# Implications of the Decision Vacating the 'Broker's Exception' Rule

On March 30, 2007, the D.C. Court of Appeals vacated Rule 202(a)(11)-1 under the Investment Advisers Act of 1940, as amended ("Advisers Act"), on the grounds that the SEC lacked statutory authority to adopt the Rule.[1] On May 14, 2007, the SEC announced that it would not appeal this decision, but would request an approximately 120-day stay of the effective date of the decision vacating the Rule, until October 1, 2007. The SEC also announced that it would seek to accelerate and complete a previously commenced study of the financial products offered by broker-dealers and investment advisers prior to proposing new rules in this area, although the SEC does not expect this study to be completed, even under the accelerated schedule, before the end of 2007. Since the SEC announced that it will not propose new rules in this area until the study is completed,[2] which should be several months after the decision vacating Rule 202(a)(11)-1 becomes effective, it seems virtually certain that at least a few months will elapse without an effective SEC rule relating to the so-called broker's exception. This will leave the few SEC pronouncements on the scope of the broker's exception issued prior to 1999 as the only interpretive gloss on that exception, and these interpretations are inapplicable to many current practices of broker-dealers.

The D.C. Circuit decision and the SEC's actions have important implications both for the ability of the SEC to promulgate future rules and for the operation of the brokerage and advisory industries.[3]

## Background on Rule 202(a)(11)-1

The term "investment adviser" is broadly defined in the Advisers Act to include virtually any form of advice about securities provided for compensation.[4] Recognizing the breadth of this definition, the Advisers Act includes several exceptions from the definition of "investment adviser." One of these exceptions, the so-called broker's exception, provides that broker-dealers whose advisory services are "solely incidental" to the conduct of their brokerage business <u>and</u> that receive "no special compensation" for such advisory services are not considered investment advisers under the Advisers Act.[5] A broker-dealer that falls within this exception is exempt from all provisions of the Advisers Act.

[1] <u>Financial Planning Association v. Securities and Exchange Commission</u>, 482 F.3d 481 (D.C. Cir. 2007).

[2] As noted below, there is a question whether the SEC can engage in meaningful rule-making concerning the broker's exception in light of the D.C. Circuit decision. Although it has been reported that the brokerage industry is considering seeking legislation to address the scope of the broker's exception, the pending study may delay Congressional deliberation on such legislation.

[3] The SEC estimated that one million accounts with $300 billion in assets are directly affected by the D.C. Circuit decision. SEC Motion for a Stay, May 17, 2007.

[4] "'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 . . . ."

[5] Investment adviser does not include "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."

Two industry developments since 1940 have radically changed the pricing of brokerage services and are relevant to the SEC's interpretation of the broker's exception. First, on May 1, 1975, fixed brokerage commissions, which had been mandated by law up to that date, were eliminated and replaced by price competition. Second, on April 10, 1995, a committee of brokerage industry leaders formed at the request of SEC Chairman Levitt recommended that broker-dealers consider fixed or asset based fees, rather than transaction based fees, in order to better align the broker-dealers' interests with the customers' interests.[6]

In response to these developments, in 1999, the SEC proposed[7] a temporary version of Rule 202(a)(11)-1, which was intended to clarify the application of the broker's exception in light of two new pricing models offered by broker-dealers: (1) fixed or asset based fees for brokerage accounts rather than traditional transaction based compensation (commissions and/or mark-ups and mark-downs); and (2) discount or execution-only services, particularly through electronic trading systems, that could be viewed as assigning a cost to the same broker-dealer's full service brokerage and, thus, as removing those full-service products from the broker's exception. The temporary rule broadly exempted broker-dealers from the Advisers Act provided that, when they charged non-transaction based compensation, they did not also exercise discretion over the client's account and did not advertise their services as advisory services. The SEC finally adopted a substantially revised version of Rule 202(a)(11)-1 in 2005. The Rule broadly exempted broker-dealers from the definition of an investment adviser, unless: (1) there was a separate fee charged and separate contract for advisory services; (2) the broker-dealer held itself out as a financial planner or offered financial plans; or (3) the broker-dealer managed client accounts on a discretionary basis.

The SEC remained concerned, even after it adopted Rule 202(a)(11)-1, about the new pricing models broker-dealers had developed. In 2006, the SEC awarded a contract to the Rand Corp. for a study of the financial products offered by broker-dealers and investment advisers. The study is "intended to be used by the Commission as factual background for evaluating the current legal and regulatory environment for the provision of financial products, accounts, programs and services to individual investors by broker-dealers and investment advisers and for determining . . . the most effective legal and regulatory approach to regulating investment professionals in today's marketplace." It is apparent from this study that, even before Rule 202(a)(11)-1 was vacated, the SEC was concerned about how best to define the scope of the broker's exception.

