FINAL EXTENSION OF TEMPORARY EXEMPTION FROM THE INVESTMENT ADVISERS ACT FOR CERTAIN BROKERS AND DEALERS

SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISORS ACT OF 1940
Release No. 626

SECURITIES EXCHANGE ACT OF 1934
Release No. 14714

April 27, 1978

TEXT:

AGENCY: Securities and Exchange Commission.

ACTION: Final extension of temporary rule.

SUMMARY: Because some broker-dealers might have decided, as a result of the May 1, 1975, elimination of fixed commission rates on securities transactions, to impose charges for their investment advisory services which might have caused such broker-dealers to lose their exemption from the Investment Advisers Act of 1940 ("Advisers Act"), the Commission on a temporary basis exempted certain broker-dealers from the Advisers Act. The Commission now has determined that the temporary exemption will be allowed to expire at the end of an additional six-month period and that no permanent exemption will be adopted. Current staff views on the meaning of the term "special compensation" are also set forth and public comments are solicited on those views and on the question whether brokers or dealers who have discretionary authority over customers' accounts should, per se, be considered investment advisers with respect to such accounts.

DATES: Effective date of final extension -- April 27, 1978; comments must be received on staff views on the meaning of "special compensation" and other issues on or before June 30, 1978.

ADDRESSES: Interested persons should submit their views and comments in triplicate to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549. All submissions should refer to File No. S7-740, and will be made available for public inspection at the Commission's Public Reference Section, Room 6101, 1100 L Street, N.W., Washington, D.C. 20005.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:

I. Synopsis

The adoption of Rule 19b-3 [17 CFR 240.19b-3] n1 under the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.] ["Exchange Act"], if followed by the "unbundling" of brokerage commission charges and charges for research and other investment advice, could cause those brokers or dealers who unbundled to become investment advisers as that term is defined in the Investment Advisers Act of 1940 [15 U.S.C. 80b-1 et seq.] ["Advisers Act"]. Believing that the change from fixed to negotiated rates was itself a very significant change for brokers and dealers, the Commission adopted a series of temporary exemptions from the Advisers Act for certain brokers and dealers who had been registered pursuant to Section 15 of the Exchange Act prior to the May 1, 1975, effective date of Rule 19b-3 and

who were not then registered as an investment adviser. The latest of such exemptions expires on April 30, 1978.

n1 Rule 19b-3 prohibits any national securities exchange from adopting or retaining any rule that requires, or from otherwise requiring, its members to charge fixed rates of commission for transactions executed on, or by the use of the facilities of, such exchange after May 1, 1975, (May 1, 1976, as to the rules of an exchange relating to floor brokerage commissions).

An adequate period has elapsed for broker-dealers to become familiar with the provisions of the Advisers Act and to adjust to the unfixing of commission rates. The Commission has considered the impact of the Advisers Act on all broker-dealers, including those previously exempt, and does not believe compliance with the Advisers Act is overly burdensome. This is especially true since the Commission has taken several actions since the temporary exemptions were first initiated to reduce the burdens regulation under the Advisers Act imposes on broker-dealers. In addition, the Commission believes that the Advisers Act provides individuals with certain protections not available under the Exchange Act. Accordingly, the Commission has concluded that neither a continuation of the temporary exemption, beyond a final extension to October 31, 1978, permitting broker-dealers to prepare for compliance with the Advisers Act, nor adoption of a permanent exemption from the Advisers Act for any or all broker-dealers is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Advisers Act.

II. Background

On April 23, 1975, the Commission published notice of the adoption of temporary Rule 206A-1(T) [17 CFR 275.206A-1(T)] under the Advisers Act n2 effective May 1, 1975, to coincide with the effective date of Rule 19b-3 under the Exchange Act. The rule was adopted in order to allow brokers and dealers to become familiar with the Advisers Act and to afford them an adequate period of time to develop and test new pricing practices after May 1, 1975, without at the same time having to register under and comply with the Advisers Act. The rule also was adopted to provide for a thorough consideration by the Commission and the public of questions related to the applicability of the Advisers Act to brokers and dealers. Registration under and compliance with the Advisers Act might otherwise have been required of a broker or dealer who made a separate charge for investment advice since by doing so he might lose the benefit of the benefit of the exclusion from the definition of investment adviser in Section 202(a)(11) [15 U.S.C. 80b-2(a)(11)] of the Advisers Act n3 provided by Section 202(a)(11)(C) [15 U.S.C. 80b-2(a)(11)(C)] for "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."

n2 Securities Exchange Act Release No. 11368, Investment Advisers Act Release No. 455, 40 FR 18424 (April 28, 1975).

n3 Section 202(a)(11) of the Advisers Act defines the term "investment adviser" to mean, with certain exclusions, --

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.

