ROBERT S. STREVELL - AMERICAN CAPITAL FINANCIAL SERVICES, INCORPORATED

Publicly Available April 29, 1985

SEC LETTER

Rule 202(a)(11)(c)

April 29, 1985

Robert S. Strevell
Vice President-Director of Marketing
American Capital Financial Services, Inc.
2800 Post Oak Boulevard
P.O. Box 1411
Houston, Texas 77251-1411

Dear Mr. Strevell:

Mrs. McGrath has asked me to respond to your letter of December 12, 1984, in which you express concern about the direction you perceive this Division to be taking in applying the Investment Advisers Act of 1940 ("Act") to financial planners who are registered representatives of broker-dealers (an "FPRR"). Specifically, based on the Division's no-action responses in Southmark Financial Services ("Southmark")1 and Linda Arnold ("Arnold"),2 you believe our position is that an FPRR who is compensated only from the sales or brokerage commission it earns upon a client's purchase of securities and other investments (a "commission") is receiving "compensation" for purposes of the Act and thus must register as an investment adviser.3 In your view, however, Congress did not intend the Act to apply to an FPRR unless it receives an "unbundled" fee for investment advice, i.e., a fee which, in your words, is "over and above" commissions. The short answer to your concern is that Southmark and Arnold were not intended to address the question of what type of compensation arrangements require an FPRR to register under the Act. Moreover, the staff's views on when an FPRR is receiving compensation that requires it to register are generally consistent with yours. In order to clarify this matter for you, and because the issue you raise is one of general interest, I would like to take this opportunity to present a more detailed discussion of our views.

As you are aware, section 202(a)(11) broadly defines an "investment adviser" as any person who, for compensation, is in the business of advising others about investing in securities.4 Based on this definition, an FPRR generally would have to register under the Act,5 unless it can rely on the broker-dealer exception set forth in section 202(a)(11)(C).6 This provision exempts from the investment adviser definition any broker-dealer (or registered representative thereof) who gives investment advice solely on an incidental basis, provided it receives "no special compensation therefor." A threshold question is, of course, whether an FPRR is providing investment advice in its capacity as a registered representative of the broker-dealer by whom it is employed. If it is not, it cannot rely on the broker-dealer exception. Assuming the FPRR is acting on behalf of its employer broker-dealer, if the FPRR (or its firm) makes an explicit charge for investment advice, it is receiving special compensation and therefore cannot rely on the exception. Since the FPRR in your situation is being compensated only by commissions, the question presented is whether its commissions are, or may include, "special compensation."

While neither the Act nor the rules thereunder specify whether a commission is, in and of itself, "special compensation," the Commission has published two releases which included the staff's view that it is not.7 We believe that the qualifying term "special" in the broker-dealer exception clearly indicates that Congress was concerned with compensation other than that received by a broker-dealer in the ordinary course of its brokerage activities, i.e., commissions. A more difficult question is presented where a portion of a commission may be viewed as compensation to an FPRR for its investment advice. In this situation, we believe "special" compensation exists only where the commission includes a "clearly definable charge" for investment advice (a "non-segregated charge").8 We believe the essential distinction between a commission which includes special compensation and one which does not is whether the FPRR is being specifically compensated for investment advice itself or for brokerage or other

services to which the advice is merely incidental.9

It is evident from the discussion above that determining whether an FPRR (or its firm) is being compensated in any particular case for investment advice or for brokerage or other services is an inherently factual determination that is not necessarily subject to rules of general application. Nevertheless, the two Commission releases include several general illustrations of the staff's approach in determining whether a particular situation involved special compensation. The list below applies these illustrations in the FPRR context:

> —If the same commission is charged for executing any client transactions, regardless of whether a particular client also receives financial planning advice, the FPRR is not receiving special compensation;10
>
> —If two general commission 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, the FPRR is receiving special compensation;11
>
> —It is not necessary to look outside the commission structure of an FPRR's broker-dealer employer to determine whether the FPRR is receiving special compensation. For example, simply because an FPRR at a “full service” firm receives higher commissions than an FPRR employed by a “discount” brokerage firm, the additional amount of the former's commissions is not necessarily special compensation;12 and,
>
> —The fact that an FPRR may negotiate different commissions with its clients for similar transactions does not mean that the difference must be viewed as special compensation, provided the discrimination follows a clear and consistent policy which is not related to the rendition of investment advice.13

