SECURITIES AND EXCHANGE COMMISSION

OPINION OF CHESTER T. LANE, SEC GENERAL COUNSEL

INVESTMENT ADVISORS ACT OF 1940, Release No. 2

October 28, 1940

TEXT:

The Securities and Exchange Commission today made public an opinion of Chester T. Lane, General Counsel, regarding the status under the Investment Advisers Act of 1940 of over-the-counter brokers who charge an "overriding commission" or "service charge" on transactions involving the purchase or sale of listed securities through correspondent brokers who are members of a national securities exchange.

In the execution of an order on a national securities exchange, the regular commission is paid to the member broker who executes the order. A broker who transmits a customer's order to a member broker for execution, since he himself gets no part of the regular commission, frequently charges the customer an additional fee or commission. This extra charge is in no case more than the member broker's commission. Since this extra charge is ordinarily made for the purpose of remunerating the non-member broker for the time he has spent and the expenses he has incurred, not merely in transmitting the order to the member broker but also in advising his customer, the question has been raised as to whether the additional remuneration makes the non-member broker an "investment adviser" within the meaning of the Investment Advisers Act of 1940.

Mr. Lane's opinion indicates that the charging of such an additional commission or fee by the non-member broker does not in itself make the non-member broker an "investment adviser" within the meaning of the Act, if the charge is imposed on a uniform basis without distinction between those customers to whom investment advice is given and those to whom it is not given.

The text of the opinion, which was in the form of a letter from Mr. Lane to the National Association of Securities Dealers, Inc., is as follows:

National Association of Securities Dealers, Inc., 821 15th Street, N.W., Washington, D.C.

Gentlemen:

You have requested my opinion whether participation by an over-the-counter broker or dealer in transactions of the character described below renders him an "investment adviser" within the meaning of Section 202 (a) (11) of the Investment Advisers Act of 1940.

In each of the situations presented, a broker who is not a member of a national securities exchange transmits to a broker who is a member of such an exchange an order for the member broker to purchase or sell a security listed on the exchange for the account of a customer of the non-member broker. In each case the non-member broker charges his customer an "overriding commission" or "service charge" in addition to the regular commission which the member broker receives for executing the transaction. In no instance is the amount of the "overriding commission" or "service charge" greater than the regular commission charged by the member broker.

I understand that there are four distinct practices or policies followed by over-the-counter brokers in making such charges:

1. Frequently the over-the-counter broker charges the overriding commission or service charge in every instance in which he transmits such an order to a member broker, and the amount of such additional commission or charge is the same for all transactions of the same size, no matter

who the customer is or how much consultation or advice the over-the-counter broker has given him.

2. Other over-the-counter brokers charge an overriding commission or service charge which may be uniform in amount, but which is charged only to those customers to whom the broker has given advice. In these cases the non-member broker receives no remuneration on transactions in listed securities if the customer has simply asked him to have an order executed, without seeking or receiving any advice.

3. A number of over-the-counter houses charge, on a uniform basis, an overriding commission or service charge for the execution of such transactions, except that they make no charge to certain clients, for example, clients who do a substantial amount of over-the-counter business through or with the house.

4. Occasionally an over-the-counter broker follows the practice of charging an overriding commission or service charge to all customers and on all transactions, but the amount of the charge varies in relation to the amount of consultation between the broker and his customer regarding the transaction.

The pertinent provisions of Section 202 (a) (11) of the Investment Advisers Act, under which these questions arise, are the following:

> "'Investment adviser' means any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities . . .; but does not include . . . (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor . . ."

I shall assume for the purposes of this letter that, in every situation outlined above, the transaction is "solely incidental to the conduct of . . . business as a broker or dealer." The precise question presented, therefore, is whether in each of these situations the over-the-counter broker in taking an overriding commission is receiving "special compensation for" advice which he may have given his customer.

Clause (C) of Section 202 (a) (11) 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 Investment Advisers Act merely because of this aspect of their business. On the other hand, 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. 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. The essential distinction to be borne in mind in considering borderline cases, such as those which you have presented, is the distinction between compensation for advice itself and compensation for services of another character to which advice is merely incidental.

Let me turn now to the four specific situations as to which you have inquired. In the first situation the over-the-counter broker charges an overriding commission or service charge for participating in the execution of every purchase or sale of listed securities. While the time and expense involved in giving advice to customers may be among his motives for charging the overriding commission or service charge, they represent only one part of his general expenses, and are no more directly related to the charge which he makes than is similar advice given customers with respect to over-the-counter transactions for which the broker receives a regular commission. In this first situation the imposition of the overriding commission or service charge does not in itself make the over-the-counter broker an "investment adviser" within the meaning of the Act.

The second situation presents a clear antithesis to the first. Here the charge is directly related to the giving of ad-vice. Those customers who receive the advice have to pay an additional charge, while those who do not receive advice do not.

The fourth situation is no different in principle from the second. Although all customers must pay an additional charge, at least part of the charge to customers receiving advice is attributable to such advice, and it is therefore clear that the charge includes "special compensation" for advice. It is my opinion that in both the second and fourth situations the over-the-counter broker is acting as an investment adviser.

From a practical point of view the third situation presents a difficult problem. It is true that if the broker's discrimination between customers bears no relation to the nature or amount of advice which they receive from him, the additional charge does not in principle appear to be "special compensation." Nevertheless, I am sure you will recognize that difficult questions of fact are presented whenever the additional charge is not imposed on a wholly uniform basis. If a broker is confident that his discrimination between customers follows a clear and consistent policy, bearing no relation whatsoever to the rendition of investment advice to his customers, he may safely consider himself excluded from the definition of the term "investment adviser. When the circumstances are not so clear, I suggest that you recommend to your members that they call their peculiar problems to the Commission's attention, and take the precaution of registering under the Act pending the Commission's determination of the question. If the Commission is of the opinion that the broker is not an "investment adviser" within the meaning of the Act he will be entitled to withdraw his registration pursuant to Section 203 (g).

Very truly yours,

Chester T. Lane