SEC Regulation of Investment Advisers and Brokers in the Brave New World

James Hamilton, J.D., LL.M.
CCH Principal Analyst

Wolters Kluwer
Law & Business

Introduction

As the worlds of brokers and investment advisers increasingly converge, the SEC is attempting to calibrate the regulation of these securities professionals in a flexible and innovative manner consistent with investor protection. More practically, the SEC is trying to accommodate a regulatory regime erected in the 1930s with the realities of 2008. In order to assist it in this endeavor, the SEC commissioned the Rand Center for Corporate Ethics, Law and Governance to prepare a report on investor and industry perspectives on investment advisers and broker-dealers.

The Rand report took on a sense of urgency after a federal appeals court struck down an SEC rule permitting non-adviser broker-dealers to charge fees to investors based on account size without registering as investment advisers. Rule 202(a)(11)-1 (ip access user) represented the new reality of fee-based brokerage accounts. The SEC believes that the Rand study will provide useful data about the ways in which broker-dealers and investment advisers market, sell, and deliver financial products, accounts, programs, and services to individual investors. The study also should help the SEC more fully evaluate how it can improve investor protection by updating regulations to deal with the realities of today's marketplace. The SEC staff is currently studying the report and the potential regulatory implications of its findings.

Rand Report Findings

The report's essential conclusion is that the regulatory environment for broker-dealers and investment advisers is eroding along with the distinctions between the two types of financial professionals on which it is based, which after all date back to the early 20th century. More broadly, the report found that the current regulatory regime treats brokers and advisers differently when, in practice, their role is essentially the same, especially from the investor's viewpoint. This regime was essentially erected during the New Deal and, while amended many times over the years, is still organically rooted in the last century.

The report found that the bright line between brokers and investment advisers that may have existed in the 1930s has become increasingly blurred. Indeed, the report found that whether a financial services professional is a broker or an investment advisers is indistinguishable to most investors. Many investors think that brokers and advisers offer the same products and services. They do not know the differences between a broker and an investment adviser, nor do they know that the regulatory burdens for each may differ.

One reason cited in the report for the blurring of the line between brokers and advisers is that much of the marketing by brokers focuses on the ongoing relationship between the broker and the investor as brokers have adopted such titles as "Financial Advisor" and "Financial Manager." Moreover, academic studies and media and trade reports confirm that the industry is becoming increasingly complex and intertwined and that investors do not operate with a clear understanding of the different functions and fiduciary responsibilities of their financial professionals.

Because disclosure is at the heart of the federal securities laws, it is disconcerting that the report found, according to many investors and industry people, that SEC mandated disclosures do not help inform investors because few investors actually read them. The disclosures themselves may be the root of the problem. Many participants in the study said that the way the disclosures are written is not easily understandable to the average investor. Although disclosures mandated for investment advisers were viewed as more complete than brokers' disclosures, participants thought that both broker and adviser disclosure should be enhanced and use plainer language.

Even more, many participants reported that financial services providers, be it broker or adviser, make little effort to help investors understand disclosures. They merely present the disclosure without explaining it. But it was also found that many investors do not take the necessary time to fully read and understand the disclosures.

The report found the timing of disclosure to be important. Brokers give disclosure at the point of sale, said Rand, which many people think is too late in the game to make a difference. Investment advisers must provide Form ADV Part II in advance or at the time of contract if rescission is permitted within a specifically allotted time.

Regulation of Advisers

The Investment Advisers Act of 1940 is the primary vehicle for the federal regulation of investment advisers. The Advisers Act is applied on an "entity" basis, that is, when an investment adviser registers under the Act its activities everywhere are subject to the Act.

Most states also regulate investment advisers, and this dual regulation had often led to duplication and inefficiency. In 1996, in the National Securities Markets Improvement Act, Congress eliminated regulatory overlap and improved allocation of resources by giving the states the primary responsibility for the supervision of investment advisers managing less than $25 million in client assets, while giving the SEC the primary responsibility for the supervision of advisers who manage $25 million or more in client assets or who advise mutual funds. The SEC continues to regulate all investment advisers in those states that do not have their own regulatory scheme.

