SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release Nos. 34-51523; IA-2376; File No. S7-25-99]

RIN 3235-AH78

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 programs. Under the rule, a broker-dealer providing advice that is solely incidental to its brokerage services is excepted 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" (a) the business of a broker or dealer within the meaning of the Advisers Act or (b) 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: (i) holds itself out to the public as a financial planner or as providing financial planning services; 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. 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.

DATES: Effective date: April 15, 2005, except that 17 CFR 275.202(a)(11)-1(a)(1)(ii) is effective May 23, 2005. Compliance dates: see Section IV of this Release.

FOR FURTHER INFORMATION CONTACT: Robert L. Tuleya, Senior Counsel, or Nancy M. Morris, Attorney-Fellow, at 202-551-6787, Iarules@sec.gov, Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0506.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission" or "SEC") is adopting new rule 202(a)(11)-1[1] under the Investment Advisers Act of 1940 ("Advisers Act" or "Act").[2]

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[1] 17 CFR 275.202(a)(11)-1. When we refer to rule 202(a)(11)-1 or any paragraph in that rule, we are referring to 17 CFR 275.202(a)(11)-1 where it is published in the Code of Federal Regulations.

[2] 15 U.S.C. 80b-1. When we refer to the Advisers Act, or any paragraph of the Act, we are referring to 15 U.S.C. 80b of the United States Code in which the Act is published.

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.

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[3] 15 US.C. 78a ("Exchange Act").

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 and the changes in brokerage services 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." 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

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[4] For a discussion of the scope of the Advisers Act, see Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 8, 1987) [52 FR 38400 (Oct. 16, 1987)] ("Advisers Act Release No. 1092").

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

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5 See Opinion of the General Counsel Relating to Section 202(a)(11)(C) of the Investment Advisers Act of 1940, Investment Advisers Act Release No. 2 (Oct. 28, 1940) [11 FR 10996 (Sept. 27, 1946)] ("Advisers Act Release No. 2").

6 Certain Broker-Dealers Deemed Not to be Investment Advisers, Investment Advisers Act Release No. 2340 (Jan. 6, 2005) [70 FR 2716 (Jan. 14, 2005)] ("Reproposing Release" or "Reproposal"); Certain Broker-Dealers Deemed Not to be Investment Advisers, Investment Advisers Act Release No. 1845 (Nov. 4, 1999) [64 FR 61226 (Nov. 10, 1999)] ("Proposing Release" or "1999 Proposal"). Cf. Final Extension of Temporary Rules, Investment Advisers Act Release No. 626 (Apr. 27, 1978) [43 FR 19224 (May 4, 1978)] ("Advisers Act Release No. 626").

7 Proposing Release, supra note 6.

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]

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8 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.

9 See Patrick McGeehan, The Media Business: Advertising, Schwab Takes Another Kind of Swipe at the Big Wall Street Firms in a New Campaign, N.Y. TIMES, Aug. 28, 2000, at C11; Jack White and Doug Ramsey, A Belle Epoque for Wall Street, BARRON'S, Oct. 18, 1999, at 54; John Steele Gordon, Manager's Journal: Merrill Lynch Once Led Wall Street. Now It's Catching Up, WALL ST. J., June 14, 1999, at A20.

10 See S. REP. NO. 76-1775, 76th Cong., 3d Sess. 22 (1940) ("S. REP. NO. 76-1775") (section 202(a)(11)(C) of the Advisers Act applies to broker-dealers "insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions.") (emphasis added). See also Disclosure by Investment Advisers Regarding Wrap Fee Programs, Investment Advisers Act Release No. 1401 (Jan. 13, 1994) at n.2. Our references in this Release to "commission-based brokerage" include transactions effected on a principal basis for which the broker-dealer is compensated by a mark-up or mark-down.

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 two-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 application of the Advisers Act to broker-dealers

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[11] Advisers Act Release No. 626, supra note 6; Advisers Act Release No. 2, supra note 5; Robert S. Strevell, SEC Staff No-Action Letter (Apr. 29, 1985) ("Strevell 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.").

[12] 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 Levitt. 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 investment advice to individual clients, not generating

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. We proposed 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.[13]

Under the 1999 Proposal, a broker-dealer providing investment advice to customers would be excluded from the definition of investment adviser regardless of the form that 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

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transaction revenues. See REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES (Apr. 10, 1995) ("TULLY REPORT").

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.

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.[14]

We received over 1700 comment letters on the 1999 Proposal, most of which addressed only the rule provisions concerning fee-based brokerage programs.[15] Generally, broker-dealers commenting on the proposed rule strongly supported it,[16] asserting that fee-based brokerage programs benefited customers by aligning the interests of representatives with those of their customers.[17] 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.[18]

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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. S7-25-99).

16 See, e.g., Comment Letter of Merrill, Lynch, Pierce, Fenner & Smith Incorporated (Sept. 22, 2004) ("Merrill Lynch Sept. 22, 2004 Letter"); Comment Letter of Raymond James Financial, Inc. (Sept. 21, 2004); Comment Letter of Northwestern Mutual Investment Services, LLC (Sept. 22, 2004); Comment Letter of Smith Barney Citigroup (Jan. 14, 2000). See also Comment letter of Securities Industry Association (Sept. 22, 2004) ("SIA Sept. 22, 2004 Letter").