Rule 206A-1(T) provided a four-month exemption from the Advisers Act for any broker or dealer who was registered as such on May 1, 1975, pursuant to Section 15 [15 U.S.C. 78o] of the Exchange Act and who was not then registered with the Commission as an investment adviser. On August 20, 1975, the exemptive period was extended to April 30, 1976, and at that time the exemption was narrowed to exclude after November 30, 1975, broker-dealers performing investment supervisory services or investment management services for special compensation or not solely incidental to their business as broker-dealers. n4 Subsequently, the Commission amended Rule 206A-1(T) to provide two additional extensions of the rule, expiring April 30, 1977, n5 and April 30, 1978. n6

n4 Securities Exchange Act Release No. 11607, Investment Advisers Act Release No. 471 (August 20, 1975), 40 FR 38157 (August 21, 1975).

n5 Securities Exchange Act Release No. 12297, Investment Advisers Act Release No. 506 (April 1, 1976), 41 FR 14507 (April 6, 1976).

n6 Securities Exchange Act Release No. 13454, Investment Advisers Act Release No. 581 (April 20, 1977), 42 FR 21769 (April 29, 1977).

III. Statutory protections provided by the Advisers Act and the rules thereunder which may not be available under he Exchange Act and the rules thereunder.

Both the Advisers Act and the Exchange Act provide a regulatory framework designed to protect investors and the public interest while permitting the provision of professional services in the financial marketplace. While the two statutes are similar, there are some differences, particularly with respect to their antifraud provisions. Both investment advisers and broker-dealers are subject to general antifraud provisions under their respective Acts. In light of several recent Supreme Court decisions, however, the Commission believes that the protections afforded investors under Rule 10b-5 [17 CFR 240.10b-5], the general antifraud rule adopted pursuant to Section 10(b) [15 U.S.C. 78j(b)] of the Exchange Act, may not be so broad as those afforded under the comparable provisions in Section 206 [15 U.S.C. 80b-6] of the Advisers Act, particularly with regard to a person who is not a purchaser or seller of securities. These differences are appropriately related to the obligations of persons required to be registered under the Advisers Act.

Other provisions of the Advisers Act have no equivalents in the Exchange Act. There are not any general requirements under the Exchange Act comparable to the consent requirement in Section 206(3) of the Advisers Act, nor are there specific provisions relating to contracts as in Section 205 [15 U.S.C. 80b-5] of the Advisers Act. n7

n7 There are also advertising rules (Rule 206(4)-1 [17 CFR 275. 206(4)-1]) and certain recordkeeping rules under the Advisers Act, e.g., Rules 204-2(a)(12) and (13) [17 CFR 275.204-2(a)(12) and (13)], for which there are no parallel provisions in the Exchange Act. Because of differences in the manner in which broker-dealers and investment advisers conduct their respective businesses, and because of certain common law protections and certain rules of self-regulatory organizations adopted pursuant to the Exchange Act, these differences may in some instances reflect alternative regulatory approaches under the two Acts and not necessarily differing levels of investor protection.

IV. The feasibility of compliance by brokers and dealers with both the Advisers Act and the Exchange Act.

A. General burdens

Public commentators on Rule 206A-1(T) have stated that it would be burdensome for brokers and dealers to become subject to the Advisers Act. There are, however, currently over 300 firms which are dually registered, apparently including fourteen of the fifteen largest brokers and dealers doing a primarily public business. The number and size of the dual registrants suggest that registration under and compliance with the Advisers Act is not unduly burdensome. Furthermore, as indicated below, the Commission has significantly alleviated certain burdens which have been brought to its attention.