Comparing the discussion above to your letter, it is apparent that our respective interpretations of how the Act should be applied to an FPRR are generally consistent. We both agree that an FPRR who is compensated only from commissions is not required to register because it is not receiving special compensation. Similarly, we both agree that an FPRR who makes a charge for investment advice that is over and above and separate from commissions is required to register. The only issue on which we may not agree is whether an FPRR must register if it includes within commissions a non-segregated charge for advice. It appears that you may believe that registration is required only if an FPRR receives compensation “over and above” (i.e., segregated from) commissions. As discussed above, we believe a non-segregated charge is special compensation because in our view that phrase includes any clearly definable charge for investment advice, regardless of whether the charge is separate from or included within commissions. If we did not follow this interpretation, an FPRR could circumvent Congress' intent to exclude from the Act only a broker-dealer receiving bona fide commissions by merely incorporating an advisory charge into commissions. Accordingly, while we agree with you that an FPRR who makes a separate charge for investment advice clearly must register, we do not believe that the absence of such a separate charge invariably leads to the opposite conclusion.

The staff's responses in Southmark and Arnold do not depart from our longstanding interpretation of special compensation. In fact, neither addresses this issue. Southmark involved an FPRR who appeared to be advising clients outside of the scope of its employment as a registered representative. Thus, because the broker-dealer exception was unavailable to the FPRR, its status under the Act had to be analyzed under the general definition of an investment adviser set forth under section 202(a)(11). Since under that definition the FPRR's commissions would be “compensation,” we advised the FPRR that it would have to register. If the FPRR had been providing investment advice in its capacity as a registered representative, its commissions would not have required it to register unless, as discussed above, the commissions included a non-segregated charge that would constitute special compensation under the broker-dealer exception.

The financial planner in Arnold was not a registered representative. Under these circumstances, we advised the requestor that receipt of a share of her clients' commissions would be compensation for purposes of the section 202(a)(11) definition and she therefore would have to register. As in

Southmark, the broker-dealer exception was not at issue.

We appreciate very much your taking the time to bring your views to our attention and I trust this response will be helpful to you. If you should have any further questions or comments, please feel free to contact Stephanie M. Monaco of my office at (202) 272-2030.

Very truly yours,
Thomas P. Lemke
Chief Counsel

Footnotes

1 Pub. avail. Aug. 23, 1984.

2 Pub. avail. Aug. 23, 1984.

3 The discussion here and elsewhere in this letter assumes, of course, that the activities of the FPRR satisfy the other elements of the statutory definition as set forth in note 4, infra.

4 Section 202(a)(11), in relevant part, defines an “investment adviser” as “any person who, for compensation, engages in the business of advising others, either directly or through publications, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities * * *.”

5 See Investment Advisers Act Rel. No. 770 (Aug. 13, 1981).

6 Section 202(a)(11)(C) excepts from the definition of an investment adviser “any broker or dealer whose performance of such [investment advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor.” For purposes of this discussion, we shall assume that none of the other exceptions in section 202(a)(11) would be available to an FPRR.

7 The most recent publication of the Division's views on the meaning of this term is Investment Advisers Act Rel. No. 626 (April 27, 1978) (“Release 626”), a release relating to the applicability of the Act to broker-dealers after the elimination of fixed commission rates on securities transactions. Previously, in Investment Advisers Act Rel. No. 2 (Oct. 28, 1940) (“Release 2”), the Commission's General Counsel set forth his views on the meaning of this term in various circumstances in which a broker-dealer provided advice solely incidental to the conduct of its business as such.

8 Release 626, supra note 7. This position reflects the staff's view that a client who perceives he is paying a specific charge for investment advice is entitled to the Act's protections. Id.

9 See Release 2, supra note 7.

10 Id.

11 Release 626, supra note 7.

12 Id.

13 Id.

INCOMING LETTER

December 12, 1984

Securities & Exchange Commission
Attn: Katherine McGrath, Director
Division of Investment Management
450 5th St., N.W.
Washington, DC 20549

Re: Investment Adviser Definition

Dear Ms. McGrath:

This letter is not a no action request. The purpose of this letter is to express my personal thoughts regarding an interpretive direction being taken by the Division of Investment Management. I am hopeful that you will view these opinions as constructive input from a concerned member of the securities industry and not as rancorous criticism motivated by self-interest.