17 See, e.g., Comment Letter of Citigroup Global Markets Inc. (Sept. 22, 2004) ("CGMI Sept. 22, 2004 Letter"); Comment Letter of Charles Schwab & Co. (Sept. 22, 2004) ("Charles Schwab Sept. 22, 2004 Letter"); Comment Letter of Securities Industry Association (Sept. 13, 2000) ("SIA Sept. 13, 2000 Letter"); Comment Letter of Securities Industry Association (Aug. 5, 2004).

18 See, e.g., CGMI Sept. 22, 2004 Letter, supra note 17, Merrill Lynch Sept. 22, 2004 Letter, supra note 16; SIA Jan. 13, 2000 Letter, supra note 17.

A large number of investment advisers – in particular, financial planners – and several groups representing investor interests – submitted letters strongly opposed to the proposed rule.[19] Some of these commenters took issue with our conclusions that the new programs do not differ fundamentally from traditional brokerage programs.[20] 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.[21] 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.[22] Many commenters

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19 See, e.g., Comment Letter of Carl Kunhardt (Dec. 28, 1999); Comment Letter of Pamela A. Jones (Jan. 4, 2000); Comment Letter of Investment Counsel Association of America (Jan. 12, 2000) ("ICAA Jan. 12, 2000 Letter") (representing SEC-registered investment advisers); Comment Letter of Consumer Federation of America (Jan. 13, 2000) ("CFA Jan. 13, 2000 Letter"); Comment Letter of The Financial Planning Association (Jan. 14, 2000) ("FPA Jan. 14, 2000 Letter"); Comment Letter of AARP (Nov. 17, 2003); Comment Letter of PFPG Fee-Only Advisors (June 21, 2004); Comment Letter of Timothy M. Montague (Sept. 10, 2004); Comment Letter of William S. Hrank (Sept. 20, 2004); Comment Letter of Marilyn C. Dimitroff (Sept. 21, 2004).

20 See, e.g., Comment Letter of Arthur V. von der Linden (May 10, 2000); CFA Jan. 13, 2000 Letter, supra note 19; FPA Jan. 14, 2000 Letter, supra note 19; ICAA Jan. 12, 2000 Letter, supra note 19.

21 See, e.g., Comment Letter of American Institute of Certified Public Accountants (Sept. 22, 2004) ("AICPA Sept. 22, 2004 Letter"); CFA Jan. 13, 2000 Letter, supra note 19; FPA Jan. 14, 2000 Letter, supra note 19.

22 See, e.g., Comment Letter of Dan Jamieson (June 1, 2000); Comment Letter of Joel P. Bruckenstein (May 31, 2000); Comment Letter of Margaret Lofaro (May 8, 2000); Comment Letter of Shawnee Barbour (Sept. 13, 2004); Comment Letter of Roselyn Wilkinson (Sept. 13, 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 Ellison (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 Jami M. Thornton (Sept. 20, 2004); see also Comment Letter of Consumer Federation of America (Feb. 28, 2000) ("CFA Feb. 28, 2000 Letter").

focused on whether and when advisory services can be considered "solely incidental to" brokerage and urged us to provide guidance on the meaning of the phrase.[23]

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.[24]

2. The Reproposal

In January we published a release in which we affirmed the basic approach of the 1999 Proposal.[25] Like our 1999 Proposal, our reproposed rule would deem a broker-dealer registered under the Exchange Act not to be an investment adviser solely as a result of receiving special compensation if the securities advice given to customers is provided on a non-discretionary basis, and it is solely incidental to the brokerage services provided to the customers, provided certain disclosure is made. We did, however, propose some significant changes in response to comments we received on the 1999 Proposal.

First, we proposed expanded disclosure to address many commenters' concerns that investors were confused about the differences between brokers and advisers. As reproposed, the rule would require that all advertisements for, and all agreements,

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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 its compensation takes, as long as the advice is solely incidental to its brokerage services. Investment Advisers Act Release No. 2339 (Jan. 6, 2005) [70 FR 2712 (Jan. 14, 2005)]. The temporary rule expires on April 15, 2005.

25 Reproposing Release, supra note 6.

contracts, applications and other forms governing the operation of, a fee-based brokerage account contain a prominent statement that the account is a brokerage account and not an advisory account. In addition, the disclosure would have to explain that, as a consequence, the customer's rights and the firm's duties and obligations to the customer, including the scope of the firm's fiduciary obligations, may differ. Finally, broker-dealers would have to identify an appropriate person at the firm with whom the customer could discuss those differences.

Second, we responded to concerns that commenters raised about the lack of guidance as to when the advisory services of broker-dealers were not solely incidental to their brokerage activities. We included in the Reproposing Release a proposed statement of interpretive position under which investment advice would be "solely incidental to" brokerage services provided to an account when those advisory services are in connection with and reasonably related to the brokerage services. The proposed interpretation provided that, under certain circumstances, financial planning services would not be solely incidental to the business of brokerage. Finally, we proposed to add a provision to rule 202(a)(11)-1 interpreting a broker-dealer's exercise of investment discretion on behalf of a customer as providing advice that is not solely incidental to its business as a broker.

