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Part II

Securities and Exchange Commission

17 CFR Part 275
Certain Broker-Dealers Deemed Not To Be Investment Advisers; Final Rule
CERTAIN BROKER-DEALERS DEEMED NOT TO BE INVESTMENT ADVISERS

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting a rule addressing the application of the Investment Advisers Act of 1940 to broker-dealers offering certain types of brokerage services. Under the rule, a broker-dealer providing advice that is solely incidental to its brokerage services is exempted from the Advisers Act if it charges an asset-based or fixed fee (rather than a commission, mark-up, or mark-down) for its services, provided it makes certain disclosures about the nature of its services. The rule states that exercising investment discretion is not "solely incidental to" the business of a broker or dealer within the meaning of the Advisers Act or to brokerage services within the meaning of the rule. The rule also states that a broker or dealer provides investment advice that is not solely incidental to the conduct of its business as a broker or dealer or to its brokerage services if the broker or dealer charges a separate fee or separately contracts for advisory services. In addition, the rule states that when a broker-dealer provides advice as part of a financial plan or in connection with providing planning services, a broker-dealer provides advice that is not solely incidental if it: holds itself out to the public as a financial planner or as a financial planning firm; or represents to the customer that the advice is provided as part of a financial plan or planning services. Finally, under the rule, broker-dealers are not subject to the Advisers Act solely because they offer full-service brokerage and discount brokerage services (including electronic brokerage) for reduced commission rates.


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SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission" or "SEC") is adopting new rule 202(a)(11)–1 under the Investment Advisers Act of 1940 ("Advisers Act" or "Act").

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I. Introduction

This rulemaking addresses the question of when the investment advisory activities of a broker-dealer subject it to the Advisers Act. The activities of broker-dealers are regulated primarily under the Securities Exchange Act of 1934 3 and by the self-regulatory organizations ("SROs"). The activities of investment advisers are regulated primarily under the Advisers Act. The Advisers Act and the Exchange Act are not exclusive in their application to advisers and broker-dealers, respectively. Many broker-dealers are also registered with us as advisers because of the nature of the services they provide or the form of compensation they receive. Until recently, the division between broker-dealers and investment advisers was fairly clear, and the regulatory obligations of each fairly distinct. Of late, however, the distinctions have begun to blur, raising difficult questions regarding the application of statutory provisions written by Congress more than half a century ago.

Our efforts to address this question, which began in 1999, have prompted substantial interest from advisers and broker-dealers as well as groups representing the interests of investors. We very much appreciate the efforts of these groups in commenting on our proposal, meeting with us and our staff, and offering their many suggestions. The evolution of our thinking about these questions, and the important contribution these commenters have made to that evolution, is demonstrated in the rule we are today adopting.

Although many commenters urge that all who render investment advice must be regulated as advisers, Congress created a different scheme of regulation—one that excepted many who provide investment advice, including many broker-dealers registered under the Exchange Act, from the Advisers Act. As a consequence, many of the concerns about broker-dealer conduct voiced in the course of this rulemaking may be more appropriately addressed under the Exchange Act. Although we share the concern that there is confusion about the differences between broker-dealers and investment advisers, and although we believe that some of that confusion may be a result of broker-dealer marketing (including the titles broker-dealers use), we do not believe that this confusion arises as a result of this rulemaking or that it is confined to the new programs addressed by this rulemaking. Indeed, to a large extent, this rulemaking does address confusion in the context of the brokerage programs addressed here. Again, however, we believe that many of these concerns may more appropriately fall under broker-dealer regulation and, as stated below, the Chairman has directed our staff to determine and report to us within 90 days the options for most effectively responding to these issues and a recommended course of action. This schedule reflects both our appreciation of the significance of these concerns and our determination to pursue an appropriate and effective solution.

We begin with a discussion of the relevant provisions of the Advisers Act that change in light of the concerns that raise these vexing issues. Finally, and before describing the rule we are...
today adopting, we review the history of this rulemaking and the evolution of our thinking on this subject.

II. Background

A. The Advisers Act Broker-Dealer Exception

The Advisers Act regulates the activities of certain “investment advisers,” which are defined in section 202(a)(11) as persons who receive compensation for providing advice about securities as part of a regular business.4 Section 202(a)(11)(C) of the Advisers Act excepts, from the definition, a broker or dealer whose performance of (advisory) services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor.5 The broker-dealer exception thus has two prongs, both of which a broker-dealer must meet in order to avoid application of the Act: (i) The broker-dealer’s advisory services must be “solely incidental to” its brokerage business; and (ii) 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. We (and our staff) have stated our views of what the phrases mean in several releases we have issued over the years. One of the earliest of these releases explained that the broker-dealer exception “amounts to a recognition that brokers and dealers 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 scope of the [Advisers Act] merely because of this aspect of their business.”5

As we noted above, many broker-dealers are also registered as advisers. We have viewed the Advisers Act, and the protections afforded by the Act, as applying only to those accounts to which the broker-dealer provides investment advice that is not solely incidental to brokerage services or for which the firm receives special compensation.6 For these firms, the issues raised in this rulemaking relate not to whether the firm is subject to the Advisers Act, but to which of its accounts must be treated as advisory accounts.

B. The Current Rulemaking

1. The 1999 Proposal

This rulemaking began on November 4, 1999, when we first proposed new rule 202(a)(11)–1.7 Our 1999 Proposal responded to the introduction of two new types of brokerage programs—“fee-based brokerage programs” and “discount brokerage programs”8—that full-service broker-dealers were offering in response to changes in the market place for retail brokerage.9 The 1999 Proposal addressed whether, as a result of introducing these programs, broker-dealers would be unable to rely on the broker-dealer exception in the Advisers Act. If so, some broker-dealers would be required to register under the Act, and those already registered would be required to treat customers with such accounts as advisory clients rather than brokerage customers.

Fee-based brokerage programs provide customers a package of brokerage services—typically including execution, investment advice, arranging for delivery and payment, and custodial and recordkeeping services—for a fee based on the amount of assets on account with the broker-dealer (i.e., an asset-based fee) or a fixed-fee. A broker-dealer receiving such fee-based compensation may be unable to rely on the statutory broker-dealer exception because the fee constitutes “special compensation” under the Act—i.e., it involves the receipt by a broker-dealer of compensation other than brokerage commissions or dealer compensation (i.e., mark-ups, mark-downs, or similar fees).10

Discount brokerage programs, including electronic trading programs, give customers who do not want or need advice from brokerage firms the ability to trade securities at a lower commission rate. Electronic trading programs provide customers the ability to trade on-line, typically without the assistance of a registered representative, from any personal computer connected to the Internet. Customers trading electronically may devise their own investment or trading strategies, or may seek advice separately from investment advisers. The introduction of electronic trading and other discount services at a lower commission rate may trigger application of the Advisers Act to any full-service accounts for which the broker-dealer provides some investment advice. This is because the difference in the commission rates represents a clearly definable portion of the brokerage commission that may be primarily attributable to investment advice. Our staff has viewed such a tiered fee structure as involving “special compensation” under the Advisers Act.11

Fee-based brokerage programs responded to concerns we have long held about the incentives that commission-based compensation provides to churn accounts, recommend unsuitable securities, and engage in aggressive marketing of brokerage services.12 We were troubled that

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7 Proposing Release, supra note 6. In the Proposing Release, we referred to what we now term “discount brokerage” programs as “execution-only” programs. “Discount brokerage” more fully describes the programs referenced in this Release.
10 11 Advisers Act Release No. 626, supra note 6; Advisers Act Release No. 2, supra note 5; Robert S. Strevel, SEC Staff No-Action Letter (Apr. 29, 1985) ["Strevel No-Action Letter"] (“If two general fee schedules are in effect, either formally or informally, the lower without investment advice and the higher with investment advice, and the difference is primarily attributable to this factor there is special compensation”).
11 These concerns led to the formation of a broad-based committee whose mandate was to identify conflicts of interest in brokerage industry compensation practices and “best” practices in compensating registered representatives. The committee was formed in 1994 at the suggestion of then Commission Chairman Arthur Levin. The committee found that fee-based compensation would better align the interests of broker-dealers and their clients and allow registered representatives to focus on what the committee described as their most important role—providing 
application of the Advisers Act to broker-dealers offering these new brokerage programs would discourage their development, which we viewed as potentially providing benefits to brokerage customers. After reviewing these new fee-based brokerage programs, we concluded that they were not fundamentally different from traditional brokerage programs. We viewed broker-dealers offering these new programs as having re-priced traditional brokerage programs rather than as having created advisory programs of the form that Rule 202(a)(11)-1 Because we believed that Congress could not have intended to subject full-service broker-dealers offering these programs to the Advisers Act when, in conducting these programs, broker-dealers offer advice as part of a traditional package of brokerage services.

Under the 1999 Proposal, a broker-dealer providing investment advice to customers would be excluded from the definition of investment adviser regardless of whether its compensation takes as long as: (i) The advice is provided on a non-discretionary basis; (ii) the advice is solely incidental to the brokerage services; and (iii) the broker-dealer discloses to its customers that their accounts are brokerage accounts. These provisions of the proposed rule were designed to make application of the Advisers Act turn more on the nature of the services provided by the broker-dealer than on the form of compensation. In addition, we proposed that a broker or dealer would not be deemed to have received special compensation solely because the broker or dealer charges one customer 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 provision was designed to permit full-service broker-dealers to offer discount brokerage, including electronic trading, without having to treat full-price, full-service brokerage customers as advisory clients.

We received over 1700 comment letters on the 1999 Proposal, most of which addressed only the rule provisions concerning fee-based brokerage programs. Generally, broker-dealers commenting on the proposed rule strongly supported it, asserting that fee-based brokerage programs benefited customers by aligning the interests of representatives with those of their customers. The application of the Advisers Act, broker-dealers argued, would discourage the introduction of fee-based programs by imposing a duplicative and unnecessary regulatory regime.

A large number of investment advisers—in particular, financial planners—and several groups representing investor interests—submitted letters strongly opposed to the proposed rule. Some of these commenters took issue with our conclusions that the new programs do not differ fundamentally from traditional brokerage programs. Many of these commenters asserted that adoption of the rule would deny investors important protections provided by the Advisers Act, in particular, the fiduciary duties and disclosure obligations to which advisers are held. Another theme among some opponents of the rule was the competitive implications for financial planners, who would generally be subject to the Act, while broker-dealers would not. Many commenters focused on whether and how traditional brokerage services could be considered “solely incidental to” brokerage and urged us to provide guidance on the meaning of the phrase.

The many comments we received caused us to reconsider our proposed rule. We decided to repropose the rule with some modifications, reflecting the thoughtful comments we received, and sought comment on our Reproposal.

2. The Reproposal

In January we published a release in which we affirmed the basic approach of the 1999 Proposal. Like our 1999 Proposal, our reproposed rule would deem a broker-dealer registered under

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13 See infra notes 41–50 and accompanying text (discussing “traditional brokerage services”). We did not then, nor do we now, intend to suggest that brokerage services (including advice) have remained static throughout the years. We simply conclude that the broad services we identify as part of the package of traditional brokerage services have not changed.

14 See supra note 11 and accompanying text.

15 Twenty-five letters were submitted during the comment period for the 1999 Proposal. Following the close of the comment period, however, we received hundreds more letters. In view of ongoing and significant public interest in the Proposal, and in order to provide all persons who were interested in this matter a current opportunity to comment, we reopened the period for public comment on the 1999 Proposal in August 2004. Investment Advisers Act Release No. 2278 (Aug. 18, 2004) [69 FR 51620 (Aug. 20, 2004)]. The reopened comment period closed on September 22, 2004. Comment letters received throughout this rulemaking are generally available for viewing and downloading on the Internet at http://www.sec.gov/rules/proposed/s72599.shtml. Letters are otherwise available for inspection and copying in the Commission’s Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549 (File No. 57—25–99).


22 See, e.g., Comment Letter of Dan Jamieson (June 20, 2000); Comment Letter of Jane J. Bruckenstein (May 31, 2000); Comment Letter of Margaret Lofaro (May 8, 2000); Comment Letter of Shazwnee Barbour (Sept. 13, 2004); Comment Letter of Roselyn Wilkinson (Sept. 20, 2004); Comment Letter of Robert J. Lindner (Sept. 14, 2004); Comment Letter of Robert Lawson (Sept. 16, 2004); Comment Letter of Linda Patchett (Sept. 20, 2004); Comment Letter of John Finn (Sept. 20, 2004); Comment Letter of Connie Brezik (Sept. 18, 2004); Comment Letter of Keven M. Doll (Sept. 20, 2004); Comment Letter of Phoebe M. White (Sept. 20, 2004); Comment Letter of Eric G. Shisler (Sept. 20, 2004); Comment Letter of Jani M. Thornton (Sept. 20, 2004); see also Comment Letter of Consumer Federation of America (Feb. 26, 2000) (“CFA Feb. 26, 2000 Letter”).

23 AICPA Sept. 22, 2004 Letter, supra note 21; Comment Letter of The Financial Planning Association (June 21, 2004); Comment Letter of Consumer Federation of America (Nov. 4, 2004); ICAA Jan. 12, 2000 Letter, supra note 19.

24 Reproposing Release, supra note 6. In a companion release issued on the same day, the Commission adopted a temporary rule under which a broker-dealer providing non-discretionary advice to customers would be excluded from the definition of investment adviser under the Advisers Act regardless of its form or its compensation takes as long as: (i) The advice is provided on a non-discretionary basis; (ii) the advice is solely incidental to the brokerage services; and (iii) the broker-dealer discloses to its customers that their accounts are brokerage accounts. These provisions of the proposed rule were designed to make application of the Advisers Act turn more on the nature of the services provided by the broker-dealer than on the form of compensation. In addition, we proposed that a broker or dealer would not be deemed to have received special compensation solely because the broker or dealer charges one customer 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 provision was designed to permit full-service broker-dealers to offer discount brokerage, including electronic trading, without having to treat full-price, full-service brokerage customers as advisory clients.

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that broker-dealers be subject to the Advisers Act whenever they provide investment advice. Others urged us to adopt a narrow interpretation of “solely incidental to” under which many more activities (and customer accounts) of broker-dealers would be subject to the Advisers Act. Broker-dealers strongly supported the rule for many of the same reasons they supported the 1999 Proposal. Most, but not all, however, objected to our proposed interpretation that would require them to treat financial planning customers as advisory clients.

III. Discussion

We are today adopting new rule 202(a)(11)–1 under the Advisers Act for the reasons discussed below and in this rulemaking record. The rule is designed to avoid application of the Advisers Act to broker-dealers merely because they re-price their full-service brokerage or provide execution-only or similar discount brokerage services in addition to full-service brokerage. As discussed in more detail below, we believe the rule draws an appropriate line as to when a broker-dealer’s advisory activities trigger application of the Advisers Act.

A. Fee-Based Brokerage Programs

Comments on the Reproposal viewed these new fee-based brokerage accounts through entirely different prisms and came to entirely different conclusions. Some saw the introduction of fee-based brokerage programs as a significant migration from a brokerage relationship to an advisory relationship. They urged, therefore, that we treat all fee-based brokerage accounts as advisory accounts. Broker-dealers, on the other hand, viewed the new fee-based programs as providing the same services, including investment advice, that they have traditionally provided to customers. They did not

26 See, e.g., Comment Letter of Richard L. Cox (Jan. 6, 2005) (“Cox Letter”); Comment Letter of Bill McDonald (Jan. 14, 2005); Comment Letter of Timothy F. Bock (Jan. 6, 2005); Comment Letter of Harry Scheyer (Jan. 15, 2005); Comment Letter of William M. Harris (Jan. 16, 2005); Comment Letter of Colin S. Mackenzie (Jan. 17, 2005); Comment Letter of James L. Gruning (Jan. 17, 2005); Comment Letter of Roy L. Komack (Feb. 5, 2005); Comment Letter of Terry F. Oldham (Feb. 5, 2005); Comment Letter of Leon Morris (Feb. 9, 2005).


view the change in pricing as significant except insofar as it better aligns the interests of registered representatives with those of their customers.\textsuperscript{34} In order to explain how we have resolved the issues on which the commenters disagree, and consistent with our authority in the Advisers Act,\textsuperscript{35} we consider Congress’ intent in defining the scope of the Act. We first review the historical context in which Congress passed the Advisers Act, including the broker-dealer exception, in 1940.\textsuperscript{36}

1. Historical Context

Until after World War I, broker-dealers provided investment advice exclusively as a part of the brokerage services for which customers paid fixed commissions (“traditional brokerage services”)\textsuperscript{37}—in other words, customers did not pay a separate fee for that advice.\textsuperscript{38} Beginning in approximately 1920, however, some broker-dealers began offering investment advice for a separate and specific fee, typically through “special departments” within their firms.\textsuperscript{39} By 1940, when the Advisers Act was enacted, broker-dealers were providing investment advice in two distinct ways—as an auxiliary part of the traditional brokerage services for which their brokerage customers paid fixed commissions and, alternatively, as a distinct advisory service for which their advisory clients separately contracted and paid a fee.\textsuperscript{40}