The subject of my concern is the apparent application of the statutory definition of investment advisor to the activities of a “financial planner.”

The representatives of our broker/dealer are primarily engaged in offering long term investment programs funded through securities such as investment company shares, unit trust shares, direct participation programs, and variable annuity or variable life products.

Due to the longer term nature of such investments, we have long stressed with our sales force the ethical and business need to fit the sales of such products into the overall financial situation and objectives of the client. Done properly this tailoring process requires individual considerations which exceed the threshold “know your customer” inquiries and minimum suitability standards dictated by the N.Y.S.E. and N.A.S.D. The process often involves face-to-face client interviews and data gathering in sufficient depth to analyze and discuss the client's short, intermediate, and long term needs for income, liquidity, capital growth as well as tax and estate planning objectives. The purpose of the process is to provide a rational predicate for product recommendation.

Once the client's overall financial situation is understood, it is then necessary to discuss financial products both generally and specifically so that the client fully understands the reasons for a product recommendation as it fits into his or her financial situation and objectives.

Unfortunately, the direction which I perceive the Division to be taking in recent no-action letters (See your reference numbers 84-188-cc and 84-189-cc) appears to be at odds with the clear direction our industry is trending towards, i.e. financial planning in which product sale is merely a means to the end of working towards fulfilling an established and integrated matrix of financial goals and objectives. My concern centers on bringing the “financial planner” into the definition of an investment advisor by interpreting “compensation” as used in the advisors definition to include commission income from product sale even when no unbundled separate advisory fee is charged.

Either I misunderstand the administrative position taken in the above referenced no-action letters, or, the position ought to be carefully reconsidered.

In my opinion, the term “compensation” as used in the definition clearly means, and was intended by Congress to mean, an unbundled payment over and above commission income. If this is not the case, then I am left in the perplexing situation of advising our securities representatives to choose one of two courses: one, under no circumstances exceed minimum “know your customer” inquiries necessary to meet bare-bones suitability standards for fear that investment advisor registration will be triggered; or two, if you choose to serve the needs of your clients in a professional manner, then register as an investment advisor (and while you're at it, you might as well charge an additional fee for the service you

were previously providing at no additional cost).

Where do we draw the line between “needs analysis” in the context of extended suitability focus and the provision of investment advisory service. I submit that there is no rational way to draw such a line based on quality or quantity or service (as attempted in the recent no-action letters) nor is there a need to struggle in semantic quicksand attempting to do so.

The solution seems simple and lends itself to ease of regulation. So long as no unbundled additional compensation is received beyond commission income, a representative's financial planning activities do not require registration as an investment advisor. To conclude otherwise will result in the registration of tens of thousands of investment advisors with the following consequences: (1) the S.E.C. will not possibly be able to regulate that number of registrants absent a Self Regulatory Organization established for the purpose (in fact, the S.E.C. had to force S.E.C.O. broker/dealers into NASD membership because it couldn't adequately monitor the activities of a mere handful of such firms.); and (2) the now clear responsibility of a broker/dealer to supervise the activities of its representatives becomes clouded when the representative becomes independently registered as an advisor.

Neither result is desirable.

What public policy is served by discouraging a representative from offering an expanded service at no additional charge and holding out to the public that such service is available? If I go to a hardware store and ask to buy a saw, the clerk can do one of two things: he can offer me the one that is overstocked and ring up the ticket, or he can make sure that the recommended saw meets the requirements of my particular application by inquiring the purpose to which it will be put and the manner of its use. The saw costs the same either way. In second instance, I am a satisfied customer who will return to the same store. As simplistic as the above analogy is, its substance parallels the circumstances of a representative trying to do a good job by providing financial planning services. If he doesn't charge extra for the service and doesn't maintain custody of client funds or securities, don't require registration as an advisor. It's unnecessary and serves no policy needs.

Thank you for taking the time to read this expression of personal opinion.

I would be pleased to discuss this matter with you further if additional clarification of these comments would be useful.

Sincerely,

AMERICAN CAPITAL FINANCIAL SERVICES, INC.
Robert S. Strevell
Vice President—Director of Marketing