We received over 300 comment letters on the reproposed rule. Many commenters, including most financial planners, strongly objected to the rule. They viewed fee-based brokerage accounts as advisory accounts, and urged that they be

regulated as such under the Advisers Act.[26] Many urged that broker-dealers be subject to the Advisers Act whenever they provide investment advice.[27] 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.[28] Broker-dealers strongly supported the rule for many of the same reasons they supported the 1999 Proposal.[29] Most, but not all, however, objected to our proposed interpretation that would require them to treat financial planning customers as advisory clients.[30]

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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 P. Welsh (Feb. 7, 2005); Comment Letter of Leon Morris (Feb. 9, 2005).

27 See, e.g., Comment Letter of Stephanie Berger (Jan. 7, 2005); Comment Letter of Mote Wealth Management (Jan. 11, 2005); Comment Letter of Donny E. Long (Jan. 12, 2005); Comment Letter of Mark Greenberg (Jan. 14, 2005); Comment Letter of Kelly F. Crane (Jan. 14, 2005); Comment Letter of William B. Burns, Jr. (Jan. 14, 2005); Comment Letter of Randy Gerard (Jan. 17, 2005); Comment Letter of Margery K. Schiller (Jan. 18, 2005); Comment Letter of Michael J. Zmistowski (Jan. 18, 2005); Comment Letter of Glencrest Investment Advisors (Jan. 20, 2005); Comment Letter of Evensky & Katz (Feb. 3, 2005); Comment Letter of Financial Planning Association (Feb. 7, 2005) ("FPA Letter"); Comment Letter of John K. Ritter (Feb. 7, 2005); Comment Letter of Thomas M. Wargin (Feb. 7, 2005). See also Comment Letter of International Association of Registered Financial Consultants (Jan. 4, 2005).

28 See, e.g., Comment Letter of Michael Boyd (Jan. 11, 2005) ("Boyd Letter"); Comment Letter of Michael O. Babin (Jan. 17, 2005); Comment Letter of Daniel H. Boyce (Jan. 18, 2005); Comment Letter of Certified Financial Planner Board of Standards (Feb. 6, 2005) ("CFP Board Letter"); Comment Letter of Consumer Federation of America (Feb. 7, 2005) ("CFA Letter"); Comment Letter of Fund Democracy, Consumer Federation of America, Consumers Union, Consumer Action (Feb. 7, 2005) ("Joint Letter of Fund Democracy et al."); Investment Counsel Association of America (Feb. 7, 2005) ("ICAA Letter"); Comment Letter of T. Rowe Price Associates (Feb. 22, 2005) ("T. Rowe Price Letter"); Comment Letter of AARP (Mar. 9, 2005) ("AARP Letter").

29 See, e.g., Comment Letter of Merrill, Lynch, Pierce, Fenner & Smith (Feb. 7, 2005) ("Merrill Lynch Letter"); Comment Letter of Raymond James & Associates, Inc. (Feb. 7, 2005) ("Raymond James Letter"); Comment Letter of Citigroup Global Markets Inc. ("CGMI Letter"); Comment Letter of Morgan Stanley (Feb. 7, 2005) ("Morgan Stanley Letter"); Comment Letter of Northwestern Mutual Investment Services, LLC (Feb. 7,

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

Commenters 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.[31] They urged, therefore, that we treat

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2005) ("Northwestern Mutual Letter"); Comment Letter of UBS Financial Services, Inc. (Feb. 7, 2005) ("UBS Letter"); Comment Letter of Wachovia Securities, LLC (Feb. 7, 2005) ("Wachovia Letter"). See also Comment Letter of Securities Industry Association (Feb. 7, 2005) ("SIA Letter"); Comment Letter of National Association of Securities Dealers (Feb. 11, 2005) ("NASD Letter").

30 See, e.g., Merrill Lynch Letter, supra note 29; Raymond James Letter, supra note 29; CGMI Letter, supra note 29; Morgan Stanley Letter, supra note 29; Northwestern Mutual Letter, supra note 29; SIA Letter, supra note 29; UBS Letter, supra note 29; Wachovia Letter, supra note 29.

31 See, e.g., Cox Letter, supra note 26; Comment Letter of Public Investors Arbitration Bar Association (Feb. 4, 2005) ("PIABA Letter"); FPA Letter, supra note 27; Joint Letter of Fund Democracy et al., supra note 28; Comment Letter of National Association of Personal Financial Advisors (Feb. 7, 2005) ("NAPFA Letter"); Comment Letter of American Institute of Certified Public Accountants (Feb. 7, 2005) ("AICPA Letter"). See also Comment Letter of Federated Investors, Inc. (Jan. 14, 2000) ("Federated Letter"); ICAA Jan. 12, 2000 Letter, supra note 19; CFA Feb. 28, 2000 Letter, supra note 22; FPA Jan. 14, 2000 Letter, supra note 19; Comment Letter of Joseph Capital Management, LLC (Aug. 30, 2004); Comment Letter of Jared W. Jameson (Sept. 16, 2004); Comment Letter of Geoffrey F. Fosie (Sept. 22, 2004); Comment Letter of the Foundation for Fiduciary Studies (Sept. 12, 2004).

all fee-based brokerage accounts as advisory accounts.[32] 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.[33] They did not view the change in pricing as significant except insofar as it better aligns the interests of registered representatives with those of their customers.[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,[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.[36]

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32 See, e.g., Cox Letter, supra note 26; Comment Letter of Anna M. Taglieri (Jan. 9, 2005); Comment Letter of Harrod Financial Planning (Jan. 14, 2005); PIABA Letter, supra note 31; FPA Letter, supra note 27; Joint Letter of Fund Democracy et al., supra note 28; NAPFA Letter, supra note 31; AICPA Letter, supra note 31. See also Comment Letter of Roy T. Diliberto (Aug. 24, 2004); Comment Letter of Don B. Akridge (Sept. 7, 2004); Comment Letter of William K. Dix, Jr. (Sept. 21, 2004) ("Dix Letter"); CFA Jan. 13, 2000 Letter, supra note 19.