The advice that broker-dealers provided as an auxiliary component of traditional brokerage services was referred to as “brokerage house advice” in a leading study of the time.\textsuperscript{41} “Brokerage house advice” was extensive and varied,\textsuperscript{42} and included information about various corporations, municipalities, and governments;\textsuperscript{43} broad analyses of general business and financial conditions;\textsuperscript{44} market letters and special analyses of companies’ situations;\textsuperscript{45} information about income tax schedules and tax consequences;\textsuperscript{46} and “chart reading.”\textsuperscript{47} The principal sources of auxiliary advice were firm representatives—known as “customers’ men” until 1939 \textsuperscript{48}—who served as the main point of contact with brokerage customers,\textsuperscript{49} and the “statistical departments” within firms, which provided research analysis to customers’ men or directly to the firms’ brokerage customers.\textsuperscript{50}

\begin{itemize}
  \item \textbf{Supra note 29}.
  \item \textbf{Supra note 33}.
  \item \textbf{Supra note 16}.
  \item \textbf{Supra note 17}.
  \item \textbf{Supra note 27}.
  \item \textbf{Supra note 29}.
  \item \textbf{Supra note 33}.
  \item \textbf{Supra note 33}.
  \item \textbf{Supra note 37}.
  \item \textbf{Supra note 39}.
  \item \textbf{Supra note 39}.
  \item \textbf{Supra note 40}.
  \item \textbf{Supra note 33}.
  \item \textbf{Supra note 39}.
  \item \textbf{Supra note 41}.
  \item \textbf{Supra note 42}.
  \item \textbf{Supra note 43}.
  \item \textbf{Supra note 44}.
  \item \textbf{Supra note 45}.
  \item \textbf{Supra note 46}.
  \item \textbf{Supra note 47}.
  \item \textbf{Supra note 48}.
  \item \textbf{Supra note 49}.
  \item \textbf{Supra note 50}.
\end{itemize}
The second way in which broker-dealers dispensed advice was to charge a distinct fee for advisory services, which typically were provided through special “investment advisory departments” within broker-dealer firms that advised customers for a fee in the same manner as did firms whose sole business was providing “investment counsel” services.51 Through these special departments, broker-dealers offered two types of advisory accounts, one known as “purely advisory” and the other as “discretionary.”52 In purely advisory accounts, the “investment counsel under[look] to advise the client at stated intervals, or to keep him constantly advised, as to what changes ought, in the opinion of counsel, to be made in his holdings” but left the ultimate decision about such changes to the client.53 Discretionary advisory accounts, on the other hand, provided the broker-dealer—through powers of attorney or otherwise—additional “control over the client’s funds, with the power to make the ultimate determination with respect to the sale and purchase of securities for the client’s portfolio.”54 Broker-dealers generally charged for the advisory services provided to these accounts under the same system that had been adopted by the independent investment counseling firms—a fee based on a percentage of the market value of the cash and securities in the account being supervised.55 Securities transactions for the discretionary accounts were effected through the broker-dealer, and clients paid a commission on each trade. Between 1935 and 1939, the Commission conducted a congressionally mandated study of investment trusts and investment companies and in connection with this study surveyed investment advisers.56 For those entities that did not engage solely in the business of providing investment advice for a fee, the “study dealt only with the department of the organization engaged in the business of furnishing such service,” 57 including broker-dealers with investment advisory departments.58 Following the survey, the Commission held a public hearing at which representatives of the investment counsel industry offered testimony about the history of the investment counsel business, the nature of the services investment counsel provided, and what they saw as the main problems involved in the business of providing investment advice.59 In a report to Congress (the “Investment Counsel Report”), the Commission informed Congress that the Commission’s study had identified two broad classes of problems relating to investment advisers that warranted legislation: “(a) the problem of distinguishing between bona fide investment counselors and ‘tipster’ organizations and (b) those problems involving the organization and operation of investment counsel institutions.”60 Based on the findings of the Investment Counsel Report, representatives of the Commission testified at the Congressional hearings on what ultimately became the Advisers Act in favor of regulating the largely unregulated community of persons engaged in the business of providing investment advice for compensation. As Commission staff explained, a “compulsory census” in the form of a registration requirement for investment advisers was necessary both to protect investors against the unregulated “fringe” offering investment advisory services and to advance the interests of legitimate investment counselors by eliminating “tipsters” who “crash in on the good will of these reputable organizations * * * by giving themselves a designation of investment counselors.” 61

Congress chose to fill this regulatory gap by passing the Advisers Act. Section 202(a)(11) of the Act defined “investment adviser”—those subject to the requirements of the Act—broadly to include “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 * * *”

In adopting this broad definition, Congress necessarily rejected arguments presented during its hearings that legitimate investment counselors should be free from any oversight except, perhaps, by the few states that had passed laws regulating investment counselors and brokers.62 and by private

51 See Advisers Act Release No. 2, supra note 5.
52 See also Securities, supra note 39, at 646, 653 (referring to “investment supervisory departments” and “special investment management departments”). In general, contemporaneous literature used the term “investment counsel” or “investment counselor” to refer to those who provided investment advice for a fee and whose advisory relationship with clients had a supervisory or managerial character. See id. at 646 (defining “investment counselor” as “an individual, institution, organization, or department of an institution or organization which undertakes for a fee to advise or to supervise the investment of funds by, and on occasion to manage the investment accounts of, clients”). Under the Investment Advisers Act, “investment counsel” is a defined subset of the “investment advisers” to whom the Act applies. See section 206(c) of the Act.
53 See also Security Markets, supra note 39, at 649–50. See also Investment Counsel Report, supra note 38, at 13–14.
55 Investment Counsel Report, supra note 38, at 13; Security Markets, supra note 39, at 649 (noting that “[g]enerally speaking, the larger independent investment counsel firms [were] more willing to take discretionary accounts than [were] the trust companies, the investment banks and those brokerage houses which undertake to perform the functions of investment counsel”).
57 61 Hearings on S. 3580, supra note 40, at 745–746. Two commenters suggested that this testimony by investment counselors, which included references to differences between independent investment counselors and broker-dealers who provided investment advice, supports the notion that Congress intended the Act to broadly cover broker-dealer investment advice. See CFA Letter, supra note 28; PPA Letter, supra, note 27. In support of this, one commenter points to the statement of Dwight Rose that “[s]ome of these organizations using the descriptive title of investment counsel were in reality dealers or brokers offering to give advice free in anticipation of sales and brokerage commissions on transactions executed upon such free advice” as evidence that Congress was concerned about bringing such broker-dealers under the scope of the Act. CFA Letter, supra note 28 (citing Hearings on S. 3580, supra note 40, at 736). Mr. Rose’s comments, however, were part of his identification of the various sorts of persons who rendered advice—not a call for regulation of those persons. Instead, consistent with the bulk of the hearings, the comments were offered in the context of an extended discussion of why investment counselors believed that the proposed legislation was unnecessary in its entirety. Moreover, the members of the committees holding hearings on the Continued
organizations, such as the Investment Counsel Association of America. Instead, in responding to such views, congressional committee members repeatedly observed that those whose business was limited to providing investment advice for compensation were subject to little if any regulatory oversight, and questioned why they should not be subject to regulation even though other professionals were. Conversely, in recognition of the fact that the broad definition of “investment adviser” also captured a number of individuals and entities that were already subject to substantial oversight and regulation, the Act specifically proposed legislation were also informed by investment counselors who testified on the legislation, that it would cover only broker-dealers who were separately held for the giving of investment advice (see Hearings on S. 3580, supra note 40, at 711; Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcommittee of the Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. at 87 (1940) (“Hearings on H.R. 10065”)—which would not include the broker-dealers to which Mr. Rose was referring.


63 Hearings on S. 3580, supra note 40, at 738–39, 745–49, 751–53 (Senators Wagner and Hughes). David Schenker, chief counsel for the Commission’s study, offered the following observations in response to investment counselors’ arguments against the registration and regulation required by the Act:

‘’Then there is another curious thing, Senator, that those people who are subject to supervision by some authoritative body of some kind, such as securities dealers or investment bankers, have to register with us as brokers and dealers. People, who are brokers and members of stock exchanges and are supervised by the stock exchanges. Curiously enough, the investment-counsel business is not supervised by any such body. We are not subject to the regulation of the exchanges or the state bar associations. The rule or regulation is such that we are not subject to regulation by anybody at all. These investment counselors who appeared here are no different from the over-the-counter brokers and dealers or the members of the New York Stock Exchange. All we ask them to do file a registration statement which asks ‘What is your name and address, and have you ever been convicted of a crime?”

Hearings on S. 3580, supra note 40, at 995–96. Eventually, members of the investment counsel industry agreed with the proposed legislation. See id. at 1124. Hearings on H.R. 10065, supra note 62. See also supra note 25, supra note 10, at 21; H.R. Rep. No. 76–2639, supra note 61, at 27.

64 Members of the congressional committees conducting the hearings on the Advisers Act suggested that the broad definition could result in overlapping (and unnecessary) regulation—particularly of lawyers providing investment advice. See, e.g., Hearings on H.R. 10065, supra note 63, at 108 (H. Rep. No. 76–775, supra note 10, at 21); H. Rep. No. 76–2639, supra note 61, at 27.

65 In the hearings in the Senate, several of the Senators raised considerable objection to the possibility of the bill reaching law firms * * * and I gather from reading the testimony and discussions on the bill, that the only reason these law firms are not under the bill is that they are pretty well regulated at home. I have understood that we created a distorted picture of the historical record, however, by failing to cite congressional testimony of a Commission employee that it was appropriate to except lawyers from the proposed legislation because, in addition to being regulated by state bar associations, lawyers are subject to a “high fiduciary duty” to their clients. See CFA Letter, supra note 28 (suggesting that Congress intended the exception in section 202(a)(11)(C) was included in the Advisers Act because broker-dealers routinely give investment advice as part of their brokerage activities, yet are already subject to extensive regulation under the 1934 Act and possibly state law”); Thomas P. Lemke & Gerald T. Lins, Regulation of Investment Advisers § 21.8 (1990), and note 66, supra note 61, at 27.

66 This exception for certain professionals is very similar to certain state-law provisions governing investment counselors at the time, which excepted banks, attorneys, brokers, and loan and trust companies, and certified public accountants. See Statutory Regulation of Investment Advisers (prepared by the Research Department of the Illinois Legislative Council) (“Illinois Legislative Council Report”) reprinted in Hearings on S. 3580, supra note 40, at 1007. That report stated that “the basic reason for [such exceptions] seems to be that such persons and firms are already subject to governmental regulation of one type or another (and) * * * the investment advice furnished by these excepted groups would seem to be merely incidental to some other function being performed by them.” Id.

67 Pub. L. 73–291, 48 Stat. 881 (June 6, 1934). Four years later in the Maloney Act, Congress amended the Exchange Act of 1934 to require the Commission to register national securities associations. Pub. L. No. 75–719, 52 Stat. 1070 (June 25, 1938). One commenter suggested that, in determining that the broker-dealer exception (and the other exceptions) reflected a decision to avoid additional and largely duplicative regulation, we disregarded evidence that the exception was included to provide a narrower construction of the exception. See CFA Letter, supra note 28. In fact, we have not stated that the only purpose of section 202(a)(11)(C) was to avoid duplicative regulation. We have focused on strong evidence that the exception reflected an intent to remove from the coverage of the Act only certain broker-dealers: those who provided investment advice as part of the package of broker-dealer exception in the Advisers Act was understood to distinguish between broker-dealers who provide investment advice to customers only as part of the package of traditional brokerage services for which customers paid fixed commissions—who were not covered by the Advisers Act—and broker-dealers who also provided advisory services (typically through their special advisory departments) for which customers separately contracted and paid a fee—who were covered by the Act. As the legislative history shows, representatives of the investment counsel industry who participated in the Advisers Act hearings (and cooperated in drafting the version of the brokerage services for which customers were paying commissions, as opposed to those broker-dealers who were providing advice for a fee, typically through separate advisory departments, who were covered by the Act)
Although, as discussed above, the Advisers Act was written in such a way that it covers fee-based programs because the fee would constitute “special compensation,” we do not believe that it would be consistent with Congress’ intent to apply the Act to cover broker-dealers providing advice as part of the package of brokerage services they provide under fee-based brokerage programs. First, as we have said, one of the reasons Congress enacted the broker-dealer exception was to avoid largely duplicative regulation. If anything, broker-dealers today operate at a much higher level of regulation far greater than in 1940, as we explain below. Much of that regulation concerns matters pertinent to their advice-giving function.

Second, the Advisers Act was enacted in an era when broker-dealers were paid fixed commission rates for the traditional package of services (including investment advice) excepted from the Act, and, therefore, Congress understood “special compensation” to mean non-commission compensation.75 There is no evidence that the “special compensation” requirement was included in section 202(a)(11)(C) for any purpose beyond providing an easy way of accomplishing the underlying goal of excepting only advice that was provided as part of the package of traditional brokerage services.76 In particular, broker is not “excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities.” See CFA Letter, supra note 28. We cannot agree. The point of the reference is to identify the type of advisory services provided by broker-dealers for compensation that the Act was intended to cover. See CFA Letter, supra note 28. Instead, the commenter contended, the final legislation—which contains an express exception for broker-dealers—reaches a broader range of broker-dealer investment advice than Mr. Johnston’s testimony suggested. We believe that the later addition of the exception for broker-dealers cannot reasonably be read to have expanded the group of broker-dealers to which the Act would apply. In our view, the better reading of the record is that Mr. Johnston—who participated in the Commission hearings that gave rise to the proposed legislation (see Investment Counsel Report, supra note 7)—understood that the legislation was never intended to reach the sort of investment advice provided by broker-dealers as part of the package of brokerage services for which customers paid commissions. See Investment Counsel Report, supra note 38, at 1, n.1 (the Commission study “included only those persons or organizations who were engaged primarily in the business of furnishing investment counsel or advice and therefore did not include lawyers, accountants, trustees, customers’ men in brokerage offices, security brokers and dealers, and other similar persons who may give investment advice in similar capacities.”).

75 See Advisers Act Release No. 2, supra note 5 (“[T]hat portion of clause (C) which refers to ‘special compensation’ amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities. It is well known that many brokers and dealers have investment advisory departments which furnish investment advice for compensation in the same manner as does an investment adviser who operates solely in an advisory capacity.”). One commenter argued that the former “investment advisory departments” does not support our conclusion that the Act was drafted to cover the sort of advisory services provided by such departments, but “merely supports the document’s preceding assertion, that a

80 See Hearings on S. 3580, supra note 40, at 1124.

81 Id. at 736.

79 Id. at 711 (testimony of Douglas T. Johnston, vice-president and General Counsel Association of America) (“The definition of ‘investment adviser’ as given in the bill * * * * would include * * * certain investment banking and brokerage houses which maintain investment departments and make charges for services rendered * * * *.”). One commentator asserted that because this testimony was offered at a time when the draft legislation contained no explicit exception for broker-dealers, it cannot be taken as evidence of the type of advisory services by broker-dealers that the legislation was intended to cover. See CFA Letter, supra note 28. Nevertheless, the commenter contended, the final legislation—which contains an express exception for broker-dealers—reaches a broader range of broker-dealer investment advice than Mr. Johnston’s testimony suggested. We believe that the later addition of the exception for broker-dealers cannot reasonably be read to have expanded the group of broker-dealers to which the Act would apply. In our view, the better reading of the record is that Mr. Johnston—who participated in the Commission hearings that gave rise to the proposed legislation (see Investment Counsel Report, supra note 7)—understood that the legislation was never intended to reach the sort of investment advice provided by broker-dealers as part of the package of brokerage services for which customers paid commissions. See Investment Counsel Report, supra note 38, at 1, n.1 (the Commission study “included only those persons or organizations who were engaged primarily in the business of furnishing investment counsel or advice and therefore did not include lawyers, accountants, trustees, customers’ men in brokerage offices, security brokers and dealers, and other similar persons who may give investment advice in similar capacities.”).

76 See Advisers Act Release No. 2, supra note 5 (“That portion of clause (C) which refers to ‘special compensation’ amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities.”). One commentator argued that the former “investment advisory departments” does not support our conclusion that the Act was drafted to cover the sort of advisory services provided by such departments, but “merely supports the document’s preceding assertion, that a
fundamental set of issues they have with the statutory broker-dealer exception in the Advisers Act. Notwithstanding the statutory exception, these commenters argue that broker-dealers providing any investment advice should be registered as investment advisers under the Advisers Act. \(^*\) They assert that today, brokerage is incidental to the advisory services provided by full-service broker-dealers, and point to brokerage advertising that emphasizes the quality of the advisory services provided by the broker-dealer as indicative of a change. \(^*\) These comments fail to give weight to Congress’ decision to include the exception in the Advisers Act, and fail to recognize the historical role of advice in retail brokerage.

Broker-dealers have traditionally provided investment advice that is substantial in amount, variety, and importance to their customers. \(^*\) Full-service retail broker-dealers have always relied on ancillary services, such as advisory services, to promote and sell their brokerage services. \(^*\) The nature, amount and significance of the advice broker-dealers provided as part of traditional brokerage services was evident in 1940 when Congress expressly excepted broker-dealers from the Advisers Act to the extent they were providing advice in that context. \(^*\) A rule or interpretation of the Advisers Act that would apply the Act to broker-dealers merely because their advice is important or valuable to customers, or who market themselves based on their advice, as commenters suggested, would extend the Act to most full-service broker-dealers—a result at conflict with the purpose of the statutory exception.

As a general matter, broker-dealers and investment advisers have, in the past, often provided similar advisory services and competed for similar clients seeking similar advice. Applying the rule which broker-shareholders in 45 common stock providers investment advice would seem to necessarily apply the Act to every full-service brokerage account once advice is provided. Whatever policy advantages one might conclude could be gained by such a result, we believe it would be inconsistent with the conclusions reached by Congress when it passed the Act. \(^*\)

Many commenters opposing the proposed rule focused their arguments on an additional investor protections that regulation under the Advisers Act provides and argued that the rule would harm investors. \(^*\) There are differences between the regulatory frameworks provided by the Exchange Act and the Advisers Act, but Congress was well aware of these differences when it passed the Advisers Act and excepted broker-dealers from the definition of investment adviser. \(^*\) Broker-dealers are per cent of the population “over 10 years of age gainfully employed.” Security Markets, supra note 39, at 54. In 1940, the Temporary National Economic Committee estimated that in 1937 there were from eight to nine million individual share owners—about 1 in 15 inhabitants of the country and around 1 in 5 persons receiving income—who held stock in at least one corporation. Temporary National Economic Committee, The Distribution of Ownership in the 20 Largest Nonfinancial Corporations at 9. See also Brookings Institution, Share Ownership in the United States, App. A (1952). Discussing shareholdings in 45 common stock listed on the New York Stock Exchange for the years 1930 to 1950 and noting that there was an extremely sharp rise in shareholdings from 1930 to 1935 followed by an “asphatic market” in the period 1935–1940.

\(^{*}\) For the same reason, we do not believe that the competitive concerns of many of the financial planners that commented here about the need for additional financial counseling and repromulogous counsel against adopting this rule.


\(^{*}\) See supra notes 37–38 and accompanying text.

\(^{*}\) See id.

\(^{*}\) See, e.g., Investment Counsel Report, supra note 38, at (“The availability of such [advisory] service to investors created an additional incentive to a purchaser or trader in securities to patronize particular brokers or investment bankers with the resultant increase in their brokerage or securities business”).

\(^{*}\) See supra notes 37–66 and accompanying text.