The Advisers Act defines an "investment adviser" as a 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 or purchasing or selling securities. The definition is broad and also includes persons who, as part of a regular business, issue analyses or reports concerning securities.

But the Advisers Act specifically excludes lawyers, accountants and brokers whose investment advice is solely incidental to their professions. However, it's important to note that brokers who receive special compensation for their advice must register as investment advisers. The Act also excludes publishers of newspapers, magazines or financial publications of general and regular circulation from registration as advisers.

Investment advisers pay a one-time fee to the SEC upon registration. The securities laws require that advisers disclose to clients information about their backgrounds, business practices, and potential conflicts of interest. Advisers must also keep certain prescribed books and records and make them available to SEC examiners.

In addition, advisers owe their clients a fiduciary obligation to act in the client's best interest and to refrain from engaging in self-dealing and conflicts of interest or to otherwise take advantage of the client. Breaches of this duty may be actionable under the Advisers Act. The SEC enforces the Advisers Act requirements through periodic and "cause" inspection of investment advisers.

The fiduciary duty imposed by the Act requires advisers to act solely with the client's investment goals and interests in mind, free from any conflicts of interest that would tempt them to make recommendations that would also benefit them. Although the specific standards for fiduciary obligations are not laid out clearly in the statute, the report noted, they are unambiguously a centerpiece of the 1940 Act's differential treatment of investment advisers, and their categorical application has since been upheld in numerous specific circumstances. See *Lowe v SEC*, (US Sup Ct 1985), CCH FED. SEC. L. REP. ¶92,062 (ip access user), in which the Court noted the kind of fiduciary, person-to-person relationships that are characteristic of investment adviser-client relationships. Some of these requirements are similar to those that apply to non-fiduciary brokers, including a suitability requirement, a requirement that advisers have a reasonable basis for their recommendations, and a best-execution requirement.

However, the universal duties imposed on investment advisers differ in number, degree, and mechanism of enforcement. As noted in the report, the kernel of the fiduciary obligations that investment advisers owe to clients is to refrain from any undisclosed conflicts of interest, a requirement that constrains only some broker-dealers. In addition, even for those requirements that appear similar to those for broker-dealers, violation may be viewed as much more significant. The fiduciary duties imposed on investment advisers require any adviser either to refrain from acting with a conflict of interest or fully disclose the conflict and receive specific consent from the client to so act.

Examples of such conflicts include various practices in which an adviser may have a pecuniary interest through fees or outside commissions in recommending a transaction to a client. Moreover, these duties have been held to apply both to current and to prospective clients, and thus even deceptive advertising falls under the Act's proscriptions.

Regulation of Broker-dealers

The Securities Exchange Act is the primary vehicle for the regulation of broker-dealers. The SEC imposes stringent capital requirements on brokers and dealers in order to deal with the risks inherent in securities activities. A broker is any person in the business of effecting transactions in securities for the account of others. A dealer is any person in the business of buying and selling securities for such person's own account through a broker or otherwise.

The SEC's net capital rule requires securities firms to have total capital exceeding the full value of illiquid assets, such as property and equipment, and a prescribed percentage of other assets, such as security positions.

Both the SEC and self-regulatory organizations such as FINRA examine various aspects of broker-dealer firms. They have programs for examining a firm's financial integrity and for evaluating a firm's trading integrity. They also have sales practice programs for evaluating a firm's compliance with SEC rules pertaining to fair and non-manipulative sales practices. The Commission has repeatedly stressed the obligation of broker-dealers to assure that retail sales activities comply with the antifraud provisions of the securities laws.

The concept of suitability is important in this area. Suitability means that brokers must recommend investments that are suitable to their clients' individual financial status and investment goals. For example, a brokerage firm that recommended to elderly retired investors seeking conservative investments that they transfer money from investments with relatively little risk to naked options or to speculative, illiquid limited partnerships would violate securities antifraud provisions.

Churning is another practice that can result in SEC sanctions. Churning occurs when a broker exercising control over the volume and frequency of trading abuses the customer's confidence for personal gain by initiating transactions excessive in the view of the character of the account. The hallmarks of churning are disproportionate turnover, frequent in and out trading, and large brokerage commissions.