33 See, e.g., Merrill Lynch Letter, supra note 29; Morgan Stanley Letter, supra note 29; Wachovia Letter, supra note 29; NASD Letter, supra note 29; Comment Letter of American Express Financial Advisers, Inc. (Mar. 4, 2005) ("American Express Letter"). See also Comment Letter of Paine Webber Incorporated (Jan. 14, 2000); Comment Letter of U.S. Bancorp Piper Jaffray Inc. (Jan. 19, 2000) ("U.S. Bancorp Jan. 19, 2000 Letter"); Comment Letter of Prudential Securities Incorporated (Jan. 31, 2000) ("Prudential Jan. 31, 2000 Letter"); Merrill Lynch Sept. 22, 2004 Letter, supra note 16.

34 See, e.g., Merrill Lynch Letter, supra note 29; American Express Letter, supra note 33. See also U.S. Bancorp Jan. 19, 2000 Letter, supra note 33; Prudential Jan. 31, 2000 Letter, supra note 33; CGMI Sept. 22, 2004 Letter, supra note 17; Merrill Lynch Sept. 22, 2004 Letter, supra note 16; SIA Sept. 22, 2004 Letter, supra note 16.

35 Section 202(a)(11)(F) excludes from the definition of investment adviser, and thus the Act, "such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order." See also Section X of this Release, infra.

36 In the Reproposing Release, we solicited comments on our reading of the history and background of the Act and, in particular, the broker-dealer exception. Some commenters agreed with our reading (see, e.g., SIA Letter, supra note 29) and others did not (see, e.g., CFA Letter, supra note 28; Joint Letter of Fund Democracy et al., supra note 28; FPA Letter, supra note 27; Comment Letter of Morgan, Lewis & Bockius LLP (Feb 7, 2005) ("Morgan, Lewis Letter")). Our views about the issues raised by these commenters are set out throughout this Release.

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")[37] – in other words, customers did not pay a separate fee for that advice.[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.[39] By 1940, when the Advisers Act was enacted, broker-

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37 Then, as now, brokerage services included services provided throughout the execution of a securities transaction, including providing research and advice prior to a decision to buy or sell, implementing that decision on the most advantageous terms and executing the transaction, arranging for delivery of securities by the seller and payment by the buyer, maintaining custody of customer funds and securities, and providing recordkeeping services. See Exchange Act section 28(e)(3), 15 U.S.C. 78bb(e)(3). See also generally Charles F. Hodges, WALL STREET (1930) ("WALL STREET").

38 SEC, REPORT ON INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES (1939) (H.R. Doc. No. 477) ("INVESTMENT COUNSEL REPORT") at 3. Such investment advice provided by broker-dealers was "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." Id. at 4; see INSPECTION REPORT ON THE SOFT-DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS (prepared by the Commission's Office of Compliance Inspections and Examinations) (Sept. 22, 1998) (available on the Internet at http://www.sec.gov/news/studies/softdolr.htm) ("Since the early days of the brokerage industry, full-service broker-dealers have provided research and other services to customers in addition to executing trades as part of an overall package of services provided to customers. Customers have always paid for this in-house (or proprietary) research, as well as the other services, with commissions; normally no separate price tag was attached to such research or other services. Customers' commissions are used to pay, not only for execution services, but also for proprietary research, access to information and analysts' opinions on an as-needed basis, the brokerage firm's commitment to work difficult trades, and for the firm's willingness to commit capital and other resources for the customer's benefit. These practices continue today. The costs of these services are not separately itemized or billed to customers of brokerage firms but instead are considered part of the overall service provided to customers.").

39 See Twentieth Century Fund, THE SECURITY MARKETS (1935) at 646-47 ("SECURITY MARKETS"). Additionally, some broker-dealers created subsidiary companies to offer advisory services for a fee, or established affiliations with independent investment advisory firms to which they directed brokerage customers for paid advisory services.

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.[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.[41] "Brokerage house advice" was extensive and varied,[42] and included information about various corporations, municipalities, and governments;[43] broad analyses of general

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See id. at 647; see also Brokers to Bare Advisory Services, N.Y. TIMES, Oct. 19, 1934, at 33; INVESTMENT COUNSEL REPORT, supra note 38, at 4-5, 19-20.

40 See, e.g., Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. 736 (1940) ("Hearings on S. 3580") (testimony of Dwight C. Rose, president of the Investment Counsel Association of America) ("Most . . . investment dealers . . . and brokers advise on investment problems, either as an auxiliary service without charge, or for specific charges allocated to this specific function.").