In the 1930s, there were a significant number of individual security holders. Thus, for example, according to the Twentieth Century Fund’s 1935 discussion of the securities markets, in 1930 around 10 million individuals owned stock in American corporations and these ten million were about 20 times larger than the 202(a)(11)(B) was based in large part on a desire to avoid multiple regulation (Hearings on H.R. 10065, supra note 62, at 88) The Act does not provide a blanket exception for lawyers, either.
reality dealers or brokers offering to give advice free in anticipation of sales and brokerage commissions on transactions executed upon such free advice”); Investment Co. Act, supra note 38, at 23–25 (quoting testimony of investment advisers regarding “vital conflicts” in broker-dealers providing investment advice when they were at the same time in a position to sell a particular security they owned); Illinois Legislative Council Report, supra note 66, at 1010 (“This might give rise to questions as to whether a counselor who is also a dealer is grouped upon always having unbiased advice.”); Segregation Study, supra note 48, at xv (“A broker who trades for his own account or is financially interested in the distribution or accumulation of a security may furnish his customers with investment advice inspired less by any consideration of their needs than by the exigencies of his own position.”). Despite such conflicts, Congress nonetheless determined that except brokers providing such advice from the scope of the Advisers Act.

One commenter challenged this conclusion, maintaining that the legislative history showed that “the interplay of brokerage and advising functions was a significant part of the problem Congress was attempting to resolve” by passing the Advisers Act, implying that the Act was drafted to broadly cover investment advice provided by broker-dealers. FPA Letter, supra note 27. The testimony on which the commenter relies (see Hearings on S. 3580, supra note 40, at 725, however, did not address advice supplied by brokers as a part of the package of brokerage services for which they charged only commissions, but concerned broker-dealers that had separate investment advisory departments that provided investment advice to clients for a fee, precisely the sort of advisory services that we have stated the Act was drafted to cover.

Broker-dealers are subject to more obligations to disclose conflicts today than they were in 1940. Those obligations derive from many sources, including agency law, the shingle theory, antifraud provisions of the securities laws and the rules and regulations of the Commission and the SROs. Required disclosures in client communications include those relating to investment recommendations (e.g., the nature of any financial interest that the firm or any of its officers or directors have in any securities of an issuer (NASD IM–2210–1)); confirmations (e.g., disclosure of principal or agency execution status and compensation (Exchange Act Rule 10b–10)); marketing materials (e.g., must be fair and balanced and provide a sound basis for evaluating the facts (NASD Rule 2210(d)); customer statements (e.g., quarterly account statements must contain a description of any securities positions, money balances and account activity (NASD Rule 2340(a)), and margin disclosure statements (e.g., must discuss operation and risks of trading on margin (NASD Rule 2341)). In addition, the Commission has proposed “point of sale” disclosure requirements and additional customer confirmation requirements for broker-dealers to provide cost and conflict of interest information to investors in mutual funds, unit investment trust interests and college savings plan interests. See Securities Act Release No. 1039, 49 FR 6368 (Feb. 10, 1984) and Securities Act Release No. 8544 (Feb. 28, 2005 [70 FR 10521 [Mar. 4, 2005]). Broker-dealers must also disclose information about revenue sharing arrangements for the sale of mutual funds. See In the Matter of Morgan Stanley DW Inc., Exchange Act Release No. 34–48789 (Nov. 17, 2003); In the Matter of Edward D. Jones & Co., L.P., Exchange Act Release No. 34–50010 (Dec. 21, 2004) (both dated Feb. 10, 2004); In the Matter of Putnam Investment Management, LLC, Advisers Act Release No. 2370 (Mar. 23, 2005). See also In the Matter of Citigroup Global Markets, Inc., Exchange Act Release No. 34–51415 (Mar. 23, 2005) (in addition to revenue sharing arrangements, also required to disclose material information

subject to oversight by the Commission as well as by one or more SROs under the Exchange Act. The Exchange Act. Commission rules, and those of the SROs provide substantial protections for broker-dealer customers.94 Given that broker-dealers are today subject to a level of regulation far greater than in 1940, we believe that the rule is consistent with the statute’s intent to avoid largely duplicative regulation of firms already subject to Commission oversight.95 Some commenters opposed to the rule asated that the Commission, by providing the proposed exception in the rule, would relieve broker-dealers of the fiduciary responsibility to clients that regarding overall rate of return for purchase of Class A shares rather than Class B shares).96

An entity that wishes to act as a broker-dealer, and that does not qualify, must register both with the Commission and with at least one SRO. See Exchange Act section 15(b)(8). The Uniform Application for Broker-Dealer Registration, Form BD, requires the disclosure of detailed information about their business, including their disciplinary history, if any. Similar information about registered personnel of broker-dealers must be disclosed on Form U4, the Uniform Application for Securities Industry Registration. This information is maintained in the Central Registration Depository (CRD), which is operated by the National Association of Securities Dealers, Inc. (NASD). Much of this information, including disciplinary history, is made publicly available by NASD through BrokerCheck. All registered personnel of broker-dealers must pass examinations administered by the NASD in order to work for a broker-dealer and complete continuing education requirements. Registered securities representatives must be supervised by a principal of the broker-dealer who is also registered with the NASD. See NASD Conduct Rule 3010(a)(5).

Under the antifraud provisions in Sections 9(e), 10(b), and 15(c)(1) and (2) of the Exchange Act and the regulations thereunder, as well as the rules of the various SROs, broker-dealers owe their customers a duty of best execution and are required to make only suitable recommendations. They are also subject to various financial responsibility requirements, including segregation of customer assets from firm assets and capital adequacy requirements, as well as recordkeeping and reporting requirements. See Exchange Act Rules 15c3–1, 15c3–3, 17a–3, 17a–4, 17a–5, and 17c–11. Moreover, broker-dealers are subject to statutory disqualification standards and the Commission’s disciplinary authority, which are designed to prevent persons with any disciplinary history from becoming, or becoming associated with, registered broker-dealers. See Exchange Act sections 3(a)(39), 15(b)(4) and 15(b)(6). See also Reproposing Release, supra note 6, at n. 52 and accompanying text.

For example, while our staff examinations of broker-dealers offering fee-based accounts suggest that some firms may be maintaining such accounts for customers in instances in which they are not appropriate—for example for a customer whose trading activity is limited—we note that the SROs are taking steps to address this practice. The NASD has issued a Notice to Members requiring supervisory procedures to determine whether fee-based brokerage is appropriate for a customer and periodic review of the customer’s accounts to determine whether it remains appropriate. NASD Notice to Members No. 03–68 (Nov. 2003). The NYSE has filed a proposed rule with the Commission that would also deal with these issues. SR-NYSE–2004–13.

The Advisers Act imposes.96 Many of these commenters believed that, as a result, we would be denying fee-based brokerage customers an important investor protection. Investment advisers are fiduciaries by virtue of the nature of the position of trust and confidence they assume with their clients. They owe their clients “an affirmative duty of ‘utmost good faith, and full and fair disclosure of all material facts.’”97 In some cases, such as when broker-dealers assume positions of trust and confidence with their customers similar to those of advisers, broker-dealers have been held to similar standards.98 As we noted in our Reproposing Release, however, broker-dealers often play roles substantially different from investment advisers and in such roles they should not be held to standards to which advisers are held.99 Thus, we believe that broker-dealers and advisers should be held to similar standards depending not upon the statute under which they


98 See, e.g., Arleen W. Hughes, 27 S.E.C. 629 (1948) (noting that fiduciary requirements generally are not imposed upon broker-dealers who render investment advice as an incidental to their brokerage unless they have placed themselves in a position of trust and confidence). In re Prime Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

99 See, e.g., C. Weiss, supra note 40, at 725 (quoting testimony of investment advisers supra note 6, at n. 51).
B. Exception for Fee-Based Brokerage Accounts

Under rule 202(a)(11)–1(a), a broker-dealer providing investment advice to its brokerage customers is not required to treat those customers as advisory clients solely because of the form of the broker-dealer’s compensation. The rule is available to any broker-dealer registered under the Exchange Act that satisfies two conditions: (i) Any investment advice it provides to an account must be solely incidental to the brokerage services provided to the account (and thus must be provided on a non-discretionary basis); and (ii) advertisements for and contracts, agreements, applications and other forms governing its accounts must include a prominent statement that the account is a brokerage account and not an advisory account, and that the broker-dealer’s interests may not always be the same as the customer’s.

Customers would be encouraged to ask questions about their rights and the broker-dealer’s obligations to them, including the extent of the broker-dealer’s obligations to disclose conflicts of interest and to act in their best interest. This would include information about sales incentives and how a broker-dealer is compensated. In addition, the broker-dealer must identify an appropriate person at the firm with whom the customer can discuss the differences between brokerage and advisory accounts.

A broker-dealer receiving special compensation for advisory services provided to customers must satisfy both of these requirements to avoid application of the Advisers Act. The failure of a broker-dealer to meet either of the requirements of the rule will result in loss of the exception, and, unless another Advisers Act exception is available, the broker-dealer will likely violate one or more provisions of the Act.

1. Solely Incidental To

Rule 202(a)(11)–1(a) includes the requirement, taken from the statutory broker-dealer exception, that advisory services provided in reliance on the rule must be solely incidental to the brokerage services provided. The rule provides that the advice a broker-dealer provides to any account must be solely incidental to brokerage services provided by the broker-dealer to that account rather than to the overall operations of the broker-dealer.

As a result (and as proposed), the advice that a broker-dealer provides to fee-based brokerage accounts must be non-discretionary and advisory. Commenters favoring the rule generally agreed that discretionary accounts that are charged an asset-based fee should be subject to the Advisers Act. These accounts bear a strong resemblance to traditional advisory accounts, and it is highly likely that investors will perceive such accounts to be advisory accounts. Fee-based discretionary accounts were clearly the type of accounts that Congress understood would be covered by the Advisers Act when it passed the Act in 1940.

2. Customer Disclosure

As reproposed, rule 202(a)(11)–1(a) would have required that all advertisements for accounts excepted under the rule and all agreements, contracts, applications and other forms governing the operation of such accounts (“customer documents”) must contain a statement that the accounts are brokerage accounts and not advisory accounts. In addition, the reproposed rule would have required that the disclosure explain that the customer’s rights and the firm’s duties and obligations to the customer, including the scope of the firm’s fiduciary
obligations, could differ. Finally, under the reproposed rule, broker dealers would have been required to identify an appropriate person at the firm with whom the customer could discuss the differences.\textsuperscript{110} As reprouposed, the disclosure was designed to put investors selecting a fee-based brokerage account on notice that their account is a brokerage account, with all the legal attributes of a brokerage account, rather than an advisory account. Only a few commenters were satisfied with the disclosure.\textsuperscript{111} Some commenters thought it should be “strengthened” by focusing on what these commenters considered a lack of investor protections associated with a broker-dealer relationship.\textsuperscript{112} Others expressed a great deal of skepticism about the ability of any disclosure to convey to investors the differences between broker-dealers’ and advisers’ legal obligations to clients in a reasonably succinct way because of the complexity of the issues.\textsuperscript{113} Some commenters expressed concern about the usefulness of providing a contact person within the broker-dealer to aid investors with questions about the differences between investment advisers and broker-dealers.\textsuperscript{114} They thought it would be very unlikely that such a person would accurately describe the differences in legal rights and obligations.\textsuperscript{115} Some of these commenters urged us to direct investors to a neutral source of information, such as the Commission’s web site, for the information.\textsuperscript{116}

The federal securities laws place disclosure obligations on persons registered with us because they are in the best position to know what is and is not material to their circumstances.

Like all registrants, broker-dealers are responsible for the accuracy and veracity of their statements. The legal obligations a broker-dealer owes to a customer vary from firm to firm and account to account depending upon such matters as the terms of the brokerage agreement, the state in which the broker-dealer is located, the SRO of which it is a member, the nature of the relationship between the broker-dealer and its customer, and the product the broker-dealer is selling.\textsuperscript{117} Thus, we believe broker-dealers are in the best position to make disclosures most appropriate to their customers.

Recently, we convened focus groups of investors to gauge the impact of this rule. Our investor focus groups found that the proposed disclosure statement alerted them to the fact that differences existed between brokerage accounts and advisory accounts,\textsuperscript{118} although the disclosure did not communicate what those distinctions might mean. Focus group participants viewed the terms such as “duties,” “rights” and “obligations” as important terms that “would prompt [them] to ask questions.”\textsuperscript{119} The ability to contact a person at the broker-dealer was considered to be a positive factor.\textsuperscript{120} Focus group investors were, however, confused by the use of legal terms in the disclosure, including “fiduciary,” “rights” and “obligations.” They suggested using a “plain-English” approach that would avoid terms such as “fiduciary” and “specify the actual differences between brokerage and advisory accounts.”\textsuperscript{121} We believe it is appropriate to inform broker-dealer customers of the nature of the account they are opening.\textsuperscript{122} At the same time, we are concerned about mandating detailed disclosure on complex legal issues, the outcome of which may vary depending upon the nature of the particular customer relationship. Our investor focus groups, however, indicated the need for some language that would help identify the actual differences between brokerage and advisory accounts. Thus, we believe it is most appropriate to emphasize that an investor’s account is a brokerage account and not an advisory account, to provide some information on the nature of the conflicts inherent in the broker-dealer relationship, and to encourage investors to ask questions about their rights and the broker-dealer’s obligations to them. We are also mindful of the need for plain-English disclosure, and accordingly, we are making modifications to the disclosure language to help achieve that goal. As adopted, rule 202(a)(11)-1(a) now requires all customer documents to contain a clear, prominent statement\textsuperscript{123} as follows:

Your account is a brokerage account and not an advisory account. Your 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.\textsuperscript{124}

\textsuperscript{110} Reproposing Release, supra note 6.

\textsuperscript{111} ICI Letter, supra note 109; Morgan Stanley Letter, supra note 28; American Express Letter, supra note 33.


\textsuperscript{113} CFA Letter, supra note 28; NAPFA Letter, supra note 31; PIABA Letter, supra note 31; Comment Letter of TD Waterhouse (Feb. 7, 2005) (“TD Waterhouse Letter”).


\textsuperscript{115} PIABA Letter, supra note 31; Northwestern Mutual Letter, supra note 29.

\textsuperscript{116} EPA Letter, supra note 27; CFP Board Letter, supra note 28.

\textsuperscript{117} Some commenters echoed this concern. See, e.g., Northwestern Mutual Letter, supra note 29.

\textsuperscript{118} Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures, Report to the Securities and Exchange Commission, Siegel & Gale, LLC, Gelb Consulting Group, Inc. (Mar. 10, 2005) at 4 (“Focus Group Report”). The Focus Group Report is available for viewing and downloading on the Internet at http://www.sec.gov/rules/proposed/s72599.shtml. Two other investor surveys were cited by commenters on the Reproposal. See TD Waterhouse Letter, supra note 113 (citing a survey conducted at the request of TD Waterhouse USA); Joint Letter of Fund Democracy et al., supra note 28 (citing a survey prepared for the Consumer Federation of America and the Zero Alpha Group) (available at http://www.zeroalphagroup.com/news/Rinveste\textsuperscript{2}mZAG.pdf). Our focus group study differed in methodology from the CFA Survey and the TD Waterhouse survey. See infra notes 212–214 and accompanying text. Because of these differences, we discuss only our Focus Group Report.

\textsuperscript{119} Id.

\textsuperscript{120} Id.

\textsuperscript{121} Id. at 4 & 9.

\textsuperscript{122} The Commission expects to consider the broader broker-dealer disclosure and sales practice concerns discussed in the reproposing release in the study discussed in section V of this Release.

\textsuperscript{123} Some commenters suggested that the Commission establish minimum standards, including font size, for the disclosure statement. Rather than specify a particular size or placement for the disclosure, however, we believe that establishing general guidelines will be most effective. To be “prominent,” the statement should be included, at a minimum, on the front page of each document or agreement a customer is likely intended to draw attention to it. In a televised or video presentation, a voice overlay must clearly convey the required information.

\textsuperscript{124} Some commenters sought confirmation that they could tailor the language of the disclosure (see, e.g., Northwestern Mutual Letter, supra note 29). The rule is intended to be responsive to focus group investor concerns that all broker-dealers be required to use standard language. See Focus Group Report, supra note 118, at 9. We recognize, however, that it may be appropriate to make minor modifications to the language to fit individual circumstances. For example, in marketing material, it may be appropriate to substitute the name of the account, such as the “ABC Account” in lieu of “your account.” The substance of the disclosure should not, however, be altered.

The rule does not prohibit broker-dealers from providing additional disclosure materials discussing such matters as the nature of the fee-based account, customers’ rights, the broker-dealer’s obligations, and the differences from an advisory account, so long as it does not interfere with the prominence of the disclosure statement and contact information. In addition, additional disclosure, 

Continued
Finally, broker-dealers must identify an appropriate person at the firm with whom the customer can discuss the differences between brokerage and advisory accounts.\(^{125}\) We are aware that this approach to disclosure of the nature of a brokerage account and the differences between such an account and an advisory account addresses many, but not all, concerns about investor confusion. As a consequence, as indicated in Section V of this Release, the Chairman has directed our staff to report to us regarding other options for addressing this confusion, including a study to consider, among other things, the need for additional investor education efforts and limits on broker-dealer marketing.

C. Discount Brokerage Programs

Rule 202(a)(11)–1(a)(2), which we are adopting as proposed, provides that a broker-dealer will not be considered to have received special compensation solely because the broker-dealer charges one customer a commission, mark-up, mark-down or similar fee for brokerage services that is greater than or less than one it charges another customer.\(^{126}\) This provision is intended to keep a full-service broker-dealer from being subject to the Act solely because it also offers electronic trading or some other form of discount brokerage. Conversely, a discount broker-dealer would not be subject to the Act solely because it introduces a full-service brokerage program.

