has noted, this would require a major upheaval and changes for broker-dealers that expressly or impliedly represent that they provide financial planning as an inherent part of any recommendation. Congress or the SEC should also provide a safe harbor that states whether or not suitability reviews and compliance with the shingle theory are financial planning.

** The authors cite to Lemke & Lins, Regulation of Investment Advisers (2010) and recommend it as a most valuable resource.

2. SEC Rel. No. IA-2376 (2005).
3. 482 F.3d 481 (D.C. Cir. 2007).
4. SEC Rel. No. IA-2652 (Sept. 24, 2007).
5. PL111-203 126 Stat. (July 21, 2010). Dodd-Frank Act §913(g) amended Section (k) of the Securities Exchange Act Section 15 by adding a new section (g). Congress, in Section 913 of the Dodd-Frank Act, among other things, gives the SEC authority to promulgate a uniform standard of care for "retail" customers of broker-dealers and investment advisers. Although Section 913 does not require the SEC to adopt such a rule, it points strongly in that direction by giving the SEC authority to establish a uniform fiduciary duty for broker-dealers and investment advisers. The proposed uniform fiduciary standard would provide that broker-dealers and investment advisers must act in the best interest of customers without regard to the financial or other interests of the broker-dealer or investment adviser providing advice and also requires a new standard of conduct that broker-dealer and investment advisers must disclose material conflicts of interest to their customers. Importantly, however, customers may consent to conflicts of interest after disclosure.
6. Section 202(a)(11)(C), Investment Advisers Act, 15 U.S.C.A. §80b-1-2(hereinafter the "IAA").
7. www.sec.gov/news/studies/2011/913studyfinal.pdf (hereinafter "913 Study"). It should be noted that the 913 Study was a study by the staff and not by the SEC. While the Commission acquiesced in its publication, the staff says on the cover page: "The Commission has expressed no view regarding the analysis, findings or conclusions contained herein." Further, at least two Commissioners commented that they disagree with the conclusions of the 913 Study. Statement by Commissioner Kathleen L. Casey and Troy A. Peredes (Jan. 31, 2011).
8. 913 Study, p. ix.
9. Section 202(a)(11)(C), IAA, 15 U.S.C.A. §80b-1-2.
10. SEC Rel. No. IA-1092, (Oct. 8, 1987).
11. Lemke & Lins, Regulation of Investment Advisers §1:4 (2010) (hereinafter "Lemke")
12. Lemke, §1:4.
13. Lemke, §1:4.
14. Lemke, §1:5, p. 4; *Zinn v. Parrish*, 644 F.2d 360, (7th Cir. 1981).
15. Lemke, §1:5, p. 5.
16. Lemke, §1:7, p. 5.
17. Lemke, §1:8, p. 6; *see also e.g.,* Dow Theory Forecasts, Inc., SEC No-Action Letter, 1978 WL 9779 (Feb. 2, 1978).
18. Lemke, §1:8; *see e.g.,* Dow Theory Forecasts, Inc., SEC No-Action Letter, 1978 WL 9779 (Feb. 2, 1978); Maratta Advisory, Inc., SEC No-Action Letter, 1981, Fed. Sec. L. Rep. (CCH) ¶77,035 (July 16, 1981); *see* National Football League Players Association, SEC No-Action Letter, 2002 WL 100675 (Jan. 25, 2002).
19 *See* EJV Partners, L.P., UniVu System, SEC No-Action Letter, 1992 WL 372147 (Dec. 7, 1992); Executive Asset Mgmt., Inc., SEC No-Action Letter, 1988 WL 235366 (Dec. 15, 1988)l
20. Lemke, §1:11, p. 9.
21. Lemke, §1:10, p. 8.
22. *See supra* discussion at III.A below. For additional information about financial planners and the regulation, see Lemke and Lens, Regulation of Financial Planners, §§1:1, *et seq*.
23. Lemke, §1:19, p. 13; SEC Rel No. IA-2652, p. 1 & p. 13, *et seq*. (Sept. 24, 2007).
24. Lemke, §1:19.
25. *See* SEC Rel. No. IA-2376, pp. 15-25 (April 12, 2005).
26. SEC Rel. No. IA-2652, p. 11 (2007); *see also* SEC Rel. No. IA-18945 (Apr. 12, 2005).
27. Lemke, §1:20.
28. 17 CFR 275.202(a)(11)-1(a)(2); SEC Rel. No. IA-2652, p. 6 (Sept. 24, 2007).
29. Lemke, §1:21, p. 14; *see* SEC Rel. No. IA-2, 1940 WL 975 (Oct. 28, 1940); American Capital Fin. Servs., Inc., SEC No-Action Letter, 1985 WL 54220 (Apr. 29, 1985); *see also* vacated Rule 202(11)(a)-1(b).
30. Lemke, §1:21, p. 14; *see* SEC Rel. No. IA-2652, p. 4 & p. 11, *et seq*. (Sept. 24, 2007).
31. Lemke, §1:20; *see* SEC Rel. No. ICA-21260 n.7, (July 27, 1995).
32. Lemke, §1:14, p 10; *see SEC v. Dynamic Daytrader.com* SEC Lit. Rel. No. Lit-16475 (Mar. 20, 2000).
33. Lemke, §1:20; *see* SEC Rel. No. IL-18945 pp. 57-59 (April 12, 2005); *see* Townsend and Assoc., Inc., SEC No-Action Letter, 1994 WL 570707 (pub. avail. Sept. 11, 1994); Koyen, Clarke and Associates Incorporated, SEC No-Action Letter, 1986 WL 67380 (pub. avail. November 10, 1986).
34. *See* Adoption of Amendments to Rule 206A.1 (T) Under the Investment Advisers Act of 1940 Extending the Duration and Limiting the Scope of the Temporary Exemption From the Advisers Act for Certain Brokers and Dealers, Release No. 34-11607, Release No. IA-471.
35. FINRA Rule 2310 and interpretations.
36. The SEC also has its own suitability rule in the form of the shingle theory which requires a broker-dealer to obtain sufficient information to assess the customer's financial or tax condition as well as requiring any security that is recommended and sold to be suitable to the customer. *See Charles Hughes and Co. v. SEC*, 137 F.2d 434 (2nd Cir. 1943); *see also* Weiss, Review of the Historic Foundations of Broker Dealer Liability for Breach of Fiduciary Duty, Journal of Corporation Law, Fall 1997, p. 88 *et seq.* (1997).
37. *See* SEC Rel. No. IA-18945, p. 56-59 (April 12, 2005).
38. *See* Proposed Interpretive Rule 202(a)(11)(1), SEC Rel. No. IA-2652, p. 1 (Sept. 24,