Compliance is a very important aspect of broker-dealer oversight. The SEC has emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the federal securities regulatory scheme. The Exchange Act authorizes the Commission to impose sanctions for deficient supervision on the firm and on individuals associated with the firm.

Unlike investment advisers, brokers are not categorically bound by statute, regulation, or precedent to a per se rule imposing fiduciary obligations toward clients. Instead, the existence of fiduciary duties within a broker-client relationship has historically been significantly more contingent, turning ultimately on the factual nature of the relationship as interpreted by courts and arbitrators. Perhaps the most critical distinction along these lines is that between non-discretionary accounts in which the broker simply carries out specific market or limit orders on behalf of its client and discretionary accounts under which clients give consent for the broker to purchase and sell securities on their behalf without consent for each transaction, but often with restrictions on the categorical domain of such securities.

By both title and description, discretionary accounts give a broker significantly more freedom to exercise judgment for the client. Instead of merely executing the client's transactional instructions, brokers for a discretionary account will tend to make trades on their own accord, on an ongoing basis, on the client's behalf.

The report emphasizes that such freedom comes at additional potential risk that the broker may abuse that discretion or otherwise run afoul of the client's best interests. Accordingly, brokers who handle discretionary accounts are generally thought to owe fiduciary obligations to their clients. Not only do such duties transcend the basic regulatory constraints placed on the broker, but they also give rise to individual enforcement rights by the client.

In contrast, brokers handling non-discretionary accounts are generally thought to owe a much more limited and shallow pool of duties to the customer, principally concerning many of the rules that apply to all registrants, including prompt order execution, knowing one's security, knowing one's customer, disclosing conflicts of interest, and refraining from engaging in securities fraud.

According to the Rand report, at least two additional factors further cloud this landscape. First, some brokerage accounts may possess some characteristics of both discretionary and nondiscretionary accounts. For example, brokers handling a putatively nondiscretionary account may simply begin to make decisions on their client's behalf, effectively exercising de facto control over not only executions of client orders but also over the contents of those orders themselves.

According to the Rand report, over the years, courts have developed a number of tests to diagnose whether fiduciary-like control exists, usually turning on multifactor tests that are sometimes difficult to predict in practice. These tests include such factors as (1) the broker's past activities as investment advisor; (2) the extent to which the customer followed the broker's advice; (3) the extent to which the broker trades without the customer's prior approval; (4) the frequency of communication between the broker and customer; (5) the investment sophistication of the customer; and (6) the degree of trust and confidence reposed in the broker.

The report, however, importantly notes that the jurisprudential tests for divining the existence and extent of fiduciary obligations among brokers have remained in a form of doctrinal stasis for nearly two decades, with little or no evolutionary development of legal precedents. The reason for this hiatus is that virtually all disputes in this period involving brokers' allegedly breached duties to their clients have been adjudicated through arbitration, a process that does not generate published, written opinions. And challenges to the validity of such binding arbitration requirements are both rare and rarely successful, leaving much of the current set of disputes beyond the public view. It is difficult to tell with much certainty, then, whether courts hearing such cases today would adopt a fiduciary-duty jurisprudence for brokers that is stronger, weaker, or roughly the same as the one that developed during the 1970s and early 1980s.

Blurring of Roles

Because of the distinct regulatory structures placed on investment advisers and broker-dealers, the dividing line between them has always been an elusive one, albeit an important one. Congress excluded brokers from the Advisers Act so long as the advice they give clients is solely incidental to their business as a broker and they do not receive any special compensation for rendering such advice.

The proscription on special compensation has traditionally meant that broker-dealers receive compensation from their brokerage clients in the form of commissions, markups, and markdowns on specific trades. In essence, then, investment advisers' business practice of charging a general fee, rather than broker-dealers' practice of charging transaction-specific fees, has evolved into one of the hallmark distinctions between investment advisers and brokers.