The rule supersedes staff interpretations under which a full-service broker-dealer would be subject to the Act with respect to accounts for which it provides advice incidental to its brokerage business merely because it offers electronic trading or other forms of discount brokerage.\(^{127}\) These staff interpretations were not compelled by the Act and have led to the odd result that a full-service broker-dealer cannot offer discount brokerage without treating its full-service brokerage accounts as advisory accounts even though the services offered to those full-service accounts remained unchanged. Moreover, the staff interpretations create disincentives for full-service broker-dealers to offer electronic or other types of discount brokerage, and may therefore limit customers’ choices of the types of brokerage service they want from a broker-dealer, and may reduce competition in discount brokerage.\(^{128}\) The new rule makes a broker-dealer’s eligibility for the broker-dealer exception with respect to an account turn on the characteristics of that account and not other accounts. Commenters discussing this aspect of the proposed rule generally supported it.\(^{129}\)

D. Scope of Exception

Rule 202(a)(11)–1(c) provides that a broker-dealer that is registered under the Exchange Act and registered under the Advisers Act would be 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.\(^{130}\) We received few comments regarding this provision of the rule, and we are adopting it as proposed.\(^{131}\) The provision codifies our earlier interpretation of the Act that permits a broker-dealer registered under the Advisers Act to distinguish its brokerage customers from its advisory clients.\(^{132}\)

E. Solely Incidental To

As discussed above, the exceptions from the Advisers Act provided by section 202(a)(11)(C) and new rule 202(a)(11)–1 are available to broker-dealers only with respect to advice provided that is solely incidental to the broker-dealer’s business. (Or, in the case of the rule, to the brokerage services provided to the account.) In the Reproposing Release, we set forth our views on when advice is solely incidental to brokerage services and solicited comment on our interpretation of section 202(a)(11)(C). We also requested comment on our preliminary conclusions that certain advisory services did not appear to be solely incidental to brokerage services.

In general, investment advice is “solely incidental to” the conduct of a broker-dealer’s business within the meaning of section 202(a)(11)(C) and to “brokerage services” provided to accounts under the rule when the advisory services rendered are in connection with and reasonably related to the brokerage services provided. This is consistent with the language Congress chose and the legislative history of the Advisers Act, including contemporaneous industry practice, which indicates Congress’ intent to exclude broker-dealers providing advice as part of traditional brokerage services.\(^{133}\) It is also consistent with the Commission’s contemporaneous construction of the Advisers Act as excepting broker-dealers whose investment advice is given “solely as an incident of their regular business.”\(^{134}\) Several commenters, some of whom examined the statutory language\(^{135}\) and
legislative history themselves, disagreed with us. They urged us to adopt a very narrow view of the meaning of “solely incidental to,” “arguing that it should include only advice that is provided on an “isolated,” “occasional,” “unpredictable” or “limited” basis.” Advice arising out of specific transactions, or advice that is not marketed by a broker-dealer. We disagree with commenters for several reasons.

First, the view that only minor, insignificant, or infrequent advice is excepted by section 202(a)(11)(C) misreads historical background, including the legislative history of the Act. It fails to adequately appreciate the fact that the advice broker-dealers gave as part of their traditional brokerage services in 1940 was often substantial in amount and importance to the customer. This has remained true throughout the following decades. Indeed, the importance of the broker-dealer’s role as advice-giver in connection with brokerage transactions has shaped how we and the self-regulatory organizations have regulated and continue to regulate broker-dealers.

Second, this narrow reading of section 202(a)(11)(C) urged by commenters would lead to brokers being required to treat many, if not most, full service brokerage accounts as advisory accounts, regardless of the nature of the compensation provided to the broker. Thus, it would extend the Advisers Act well beyond what we believe Congress intended when it enacted the broker-dealer exception.

Finally, this narrow view would lead to results we believe even these commenters may not have intended. If a broker could give advice only infrequently (unless it registered under the Advisers Act), customers could not obtain advice in connection with each transaction they propose to make, even if that advice is simply seeking assurances of the wisdom of the proposed transaction. If a broker were permitted to give advice only in connection with a transaction, the broker (unless it registered under the Act) would be unable to advise clients to stay out of the market or to refrain from a particular transaction, or to provide generalized market reports to their clients. Yet brokers have long provided such advice as part of their traditional brokerage services, and continue to do so today. We do not believe that Congress in 1940, fully informed of then-extant brokerage practices, would have passed an exception from the Advisers Act that had such limited utility to broker-dealers.

In a new section (b) of the rule, we are identifying three general circumstances under which we believe the provision of advisory services by a broker-dealer would not be solely incidental to brokerage. In addition, we are reaffirming our long-held view that advisory services provided by certain brokers in connection with wrap fee programs are not solely incidental to brokerage. As the rule makes clear, these are, of course, not an exclusive list of advisory services that are not solely incidental to brokerage and thus may lead to the loss of the broker-dealer exception.

143 Two commenters contended that our discussion of the purpose and scope of the broker-dealer exception is inconsistent with evidence that a “significant” reason for the Advisers Act was the need to regulate the investment advisory activities of broker-dealers, which, the commenters argue, supports the conclusion of the Act. See supra note 27; FPA Letter, supra note 28. In fact, the record shows that investment advisory services provided by broker-dealers simply were not a significant concern of those conducting the hearings on this legislation. See, e.g., Hearings on S. 3580, supra note 40, at 739. The statements on which the commenters rely, on balance, do not support their view that the Advisers Act was designed to reach all but an insignificant amount of broker-dealer investment advice. Indeed, to the contrary, statements by members of Congress during debate on the final version of the legislation indicate that those members recognized exceptions in section 202(a)(11) as broadly excepting investment advice provided by broker-dealers and other professionals. See, e.g., 86 CONG. REC. 9813 (Aug. 1, 1940) (statements of Reps. Hinshaw and Salathé).
1. Separate Contract or Fee

Our rule contains a provision that a broker-dealer that separately contracts with a customer for investment advisory services (including financial planning services) cannot be considered to be providing advice that is solely incidental to its brokerage.144 A separate contract specifically providing for the provision of investment advisory services reflects a recognition that the advisory services are provided independent of brokerage services and, therefore, cannot be considered solely incidental to the brokerage services. Some commenters agreed that separate contracts provide a sensible approach to dealing with this issue.145

Similarly, advisory services are not solely incidental to brokerage services when those services are rendered for a separate fee. Charging a separate fee reflects the recognition that such services are rendered independently of brokerage services and, therefore, cannot be considered to be solely incidental to brokerage services. Many commenters agreed with this approach.146 We understand that many broker-dealers already use the payment of a separate fee as a bright line test to distinguish their brokerage activities from their advisory activities.147

2. Financial Planning

Under rule 202(a)(11)–1(b)(2), a broker-dealer would not be providing advice solely incidental to brokerage if it provides advice as part of a financial plan or in connection with providing planning services and: (i) holds itself out generally to the public as a financial planner or as providing financial planning services; 148 or (ii) delivers to its customer a financial plan; or (iii) represents to the customer that the advice is provided as part of a financial plan or financial planning services. As a result, when the advice described above is provided, a broker-dealer that advertises (or otherwise generally lets it be known that it is available to provide) financial planning services must register under the Act (unless an exemption from registration is available). Further, a broker-dealer that provides such advice and delivers a financial plan to a customer or represents to a customer that its advice is provided as part of a financial plan or in connection with financial planning services must also register under the Act (unless another exemption from registration is available) and treat that customer as an advisory client.

Financial planning services typically involve assisting clients in identifying long-term economic goals, analyzing their current financial situation, and preparing a comprehensive financial program to achieve those goals. A financial plan generally seeks to address a wide spectrum of a client’s long-term financial needs, including insurance, savings, tax and estate planning, and investments, taking into consideration the client’s goals and situation, including anticipated retirement or other employee benefits.149 Typically, what distinguishes financial planning from other types of advisory services is the breadth and scope of the advisory services provided.

Although most financial planners are registered under the Advisers Act or similar state statutes, financial planners today belong to a distinct profession, and financial planning is a separate discipline from portfolio management.150 This development has occurred only relatively recently, over approximately the last twenty-five years—well after the enactment of the Investment Advisers Act in 1940.151

In the Reproposing Release, we expressed the view that the advisory services provided by financial planners and the context in which they are provided may extend beyond what Congress, in 1940, reasonably could have understood broker-dealers to have provided as an advisory service ancillary to their brokerage business.152 Moreover, we expressed concern that some broker-dealers may have promoted “financial planning” as a way of acquiring the confidence of investors and then offered their brokerage services without providing any meaningful financial planning services. We asked for comment on whether we should take an interpretive position that advice provided in connection with financial planning was not solely incidental to brokerage.153 Broker-dealers, on the other hand, argued that financial planning was an integral part of full-service brokerage, and that our proposed interpretation may interfere with broker-dealers’ suitability obligations.155 Some

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144 Section 202(a)(11)–1(b)(1).
145 See Northwestern Mutual Letter, supra note 29; Raymond James Letter, supra note 29.
146 See, e.g., The Consortium Letter, supra note 114; Merrill Lynch Letter, supra note 29; Raymond James Letter, supra note 29; SIA Letter, supra note 29. Some of the commenters further argued, however, that broker-dealers should be permitted to offer financial planning type services without registering under the Advisers Act if the customer does not pay a separate fee for such services. Merrill Lynch Letter, supra note 29; Raymond James Letter, supra note 29; SIA Letter, supra note 29.
147 Some, e.g., SIA Letter, supra note 29.
148 Under the rule, a broker-dealer would hold itself out as a financial planner if, for example, it advertises financial planning services; (2) maintains a listing as a financial planner in a telephone or building directory; (3) lets it be known by word of mouth or otherwise that new financial planning clients will be accepted; or (4) uses letterhead or business cards referring to financial planning services.
149 See Advisers Act Release No. 1092, supra note 4 (“Generally, financial planning services include preparing a financial program for a client based on the client’s financial situation, establishing individual investment objectives. This information normally would cover present and anticipated assets and liabilities, including insurance, savings, investments, and anticipated retirement or other employee benefits. The program developed for the client usually includes general recommendations for a course of activity, or specific actions, to be taken by the client. For example, recommendations may be made that the client obtain insurance or revise existing coverage, establish an individual retirement account, increase or decrease funds held in savings accounts, or invest funds in securities. A financial planner may develop tax or estate plans for clients or refer clients to an accountant or attorney for these services.”).
150 See, Conrad S. Ciccolotto et al., Will Consult For Food! Rethinking Barriers To Professional Entry In The Information Age, 40 AM. BUS. L.J. 905 (2003) (“‘Barriers to Professional Entry’ at 921 (‘Personal financial planning as a distinct profession is quite new’).” Cf. Clifford E. Kirsch, INVESTMENT ADVISER REGULATION (May 2004) (“INVESTMENT ADVISER REGULATION”) at § 2.3.1 (“Even though the financial community distinguishes between financial planners and investment advisers * * * financial planners generally fall within the definition of section 202(a)(11) and are required to register as advisers!”).
commenters were concerned that if the applicability of the Act turned on whether a broker-dealer held itself out as being a financial planner, broker-dealers would simply use a slightly different title, such as “financial consultant,” to create the same impression in the minds of investors.\(^{156}\) We do not believe that financial planning, as it is understood today, necessarily follows as a consequence of rendering brokerage services. Instead, it is a relatively new service that many brokers provide in a manner essentially independent of their brokerage services. That being said, and as we acknowledged in the Reproposing Release, elements of financial planning have been, are, and should be a part of every broker-dealer’s considerations as to the suitability of their recommendations. We have concluded that it would be unwise for us to attempt to distinguish when a suitability analysis ends and financial planning begins, and we do not want to interfere in any way with a broker-dealer’s fulfillment of its suitability obligations.

We have determined instead to rely primarily on how a broker-dealer holds itself out to the public and its customers in distinguishing the advice provided in connection with financial planning from other types of investment advice, such as transaction-specific advice, which may be solely incidental to brokerage.\(^{157}\) Our experience generally informs us that investors understand financial plans and financial planning to mean something different from brokerage. Our investigations showed that investors were confused about the differences among financial service providers generally, but in many cases understood financial planning to be a separate category, and assumed financial planners held responsibilities relating to the long-term needs of their clients.\(^{158}\) Moreover, our approach would provide broker-dealers the certainty they need to determine when their advisory activities will trigger obligations under the Advisers Act because they can control how they hold themselves out to the public and their customers.

Under the rule, a broker-dealer would be subject to the Advisers Act if it portrays itself to the public as a financial planner or as providing financial planning services, whether it uses those particular terms or not. And it must treat as advisory clients all those customers to whom it delivers a financial plan, regardless of what it chooses to call the plan. While we have recognized there are some common elements in a financial plan and a broker-dealer’s advice based on its understanding of a customer’s needs and objectives, which is incumbent in its suitability analysis, we do not consider this broker-dealer advice alone as constituting a financial plan. The broker-dealer must also treat as advisory clients those customers to whom it represents that its advice is part of a financial plan even if it uses some other term to describe the plan.\(^{159}\)

Whether a particular document is, under the rule, a financial plan will turn on whether the document or representation bears the characteristics of a financial plan. Whether a communication represents that the services provided or financial planning services will depend on how a reasonable investor would understand the services described in the communication.\(^{160}\)

3. Holding Out

We have decided not to include in rule 202(a)(11)–1 any other limitations on how a broker-dealer may hold itself out or titles it may employ without complying with the Advisers Act. Many commenters argued that we should prohibit broker-dealers from calling themselves financial advisors, financial consultants or other similar names. These commenters asserted such titles are inconsistent with the broker-dealer exception for advice that is solely incidental to brokerage.\(^ {161}\) Other commenters, however, argued that, in many instances, such titles are fully consistent with the services provided to brokerage customers, whether fee-based or commission-based, and should not be proscribed.\(^ {162}\)

The statutory broker-dealer exception is a recognition by Congress that a broker-dealer’s regular activities include offering advice that could bring the broker-dealer within the definition of investment adviser, but which should nonetheless not be covered by the Act. The terms “financial advisor” and “financial consultant,” for example, are descriptive of such services provided by broker-dealers. As part of their ongoing business, full service broker-dealers consult with or advise customers as to their finances. Indeed, terms such as “financial advisor” and “financial consultant” are among the many generic terms that describe what various persons in the financial services industry do, including banks, trust companies, insurance companies, and commodity professionals. Moreover, we are concerned that any list of proscribed names we develop could lead to the development of new ones with similar connotations.

We believe the better approach, which we are adopting today, is to require broker-dealers to inform clients clearly that they are entering into a brokerage, and not an advisory, relationship. The customer disclosure requirements, which we discuss above, must be included in all customer documents for fee-based brokerage accounts. We encourage brokers to consider making similar disclosure in other communications.\(^ {163}\)

4. Discretionary Asset Management

Under the rule we adopt today, discretionary investment advice is not “solely incidental to” brokerage services within the meaning of the rule (or to the business of a broker-dealer within the meaning of section 202(a)(11)(C)) and

\(^{156}\) See, e.g., CFP Board Letter, supra note 28: FPA Letter, supra note 27.

\(^{157}\) However, we do go beyond focusing exclusively on “holding out” as a determining factor, and also include a restriction on financial planning activity, when we include the delivery of a financial plan as not solely incidental to brokerage. We do so because, even though this restriction may, in certain circumstances, result in limiting a broker-dealer’s “financial planning” activity, this restriction addresses another form of holding out. The delivery of a financial plan to a customer demonstrates to the customer that the broker-dealer is offering its financial planning services, and thus delivery has the same effect as other forms of holding out. Accordingly, we have concluded that, on balance, this type of financial planning activity should also be restricted.

\(^{158}\) Focus Group Report, supra note 118, at 2, 9 & 13. Many focus group participants perceived that financial planning involved separate and distinct services, in addition to services that other financial service professionals might provide.

\(^{159}\) The rule would not, however, require broker-dealers to treat as an advisory client a customer to whom it merely makes known that financial planning services are available but to whom it does not provide such services.

\(^{160}\) Including a disclaimer that comprehensive advisory services were offered to customers would not constitute “financial planning services” or is “not comprehensive” would not permit a broker-dealer to avoid application of the Advisers Act under the rule.


\(^{162}\) See, e.g., Merrill Lynch Letter, supra note 29; Morgan Stanley Letter, supra note 29. See also Northwestern Mutual Letter, supra note 29; Raymond James Letter, supra note 29; Wachovia Letter, supra note 29.

\(^{163}\) See also Sections I and V of this Release for additional steps that may be taken in the future to address issues of investor confusion and broker-dealer marketing.
accordingly, brokers and dealers are not excepted from the Act for any accounts over which they exercise investment discretion as that term is defined in section 3(a)(35) of the Exchange Act164 (except that investment discretion granted by a customer on a temporary or limited basis is excluded). The rule terminates the existing staff approach, under which a discretionary account is subject to the Act only if the broker-dealer has enough other discretionary accounts to trigger the Act.165 Under the new rule, the exception provided by section 202(a)(11)(C) is unavailable for any account over which a broker-dealer exercises investment discretion, regardless of the form of compensation and without regard to how the broker-dealer handles other accounts.166

We believe that a broker-dealer’s authority to effect a trade without first consulting a client is qualitatively distinct from simply providing advice as part of a package of brokerage services. When the broker-dealer has discretion, it is not only the source of advice, it is also the person with the authority to make investment decisions relating to the purchase or sale of securities on behalf of the broker-dealer’s clients. This quasijudicial supervisory or managerial character warrants the protection of the Advisers Act because of the “special trust and confidence inherent” in such relationships.167 Most commenters addressing the issue, including those representing investors,168 advisers,169 broker-dealers,170 and others,171 generally agreed with us.

One commenter who disagreed with this provision disputed our interpretation of the Act. This commenter argued that Congress must have been aware that broker-dealers exercised discretionary authority over commission-based accounts and, by not expressly stating that brokers offering such accounts were subject to the Act, Congress indicated its intent to except such broker-dealers from the Act.172 We disagree. The Advisers Act does not address directly whether a broker-dealer exercising investment discretion over a commission-based account must comply with the Act. The Act applies unless the advisory services are “solely incidental” to the broker-dealer’s business and no special compensation is received.

Whether the exercise of investment discretion meets the requirements of the exception depends on the sort of analysis and judgment that we have made in this rulemaking.

This commenter also suggested that our failure to assert the applicability of the Act to commission-based discretionary accounts in the past, implicitly supports the view that the Act should not apply to such accounts.173 As we explained in the Reproposing Release, however, we have previously expressed concern that brokerage relationships “which include discretionary authority to act on a client’s behalf have many of the characteristics of the relationships to which the protections of the Advisers Act are important.”174 Although we determined not to take action in the past on whether discretionary accounts should be treated as advisory accounts, we explained that our staff would continue to examine the applicability of the federal securities laws to discretionary accounts. Our determination that the Act applies to all accounts over which broker-dealers exercise investment discretion (with certain exceptions) instead of only to the discretionary accounts of those broker-dealers whose accounts are almost exclusively discretionary (the staff’s position since 1978) follows that examination and is based on the reasons stated above and in the Reproposing Release. We are not persuaded by certain commenters’ challenge to our determination relating to discretionary commission-based accounts. Indeed, in criticizing our determination that the exercise of investment discretion cannot be “solely incidental to” a broker-dealer’s business, one commenter acknowledges that (apart from the circumstances the commenter identifies) the exercise of investment discretion “would typically be viewed by customers as investment supervisory services where the broker-dealer or investment adviser makes decisions constrained only by investment guidelines or a description of the investment strategy.”175 We remain unable to conclude that in 1940 Congress would have understood investment discretion to be part of the traditional package of services broker-dealers offered for commissions.176

164 15 U.S.C. 78(a)(35). Under section 3(a)(35) of the Exchange Act, a broker-dealer exercises “investment discretion” with respect to an account if, “directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold or by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though the person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.” Of course, such discretionary accounts continue to be subject to the Exchange Act and SRO rules.