2007); SEC Rel. No. IA-18945, pp. 58-59 (April 12, 2005).
39. Lemke, §1:22; *see* Institute of Certified Financial Planners, SEC No-Action Letter (Jan. 21, 1986).
40. *See* Letter from Douglas Scarff, Director, Division of Market Regulation, to Gordon S. Macklin, President, NASD, 1989 WL 246098, SEC No-Action Letter (June 18, 1982).
41. Lemke, §1:23; *see* Charterhouse Tilney, SEC No-Action Letter, 1993 WL 277798 (July 15, 1993); James Capel & Co. Limited, SEC No-Action Letter, 1989 WL 246587 (Dec. 6, 1989).
42. *See e.g.,* Ill. Corp. Stat. Anno. Ch. 815 5/2.113
43. 17 CFR §275.202(a)(11)-1.
44. 17 CFR §275.202(a)(11)-1.
45. SEC Rel. No. IA-18945, pp. 56-57 (April 12, 2005).
46. SEC Rel. No. IA-2652 (Sept. 24, 2007), p.1.
47. Id.
48. Dodd-Frank Act §913(g) amending Section 15 of the 34 Act.
49. 913 Study, p. vi.
50. SEC Rel. No. IA-2652, p. 11 (2007); If the SEC would take the position that broker-dealers may not hold themselves out as offering financial planning in connection with brokerage transactions, there will be a significant change in the industry because many full service broker-dealers would need to register as investment advisers.
51. 913 Study, p. iii.
52. De facto discretion is an account executive executing most or all trades on a discretionary basis without written authorization.
53. 17 CFR §275.202(a)(11)-1(a)(1)(ii).
54. 913 Study, pp. vii and viii.

NSCP CURRENTS

is a publication of the
National Society of Compliance Professionals, Inc.
22 Kent Road, Cornwall Bridge, CT 06754
(860) 672-0843 / info@nscp.org