41 See SECURITY MARKETS, supra note 39, at 633-46 (discussing "brokerage house advice"). See also WALL STREET, supra note 37, at 253-85; INVESTMENT COUNSEL REPORT, supra note 38, at 1 n.1.

42 E.g., REPORT OF PUBLIC EXAMINING BD. ON CUSTOMER PROTECTION TO N.Y. STOCK EXCHANGE, at 3 (Aug. 31, 1939):

> The customer entrusts the broker with information regarding his financial affairs and dealings which he expects to be kept in strict confidence. Frequently he looks to the broker to perform a whole series of functions relating to the investment of his funds and the care of his securities. Although he could secure similar services at his bank, he asks his broker, as a matter of choice and convenience, to hold credit balances of cash pending instructions; to retain securities in safekeeping and to collect dividends and interest; to advise him respecting investments; and to lend him money on suitable collateral.

43 SECURITY MARKETS, supra note 39, at 633; WALL STREET, supra note 37, at 254 ("This information includes current and comparative data for a number of years on earning and earnings records, capitalization, financial position, dividend record, comparative balance sheets and income statements . . . production and operating statistics, territory and markets served, officers and directors of the company and much other information of value to the investor in appraising the value of a security").

business and financial conditions;[44] market letters and special analyses of companies' situations;[45] information about income tax schedules and tax consequences;[46] and "chart reading."[47] The principal sources of auxiliary advice were firm representatives – known as "customers' men" until 1939[48] – who served as the main point of contact with brokerage customers,[49] and the "statistical departments" within firms, which provided research and analysis to customers' men or directly to the firms' brokerage customers.[50]

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44 SECURITY MARKETS, supra note 39, at 634; WALL STREET, supra note 37, at 254.

45 SECURITY MARKETS, supra note 39, at 640-43; WALL STREET, supra note 37, at 277-85.

46 SECURITY MARKETS, supra note 39, at 641.

47 Id. at 643 (defining "chart reading" as "the study of the charted course of prices and volume of trading over a long period of time in order to discover typical conformations recurring in the past with sufficient frequency to be utilized in the present as a basis of judgment as to impending price changes").

48 Customers' Men Undecided on New Name; They Will Be Called Registered Representatives By Stock Exchange, Along With Other Groups, WALL ST. J., May 13, 1939 at 7. See also SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER (June 20, 1936) (submitted to Congress by the Commission pursuant to section 11(e) of the Exchange Act) ("SEGREGATION STUDY") at 3; United States v. Brown, 79 F.2d 321, 323 (2d Cir. 1935) ("Brokers have managers, clerks and so on who deal directly with their customers and on their advice the customers rely in investing").

49 Oliver J. Gingold, Give the Poor Customers' Man His Due, BARRON'S, May 24, 1937 at 11; The Broker Changes with the Changing Times, N.Y. TIMES MAGAZINE, May 30, 1937 at 22 ("[T]he brunt of the demand for market advice falls on the boardroom philosopher and economist, otherwise known as the customers' man").

50 SECURITY MARKETS, supra note 39, at 640; WALL STREET, supra note 37, at 253. In the years following the stock market crash in 1929, customers' men were made subject to a series of rules designed to ensure that they had the knowledge and experience required to advise customers and that they acted in the best interests of the customer. See SECURITY MARKETS, supra note 39, at 638-40 (discussing and quoting rules adopted on May 7, 1930 by the Committee on Quotations of the New York Stock Exchange and on June 28, 1933 by the Exchange's Governing Committee); Wall St. Problem in Customers' Men, N.Y. TIMES, Jan. 14, 1934 at N7 ("[T]he Stock Exchange has approved rules prohibiting customers' men from handling discretionary accounts, which powers are now delegated with few exceptions, only to partners in Stock Exchange firms. . . . These employees, who were regarded merely as business getters in 1929, should be well-informed on financial matters and able to give sound investment advice to customers, brokers now believe.").

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 undert[ook] 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

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51 See Advisers Act Release No. 2, supra note 5. See also SECURITY MARKETS, supra note 39, at 646, 653 (referring to "investment supervisory departments" and "special investment management departments" of broker-dealers). 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 208(c) of the Act.

52 SECURITY MARKETS, supra note 39, at 649-50. See also INVESTMENT COUNSEL REPORT, supra note 38, at 13-14.

53 SECURITY MARKETS, supra note 39, at 649. See also INVESTMENT COUNSEL REPORT, supra note 38, at 13.

54 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,

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]

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the investment banks and those brokerage houses which undertake to perform the functions of investment counsel").

55 For example, one brokerage firm that had added an "extensive counsel service" to its brokerage business in 1931 put that service on a "fee basis" in 1933 and charged an annual advisory fee of 0.25 percent of the market value of the account being supervised on accounts with a value of less than $1 million (with a minimum fee of $250) and a fee of 0.1 percent on accounts in excess of $1 million. SECURITY MARKETS, supra note 39, at 653. See also INVESTMENT COUNSEL REPORT, supra note 38, at 16-17.

56 INVESTMENT COUNSEL REPORT, supra note 38, at 1. The study was conducted pursuant to section 30 of the Public Utility Holding Company Act of 1935 [15 U.S.C. 79z-4].