165 As we stated in our Reproposing Release, we believe that an account-by-account approach is preferable for several reasons. First, it better ensures that the Advisers Act is applied to customers who have the sort of relationship with a broker-dealer that the Commission has long recognized the Act was intended to reach. Second, it is consistent with the longstanding view that a broker-dealer is distinct from simply providing advice as part of a package of brokerage services.

166 The fact that discretionary brokerage accounts and financial planning services are subject to the Advisers Act does not affect the obligation of a person engaged in the business of effecting transactions in securities as a broker-dealer under section 15(a) of the Exchange Act. To the extent that broker-dealer registration has previously been required, it will continue to be required.


169 See, e.g., KCAA Letter, supra note 28; T. Rowe Price Letter, supra note 28; CFP Board Letter, supra note 28; Comment Letter of 1st Global Capital Corporation (Feb. 7, 2005); Comment Letter of Ken Kessler (Feb. 8, 2005).

170 See, e.g., TD Waterhouse Letter, supra note 113; Merrill Lynch Letter, supra note 29; Morgan Stanley Letter, supra note 29; Wachovia Letter, supra note 29; NASD Letter, supra note 29; American Express Letter, supra note 33; Comment Letter of Farm Ceb (Feb. 7, 2005).

171 See, e.g., AICPA Letter, supra note 31; D.C. Securities Bureau Letter, supra note 112; PIABA Letter, supra note 31.

172 Morgan, Lewis Letter, supra note 36.

173 Id.


175 See Morgan, Lewis Letter, supra note 36.

176 One commenter challenged our statement in the Reproposing Release that, in the decade before the enactment of the Advisers Act, the NYSE had significantly restricted broker-dealers’ exercise of investment discretion, arguing that the NYSE had progressively more restrictive provisions (and supervision). See Morgan, Lewis Letter, supra note 36. Not only did the NYSE in 1930 limit the individuals within broker-dealer firms who could exercise investment discretion, however, it also subsequently further restricted such accounts by requiring firms wishing to have any employee exercise discretion over a customer’s account (with limited exceptions) to obtain prior approval of such discretionary accounts. See Morgan, Lewis Letter, supra note 36.
are aware of nothing in the legislative history of section 202(a)(11)(C) (or of the Act as a whole) or in the brokerage practices in 1940 that would preclude our interpretation of that section as being unavailable for all accounts over which broker-dealers exercise investment discretion. Given the inherently managerial nature of investment discretion, we see no reason why Congress, as a general matter, would have intended to exclude such services from the reach of the Advisers Act.

Several commenters, however, persuade us that defining “discretionary authority” by reference to section 3(a)(35) of the Exchange Act, would as a practical matter preclude many forms of limited discretion commonly exercised by broker-dealers assisting customers with otherwise non-discretionary brokerage accounts. We believe that such an effect would not benefit brokerage customers, nor would it be necessary to achieve the purpose of the rule. Therefore, the final rule permits broker-dealers to exercise investment discretion on a temporary or limited basis without becoming ineligible for the exception under the rule. In such cases, the customer is granting discretion primarily for execution purposes and is not seeking to obtain discretionary supervisory services. Such discretion must be limited to a transaction or series of transactions and not extend to setting investment objectives or policies for the customer. For example, we would view a broker-dealer’s discretion to be temporary or limited within the meaning of rule 202(a)(11)–1(d) when the broker-dealer is given discretion:

• To purchase or sell securities to satisfy margin requirements;
• To sell specific bonds and purchase similar bonds in order to permit a customer to take a tax loss on the original position;
• To purchase a bond with a specified credit rating and maturity; and
• To purchase or sell a security or type of security limited by specific parameters established by the customer.

5. Wrap Fee Sponsorship

Broker-dealers often serve as sponsors of wrap fee programs, under which broker-dealers effect securities transactions for one or more portfolio managers, which may be independent investment advisers. The sponsoring broker-dealer may provide wrap fee program clients with asset allocation models or with advice about selecting one or more of the portfolio managers in the program. The portfolio managers typically have discretionary authority over the client’s assets. Traditionally, we have not viewed the sponsor’s asset allocation or portfolio manager selection advice as incidental to the brokerage transactions initiated by the portfolio manager and executed by the sponsor. In our Reproposing Release, however, we asked whether such broker-dealers may have available the exception provided by rule 202(a)(11)–1 if, among other things, the portfolio manager selection and asset allocation services could be viewed as solely incidental to the sponsor’s business of brokerage. Commenters urged the Commission to reaffirm its interpretation that portfolio manager selection and asset allocation services involved in wrap fee programs are advisory services that are not solely incidental to brokerage services, and we do so here today.

IV. Effective and Compliance Dates

Rule 202(a)(11)–1 is effective April 15, 2005, except that paragraph (a)(1)(iii) of the rule is effective May 23, 2005. Consistent with the Administrative Procedures Act, the effective date of rule 202(a)(11)–1 is less than 30 days after publication because the rule recognizes an exemption, relieves a restriction, and contains interpretative rules. In addition, the Commission for good cause finds that an effective date later than April 15, 2005 is impracticable, unnecessary and contrary to the public interest because, among other things, temporary rule 202(a)(11)T will expire on that date. Beginning on April 15, 2005, broker-dealers may rely on rule 202(a)(11)–1(a)(2) when they offer discount brokerage accounts excluded under the rule. Also beginning on April 15, 2005, broker-dealers may rely on rule 202(a)(11)–1(a)(1) to provide non-discretionary investment advice in conjunction with fee-based brokerage accounts excluded under the rule. Broker-dealers relying on rule 202(a)(11)–1(a)(1) must comply with the disclosure requirements of paragraph (a)(1)(ii) by July 22, 2005. All advertisements for, and contracts, agreements, applications and other forms governing accounts opened after July 22, 2005 in reliance on rule 202(a)(11)–1(a)(1) must include the disclosure required by paragraph (a)(1)(iii). Broker-dealers relying on rule 202(a)(11)–1(a)(1) with respect to fee-based brokerage accounts opened prior to July 22, 2005 are not required to

For example, a customer may be on vacation or otherwise unavailable for a short period of time and provide specific instructions as to the handling of his accounts during this time.

A broker-dealer may purchase or sell a particular security, so long as all relevant material strategic features (e.g., type of issuer, amount, maturity and yield) are specified by the client.

We have viewed broker-sponsored wrap fee programs as being subject to the Advisers Act.


One of the commenter maintained that the legislative history shows that the Commission was fully aware that broker-dealers were exercising investment discretion over commission-based accounts and not principally in the accounts they handled through their separate investment advisory departments. See Morgan, Lewis Letter, supra note 36. In our view, however, neither of the two documents in the legislative record on which the commenter relies supports this assertion. The commenter appears to assume that simply because a broker-dealer’s customer paid commissions for executions of trades, that customer may not also have received investment advisory services related to those same trades (including the exercise of investment discretion) for a fee from a special advisory department of the same broker-dealer. But the Illinois Legislative Council Report to which the commenter refers was addressing circumstances in which the advisory departments of broker-dealers were paid a fee for advice, and then those departments advised the purchase or sale of securities for which the same broker-dealer firm also received commissions (or mark-ups or markdowns). See Illinois Legislative Council Report, supra note 66, at 1008, 1010, 1014. The same is true of the excerpt that the commenter uses from the Commission’s then General Counsel, which was included in the legislative record. See Memorandum: Federal Power to Regulate Investment Advisers (S. 3580, Title II) (reprinted in Hearings on S. 3580, supra note 40, at 1024).

See, e.g., SIA Letter, supra note 29; UBS Letter, supra note 29; CEMI Letter, supra note 29. See also Morgan, Lewis Letter, supra note 36.

Rule 202(a)(11)–1(d).


179 See 5 U.S.C. 553(d)(1) and (d)(2).

182 We have viewed broker-sponsored wrap fee programs as being subject to the Advisers Act.

See supra note 28; CGMI Letter, supra note 29; UBS Letter, supra note 29; SIA Letter, supra note 29; CEMI Letter, supra note 29. See also Morgan, Lewis Letter, supra note 36.

183 One commentator maintained that the legislative history shows that the Commission was fully aware that broker-dealers were exercising investment discretion over commission-based accounts and not principally in the accounts they handled through their separate investment advisory departments. See Morgan, Lewis Letter, supra note 36. In our view, however, neither of the two documents in the legislative record on which the commenter relies supports this assertion. The commenter appears to assume that simply because a broker-dealer’s customer paid commissions for executions of trades, that customer may not also have received investment advisory services related to those same trades (including the exercise of investment discretion) for a fee from a special advisory department of the same broker-dealer. But the Illinois Legislative Council Report to which the commenter refers was addressing circumstances in which the advisory departments of broker-dealers were paid a fee for advice, and then those departments advised the purchase or sale of securities for which the same broker-dealer firm also received commissions (or mark-ups or markdowns). See Illinois Legislative Council Report, supra note 66, at 1008, 1010, 1014. The same is true of the excerpt that the commenter uses from the Commission’s then General Counsel, which was included in the legislative record. See Memorandum: Federal Power to Regulate Investment Advisers (S. 3580, Title II) (reprinted in Hearings on S. 3580, supra note 40, at 1024).


185 See 5 U.S.C. 553(d)(1) and (d)(2).

amend existing contracts and agreements governing those accounts. 187

With respect to paragraph (b)(3) of rule 202(a)(11)–1, which provides that exercising investment discretion is not “solely incidental to” brokerage services within the meaning of section 202(a)(11)(C) of the Advisers Act, broker-dealers must treat commission-based discretionary accounts as advisory accounts no later than October 24, 2005. With respect to paragraphs (b)(1) and (b)(2) of rule 202(a)(11)–1, broker-dealers must treat as advisory accounts those accounts to which the broker-dealer provides advice in the circumstances described in paragraphs (b)(1) and (b)(2) no later than October 24, 2005.

V. Further Examination of Issues

As we noted at the beginning of this release, this rulemaking has raised a number of important issues, implicating policy concerns well beyond the scope of this rulemaking. Although we have concluded that this rulemaking is not the appropriate mechanism for resolving these concerns, we are committed to pursuing the most effective solutions to these vital issues. Accordingly, the Chairman, after consulting with, and considering the views of, the entire Commission, has directed the Commission staff to report within 90 days on ways in which these issues could be addressed. The staff is to provide a detailed description or outline of any rulemaking action that the staff would be prepared to recommend that the Commission undertake in the near term, or to recommend that the Commission ask the NASD or other SROs to undertake in the near term. The staff is also to report on options and recommendations for a study to compare the levels of protection afforded retail customers of financial service providers under the Securities Exchange Act and the Investment Advisers Act, and to recommend ways to address any investor protection concerns arising from material differences between the two regulatory regimes. The scope of the study would include, but not necessarily be limited to, questions such as:

• Should the Commission seek legislation that would integrate the existing regulatory schemes applicable to broker-dealers and investment advisers that provide services to retail clients?

• Should sales practice standards and advertising rules applicable to advice provided by broker-dealers be enhanced?

• Should broker-dealers who provide investment advice but who are excepted from the Investment Advisers Act nonetheless be subject to the fiduciary obligations imposed by that Act on investment advisers?

• Should obligations under the Investment Advisers Act applicable to dually-registered broker-dealers be modified or streamlined in order to eliminate regulatory overlap and reduce regulatory burdens?

• Are there areas in which the Commission, alone or in concert with other agencies, can engage in investor education efforts to assist investors to better understand the duties and obligations of their financial service providers?

The staff is to provide options and recommendations concerning:

• The scope of the study;

• Appropriate persons, both within and outside of the Commission, to be involved in the study; and

• Time frames for providing deliverables to the Commission, and for expected action by the Commission and its staff.

VI. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits of its rules. In the Reproposing Release, we identified possible costs and benefits of the requirements that now comprise rule 202(a)(11)–1, and requested comment on our analysis. 188 The analysis and the comments we received are discussed below.

A. Fee-Based and Discount Brokerage Accounts

Under rule 202(a)(11)–1(a)(1), broker-dealers will not be deemed to be investment advisers with respect to accounts for which they receive asset-based fees, fixed fees, or similar non-commission compensation, provided that their investment advice is solely incidental to the brokerage services provided to the account, and they make certain disclosures in their advertising and agreements for such accounts. In addition, rule 202(a)(11)–1(a)(2) clarifies that broker-dealers are not subject to the Advisers Act solely because, in addition to full-service brokerage services, they

187 We nevertheless encourage broker-dealers opening fee-based accounts for customers in reliance on the rule after April 15, 2005 but before July 22, 2005, to include with respect to those accounts the disclosure required by rule 202(a)(11)–1(a)(1)(ii).

188 Our 1999 Proposal also analyzed the costs and benefits of our first proposal to keep broker-dealers from being subject to the Advisers Act solely as a result of re-pricing their full-service brokerage services. The comments on our 1999 Proposal have also informed our analysis in preparing this cost benefit analysis.

189 Advisers registered with the Commission must prepare Part 1A of Form ADV and file it with the SEC on the IARD system. Since Part 1A requires advisers to answer basic questions about their businesses, and can be completed using information readily available to the registrant, costs to prepare the form are typically small, but for some larger registrants with complex operations and many employees and affiliates, the costs may be somewhat higher, and may include professional fees. Adviser registrants submitting their Form ADVs through the IARD are required to pay filing fees to the operator of the system which range from $150 to $1,100 initially and $100 to $550 annually. See Designation of NASD Regulation, Inc. to Establish the Investment Adviser Registration Depository; Approval of IARD Fees, Investment Advisers Act Release No. 1888 [July 28, 2000] [65 FR 47807 [Aug. 3, 2000]].

190 Rule 204–3 [17 CFR 275.204–3].

191 Rule 206(4)–7 [17 CFR 275.206(4)–7].
of ethics required under the Act’s rules.  

Because the costs of satisfying these and other requirements under the Advisers Act vary from firm to firm depending on its size and complexity, the benefits to brokers in the form of cost savings are difficult to quantify. Broker-dealer firms did not comment directly on the extent of these benefits in connection with fee-based or full-service accounts. However, we note that several broker-commenters commented on the costs of applying the Advisers Act in other contexts under our Reproposal, and most of these broker-dealers characterized the costs as significant. We also note that the popularity of fee-based accounts is growing rapidly, so the extent of these benefits will grow accordingly. One broker-commenter commented that its holdings of fee-based accounts have tripled since 1999, and one consulting firm estimates that assets in fee-based brokerage programs nationwide grew by 60.9 percent during 2003 and 2004. Several securities markets will also benefit because the rule would preserve the ability of broker-dealers to engage in principal transactions with these fee-based brokerage customers. Principal transactions are an important source of liquidity in some market sectors. While one commentor pointed out that the current effect on liquidity should be minor because fee-based accounts make up a small percentage of the overall securities markets, continuing growth in fee-based accounts could absorb existing regulatory restrictions. Investment Advisers Act Release No. 40 (Jan. 5, 1945), Section 206(3) also prohibits an adviser from obtaining best price and execution for any act in the best interests of their clients, including transaction-by-transaction disclosure if the client is acting and obtaining the blank consent for transactions is not permitted. Section 206(3) of the Advisers Act prohibits an adviser, acting as principal for its own account, purchasing any security from a client, without obtaining the client’s consent before the completion of the transaction. Notification and consent must be obtained separately for each transaction, i.e., blanket consent for transactions is not permitted. Investment Advisers Act Release No. 40 (Jan. 5, 1945). Section 206(3) also prohibits an adviser from acting as broker for both its advisory client and the party on the other side of the brokerage transaction without obtaining its client’s consent before each transaction. The SEC has adopted a rule permitting these “agency cross-transactions” without transaction-by-transaction disclosure if the client has given blanket consent in writing and certain other conditions are met, but the adviser must still act in the best interests of their clients, including the duty to obtain best price and execution for any transaction. Rule 206(3)[2] [17 C.F.R. 275.206(3)[2]]. See Merrill Lynch Letter, supra note 29; Morgan Stanley Letter, supra note 29; UBS Letter, supra note 29.  

FPA Letter, supra note 27. The FPA’s analysis focuses on the $3.9 trillion of securities currently held by individual investors (since the remainder of the $15 trillion in total securities currently in the market are held by institutional investors and public companies that are unlikely to pay asset-based brokerage fees). The currently-estimated $250–$260 billion of assets held in fee-based accounts represents only 6.4% of the $3.9 trillion held by individual investors. See supra note 82 and accompanying text. 199 D.C. Securities Bureau Letter, supra Federal Register note 12.  

SR0s can also ensure that sales practices requirements address any investor protection concerns. For example, the NASD has issued a Notice to Members requiring supervisory procedures to determine whether fee-based brokerage is appropriate for a customer and periodic review of the customer’s accounts to determine whether it continues to be appropriate. See NASD Notice to Members 03–48, supra note 95. Morgan Stanley Letter, supra note 29 (estimating commission savings for all fee-based accounts opened at the broker-dealer from 2000–2004).  

The cost of making the disclosure required by the rule. Broker-dealers relying on the rule’s exception will be required to add a prominent disclosure statement to customer communications for accounts covered by the rule’s exception. The disclosure consists of a brief plain-English statement that indicates the account is a brokerage account, not an advisory account, and encourages the customer to ask questions and gain an understanding of his or her rights and the broker-dealer’s obligations, including the broker-dealer’s obligations to disclose conflicts of interest. The disclosure also discusses compensation issues, including the fact that the firm’s profits and salespersons’ compensation may depend on what the customer buys and may include compensation from other persons. The disclosure statement must also direct the customers to a contact person who can discuss with the customers the differences between brokerage and advisory accounts. The cost of disclosure would be incurred only by those broker-dealers electing to rely on the rule, and as we discuss in our Paperwork Reduction Act analysis, we believe the cost of the disclosure is insignificant. In addition, we estimate that the total industry-wide costs for contact persons at broker-dealers to respond to customer questions about their fee-based accounts will be approximately $3.2 million annually.  