Although a broker-dealer could, in theory, charge a management fee and avoid being deemed an investment adviser by giving solely incidental investment advice, the judicial interpretation of the phrase "solely incidental" is fraught with ambiguity, said the report, and thus the mechanism by which broker-dealers and investment advisers charge clients for services has become a significant issue from a regulatory perspective. Consequently, over the past two decades, broker-dealers have begun to drift subtly into a domain of activities that have historically been the province of investment advisers.

Simultaneously, investment advisers have also begun to enhance the scope of advisory activities they offer in a way that has not been part of the traditional norm. Some investment advisers, for example, may offer services that employ computerized trading programs and may take an active, discretionary management role over customer accounts. From the retail investor's prospective, these activities may not be obviously distinct from those in which brokers typically engage.

Rule 202(a)(11)-1

In 2005, the SEC entered the fray when it adopted Rule 202(a)(11)-1 , which exempted from Advisers Act registration those brokers offering fee based accounts so long as they did not exercise investment discretion over the accounts, gave advice regarding the accounts that was solely incidental to the brokerage services, and prominently disclosed to clients that the account was a brokerage account and not an advisory account. In addition, the disclosure would have to explain that, as a consequence, the customer's rights and the firm's duties to the customer, including the scope of the firm's fiduciary obligations, may differ. Finally, the broker would have to identify an appropriate person at the firm with whom the customer could discuss those differences. Specifically, and interestingly, the disclosure must state:

> 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 both by 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 SEC maintained that the rule was needed to prevent the extension of the Advisers Act to many brokerage relationships, which would conflict with the Act's intent to fill a regulatory gap that had permitted firms and individuals to engage in advisory activities without being regulated. Moreover, such a result would create substantial regulatory overlap, which the Act was drafted to avoid.

The primary effect of Rule 202(a)(11)-1 was designed to maintain the historical ability of full-service broker-dealers to provide a wide variety of services, including advisory services, to brokerage customers, without requiring those broker-dealers to treat those clients as advisory clients.

SEC's Authority Rejected

In 2007, a federal appeals court panel struck down the rule. In a 2-1 decision, the court said that Congress provided the sole and exclusive exemption for broker-dealers in Section 202(a)(11)(C) of the Advisers Act and that subparagraph (F)'s bestowal of broad discretionary powers on the SEC over future exemptions could not be used to broaden the existing exemption for brokers. *Financial Planning Association v. SEC*, (CA DofC 2007), CCH FED. SEC. L. REP. ¶94,185 (ip access user).

By seeking to exempt brokers beyond those who receive only brokerage commissions for investment advice, reasoned the court, the SEC rule was in direct conflict with both the statutory text and congressional intent as evidenced by committee reports. The court rejected the SEC's suggestion that new broker marketing developments fall within the scope of its authority under Section 202(a)(11)(F). The dissenting judge found the SEC's interpretation of the Advisers Act to be "a reasonable interpretation of an ambiguous statute." Note that Congress added a new exception to the definition of investment adviser for statistical rating organizations in 1996 and, thus, the catchall subparagraph (F) is now subparagraph (G).

The court's rejection of the SEC's suggestion that the new reality of fee-based accounts justified the use of the agency's authority under subparagraph (F) is problematic. The court said that the SEC ignored its own contemporaneous understanding of congressional intent in order to capture new developments under subsection (F).

The court cited a 1940 opinion by the SEC General Counsel that clause (C) of Section 202 (a) (11) amounts to a recognition that brokers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the Advisers Act's scope merely because of this aspect of their business. On the other hand, that portion of clause (C) that refers to special compensation amounts to an equally clear recognition that brokers who are specially compensated for the rendition of advice should be considered investment advisers and not be excluded from the Act's purview merely because they are also engaged in effecting market transactions in securities. Trapped in its own 1940 opinion, the SEC is unable to use the existing statutory tools to adjust regulation to the new reality of fee based accounts. This appears to have been an attempt to torture a statute passed in 1940 into the realities of the 21^{st} century.

Aftermath of FPA Decision

We are thus back to the statutory exception for brokers in Section 202(a)(11)(C). It has two distinct prongs, both of which a broker-dealer must meet to avoid application of the Act. First, the broker-dealer's advisory services must be solely incidental to its brokerage business. Second, the broker-dealer must receive no special compensation for the advice. The Advisers Act defines neither of the quoted phrases, and the Act's legislative history offers limited explanation of them.