57 INVESTMENT COUNSEL REPORT, supra note 38, at 1.

58 See Hearings on S. 3580, supra note 40, at 995-96.

59 Excerpts from that testimony are included in the INVESTMENT COUNSEL REPORT, supra note 38. A complete transcript of the Commission's February 11, 1938 hearing is reproduced in the 1938 INVESTMENT COUNSEL ANNUAL, at pages 97-154.

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

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60 INVESTMENT COUNSEL REPORT, supra note 38, at 27.

61 Hearings on S. 3580, supra note 40, at 50-51. See also S. REP. NO. 76-1775, supra note 10, at 21-22; H.R. REP. NO. 76-2639, 76th Cong., 3d Sess. 28 (1940) ("H.R. REP. NO. 76-2639") at 28.

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[62] and by private organizations, such as the Investment Counsel Association of America.[63] 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.[64]

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62 Hearings on S. 3580, supra note 40, at 745-748. 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; FPA 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 proposed legislation were also informed by investment counselors who testified on the legislation, that it would cover only broker-dealers who were separately paid 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 Subcomm. of the House 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 716-18, 736-38, 740-41, 744-45, 760, 763.

64 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:

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,[65] the Act specifically excepted such persons, among others, to the extent they rendered investment advice as part of their other regular

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> 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 people in the investment-counsel business who are supervised are not eligible for membership in the investment counsel association; because the association says that if you are in the brokerage or banking business you cannot be a member of the association.
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> So the situation is that if you take their analysis, the only ones who would not be subject to regulation by the S.E.C. would be the people who 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 is 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 S. REP. NO. 76-1775, supra note 10, at 21; H.R. REP. NO. 76-2639, supra note 61, at 27.

65 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 62, at 88 (statement of Congressman Cole) ("[I]n 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."). One commenter argued that we "created a distorted picture" of the historical record, however, by failing to cite to 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 (citing Hearings on S. 3580, supra note 40, at 49). From this, the commenter implies that Congress would have considered a "high fiduciary duty" to be a prerequisite for an exception from the definition of "investment adviser." We cannot agree, however, because the same provision excepting lawyers also excepts other professionals (engineers and teachers) who have never been regarded as traditional fiduciaries.

business.[66] Broker-dealers were among these already-regulated persons, and section 202(a)(11)(C) of the Act excepts from the definition of "investment adviser" a broker-dealer who provides investment advice that is "solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."

2. Our Conclusions

We draw two relevant conclusions from this legislative history as well as from the brokerage customs of 1940. First, as drafted in 1940, the Advisers Act avoided additional and largely duplicative regulation of broker-dealers, which were regulated under provisions of the Exchange Act that had been enacted six years earlier.[67] Second, the broker-dealer exception in the Advisers Act was understood to distinguish between broker-dealers who provided advice to customers only as part of the package of traditional brokerage services for which customers paid fixed commissions – who were

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66 This exception for certain professionals is very similar to certain state-law provisions governing investment counselors at the time, which excepted "brokers, attorneys, banks, savings and loan associations, 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. No. 73-291, 48 Stat. 881 (June 6, 1934). Four years later in the Maloney Act, Congress amended the Exchange Act to authorize 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 for other reasons that support 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 also 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 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.

not covered by the Advisers Act[68] – 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.[69] 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 bill that Congress ultimately enacted)[70] understood that broker-dealers offered investment advice both as part of their traditional commission brokerage services and, alternatively, for a separate

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68 See S. REP. NO. 76-1775, supra note 10, at 22; H.R. REP. NO. 76-2639, supra note 61, at 28. See also Thomas P. Lemke & Gerald T. Lins, REGULATION OF INVESTMENT ADVISERS §1:19 ("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, Investment Advisers Act Issues for Broker-Dealers, SECURITIES & COMMODITIES REGULATION at 214 (Dec. 9, 1987) ("While most broker-dealers initially will come within the definition of an investment adviser, it is clear that Congress did not intend brokerage activities to be regulated under the 1940 Act [citing S. REP. NO. 76-1775]. Rather, such activities were intended to be regulated under the 1934 Act without the additional and often duplicative requirements under the 1940 Act.").

69 One commenter disputed our conclusion that the Act was drafted to cover the sort of advice that, in 1940, was provided through the separate advisory departments of broker-dealers. CFA Letter, supra note 28. In support of its contrary contention that Congress intended the Act to apply to most of the advice provided by broker-dealers in 1940 – including advice provided as part of the package of brokerage services for which broker-dealers received only commissions – this commenter pointed to an excerpt from the ILLINOIS LEGISLATIVE COUNCIL REPORT that describes the risk that investment counselors associated with brokerage houses would "unduly urge frequent buying and selling of securities, even when the wisest procedure might be for the client to retain existing investments." CFA Letter, supra note 28 (quoting ILLINOIS LEGISLATIVE COUNCIL REPORT, supra note 66, at 1014). This excerpt, however, is consistent with our reading of the broker-dealer exception. In describing the sort of "association" with brokerage houses that would give rise to the risk described above, the report stated that "[m]any counselors have some connection, direct or indirect, with [broker-dealer] . . . firms, although such connections are not universal. Furthermore, brokers and dealers in securities frequently maintain an investment counsel service in connection with their other activities." ILLINOIS LEGISLATIVE COUNCIL REPORT, supra note 66, at 1014). This excerpt indicates that, to the extent that broker-dealers were the investment counselors who gave rise to the concern, they were offering advisory services through special investment advisory departments – precisely the sort of advisory services we have concluded the Act was drafted to reach.