202 See Section VIII of this Release, infra. We estimate that a compliance manager at a broker-dealer relying on the rule would, in connection with reviewing the firm’s new contracts, agreements and other forms (and advertising, if any), spend an additional five minutes each year verifying that the brief disclosure statement is included. At an estimated hourly compensation rate for a compliance manager of $55 per hour (an estimated $5 per firm relying on the exception. See Securities Industry Association, Report on Management & Professional Earnings in the Securities Industry 2003 (Sept. 2003) (average salary for a compliance manager (New York City) is $66,667, to which we have added 35% for benefits and overhead). In addition, based on information submitted by broker-dealers on Form BD as of December 15, 2004, approximately 40 percent of all broker-dealers engage exclusively in specialized types of broker-dealer activities that are extremely unlikely to involve fee-based customer accounts, and approximately 3,850 engage in types of broker-dealer activities that might potentially include offering fee-based accounts. Thus, the industry-wide cost of the disclosure statement is $3.75 per firm × 3,850 firms = $14,437.50.  

203 This estimate is premised on next year’s growth of fee-based accounts continuing at current annual growth rates of approximately 20%, which would add approximately $80 billion to the current base of $268 billion in fee-based accounts. Based on an average size for a fee-based account of $111,600 (our staff’s estimate based on examination observations), this equates to approximately 378,000 new accounts. This estimate is also premised on 75 percent of these new fee-based
One broker-dealer expressed concern about the cost of litigation that might arise challenging the adequacy of contact persons’ discussion of the differences between accounts, particularly in large firms where it may be necessary to make a number of contact persons available.204 However, broker-dealers have typically encountered similar risks in connection with their operations, and can address these risks through usual measures such as written procedures and personnel training, followed up as necessary with compliance oversight. We recognize that large broker-dealers will incur certain costs to implement these controls, but we do not believe they are burdensome, and commenters generally did not suggest they would be. One large broker-dealer commented that disclosure of the differences between fee-based accounts and advisory accounts is consistent with its existing practice, and supported the contact person requirement as preferable to formulating long and detailed written explanations of the differences between accounts.205 Because it would only operate to except from the Advisers Act certain brokerage accounts, rule 202(a)(11)–1(a) will not increase the regulatory burden borne by investment advisers. Some commenters argued the proposed exception would grant broker-dealers—who give investment advice without complying with the Advisers Act—a competitive advantage over investment advisers subject to the Advisers Act, thereby indirectly imposing costs on investment advisers.206 However, to address other issues such as insurance and estate planning, they were not contacted, and they viewed it as being so significant that the competitive advantage instead lies with advisers regulated under the Advisers Act.209

Some commenters additionally asserted rule 202(a)(11)–1(a) will impose costs on investors, who would not receive the same treatment afforded a client of an investment adviser under the Advisers Act.208 These commenters asserted rule 202(a)(11)–1(a)’s disclosure requirements will put investors on notice that there are differences between fee-based brokerage accounts and advisory accounts, and provide them with a contact person who can answer any questions they may have about the investor protections they will receive in their particular circumstances.

Some commenters asserted that the proposed disclosure statement would be insufficient to dispel customer confusion about the differences between brokerage accounts and advisory accounts, citing surveys in which the majority of respondents believed that financial advice was a significant component of brokerage services and that broker-dealers are obligated to act in investors’ best interests.212 Most respondents in these surveys also indicated their choice between a stockbroker and an investment adviser would be affected by the level of investor protection available from each.213 As discussed above, our participants in our investor focus groups found that the disclosure statement, as reproposed, alerted them to the fact that differences existed between brokerage accounts and advisory accounts. While the disclosures did not communicate what those distinctions might mean, focus group participants viewed terms such as “right” and “obligation” as important terms that would prompt them to ask questions, and they viewed the ability to contact a person at the broker-dealer as a positive factor.214 In

204 Wachovia Letter, supra note 29.
205 UBS Letter, supra note 29.
206 Some commenters argued the rule does not receive the same treatment afforded a client of an investment adviser under the Advisers Act.208 However, because the rule is restricted to investment advice which is solely incidental to brokerage services (and broker-dealers have long been subject to this solely incidental standard under section 202(a)(11)(C) of the Advisers Act), the rule does not establish new opportunities for broker-dealers to compete with advisers on the nature of their investment advice.207 Also, in providing this advice, broker-dealers would remain subject to their own costs of regulation under the Exchange Act.208 One broker-dealer characterized these costs of regulation under the Exchange Act as being so significant that the competitive advantage instead lies with advisers regulated under the Advisers Act.209

208 Comment Letter of Sennet Kirk (Feb. 4, 2005).
209 Comment Letter of Bayard Bigelow (Jan. 4, 2005), whose experience in connection with the primary service of stockbrokers is to offer financial advice, and 25 percent indicated advice and assistance in conducting transactions are equally important. According to the TD Waterhouse Survey, 58 percent of respondents believed stockbrokers and investment advisers both have a fiduciary responsibility to act in investors’ best interests.

213 In the TD Waterhouse Survey, 86 percent of respondents indicated it would impact their choice of financial professional if they understood the different levels of investor protection they might receive from stockbrokers and investment advisers. In the CFA Survey, 36 percent of respondents indicated they would be much less likely to use a stockbroker if subject to weaker investor protection rules than a financial planner, and 28 percent said they would be somewhat less likely. Nearly all respondents in both surveys supported the identical investor protection rules for stockbrokers and investment advisers providing financial advice (90 percent in TD Waterhouse Survey; 91 percent in CFA Survey).

214 See Focus Group Report, supra note 118. Participants in our focus groups generally indicated that the title of a financial services professional was not helpful in informing whether the individual’s investor protection rules would apply. Id. at 8 & 13. Nevertheless, they generally indicated that brokers executed trades and were more likely focused on providing advice on specific stocks. Id. at 2–3. Our focus groups differed in methodology from the CFA Survey and the TD Waterhouse Survey. One potentially significant difference is the participants to whom questions were put. The focus group...
or the rule. Second, a broker-dealer that separately contracts with a customer under rule 202(a)(11) for the fee-based account exception to the definition of an advisory activities by a broker-dealer is indirectly by banning a particular form of compensation. Importantly, the direct approach allows investors whose accounts are appropriate for fee-based treatment to obtain the benefits of it.

**B. Advice That Is Not Solely Incidental to Brokerage**

Rule 202(a)(11)–(b) identifies three circumstances in which the provision of advisory services by a broker-dealer is not solely incidental to brokerage, making the broker-dealer ineligible for the exception from the definition of an investment adviser in section 202(a)(11) of the Advisers Act, and making such advisory services ineligible for the fee-based account exception under rule 202(a)(11)–(a). First, a broker-dealer that charges a separate fee or separately contracts with a customer for investment advisory services may not rely on the exception in the statute or the rule. Second, a broker-dealer that participates all managed their investments primarily through a broker or investment adviser. While the surveys covered larger groups of respondents, the surveys did not assess whether the respondents had any experience with broker-dealers or investment advisers. The surveys did not exclude investors who, for example, held only mutual funds acquired directly from the fund or in connection with financial planning services must generally register as investment adviser under the Act.219 A customer or represents to a customer that its advice is part of a financial plan or in connection with financial planning services must also generally register under the Act and treat that customer as an advisory client. Third, a broker-dealer may not rely on the exceptions for any accounts over which it exercises investment discretion.

1. Separate Advisory Services

a. Benefits

Under rule 202(a)(11)–(b), brokers that enter into separate contracts for, or obtain separate compensation to provide, advisory services to an account will be subject to the Advisers Act with respect to those accounts. This provision will benefit broker-dealers by creating greater transparency with regard to whether particular customer relationships are subject to the Advisers Act. As discussed above, a separate contract or fee reflects the recognition that the advisory services are independent of other brokerage services being provided to the investor.218 By clarifying that such separate services are advisory services, the rule will provide certainty for broker-dealers as to whether the Advisers Act applies to their activities.

b. Costs

Broker-dealers entering into separate contracts for, or obtaining separate compensation to provide, advisory services will incur compliance costs under the Advisers Act with respect to the affected accounts. Commenters on the Reproposing Release confirmed, however, that broker-dealers generally treat these kinds of arrangements as advisory activities subject to the Act.219 Accordingly, we believe few broker-dealers will incur new compliance costs in connection with this aspect of rule 202(a)(11)–(b).

For the remaining broker-dealers that may currently be entering into these arrangements without treating them as advisory activities under the Act, compliance costs will be lower if they are dually-registered broker-dealers that have already established a compliance infrastructure under the Advisers Act (or that could shift affected accounts to an affiliated investment adviser), and will be higher for broker-dealers that have not become newly-registered under the Advisers Act, as discussed below. Because these costs of compliance and registration will vary from firm to firm depending on its size and complexity, these costs are difficult to quantify:220

- Affected broker-dealers that are already dually-registered as investment advisers will incur the costs of handling these accounts through their existing Advisers Act infrastructure. For example, under the Advisers Act, they will be required to deliver brochures and make other required disclosures with respect to these accounts, and comply with principal trading restrictions. Nonetheless, we believe these costs will be mitigated because, as registered advisers, these broker-dealers already have systems in place to satisfy such requirements, and the costs are account-specific. Dually-registered broker dealers shifting these accounts to their Advisers Act infrastructure may also incur additional documentation costs to execute new account agreements with affected clients.

- Other affected broker-dealers may not be dually-registered, but may be affiliated with investment advisers. These broker-dealers could implement the requirements of the rule by shifting the advisory activities to their advisory affiliates. In so doing, they will incur the lesser compliance costs similar to dual registrants, rather than the greater costs discussed below for new registrants.

- For affected broker-dealers that will be required to register as investment advisers for the first time, the rule will result in costs associated with registration under the Advisers Act and compliance with the Act’s requirements. Although we acknowledge that the costs of registration and compliance under the Advisers Act are significant,221 we believe that such costs will be mitigated by the fact that these firms can build upon the infrastructure they already have in place as broker-dealers, much of which overlaps with Advisers Act

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215 SIA Letter, supra note 29; Northwestern Mutual Letter, supra note 29. In addition, our focus group participants generally indicated that they were confused by the use of legal terms in the disclosure, such as “fiduciary,” “rights,” and “obligations.”

216 See supra note 95 and accompanying text.

217 See supra note 144 and accompanying text.

218 Typically, in these arrangements, the broker-dealer is charging a separate fee for comprehensive financial planning. See SIA Letter, supra note 29; Merrill Lynch Letter, supra note 29; Morgan Stanley Letter, supra note 29; UBS Letter, supra note 29.

220 While several commenters argued in favor of a rule requiring separately-contracted-for advisory services to be subject to the Advisers Act (see supra note 145), no commenters supplied data on the costs of compliance with this approach.

221 As discussed above in Section V.A.1.a of this Release, these costs include preparing and submitting Part I of Form ADV, the adviser registration form; preparing and distributing client disclosures under Part II of Form ADV; modifying their compliance programs to address the Advisers Act and its requirements, and establishing adviser codes of ethics.
requirements. For example, these broker-dealers are already subject to rules requiring designation of a chief compliance officer, establishment and maintenance of written compliance procedures, maintenance of books and records, and oversight of employee personal securities trading. These broker-dealers will ordinarily also be in compliance with the adviser custody rule.223

2. Holding Out as a Financial Planner

a. Benefits

As a consequence of rule 202(a)(11)–1(b), a broker-dealer that holds itself out generally to the public as a financial planner or as providing financial planning services must generally register as an investment adviser under the Act, and a broker-dealer that delivers a financial plan to a customer or represents to a customer that its advice is part of a financial plan or in connection with financial planning services must also generally register under the Act and treat that customer as an advisory client. Rule 202(a)(11)–1(b) will benefit these customers by making these services subject to the protections of the Advisers Act.

b. Costs

Broker-dealers that deliver financial plans or make representations to customers causing their firms to fall within the provisions of rule 202(a)(11)–1(b) will incur costs to provide that investment advice to those customers in compliance with the Advisers Act. Commenters’ descriptions of current industry practices lead us to believe this aspect of rule 202(a)(11)–1(b) will impose new costs on relatively few broker-dealers. Several commenters indicated it is existing practice in the brokerage industry to use a two-tiered approach to financial planning activities. In the first tier, broker-dealers use certain tools (often questionnaires) to analyze customer financial situations as an aid to meeting the broker-dealers’ suitability obligations, and broker-dealers also provide full-service brokerage customers with basic financial assessment tools (often computer-assisted evaluations) as an integral part of the brokerage process.224

In the second tier, broker-dealers offer comprehensive financial plans as a separate option, for a separate fee, and treat this second-tier service as an advisory activity subject to the Act.225 So long as broker-dealers treat the first-tier activities as an integral part of the brokerage account relationship, and do not represent these activities to be financial plans, financial planning, or financial planning services, they will not be obligated to treat these first-tier activities as advisory services under the Advisers Act.

Broker-dealers whose operations vary from these industry practices will face increased costs as a result of rule 202(a)(11)–1(b), in the form of costs to comply with the Advisers Act. Similar to the costs discussed above in connection with separately-contracted-for advisory services (in Section VI.B.1.b of this Release, above), these compliance costs will be lower for dually-registered broker-dealers that have already established a compliance infrastructure under the Advisers Act (or that could shift affected accounts to an affiliated investment adviser), and will be higher for broker-dealers that will have to become newly-registered under the Advisers Act, as discussed below. Most commenters addressing the costs of treating financial planning activities as an advisory activity under the Act characterized the costs as significant.226 While other commenters indicated they were not significant.227 Because these costs of compliance and registration will vary from firm to firm depending on its size and complexity, these costs are difficult to quantify;228

• To the extent that dually-registered broker-dealers will be required to treat financial planning activities as advisory activities, they will incur costs associated with subjecting such activities to the Advisers Act and its requirements (similar to the costs to dual registrants of separately-contracted-for advisory services, as discussed in Section VI.B.1.b of this Release, above). For example, under the Advisers Act, they will be required to deliver brochures and make other required disclosures with respect to financial planning clients, and comply with principal trading restrictions. Nonetheless, we believe these costs will be mitigated because as advisers, these broker-dealers already have systems in place to satisfy such requirements, and the costs are account-specific. These dually-registered broker-dealers may also incur additional documentation costs to execute new account agreements with financial planning clients.

• Other affected broker-dealers may not be dually-registered, but may be affiliated with investment advisers. These broker-dealers could implement the requirements of the rule by shifting the financial planning activities to their advisory affiliates. In so doing, they will incur the lesser compliance costs similar to dual registrants, rather than the greater costs discussed below for new registrants.

• For broker-dealers whose financial planning activities will require them to register as investment advisers for the first time, the rule will result in costs associated with registration under the Advisers Act and compliance with the Act’s requirements.229 Although we acknowledge (as discussed above in connection with separately-contracted-for advisory services) that the costs of registration and compliance under the Advisers Act are significant,230 we believe that such costs will be mitigated by the fact that these firms can build upon the infrastructure they already have in place as broker-dealers, much of which overlaps with Advisers Act requirements. For example, these broker-dealers are already subject to rules requiring designation of a chief compliance officer, establishment and maintenance of written compliance procedures, maintenance of books and records, and oversight of employee personal securities trading.231

222 See, e.g., NASD Conduct Rule 3013 (chief compliance officer); NASD Conduct Rule 3010(b) (compliance procedures); NASD Conduct Rule 3050 (personal trading); NASD Conduct Rule 3110 (books and records). See also Exchange Act rule 17a–3 [17 CFR 240.17a–3] (records to be maintained by brokers and dealers); Exchange Act rule 17a–4 [17 CFR 240.17a–4] (records to be preserved by brokers and dealers); Exchange Act rule 17a–7 [17 CFR 240.17a–7] (records of non-resident brokers and dealers); New York Stock Exchange Rule 342 (personal trading).


224 See The Consortium Letter, supra note 114; Morgan Stanley Letter, supra note 29; Merrill Lynch Letter, supra note 29; UBS Letter, supra note 29.

225 Id.


227 Comment Letter of Donald S. Loveless (Jan. 20, 2005) at 1.

228 Commenters did not supply any data concerning these costs.

229 In the Reproposing Release, we estimated that approximately 100 broker-dealers will be required to register under the Advisers Act as a consequence of holding themselves out as financial planners. See Reproposing Release, supra note 6, at n. 149–151 and accompanying text. We received no comments on this estimate, and since we issued the Reproposing Release, we have encountered no other information that would cause us to re-evaluate this estimate, or the estimates we discuss in notes 239 and 240 infra.

230 See supra note 221.

231 See supra note 222. In addition, we expect these firms that will be required to register are likely to be smaller firms; larger firms are more likely to be dually-registered already or to be affiliated with registered investment advisers to which they can shift accounts, as discussed above. These smaller firms’ costs to comply with the Advisers Act should be further mitigated by the fact that...
broker-dealers will ordinarily also be in compliance with the adviser custody rule.232

3. Discretionary Brokerage

a. Benefits

Rule 202(a)(11)–1(b) also requires broker-dealers to treat discretionary brokerage accounts as advisory accounts under the Advisers Act. The rule will benefit investors to the extent they are confused as to the nature of discretionary brokerage. As previously noted, in many respects discretionary brokerage relationships are difficult to distinguish from investment advisory relationships. By definitively treating such accounts as advisory accounts, the rule will promote understanding by investors of the nature of the service they are receiving. More importantly, we believe that it will ensure that accounts that have the supervisory or managerial character we have identified as warranting Advisers Act coverage are, in fact, covered.

b. Costs

Rule 202(a)(11)–1(b) will entail costs for broker-dealers that maintain discretionary accounts, in the form of Advisers Act compliance costs for these accounts. Similar to the costs discussed above in connection with separately-contracted-for advisory services and financial planning services (in Sections VI.B.1.b and VI.B.2.b of this Release, above), these costs will be lower for dual-registered broker-dealers that have already established a compliance infrastructure under the Advisers Act (or that can shift affected accounts to an affiliated investment adviser), and will be higher for broker-dealers that will be required to register under the Advisers Act.233 Commenters addressing the costs of treating discretionary accounts as advisory accounts under the Act characterized the costs as significant.234 Because these costs of compliance and registration vary from firm to firm depending on its size and complexity, these costs are difficult to quantify:

- For broker-dealers already dually-registered as investment advisers, rule 202(a)(11)–1(b) will result in costs to treat discretionary accounts as advisory accounts. Based on staff experience, we believe that many dual registrants currently treat discretionary accounts as advisory accounts, and will be in compliance with the new rule without further action. To the extent that other dually-registered broker-dealers will be required to treat discretionary accounts as advisory accounts, they will incur costs associated with subjecting such accounts to the Advisers Act and its requirements (similar to the costs to dual registrants of separately-contracted-for advisory services and financial planning services, as discussed in Sections VI.B.1.b and VI.B.2.b of this Release, above). For example, under the Advisers Act, they will be required to deliver brochures and make other required disclosures with respect to these accounts, and observe principal trading restrictions. Nonetheless, we believe these costs would be mitigated because as advisers, these broker-dealers already have systems in place to satisfy such requirements, and the costs are account-specific. Several commenters focused specifically on principal trading restrictions, urging that such restrictions would be particularly inconsistent with current practices of certain fixed income institutional investors, who grant broker-dealers discretion in view of the firm’s ability to effect trades on a principal basis.