B. Specific burdens

1. Disclosures dual registrants must make in connection with securities transactions with clients.

A number of commentators on Rule 206A-1(T) suggested that it is not feasible for broker-dealers who are also investment advisers to comply with the standards set forth in two Commision pronouncements, Advisers Act Release No. 40, February 5, 1945, and In the Matter of Arleen W. Hughes 27 S.E.C. 629 (1948), aff'd sub nom. Hughes v. S.E.C., 173 F.2d 969 (D.C. Cir. 1949). In Advisers Act Release No. 40, the Commission set forth comprehensive disclosures it believed were necessary in circumstances to which Section 206(3) of the Advisers Act [15 U.S.C. 80b-6(3)] is aplicable, i.e., when an investment adviser, acting as such, proposes either to act as principal, or as broker for another person, in a transaction with a client. The Arleen Hughes case was a proceeding based primarily on a broker-dealer/investment adviser's failure to make the disclosures required by Advisers Act Release No. 40.

The Commission has already recognized "that some modification is appropriate [of the position set forth in Release No. 40], which now appears inappropriate in light of the investment advisory business as it has evolved to the present time" and indicated that in any such situation the extent of the detailed disclosure required would depend on the facts of each case. n8

n8 Advisers Act Release No. 470 (August 20, 1975).

Not only has the Commission adopted a more flexible approach concerning the disclosures a dual registrant must make when acting in a dual capacity in a transaction with a client, but, when persuasive arguments have been presented that Section 206(3) is unduly burdensome in particular circumstances, it has also adopted rules, such as Rules 206(3)-1 and 206(3)-2 [17 CFR 275.206(3)-1 and 206(3)-2] to eliminate those burdens. n9 The Commission would give serious and prompt consideration to providing further relief from any other undue burdens that might be imposed by Section 206(3) or any other provision of the Advisers Act or the rules thereunder on brokers and dealers who are registered as investment advisers.

n9 Rule 206(3)-1 states that a broker or dealer will not be construed to be acting as an investment adviser with respect to a particular transaction (and therefore the disclosure obligations of Section 206(3) will not attach) if its advice has been furnished only be means of (1) publicly distributed written statements or publicly made oral statements; (2) statements or materials which are not directed to the needs of a specific individual; (3) statistical information which does not comment on the investment merits of a particular security; or (4) a combination of the foregoing services.

Rule 206(3)-2 provides an alternative means of compliance with Section 206(3) for those advisers who wish to effect agency cross transactions for their clients. The rule allows clients to provide advance consent authorizing such transactions for a period not exceeding one year, but requires the investment adviser to furnish the client certain disclosures concerning the compensation received in connection with such transactions on a transaction-by-transaction basis, as well as a cumulative basis, within thirty days prior to the expiration of the period covered by the blanket consent the rule envisions.

2. Fiduciary Obligations of Brokers and Dealers who are Investment Advisers

Another reason some broker-dealers have given for desiring an exemption from the Advisers Act is their belief that an investment adviser, as such, may be held to have higher duties to his clients than does a broker or dealer to his customers. To the extent this may be true, no persuasive reason has been given to lower standards imposed by law. Moreover, since a dual registrant is not an investment adviser to brokerage clients to whom it provides advisory services on a solely incidental basis and without special compensation, n10 it does not appear that a dual registrant will owe such higher duties to any clients other than its advisory clients.

n10 See Section V, infra.

3. ERISA

Some commentators expressed concern that if broker-dealers were required to register as investment advisers, problems might arise with respect to the Employee Retirement Income Security Act of 1974

("ERISA") [29 U.S.C. 1001 et seq.]. In particular, those commentators were concerned that registration under the Advisers Act might bear on whether a broker-dealer would be deemed to be a "fiduciary" for purposes of ERISA. Determination of a broker-dealer's obligations under ERISA would not appear, however, to turn on whether the broker-dealer is also registered under the Advisers Act. The term "fiduciary" is defined in ERISA n11 and has been further refined in regulations adopted by the Department of Labor and the Internal Revenue Service. n12 The Commission will, of course, continue to work with the Department of Labor and the Internal Revenue Service regarding the interrelationship of ERISA and the federal securities laws.

n11 Section 3(21)(A) of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002(21)(A) (1974).

n12 29 CFR 2510.3-21 (1977).