The Rand report surveyed responses to the court's ruling vacating Rule 202(a)(11)-1. Not surprisingly, brokerage firms offering fee-based accounts lamented losing their ability to offer a product many of their clients preferred, while most investment advisers agreed with the ruling. But, the report also found that many respondents believe that the vacated rule misses the mark. They argue that it is the services provided rather than the form of compensation that should trigger the type of regulation applied. If the services provided are the same, they reason, the same rules should apply because the investor's expectation will be the same.

Despite a 2-1 split on the appeals panel, the SEC decided not to seek higher review of the court's ruling. Instead, the SEC asked the court for a stay of the ruling to allow four months for investors and their brokers to respond in light of a decision affecting an estimated one million fee-based brokerage accounts. The court granted the SEC's request and the ruling took effect on October 1, 2007, which means that the Advisers Act now applies to brokers offering fee-based accounts.

The Commission will consider whether further rulemaking or interpretations are necessary regarding the application of the Advisers Act to these accounts and the issues resulting from the court's decision. The Commission is committed to taking the opportunity provided by this decision to improve investors' ability to make educated decisions about their investment accounts and their financial services providers, said SEC Chairman Christopher Cox.

In the aftermath of the FPA decision, there are a few matters that SEC examiners may focus on if a firm is a dual registrant. They may look into how the firm is conducting principal trades and what compliance procedures are in place to ensure that those trades are in the client's best interest. Examiners also may be looking at how firms advise clients about what type of account is appropriate for them. See remarks of Andrew Donahue, Director of the Division of Investment Management, March 21, 2008, IA Compliance Summit.

As the SEC staff began discussing the decision's effect with interested parties, two things became clear. First, for operational reasons, many broker-dealers structured their fee-based brokerage accounts in a way that did not allow them simply to apply the Advisers Act to those accounts. For this reason, many firms asked their fee-based brokerage customers to convert their accounts either to advisory accounts or to traditional commission-based brokerage accounts. Before the decision, there were about one million fee-based brokerage accounts, holding about 300 billion dollars, so this conversion process represented a large undertaking.

Second, broker-dealers argued that the requirements of Advisers Act Section 206(3) made it impractical for them to offer their advisory clients transactions in certain securities that frequently trade on a principal basis. These securities include many kinds of debt obligations, including municipal bonds. Broker-dealers told the SEC that many of the fee-based brokerage customers, as a practical matter, would be unable or unwilling to transition to an advisory account, and thus would be unable to maintain a fee-based account with the additional protections of the Advisers Act. See remarks of Oct. 10, 2007 by Andrew Donohue, Director of the Division of Investment Management, at the Money Management Institute.

Section 206(3) prohibits an investment adviser from knowingly engaging in a transaction with a client for its own account, which amounts to trading as principal, without disclosing in writing to the client the capacity in which it is acting, and obtaining the client's consent. Congress enacted Section 206(3) to address concerns that an adviser might engage in principal transactions to benefit itself or its affiliates, rather than the client. In particular, Congress appears to have been concerned that advisers might use advisory accounts to dump unmarketable securities or those they fear may decline in value.

Congress's concerns were, and continue to be, weighty. Self-dealing by investment advisers involves serious conflicts of interest and a substantial risk that the proprietary interests of the adviser will prevail over those of its clients. Significantly, however, Congress chose not to prohibit advisers from engaging in principal trades with their clients, but rather established a means by which an adviser must disclose and obtain the consent of its client to the conflicts of interest involved.

Temporary Rule 206(3)-3T

In an effort to allow fee-based brokerage customers who convert to advisory accounts to continue to have access to a firm's inventory of securities, the Commission adopted, on a temporary basis, a new rule that establishes an alternative means for a firm to comply with Section 206(3). New Rule 206(3)-3T (ip access user) permits an adviser that also is a registered broker-dealer to give oral disclosure prior to each principal trade rather than the written disclosure otherwise required by Section 206(3). The rule applies only to non-discretionary accounts where there already is client involvement in every transaction.