- For investment advisers for the first time, rule 202(a)(11)–1(b) will result in costs associated with registration under the Advisers Act and compliance with the Act’s requirements.239 In so doing, they will incur the lesser compliance costs of the types discussed above for dual registrants, rather than the greater costs discussed below for new registrants.

- For broker-dealers whose maintenance of discretionary accounts will require them to register as investment advisers for the first time, rule 202(a)(11)–1(b) also requires

232 See supra note 223.

233 Some broker-dealers have limited their acceptance of discretionary accounts in accordance with our staff’s view that only broker-dealers who hold a limited number of such accounts, as opposed to those whose accounts are almost exclusively discretionary, can avoid being deemed an investment adviser. To the extent that broker-dealers have done so, there would be a correspondingly limited amount of account-specific costs for broker-dealers in complying with rule 202(a)(11)–1(b). However, one commenter indicated that the majority of accounts at his broker-dealer were discretionary accounts. Comment Letter of Arthur S. Pesner (Feb. 3, 2005) (“Pesner Letter”).

234 SIA Letter, supra note 29; Merrill Lynch Letter, supra note 29; Pesner Letter, supra note 233.

235 Commenters did not supply any data concerning these costs.

236 One commenter focused on additional recordkeeping requirements applicable under Advisers Act rule 204–2 (such as retaining copies of any written recommendations to clients). SIA Letter, supra note 29. Dual-registered broker dealers converting discretionary accounts may also incur additional documentation costs to execute new account agreements with clients whose accounts are affected by the new rule.

237 These commenters noted that some market sectors, such as fixed income, are dominated by principal trading, and applying principal transaction restrictions might negatively affect liquidity in these markets. They also expressed concerns that the notice procedures applicable to principal transactions under the Advisers Act might make it impossible for them to obtain best execution for these fixed income investors. SIA Letter, supra note 29; Morgan Stanley Letter, supra note 29; UBS Letter, supra note 29.

238 See supra notes 178–181 and accompanying text.

239 In the Reproposing Release, we estimated that there are only approximately 290 broker-dealers (approximately) that are not dually-registered as investment advisers and maintain discretionary accounts. We estimated that approximately one-third of this group will transfer their discretionary accounts to their advisory affiliates. (We also estimated approximately one-fifth of this group will be required to register as investment advisers for the first time.) See Reproposing Release, supra note 6, n. 139–142 and accompanying text. We received no comments on these estimates.

240 In the Reproposing Release, we estimated that approximately 65 broker-dealers will be required to register under the Advisers Act as a consequence of continuing to maintain discretionary accounts. See Reproposing Release, supra note 6, n. 138–142 and accompanying text. We received no comments on this estimate.

241 See supra note 221.
of written compliance procedures, maintenance of books and records, and oversight of employee personal securities trading. These broker-dealers will ordinarily also be in compliance with the adviser custody rule.

C. Wrap Fee Sponsorship

We are re-affirming our current interpretation regarding wrap program sponsorship. Since this does not change existing obligations or relationships, no new costs or benefits result.

VII. Effects of Competition, Efficiency and Capital Formation

Section 202(c) of the Advisers Act mandates that the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

A. Fee-Based and Discount Brokerage Programs

Rule 202(1)(a)–(1)(a) provides that a broker-dealer providing advice that is incidental to its brokerage services can retain its exception from the Advisers Act regardless of whether it charges an asset-based or fixed fee (rather than commissions, mark-ups, or mark-downs) for its services. The rule also provides that broker-dealers are not subject to the Act solely because in addition to offering full-service brokerage they offer discount brokerage services, including execution-only brokerage, for reduced commission rates.

We do not anticipate that rule 202(1)(a)–(1)(a) will negatively affect competition. Many commenters addressing our 1999 Proposal and our Reproposing Release raised concerns that the proposed rule would grant broker-dealers who give investment advice without registering under the Advisers Act a competitive advantage over investment advisers subject to the Advisers Act. However, as discussed in Section III.A.1 of this Release, above, broker-dealers have historically provided advisory services to their brokerage customers. As discussed in Section III.A.2 of this Release, above, broker-dealers do so subject to the cost implications of compliance with broker-dealer regulation. Because the rule does not change the types of advice broker-dealers may provide (which advice must continue to be solely incidental to brokerage) or materially change their compliance costs, we do not anticipate it will create a competitive advantage.

Rule 202(1)(1)–(1)(a) may increase efficiency by removing impediments to fee-based brokerage programs. Fee-based brokerage programs, as we discuss above, respond to changes in the market place for retail brokerage, and concerns that we have long held about the incentives that commission-based compensation provides for broker-dealers to churn accounts, recommend unsuitable securities, and engage in aggressive marketing. The availability of fee-based brokerage programs may better align the interests of broker-dealers and their customers. The availability of fee-based and discount brokerage programs should also enable brokerage customers to choose these new programs when they represent a more efficient alternative than commission-based brokerage. One commenter agreed, arguing that pricing flexibility generally promotes economic efficiency.

If rule 202(1)(1)–(1)(a) has any effect on capital formation, it will be indirect, and positive. By removing impediments to fee-based and discount brokerage programs which may be more desirable for customers than commission-based programs, rule 202(1)(1)–(1)(a) may open the door to greater investor participation in the securities markets.

B. Discretionary Brokerage and Financial Planning

Rule 202(1)(1)–(1)(b) specifies three situations in which the provision of advisory services by a broker-dealer is not solely incidental to brokerage, and such advisory services are thus ineligible for the fee-based account exception under rule 202(1)(1)–(1)(a) or the exception from the definition of an investment adviser in section 202(1)(1)(C) of the Advisers Act. First, a broker-dealer that charges a separate fee or separately contracts with a customer for investment advisory services may not rely on the exceptions.

Second, a broker-dealer that holds itself out generally to the public as a financial planner or as providing financial planning services must generally register as an investment adviser under the Act, and a broker-dealer that delivers a financial plan to a customer or represents to a customer that it is a financial planner or providing a financial plan or financial planning services must also generally register under the Act and treat that customer as an advisory client. Third, a broker-dealer may not rely on the exceptions for any accounts over which it exercises investment discretion.

Rule 202(1)(1)–(1)(b) will not negatively affect competition. Some broker-dealers would be required to begin treating as advisory clients those customers with whom they make separate contractual or compensation arrangements for advisory services, or to whom they provide certain financial planning or discretionary account services. However, as discussed above, we believe the majority of broker-dealers already apply the Advisers Act in the circumstances covered by rule 202(1)(1)–(1)(b), so we expect the effects of the rule will not be widespread.

As the remaining firms begin applying the Advisers Act to these relationships as a result, they will be competing on a more even footing with broker-dealers who already do so. We do not believe rule 202(1)(1)–(1)(b) will have any measurable effect on efficiency or capital formation.

VIII. Paperwork Reduction Act

Rule 202(1)(1)–(1)(a) contains “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995. The title of this new collection is “Rule 202(1)(1)–(1) under the Investment Advisers Act of 1940—Certain Broker-Dealers Deemed Not To Be Investment Advisers,” and the Commission, at the time of its 1999 Proposal, submitted it to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. OMB has approved, and subsequently extended, this collection under control number 3235–0532 (expiring on October 31, 2006).

Rule 202(1)(1)–(1)(b) will have the effect of requiring certain broker-dealers to register under the Advisers Act.

See supra note 222. In addition, (similar to the costs for broker-dealers engaged in financial planning, supra note 231,) we expect these firms that will be required to register are likely to be smaller firms; larger firms are more likely to be dually-registered already or to be affiliated with registered investment advisers to which they can shift accounts, as discussed above. These smaller firms’ costs to comply with the Advisers Act should be further mitigated by the fact that their operations are unlikely to be complex or widespread.

See supra note 223.

See supra note 229.

Rule 202(1)(1)–(1)(c) further provides 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 Advisers Act.

See supra note 12 and accompanying text.

Northwestern Mutual Letter, supra note 29.

See supra Sections VI.B.1.b, VI.B.2.b, and VI.B.3.b of this Release.

44 U.S.C. 3501 to 3520.

Rule 202(1)(1)–(1)(b) describes three scenarios in which a broker-dealer may not rely on the broker-dealer exception from the definition of an “investment adviser” under the Advisers Act and rule 202(1)(1)–(1)(a). First, a broker-dealer that...
Rule 202(a)(11)–1(b) will therefore likely increase the number of respondents under several existing collections of information, and, correspondingly, increase the annual aggregate burden under those existing collections of information. The Commission has submitted to OMB, in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11, the existing collections of information for which the annual aggregate burden would correspondingly increase as a result of rule 202(a)(11)–1(b). The titles of the affected collections of information are: “Form ADV,” “Form ADV–W and Rule 203–2,” “Rule 203–3 and Form ADV–H,” “Form ADV–NR,” “Rule 204–2,” “Rule 204–3,” “Rule 204A–1,” “Rule 206(4)–3,” “Rule 206(4)–4,” “Rule 206(4)–6,” and “Rule 206(4)–7,” all under the Advisers Act. The existing rules that will be affected by rule 202(a)(11)–1(b) contain currently approved collection of information numbers under OMB control numbers 3235–0049, 3235–0313, 3235–0538, 3235–0240, 3235–0276, 3235–0047, 3235–0506, 3235–0242, 3235–0345, 3235–0571 and 3235–0585, respectively.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

A. Certain Broker-Dealers Deemed Not To Be Investment Advisers

Under rule 202(a)(11)–1(a), broker-dealers will be deemed not to be “investment advisers” as defined in the Advisers Act with respect to certain accounts. With respect to these accounts, such broker-dealers will not be subject to the provisions of the Advisers Act, including the various registration, disclosure and recordkeeping requirements under the Act. Under rule 202(a)(11)–1(a), a broker-dealer will not be deemed to be an investment adviser with respect to an account for which it receives special compensation, provided that the broker-dealer’s investment advice is solely incidental to the brokerage services provided to the account and the broker-dealer makes certain disclosures in its advertising and agreements for such accounts.

In the Reproposing Release, we noted that broker-dealers taking advantage of the proposed exception would need to maintain certain records that establish their eligibility to do so, but that rules under the Exchange Act already require the maintenance of those records. We concluded that this facet of the proposed exception would not increase the recordkeeping burden for any broker-dealer. To rely on the rule 202(a)(11)–1(a) with respect to a particular brokerage account, advertisements and contracts or agreements for the account must contain a prominent disclosure statement. The disclosure consists of a brief plain English statement that indicates the account is a brokerage account, not an advisory account, and encourages the customer to ask questions and gain an understanding of his or her rights and the broker-dealer’s obligations, including the broker-dealer’s obligations to disclose conflicts of interest. The disclosure also discusses compensation issues, including the fact that the firm’s profits and salespersons’ compensation may depend on what the customer buys and may include compensation from other persons. The disclosure statement must also direct the customers to a contact person who can discuss with the customers the differences between brokerage and advisory accounts. This information is necessary to prevent customers and prospective customers from mistakenly believing that the account is an advisory account subject to the Advisers Act, and will be used to assist customers in making an informed decision on whether to establish an account. The collection of information requirement under rule 202(a)(11)–1(a) is mandatory. In general, the information collected pursuant to the rule will be held by the broker-dealers. Staff of the Commission, self-regulatory organizations, and other securities regulatory authorities would gain access to the information only upon request. Any collected information received by the Commission will be kept confidential subject to applicable law, including the provisions of the Freedom of Information Act [5 U.S.C. 552].

The burden to comply with this provision of rule 202(a)(11)–1(a) will be insignificant. In preparing model contracts and advertisements, for example, compliance officials will be required to verify that the appropriate disclosure is made. In the Reproposing Release, we estimated that the average annual burden for ensuring compliance is five minutes per broker-dealer taking advantage of the rule. We estimated that if all of the approximately 8,100 broker-dealers registered with us took advantage of the rule, the total estimated annual burden would be 673 hours.

In our 1999 Proposal, the rule only required a prominent statement that the account is a brokerage account. In our Reproposing Release, we proposed to add disclosures that the account is not an advisory account; that the firm’s obligations with respect to such accounts may differ; and that, as a consequence, the customer’s rights and the firm’s duties and obligations to the customer, including the scope of the firm’s fiduciary obligations, may differ. We also proposed to require the broker-dealer to identify an appropriate person at the firm with whom the customer can discuss the differences. The rule today modifies the prominent statement slightly to put the prominent disclosure statement into plain English, and to discuss broker compensation issues briefly. However, these modifications to the disclosure obligations under rule 202(a)(11)–1(a) do not increase the estimated paperwork burden for this collection.

B. Broker-Dealers Providing Discretionary Advice or Financial Plans

As discussed above, under rule 202(a)(11)–1(b), broker-dealers providing advisory services in three scenarios will be deemed advisers subject to the Advisers Act. Rule 202(a)(11)–1(b) will therefore increase the number of respondents under the existing collections of information identified above, and, correspondingly, increase the annual aggregate burden under those existing collections of

251 See Reproposing Release, supra note 6, at Section VII. Specifically, rule 202(a)(11)–1(a)(i) and rule 202(a)(11)–1(b)(1)(ii) have the effect of limiting the application of rule 202(a)(11)–1(a) to accounts over which a broker-dealer does not exercise investment discretion. Rule 202(a)(11)–1(a)(ii) also requires a prominent statement be made in agreements governing the accounts to which the rule applies. Under Exchange Act rules, broker-dealers are already required to maintain all “evidence of the granting of discretionary authority given in any respect of any account” [17 CFR 240.17a–4(b)(6)] and all “written agreements * * * with respect to any account” [17 CFR 240.17a–4(b)(7)].

252 As discussed in the Reproposing Release, broker-dealers already are required to maintain records regarding their advertisements under existing self-regulatory organizations’ rules.


254 See Reproposing Release, supra note 6, at Section VII.

255 0.083 hours × 8,100 broker-dealers = 673 hours.

256 See supra note 250.
information. All of these collections of information are mandatory, and respondents in each case are investment advisers registered with us, except that (i) respondents to Form ADV are also investment advisers applying for registration with us; (ii) respondents to Form ADV-NR are non-resident general partners or managing agents of registered advisers; (iii) respondents to rule 204A–1 include “access persons” of an adviser registered with us, who must submit reports of their personal trading to their advisory firms; (iv) respondents to rule 206(4)–3 are advisers who pay cash fees to persons who solicit clients for the adviser; (v) respondents to rule 206(4)–4 are advisers with certain disciplinary histories or a financial condition that is reasonably likely to affect contractual commitments; and (vi) respondents to rule 206(4)–6 are only those SEC-registered advisers that vote their clients’ securities. Unless otherwise noted below, responses are not kept confidential. We cannot quantify with precision the number of broker-dealers that will be new registrants with the Commission under the Advisers Act as a result of Rule 202(a)(11)–1(b). In the Reproducing Release, we set out our analysis that an estimated 195 broker-dealers would be required to register, and requested public comments. We received no comments on this analysis, and have encountered no information since the time of the Reproducing Release that would cause us to re-evaluate it. Thus, for purposes of this analysis, we have estimated 195 new firms would be required to register with the SEC as investment advisers as a result of rule 202(a)(11)–1(b).

1. Form ADV

Form ADV is the investment adviser registration form. The collection of information under Form ADV is necessary to provide advisory clients, prospective clients, and the Commission with information about the adviser, its business, and its conflicts of interest. Rule 203–3 requires every person applying for investment adviser registration with the Commission to file Form ADV. Rule 204–1 requires each SEC-registered adviser to file amendments to Form ADV at least annually, and requires advisers to submit electronic filings through the IARD. This collection of information is found at 17 CFR 275.203–1, 275.204–1, and 279.1. The currently approved collection of information in Form ADV is 131,611 hours. We estimate that 195 new respondents will file one complete Form ADV and one amendment annually, and comply with Form ADV requirements relating to delivery of the adviser code of ethics. Accordingly, we estimate rule 202(a)(11)–1(b) will increase the annual aggregate information collection burden under Form ADV by 5,792 hours for a total of 137,403 hours.

2. Form ADV–W and Rule 203–2

Rule 203–2 requires every person withdrawing from investment adviser registration with the Commission to file Form ADV–W. The collection of information is necessary to apprise the Commission of advisers who are no longer operating as registered advisers. This collection of information is found at 17 CFR 275.203–2 and 17 CFR 279.2. The currently approved collection of information in Form ADV–W is 578 hours. We estimate that the 195 broker-dealer/advisers that will be new registrants will withdraw from SEC registration at a rate of approximately 16 percent per year, the same rate as other registered advisers, and will file for partial and full withdrawals at the same rates as other registered advisers, with approximately half of the filings being full withdrawals and half being partial withdrawals. Accordingly, we estimate the rule 202(a)(11)–1(b) will increase the annual aggregate information collection burden under Form ADV–W and rule 203–2 by 16 hours for a total of 594 hours.