4. State regulation

The Commission has also given attention to the concerns of some brokers and dealers that if they are required to register under the Advisers Act various states may impose their investment adviser regulations on such previously exempt brokers and dealers and that this will result in unnecessary, duplicative regulation. The Commission, of course, is anxious to avoid unnecessary regulatory burdens. It would be improper, however, for the Commission to conclude not to act in a manner necessary for the protection of investors on the ground that some states, whose actions are beyond the Commission's scope of authority, may as a consequence apply regulations which members of the brokerage industry believe are unnecessary.

V. Scope of Exclusion Provided by Section 202(a)(11)(C)

When the temporary rule expires, a broker or dealer would still be excluded from the definition of investment adviser to the extent he could meet the statutory standards in Section 202(a)(11)(C) relating to the furnishing of advisory services solely incidental to the conduct of his business as a broker-dealer and without special compensation therefor.

The relationship of a broker or dealer to his brokerage customers does not become an investment advisory relationship merely because the broker or dealer is registered as an investment adviser. A broker or dealer who is registered as an investment adviser is not by reason of that fact an investment adviser to those of his brokerage clients to whom he provides advisory services on a solely incidental basis and without special compensation.

As early as October 28, 1940, the Commission, in Investment Advisers Act Release No. 2, made known the opinion of its General Counsel as to the meaning of the term "special compensation" in various circumstances in which a broker-dealer provided investment advice solely incidental to the conduct of his business as a broker or dealer.

The examples treated in this release suggest that "special compensation" for investment advice is compensation to the broker-dealer in excess of that which he would be paid for providing a brokerage or dealer service alone. However, because the existence or non-existence of "special compensation" in any particular circumstance may not be clear, the Commission considers it desirable that the current views of the Division of Investment Management on this subject be provided to broker-dealers for their guidance, while also calling for comment on this question.

The Division of Investment Management regards special compensation as existing only where there is a clearly definable charge for investment advice. This reflects the Division's position that a client who perceives that he is paying a charge specifically for investment advice is entitled to the protections of the Advisers Act.

The Division would not look outside the fee structure of a given firm to determine whether special compensation exists. That is, just because a "discount" firm offered lower rates than a "full-service" firm, the Division would not call the "full-service" firm's charges "special compensation."

If a firm negotiates different fees with its clients for similar transactions, the Division would not regard the differences in charges "special compansation" for investment advice since whether they were or were not based on the presence or absence of investment advice appears too hypothetical.

Nor would the Division regard as "special compensation" general differentials which exist because a firm provided, on the one hand, an unrestricted execution service and, on the other hand, a restricted execution service, such as one in which customers must have the necessary cash in their accounts at the time a purchase order is placed and must accept execution at the next day's opening price.

However, if a broker-dealer has in effect, either formally or informally, two general schedules of fees available to a customer, the lower without investment advice and the higher with investment advice and the difference is primarily attributable to this factor, or if a broker-dealer should separately bill a particular customer with a specific charge for investment advice, the Division would regard the extra charge as "special compensation" for investment advice. This is the position that was taken by the General Counsel in 1940 and it is the position that the Division believes would be taken by a court today. This would be the case even in a situation, currently non-existent, in which a current "full-service" firm implements a "discount" or "execution-only" service. If the differential in general rate structure offered to a particular client could be said to be primarily attributable to the rendering of investment advice, the Division would deem at least part of the differential to be "special compensation" for investment advice.

The recently adopted Rule 11a2-2(T) under the Exchange Act [17 CFR 240.11a2-2(T)] in certain circumstances permits a broker-dealer (the "initiating broker-dealer") to retain compensation in connection with effecting transactions for an account as to which he exercises investment discretion. The rule requires the initiating broker-dealer to forward the orders to other broker-dealers for execution and also requires the initiating broker-dealer to furnish to a discretionary account at least annually a statement setting forth the total amount of transactional compensation retained by the initiating broker-dealer, exclusive amounts paid to the executing broker-dealer.