It has a number of other conditions designed to prevent overreaching by advisers, including that the adviser make prospective disclosure to the client in writing of the conflicts arising from principal trades. An investment adviser taking advantage of the oral transaction-by-transaction disclosure permitted by the rule must:

- Make prospective disclosure to the client in writing of the conflicts arising from principal trades, which disclosure is likely to occur at the beginning of the advisory relationship;

- Obtain from the client written, revocable consent prospectively authorizing the adviser to enter into principal trades;

- Make oral or written disclosure and obtain the client's consent before each principal trade;

- Send to the client a confirmation statement disclosing the capacity in which the adviser has acted and indicating that the client authorized the transaction; and

- Deliver to the client an annual report itemizing the principal transactions.

The rule also requires that the investment adviser be registered as a broker-dealer and that, in addition to the Advisers Act protections, the protections of the Securities Exchange Act and the conduct rules of relevant self-regulatory organizations apply to each account for which the adviser relies on this rule.

The rule contains a sunset provision. Absent further action by the Commission, the temporary rule will expire on December 31, 2009. This gives the SEC an opportunity to observe how firms comply with their disclosure obligations under the rule, and whether, when they conduct principal trades with their clients, and whether they serve their clients' best interests.

Finally, the rule makes clear that it does not relieve an adviser from its fiduciary duties under Sections 206(1) and (2) of the Act. In other words, compliance with the rule does not relieve an investment adviser from its fiduciary obligations imposed by the Advisers Act, or by other applicable provisions of federal law. These obligations include fulfilling the duty to seek best execution of client transactions, as well as the duty to disclose material facts necessary to alert clients to the adviser's potential conflicts of interest.

Proposal to reinstate past interpretations

Another SEC rulemaking activity engendered by the appeals court ruling was a proposal to reinstate several important Commission interpretative provisions of the rule regarding exemptions for broker-dealers that were vacated as part of the FPA decision, although the

Court did not question their validity. The Commission proposed to reinstate them in order to avoid doubt about their status.

The first interpretation is that a broker-dealer that separately contracts with a customer for, or separately charges a fee for, investment advisory services is providing advice that is not solely incidental to its business as a broker-dealer. Similarly, a broker-dealer's exercise of investment discretion with respect to an account is providing advice that is not solely incidental to its business as a broker-dealer.

The second interpretation is that a broker-dealer does not receive special compensation for purposes of Advisers Act Section 202(a)(11)(C) solely because it charges a commission, mark-up, mark-down, or similar fee for brokerage services that is greater or less than one it charges another customer. In other words, a brokerage firm does not receive special compensation solely because it charges a commission for discount brokerage services that is less than it charges for full-service brokerage.

The third interpretation is that broker-dealers that are also registered as investment advisers under the Advisers Act are investment advisers solely with respect to those accounts for which they provide services or receive compensation that subjects the broker-dealers to the Advisers Act.

The Commission did not re-propose a provision regarding broker-dealers' financial planning services. Instead, the Commission plans to wait until it has had a chance to review the study by RAND of the brokerage and advisory industries before taking further action on that interpretation.

About the Author

James Hamilton is a Principal Analyst at Wolters Kluwer Law & Business, a leading provider of corporate and securities information, and a prolific blogger (Jim Hamilton's World of Securities Regulation at http://jimhamiltonblog.blogspot.com/). Hamilton has been tracking, analyzing and explaining securities law and regulation for nearly 30 years as an analyst for CCH. He has written and spoken extensively on federal securities law and has been cited as an authority by a federal court. His analysis of the Sarbanes-Oxley Act, the *Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules,* is considered a definitive explanation of the Act. His other works include the popular guidebook *Responsibilities of Corporate Officers and Directors under Federal Securities Law,* the *Guide to Internal Controls*, and the monthly newsletter *Hedge Funds and Private Equity: Regulatory and Risk Management Update*. In addition to his many books and articles, Hamilton serves as a leading contributor to the industry-standard publication, the *CCH Federal Securities Law Reporter*. Hamilton received an LL.M. from New York University School of Law.