3. Rule 203–3 and Form ADV–H

Rule 203–3 requires that advisers requesting either a temporary or continuing hardship exemption submit the request on Form ADV–H. An adviser requesting a temporary hardship exemption is required to file Form ADV–H, providing a brief explanation of the nature and extent of the temporary technical difficulties preventing it from submitting a required filing electronically. Form ADV–H requires an adviser requesting a continuing hardship exemption to indicate the reasons the adviser is unable to submit electronic filings without undue burden and expense. Continuing hardship exemptions are available only to

advisers that are small entities. The collection of information is necessary to provide the Commission with information about the basis of the adviser’s hardship. This collection of information is found at 17 CFR 275.203–3, and 279.3. The currently approved collection of information in Form ADV–H is 11 hours. We estimate that approximately one broker-dealer/adviser among the new registrants will file for a temporary hardship exemption and one will file for a continuing exception. Accordingly, we estimate the rule 202(a)(11)–1(b) will increase the annual aggregate information collection burden under Form ADV–H by 2 hours for a total of 13 hours.

4. Form ADV–NR

Non-resident general partners or managing agents of SEC-registered investment advisers must make a one-time filing of Form ADV–NR with the Commission. Form ADV–NR requires these non-resident general partners or managing agents to furnish us with a written irrevocable consent and power of attorney that designates the Secretary of the Commission, among others, as an agent for service of process, and that stipulates and agrees that any civil suit or action against such person may be commenced by service of process on the Secretary of the Commission. The collection of information is necessary for us to obtain appropriate consent to permit the Commission and other parties to bring actions against non-resident partners or agents for violations of the federal securities laws. This collection of information is found at 17 CFR 279.4. The currently approved collection of information in Form ADV–NR is 17 hours. We estimate that approximately one broker-dealer/adviser among the new registrants will make this filing. Accordingly, we estimate the rule 202(a)(11)–1(b) will increase the annual aggregate information collection burden under Form ADV–NR by one hour for a total of 18 hours.

5. Rule 204–2

Rule 204–2 requires SEC-registered investment advisers to maintain copies of certain books and records relating to their advisory business. The collection of information under rule 204–2 is necessary for the Commission staff to use in its examination and oversight program. Responses provided to the Commission in the context of its examination and oversight program are

257 Supra note 6, at Section VII.

258 195 filings of the complete form at 22.25 hours each, plus 195 amendments at 0.75 hours each, plus 6.7 hours for each of the 195 broker-dealer/advisers to deliver copies of their codes of ethics to 10 percent of their 670 clients annually who request it, at 0.1 hours per response. (195 × 22.25) + (195 × 0.75) + (195 × (670 × 0.1 × 0.1)) = 5,791.5.

259 32 filings (195 × 0.16), consisting of 16 full withdrawals at 0.75 hours each and 16 partial withdrawals at 0.25 hours each. (16 × 0.75) + (16 × 0.25) = 16.

260 2 filings at 1 hour each.

261 1 filing at 1 hour each.
generally kept confidential. The records that an adviser must keep in accordance with rule 204–2 must generally be retained for not less than five years. This collection of information is found at 17 CFR 275.204–2. The currently approved collection of information for rule 204–2 is 1,724,870 hours, or 191.78 hours per registered adviser. We estimate that all 195 broker-dealer/advisers that will be new registrants will maintain copies of records under the requirements of rule 204–2. Accordingly, we estimate rule 202(a)(11)–1(b) will increase the annual aggregate information collection burden under rule 204–2 by 37,397 hours for a total of 1,762,267 hours.

6. Rule 204–3

Rule 204–3, the “brochure rule,” requires an investment adviser to deliver to prospective clients a disclosure statement containing specified information as to the business practices and background of the adviser. Rule 204–3 also requires that an investment adviser deliver, or offer, its brochure on an annual basis to existing clients in order to provide them with current information about the adviser. The collection of information is necessary to assist clients in determining whether to retain, or continue employing, the adviser. This collection of information is found at 17 CFR 275.204–3. The currently approved collection of information for rule 204–3 is 6,089,293 hours, or 694 hours per registered adviser, assuming each adviser has on average 670 clients. We estimate that all 195 broker-dealer/advisers that will be new registrants will provide brochures as required by rule 204–3. Accordingly, we estimate rule 202(a)(11)–1(b) will increase the annual aggregate information collection burden under rule 204–3 by 135,330 hours for a total of 6,224,623 hours.

7. Rule 204A–1

Rule 204A–1 requires SEC-registered investment advisers to adopt codes of ethics setting forth standards of conduct expected of their advisory personnel and addressing conflicts that arise from personal securities trading by their personnel, and requiring advisers’ “access persons” to report their personal securities transactions. The collection of information under rule 204A–1 is necessary to establish standards of business conduct for supervised persons of investment advisers and to facilitate investment advisers’ efforts to prevent fraudulent personal trading by their supervised persons. This collection of information is found at 17 CFR 275.204A–1. The currently approved collection of information for rule 204A–1 is 1,060,842 hours, or 117.95 hours per registered adviser. We estimate that all 195 broker-dealer/advisers that will be new registrants will adopt codes of ethics under the requirements of rule 204A–1 and require personal securities transaction reporting by their “access persons.” Accordingly, we estimate rule 202(a)(11)–1(b) will increase the annual aggregate information collection burden under rule 204A–1 by 23,000 hours for a total of 1,083,842 hours.

8. Rule 206(4)–3

Rule 206(4)–3 requires advisers who pay cash fees to persons who solicit clients for the adviser to observe certain procedures in connection with solicitation activity. The collection of information under rule 206(4)–3 is necessary to inform advisory clients about the nature of a solicitor’s financial interest in the recommendation of an investment adviser, so the client may consider the solicitor’s potential bias, and to protect investors against solicitation activities being carried out in a manner inconsistent with the adviser’s fiduciary duties. This collection of information is found at 17 CFR 275.206(4)–3. The currently approved collection of information for rule 206(4)–3 is 12,355 hours. We estimate that approximately 20 percent of the 195 broker-dealer/advisers that will be new registrants will be subject to the cash solicitation rule, the same rate as other registered advisers. Accordingly, we estimate rule 202(a)(11)–1(b) will increase the annual aggregate information collection burden under rule 206(4)–3 by 2,527 hours for a total of 12,630 hours.

9. Rule 206(4)–4

Rule 206(4)–4 requires registered investment advisers to disclose to clients and prospective clients certain disciplinary history or a financial condition that is reasonably likely to affect contractual commitments. This collection of information is necessary for clients and prospective clients in choosing an adviser or continuing to employ an adviser. This collection of information is found at 17 CFR 275.206(4)–4. The currently approved collection of information for rule 206(4)–4 is 11,383 hours. We estimate that approximately 17.3 percent of the 195 broker-dealer/advisers that will be new registrants will be subject to rule 206(4)–4, the same rate as other registered advisers. Accordingly, we estimate rule 202(a)(11)–1(b) will increase the annual aggregate information collection burden under rule 206(4)–4 by 255 hours for a total of 11,638 hours.

10. Rule 206(4)–6

Rule 206(4)–6 requires an investment adviser that votes client securities to adopt written policies reasonably designed to ensure that the adviser votes in the best interests of clients, and requires the adviser to disclose to clients information about those policies and procedures. This collection of information is necessary to permit advisory clients to assess their adviser’s voting policies and procedures and to monitor the adviser’s performance of its voting responsibilities. This collection of information is found at 17 CFR 275.206(4)–6. The currently approved collection of information for rule 206(4)–6 is 119,873 hours. We estimate that all 195 broker-dealer/advisers that will be new registrants will vote their clients’ securities. Accordingly, we estimate rule 202(a)(11)–1(b) will increase the annual aggregate information collection burden under rule 206(4)–6 by 3,257 hours for a total of 123,130 hours.

11. Rule 206(4)–7

Rule 206(4)–7 requires each registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, review those policies and procedures annually, and designate an individual to serve as chief compliance officer. This collection of information under rule 206(4)–7 is necessary to ensure that investment advisers maintain comprehensive internal programs that promote the advisers’ compliance with the Advisers Act. This collection of information is found at 17 CFR
IX. Regulatory Flexibility Analysis

The Commission proposed rule 202(a)(11)–1 and related proposed interpretations of section 202(a)(11)(C) of the Advisers Act, in a release on January 6, 2005 (“Reproposing Release”). An Initial Regulatory Flexibility Analysis (“IRFA”) was published in the Reproposing Release. No comments were received specifically on the IRFA. The Commission has prepared the following Final Regulatory Flexibility Analysis (“FRFA”) in accordance with section 3(a) of the Regulatory Flexibility Act.275 It relates to rule 202(a)(11)–1.

A. Reasons for Action

Sections I through III of this Release describe the reasons for and objectives of rule 202(a)(11)–1. As discussed in detail above, rule 202(a)(11)–1(a) is designed to permit broker-dealers to offer new types of accounts, which charge asset-based or fixed fees for full-service brokerage services or make available discount brokerage services, without unnecessarily triggering registration under the Advisers Act. Rule 202(a)(11)–1(b) identifies three situations in which provision of investment advisory services to broker-dealers’ customers is not “solely incidental to” brokerage business within the meaning of the broker-dealer exception from the definition of an investment adviser in section 202(a)(11)(C) of the Advisers Act or within the exception provided by rule 202(a)(11)–1(a), making the broker-dealer ineligible for the exception from the definition of an investment adviser in section 202(a)(11)(C) of the Advisers Act, and making such advisory services ineligible for the fee-based account exception under rule 202(a)(11)–1(a).273

Our objectives with rule 202(a)(11)–1 include fostering the availability of fee-based and discount brokerage programs to brokerage customers and reducing investor confusion as to whether they are receiving brokerage services or advisory services.274

B. Significant Issues Raised by Public Comment

We received no comments on our IRFA. We discuss comments we received on the substantive rulemaking above.275

C. Small Entities

Rule 202(a)(11)–1 applies to all brokers-dealers registered with the Commission, including small entities. Under Commission rules, for purposes of the Regulatory Flexibility Act, a broker-dealer generally is a small entity if it had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared and it is not affiliated with any person (other than a natural person) that is not a small entity.276

The Commission estimates that as of December 31, 2003, approximately 905 Commission-registered broker-dealers were small entities.277 The Commission assumes for purposes of this FRFA that all of these small entities could rely on the exceptions provided by rule 202(a)(11)–1(a), although it is not clear how many would actually do so. Additionally, it is not clear how many of these small entities would be affected by proposed rule 202(a)(11)–1(b), which results in certain advisory services not being exempt from the Advisers Act.278 Therefore, for purposes of this FRFA, the Commission also assumes that all of these small entities could be affected by the new rules.

D. Reporting, Recordkeeping, and Other Compliance Requirements

The provisions of rule 202(a)(11)–1(a), pertaining to fee-based and discount brokerage accounts, impose no new reporting or recordkeeping requirements, and will not materially alter the time required for broker-dealers to comply with the Commission’s rules. Rule 202(a)(11)–1(a) is designed to prevent unnecessary regulatory burdens from being imposed on broker-dealers. Broker-dealers taking advantage of rule 202(a)(11)–1(a) with respect to fee-based brokerage accounts will be required to make certain disclosures to customers and potential customers in advertising and contractual materials. Under Exchange Act rules, however, broker-dealers are already required to maintain these documents as “written agreements * * * with respect to any account.”279

Under rule 202(a)(11)–1(b), advisory services provided by broker-dealers will be outside the broker-dealer exception from the Advisers Act under three scenarios. Thus, broker-dealers providing advisory services as described in any of these three scenarios will be subject to the Advisers Act.280 Although some broker-dealers providing advisory services as described in one or more of these three scenarios are already registered as investment advisers, rule 202(a)(11)–1(b) will result in other broker-dealers having to newly register as advisers, and will subject these brokers to the reporting, recordkeeping, and other compliance requirements under the Advisers Act.281 For these broker-dealers, registration under the Advisers Act and compliance with its requirements will constitute new reporting, recordkeeping, and other compliance requirements. For broker-dealers already registered as investment advisers, rule 202(a)(11)–1(b) will require that broker-dealers treat affected accounts as advisory accounts. Thus, for these broker-dealers, rule 202(a)(11)–1(b) will impose new reporting, recordkeeping, and other compliance

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273 195 broker-dealer/advisers at 80 hours per adviser annually = 15,600.
275 7 U.S.C. 603(a).
276 First, a broker-dealer that charges a separate fee or separately contracts with a customer for investment advisory services may not rely on the exception. Second, a broker-dealer that holds itself out generally to the public as a financial planner or as providing financial planning services may generally not rely on the exceptions to avoid registration under the Act, and a broker-dealer that delivers a financial plan to a customer or represents to a customer that its advice is part of a financial plan or in connection with financial planning services must also generally register under the Act and treat that customer as an advisory client. Third, a broker-dealer may not rely on the exceptions for any accounts over which it exercises investment discretion. See rule 202(a)(11)–1(b).
277 This section of the Final Regulatory Flexibility Analysis is based on the most recent data available, taken from information provided by broker-dealers in Form X-17A-5 Financial and Operational Combined Uniform Single Reports filed pursuant to section 17 of the Exchange Act and Rule 17a–5 thereunder.
278 Generally not to apply to publicly traded investment companies, in accordance with section 1(b) of the Investment Company Act of 1940, as amended (15 U.S.C. 80b–2(b)).
279 17 CFR 240.17a–4(b)(7). As previously discussed, although rule 202(a)(11)–1(a) would also limit its application to accounts that a broker-dealer does not exercise investment discretion over, under Exchange Act rules, broker-dealers are already currently required to maintain all “evidence of the granting of discretionary authority given in any respect of any account.” 17 CFR 240.17a–4(b)(6). Thus, this provision of the rule would not create an additional recordkeeping requirement for broker-dealers.
280 See supra note 273 for a description of these three scenarios.

For Paperwork Reduction Act purposes, we have estimated that approximately 185 broker-dealers could be required to register as investment advisers as a result of the proposed rule and interpretation. See supra Section VIII.B of this Release.
requirements with respect to these accounts. Small entities registered with the Commission as broker-dealers will be subject to these new reporting, recordkeeping, and other compliance requirements to the same extent as larger broker-dealers. In developing these requirements over the years, we have analyzed the extent to which they would have a significant impact on a substantial number of small entities, and included flexibility wherever possible in light of the requirements’ objectives, to reduce the corresponding burdens imposed.

E. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate or conflict with rule 202(a)(11)–1.

F. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any adverse impact on small entities.282 In connection with rule 202(a)(11)–1, the Commission considered the following alternatives: (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rule, or any part thereof, for such small entities.

With respect to the first alternative, the Commission presently believes that establishment of differing compliance or reporting requirements or timetables for small entities would be inappropriate in these circumstances. The provision rule 202(a)(11)–1(a) requiring prominent disclosures to customers and potential customers is designed to prevent investor confusion. We believe this requirement is already adequately clear and simple for those seeking to make use of the rule’s exception for fee-based accounts. To further consolidate this requirement would potentially impede our objective of preventing investor confusion. With respect to rule 202(a)(11)–1(b), clarification, consolidation, or simplification would involve modification of the compliance and recordkeeping requirements generally applicable to registered investment advisers under the Act. As discussed above in connection with the first alternative, the Commission, in developing these requirements over the years, has included as much flexibility as can be introduced in light of the investor protection objectives underlying them.

With respect to the third alternative, the Commission presently believes that the compliance requirements contained in rule 202(a)(11)–1 already appropriately use performance standards instead of design standards. The rule is crafted to make regulation under the Advisers Act turn on the services offered by a broker-dealer rather than strictly on the type of compensation involved. Thus, eligibility for rule 202(a)(11)–1(a)’s exception hinges on the services offered by the broker-dealer. Likewise, under rule 202(a)(11)–1(b), the treatment of the advisory activities in question also focus on the services offered.283 The reporting, recordkeeping, and other compliance requirements stemming from these of rule 202(a)(11)–1 are triggered by the performance of services by the entity in question, including small businesses.

Finally, with respect to the fourth alternative, the Commission presently believes that exempting small entities would be inappropriate. To the extent rule 202(a)(11)–1(a) eliminates unnecessary regulatory burdens that might otherwise be imposed on broker-dealers, small entities, as well as large entities, will benefit from the rule. Small broker-dealers should be permitted to enjoy this benefit to the same extent as larger broker-dealers. Furthermore, the Commission believes the provisions of rule 202(a)(11)–1(b) should apply to small entities to the same extent as larger ones. Rule 202(a)(11)–1(b) is grounded in the view that the advice described in the rule’s three scenarios is not solely incidental to brokerage. Because the protections of the Advisers Act are intended to apply equally to clients of both large and small advisory firms, it would be inconsistent with the purposes of the Advisers Act to exempt small entities further from the rule.

X. Statutory Authority

The Commission is adopting rule 202(a)(11)–1 pursuant to sections 202(a)(11)(F) and 211(a) of the Advisers Act.284

Text of Rule

List of Subjects in 17 CFR Part 275

Investment advisers, Reporting and recordkeeping requirements.

■ For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for Part 275 continues to read as follows:

282 U.S.C. 603(c).

283 Rule 202(a)(11)–1(b)(1) focuses on whether the broker-dealer separately contracts for the advisory services or charges a separate fee. Rule 202(a)(11)–1(b)(2) focuses on how the broker-dealer holds itself out generally to the public or represents its services to a customer. Rule 202(a)(11)–1(b)(3) focuses on whether the broker-dealer exercises investment discretion over customer accounts.

284 Because we are using our authority under section 202(a)(11)(F), broker-dealers relying on the rule would not be subject to state adviser statutes. Section 203(a)(1)(B) of the Act provides that “[i]n no law of any State or political subdivision thereof requiring the registration, licensing, or qualification as an investment adviser or supervised person of an investment adviser shall apply to any person . . . that is not registered under [the Advisers Act] because that person is excepted from the definition of an investment adviser under section 202(a)(11).” (emphasis added).

We also have authority under section 206A, which is available as an alternative ground, because the rule we are adopting is in the public interest and consistent with the protection of investors and the purposes intended in the Act.

* * * * *

2. Section 275.202(a)(11)–1 is added to read as follows:

§ 275.202(a)(11)–1 Certain broker-dealers.


(1) Will not be deemed to be an 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 paragraphs (b)(3) and (d) of this section);

(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 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 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):

(i) Charges a separate fee, or separately contracts, for advisory services;

(ii) 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;

(iii) Represents to the customer that the advice is provided as part of a financial plan or in connection with financial planning services;

(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(a)(35)), except that it does not include investment discretion granted by a customer on a temporary or limited basis.

Dated: April 12, 2005.

By the Commission.

Jill M. Peterson,
Assistant Secretary.

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