The Division believes that, as indicated by Investment Advisers Act Release No. 2, unless an initiating broker charged specifically for investment advice, the mere fact that he received compensation for advice and other services, in addition to the compensation paid to an executing broker, would not make such compensation "special compensation." Moreover, the mere report of such compensation should not cause such retained amounts to be "special compensation."

The views set forth above are the Division of Investment Management's current views on the meaning of the term "special compensation." The Commission requests comments and suggestions from all interested persons on these views. The Commission also requests comments on whether the meaning of "special compensation" should be expanded or narrowed, by rule or interpretation, and the impact such action would have on brokers and dealers who would be affected thereby.

For example, on the one hand, the term "special compensation" might be interpreted to apply to a part of the fee negotiated between a broker-dealer and a customer if the fee is higher than the fee that would have been negotiated for an execution service alone and one reason the fee is higher is that it includes a fee for investment advice. n13 On the other hand, the meaning of special compensation might be interpreted as not including any charge for investment advice that is made on a transactional basis as part of a charge for a broker or dealer service. n14

> n13 This interpretation might most clearly give effect to the view that a person who clearly perceives that he is paying for investment advice should receive the protections of the Advisers Act.

n14 This interpretation might tend to reduce to the greatest extent any disincentive (because of potential Advisers Act regulation) for a "full-service" brokerage firm to introduce a discount service or for a discount house to introduce a "full-service" brokerage package.

Under previous interpretation of the scope of the exclusion provided by Section 202(a)(11)(C) of the Advisers Act, broker-dealers who have exercised discretionary authority over the accounts of some of their customers were generally regarded as providing investment advice incidental to their business as a broker-dealer and were not considered subject to the Advisers Act with respect to these activities so long as the customers did not pay special compensation for these services. n15

n15 The staff of the Commission has taken the position that a broker-dealer whose business consists almost exclusively of managing accounts on a discretionary basis is not providing investment advice solely incidental to his business as a broker-dealer.

It appears, however, that 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. Accordingly, the Commission is considering whether it should take action, by rule or otherwise, to interpret the scope of the exclusion provided by Section 202(a)(11)(C) of the Advisers Act so that it is not available to a broker-dealer who exercises "investment discretion", as defined in Section 3(a)(35) of the Exchange Act n16 [15 U.S.C. 78c(a)(35)], and so that all customers of a broker-dealer whose accounts are managed on a discretionary basis would be considered advisory clients. The Commission requests comments on the advisability of such action and the effects such action would have on brokers and dealers.

n16 Section 3(a)(35) states:

A person 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 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 some other 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.

VI. Conclusion

The Commission has considered the public comments received on Rule 206A-1(T) and has concluded that the temporary exemption from the Advisers Act should not be extended beyond October 31, 1978, and that no permanent exemption should be adopted. The Commission believes it is not onerous for an entity to register under and comply with the Advisers Act and it does not believe that those registered brokers or dealers who will be required to register as investment advisers will find the requirements of the Advisers Act unduly burdensome. Furthermore, the Advisers Act and the rules thereunder provide investors certain protections which are not available under the Exchange Act and the rules thereunder.

AUTHORITY:

The amendment to Rule 206A-1(T) is adopted pursuant to Sections 206A, 211(a) and 211(b) of the Advisers Act [15 U.S.C. 80b-6a, 80b-11(b)].

Accordingly, § 275.206A-1(T), paragraph (a), Part 275 of Chapter II of Title 17 of the Code of Federal Regulations is hereby amended to change the expiration date of the temporary exemption contained therein from April 30, 1978, to October 31, 1978.

The Commission finds, in accordance with the requirements of the Administrative Procedure Act [5 U.S.C. 553(d)], that notice of the amendment to Rule 206A-1(T) prior to adoption and public procedure

thereon is unnecessary, and publication for 30 days prior to the effective date may be omitted, since the amendment continues an exemption from statutory requirements which otherwise would be applicable, and since it is in the public interest to facilitate compliance with the Advisers Act by those brokers and dealers who previously were exempt from the Advisers Act. Accordingly, the amendment to Rule 206A-1(T) shall become effective on the date hereof.

By the Commission.