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

fee through special departments,[71] and that the Advisers Act was intended to reach only the latter.[72] The earliest Commission staff interpretations of the Advisers Act also reflect the same understanding, i.e., that the Act was intended to cover broker-dealers only to the extent that they were offering investment advice as a distinct service for which they were specifically compensated (which it was "well known" they were doing through special advisory departments).[73]

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71 Id. at 736.

72 Id. at 711 (testimony of Douglas T. Johnston, vice-president of Investment 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 advisory departments and make charges for services rendered . . .".). One commenter 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, at 7. 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 38, at 2, n.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").

73 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 foregoing reference to "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 "simply supports the document's preceding assertion, that a broker is not 'excluded from the

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 are subject to a 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[74] 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

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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 reach.

74 The practice of fixing commission rates on stock exchanges in the United States is generally traced back to the so-called Buttonwood Tree Agreement of 1792, which provided: "We, the Subscribers, Brokers for the Purchase and Sale of Public Stock, do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell from this day forward for any person whatsoever, any kind of Public Stock at a less rate than one-quarter percent Commission on the Specie value of, and that we will give a preference to each other in our Negotiations. In Testimony whereof we have set our hands this 17th day of May, at New York, 1792." Eames, THE NEW YORK STOCK EXCHANGE 14 (1894).

In 1975, the Commission adopted rule 19b-3 [17 C.F.R. 19b-3] which eliminated the fixed commission rate structure on national securities exchanges. See generally Exchange Act Release No. 11203 (Jan. 23, 1975) [40 FR 7394 (Feb. 20, 1975)].

75 At the time the Advisers Act was enacted, Congress understood "special compensation" to mean compensation other than commissions. S. REP. NO. 76-1775, supra note 10, at 22 ("The term 'investment adviser' is so defined as specifically to exclude . . . brokers (insofar as their advice is merely incidental to brokerage transactions for which they

"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, neither the legislative history of section 202(a)(11)(C) nor the broader legislative history of the Advisers Act as a whole suggests that, in 1940, Congress viewed the form of compensation for the services at issue – commission versus fee-based compensation – as having any independent relevance in terms of the advisory services the Act was intended to reach.

To the extent fee-based brokerage programs offer a package of the same types of services that Congress intended the Advisers Act not to cover,[77] the rule we are adopting today is necessary to prevent the Act from reaching beyond Congress' intent.[78] Today, fee-based brokerage programs are offered by most of the larger broker-dealers, and hold

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receive only brokerage commissions.)") (emphasis added). See also H. Rep. No. 2639, supra note 61.

[76] Of course, the absence of "special compensation" was necessary but not sufficient for the section 202(a)(11)(C) exception. The other requirement – that the advice be provided "solely incidental to" the conduct of the brokerage business – has always required a judgment based on the facts and circumstances and was not the sort of "bright-line" test that non-commission "special compensation" was.

[77] When brokers re-price traditional commission-based brokerage accounts, they create a different set of incentives for their registered representatives. Thus, it is not surprising to us, nor is it inconsistent with the design of the rule we are today adopting, that customers with fee-based brokerage accounts may obtain a different level or quality of services, including advisory services, than do customers with commission-based brokerage accounts. Indeed, one of the aims of the Tully Commission, as articulated in its report, was to create incentives for brokers to improve the quality of the services provided their customers. See TULLY REPORT, supra note 12.

[78] In reaching this conclusion, we are exercising our authority under section 202(a)(11)(F) to except "such other persons not within the intent of" the definition of "investment adviser" in section 202(a)(11). Broker-dealers who provide investment advice solely incidental to traditional brokerage services for a fee are a group which, as discussed above, could not have existed at the time Congress enacted the Advisers Act because, in 1940, broker-dealers were paid only fixed commissions for traditional brokerage services. Such broker-dealers are therefore "other persons" within the meaning of section 202(a)(11)(F).

over $268 billion of customer assets.[79] Although this is still a relatively small number, it is estimated that assets in fee-based brokerage programs nationwide grew by 60.9 percent during 2003-2004.[80] Industry observers expect that fee-based programs will continue to grow as broker-dealers move away from transaction-based brokerage relationships that provide unsteady sources of revenue.[81] Our failure to adopt this rule could eventually result in the extension of the Advisers Act to many brokerage relationships. Such a result would be inconsistent with the intent of the Advisers Act, which, as discussed earlier, was designed to fill a regulatory gap that had permitted firms and individuals to engage in advisory activities without being regulated.[82] Moreover, such a result would create substantial regulatory overlap, which the Act was drafted to avoid.[83] Far from being a

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79 The Cerulli Edge, Managed Accounts Edition (1st Quarter 2005) ("Cerulli Edge 1st Quarter 2005"). One commenter asserted that fee-based accounts represent 6.4% of the $3.9 trillion of securities currently held by individual investors. FPA Letter, supra note 27.