## The D.C. Circuit Decision Vacating Rule 202(a)(11)-1

The SEC adopted Rule 202(a)(11)-1 under two statutory grants of rule-making authority: (1) Section 202(a)(11)(F) of the Advisers Act, which empowers the SEC to exempt from the definition of investment adviser "such other persons not within the intent of this paragraph as the Commission may designate by rules and regulations or order;" and (2) Section 211(a) of the Advisers Act, which empowers the SEC "to issue . . .rules and regulations [to] . . . classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters."

[6] Report of the Committee on Compensation Practices (April 10, 1995)("some of the 'best practices' found at some or many firms were . . . [p]aying a portion of RR compensation based on client assets in an account, regardless of transaction activity, so the RRs receive some compensation even if they advise a client to 'do nothing.'").

[7] When it proposed this rule, the SEC stated that "[u]ntil the Commission takes final action on the proposed rule, the Division of Investment Management will not recommend, based on the form of compensation received, that the Commission take any action against a broker-dealer for failure to treat any account over which the broker-dealer does not exercise investment discretion as subject to the Act." This effectively created a temporary exemption based upon the proposed rule.

The D.C. Circuit observed that, in evaluating whether the SEC has statutory authority to adopt Rule 202(a)(11)-1, the two-step test announced in Chevron v. Natural Resources Defense Council, 467 U.S. 837, 842-43 (1984), should be applied: (1) "whether Congress has directly spoken to the precise question at issue;" and (2) "if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." With regard to the first step, "[i]f the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguous expressed intent of Congress."

The majority opinion limited its analysis to the first of the Chevron factors. The majority found that (1) the Advisers Act unambiguously defined the scope of the broker's exception and (2) both sources of rule-making authority relied upon by the SEC in adopting Rule 202(a)(11)-1 are limited to situations not covered by the enumerated exceptions from the definition of investment adviser. The majority read the broker's exception as clearly applying only to broker-dealers "who receive only brokerage commissions for investment advice." The majority also relied upon decades-old interpretations of the broker's exception by the SEC, which concluded that "any charges 'directly related to the giving of advice' would be special compensation" and, thus, would remove the broker-dealer from the broker's exception. The majority also cited a 1978 SEC release, which concluded that "if a broker-dealer has in effect, either formally or informally, two general schedules of fees available to a customer, the lower without investment advice[,] and the difference is primarily attributable to this factor . . . the [SEC] would regard the extra charge as 'special compensation' for investment advice." 43 Fed. Reg. 19,224, 19,226 (May 4, 1978). The SEC made clear at the time that "[t]his would be the case even in a situation, currently nonexistent, in which a current 'full service' firm implements a 'discount' or 'execution-only' service."

The dissent attacked the majority decision on several grounds. The dissent found that the statutory authority for Rule 202(a)(11)-1 did in fact authorize the adoption of the Rule. The dissent read Section 202(a)(11)(F) as authorizing the SEC, through rule making, to interpret the exceptions specified in the statute. The dissent read both the broker's exception and the grant of rule-making authority as ambiguous and concluded that the SEC's interpretation of that grant of authority was reasonable.

## Implications for Future SEC Rule-Making

The SEC has now suffered four recent defeats in the D.C. Circuit invalidating SEC rules. Two of these involved the requirement that the chair of a mutual fund board be independent and are largely based upon the SEC's failure to follow procedural requirements in adopting the rule. The third involved the rule changing the manner of counting the number of advisory clients for purposes of the fifteen or fewer client exemption from the registration requirements under the Advisers Act. This rule, like Rule 202(a)(11)-1, was invalidated because the D.C. Circuit found that the SEC lacked authority to adopt the rule. Several commentators have observed that this string of defeats reflects the D.C. Circuit's loss of confidence in the SEC's credibility and hostility to the SEC's perceived carelessness in adopting rules. If correct, this perception does not bode well for the fate of future SEC rule-making.

The current decision certainly reflects an exceedingly restrictive reading of the Chevron case. Both the majority and dissent acknowledge that brokerage practices have changed radically since the elimination of fixed commissions in 1975. Pricing structures and services have evolved that were unknown in 1940, when the Advisers Act was adopted. Historically, the application of the securities laws to the evolution of products and services has fallen to the SEC. Nevertheless, unless the SEC's statutory rule-making authority is interpreted more broadly than the majority opinion suggests is appropriate, it may be necessary for Congress to stay abreast of constantly changing products and services and enact legislation to deal with such changes or to substantially revamp the federal securities laws to re-empower the SEC. Even the most recent of the major U.S. securities laws, the Investment Company Act of 1940 and the Advisers Act, are now almost 67 years old and require modification and adjustment either through rule-making or new legislation to remain workable and effective.

Finally, given the D.C. Circuit's limitation on the scope of the SEC's rule-making authority relating to the broker's exception, it seems likely that legislation will be required to address the new products and pricing structures that currently exist in this area.

## Implications for the Brokerage Business

The vacating of Rule 202(a)(11)-1 will directly affect nondiscretionary[8] products for which a fee, other than a transaction based fee (commissions and/or mark-ups and mark-downs), is charged. According to the SEC, these products will now be classified as advisory products governed by the Advisers Act.[9] Some of the language in the majority opinion also raises the question of whether a broker-dealer will risk having its full service brokerage products classified as advisory products, governed by the Advisers Act, if it also offers discount or execution-only products.

There are several implications of applying the Advisers Act to these products:

1. The broker-dealer will need to be registered as an investment adviser and comply with all of the relevant provisions of the Advisers Act. Most broker-dealers offering these products, however, are already registered.
2. The registered representatives offering the products may need to be registered as investment advisory representatives with the relevant states.
3. The fiduciary obligations imposed by the Advisers Act, which might not have been imposed on a nondiscretionary brokerage relationship (particularly in the absence of solicitation of orders), may be imposed. This may expose the broker-dealer to significantly greater liability than would otherwise have been the case.
4. The requirements imposed on principal trading under Section 206(3) of the Advisers Act -- disclosure to the client and client consent on a trade-by-trade basis -- might be imposed. Compliance with Section 206(3) for principal trades is widely viewed as impractical. However, Rule 206(3)-1 under the Advisers Act exempts from Section 206(3) advisory relationships where the provision of investment advice is solely through impersonal publications. To the extent a fee-based product is designed to limit advice to clients to the provision of published research, this exception from Section 206(3) may be available.
5. The requirements imposed on agency cross trades under Section 206(3) of the Advisers Act -- disclosure to the client and client consent -- might be imposed. However, in 1998, the SEC stated that a cross trade would not be governed by Section 206(3) if no brokerage charge is imposed for the cross trade.[10] In addition, the SEC permits blanket consents to cross trades, subject to certain conditions, under Rule 206(3)-2 under the Advisers Act.

[8] Since Rule 202(a)(11)-1 applied the Advisers Act to discretionary accounts, these accounts should not be governed differently because the Rule has been vacated.

[9] SEC Application for a Stay, May 17, 2007.

[10] Advisers Act Rel. 1732 (July 17, 1998)("We have concluded that if an investment adviser receives no compensation (other than its advisory fee), directly or indirectly, for effecting a particular agency transaction between advisory clients, the adviser would not be "acting as broker" within the meaning of Section 206(3).").

6. It has been suggested that disclosures of the disciplinary histories of registered representatives would be greater if those persons were required to complete the disciplinary reporting pages under Form ADV, rather than the less expansive disclosures currently required by Form BD.[11]

7. The inclusion of testimonials in advertising is prohibited by Rule 206(4)-1 under the Advisers Act, but is permitted under broker-dealer regulations. This difference may necessitate changing some advertising for fee-based brokerage products.

8. Depending upon how the brokerage industry responds to the vacating of Rule 202(a)(11)-1, additional burdens may be imposed upon the SEC's advisory inspection program, which may now be required to inspect relationships that were previously treated as governed only by broker-dealer regulations.

## Contact Information

If you have any questions or would like to learn more about any of these developments, please contact your usual legal advisor at Ropes & Gray LLP.

[11] Form BD requires disclosure of disciplinary information by the broker-dealer and any "control affiliate," which includes "any current employee except one performing only clerical, administrative, support or similar functions, or who, regardless of title, performs no executive duties or has no senior policy making authority." Form ADV requires disclosure of disciplinary information by the adviser and any "advisory affiliate," which includes "(1) all of [the adviser's] officers, partners, or directors (or any person performing similar functions); (2) all persons directly or indirectly controlling or controlled by [the adviser]; and (3) all of [the adviser's] current employees (other than employees performing only clerical, administrative, support or similar functions)."

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