80 Cerulli Edge 1st Quarter 2005, supra note 79.

81 The Cerulli Edge, Managed Accounts Edition (1st Quarter 2004).

82 See supra notes 56 - 64 and accompanying text.

83 See supra notes 65 - 66 and accompanying text. One commenter contended that in reaching this conclusion about the purpose of the broker-dealer exception, we did not adequately account for a discussion in the ILLINOIS LEGISLATIVE COUNCIL REPORT addressing different ways the State of Illinois might exempt certain professionals from regulation as investment counselors. See CFA Letter, supra note 28. The Illinois report stated that "[a]part from deciding the merits of each claim for exemption, a decision would have to be made as to whether to exempt only those who incidentally and occasionally give advice as to investments or whether to exempt as a general rule all who regularly furnish investment advice if they also belong to one of the groups in relation to which some other form of government regulation exists." ILLINOIS LEGISLATIVE COUNCIL REPORT, supra note 66, at 1007-1008 (emphasis supplied). According to the commenter, this excerpt indicates that, because Congress did not provide a "blanket exception" for broker-dealers, (1) Congress necessarily chose to except only broker-dealers who "'incidentally and occasionally give advice on investments'"; and (2) the exception cannot have been based on any concern about overlapping or duplicative regulation. CFA Letter, supra note 28. We cannot agree. Most critically, the broker-dealer exception in the Advisers Act says nothing about advisory services being only "occasional." Thus, to the extent the formulation in the state report is relevant here, it

radical departure from existing regulatory policy as suggested by some commenters, we believe the primary effect of rule 202(a)(11)-1 will be to maintain the historical ability of full-service broker-dealers to provide a wide variety of services, including advisory services, to brokerage customers, without requiring those broker-dealers to treat those clients as advisory clients.

The arguments of many commenters opposed to the reproposed rule go to 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.[84] They assert that today, brokerage is incidental to the advisory services provided by full-service broker-dealers,[85] and point to brokerage advertising that emphasizes the quality of the advisory services provided by the broker-dealer as indicative of this change.[86] These comments fail to give weight to Congress'

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tends to indicate that the drafters of the Advisers Act chose not to limit the broker-dealer advice excepted by section 202(a)(11)(C) to advice that is provided only occasionally. Further, even accepting the commenter's reading of the state report, there is no basis for concluding that Congress' concern about duplicative or overlapping regulation could have been addressed only by a blanket exception from the Act. The more reasonable view is that the drafters of the qualified exception in section 202(a)(11)(C) took account of the recent and substantial regulation of broker-dealers (see supra note 67) and balanced the interest in avoiding multiple regulation of broker-dealers against the interest in regulating as advisers, broker-dealers who were providing investment advisory services through "investment advisory departments . . . for compensation in the same manner as does an investment adviser who operates solely in an advisory capacity." Investment Advisers Act Release No. 2, supra note 5. Indeed, although there are clear statements in the historical record that the exception for lawyers in section 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.

84 See supra note 27.

85 See, e.g., AICPA Letter, supra note 31; Joint Letter of Fund Democracy et al., supra note 28. See also FPA Jan. 14, 2000 Letter, supra note 19.

86 See, e.g., CFA Letter, supra note 28; CFP Board Letter, supra note 28; Joint Letter of Fund Democracy et al., supra note 28; T. Rowe Price Letter, supra note 28. See also

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.[87] Full-service broker-dealers have always sought to develop long-term relationships with their customers who often come to rely on them for expert investment advice.[88] And full-service retail broker-dealers have always relied on ancillary services, such as advisory services, to promote and sell their brokerage services.[89] 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.[90] A rule or interpretation of the Advisers Act that would

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CFA Jan. 13, 2000 Letter, supra note 19; Joint Comment Letter of Consumer Federation of America, Fund Democracy, Investment Counsel Association of America, Financial Planning Association, Certified Financial Planner Board of Standards, Inc., and National Association of Personal Financial Advisors (May 6, 2003); Comment Letter of Strategic Compliance Concepts, Ltd. (Sept. 9, 2004); Dix Letter, supra note 32; Comment Letter of Joseph Capital Management (Nov. 7, 2004).

87 See supra notes 37 - 55 and accompanying text.

88 See id.

89 See, e.g., INVESTMENT COUNSEL REPORT, supra note 38, at 4 ("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").

90 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 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 stocks listed on the New York Stock Exchange

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 Act to a broker-dealer whenever it provides 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.[91]

Many commenters opposing the proposed rule focused their arguments on additional investor protections that regulation under the Advisers Act provides and argued that the rule would harm investors.[92] 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

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for the years 1930 to 1950 and noting that there was an extremely sharp rise in shareholdings from 1930 to 1935 followed by an "apathetic market" in the period 1935-1940).

91 For the same reason, we do not believe that the competitive concerns of many of the financial planners that commented on the proposal and reproposal counsel against adopting this rule.

92 AICPA Letter, supra note 31; CFP Board, supra note 28; FPA Letter, supra note 27; NAPFA Letter, supra note 31; AARP Letter, supra note 28. See also CFA Jan. 13, 2000 Letter, supra note 19; FPA Jan. 14, 2000 Letter, supra note 19; ICAA Jan. 12, 2000 Letter, supra note 19.

from the definition of investment adviser.[93] Broker-dealers are subject to oversight by the Commission as well as by one or more SROs under the Exchange Act. The Exchange

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[93] Many commenters focused on the conflicts under which broker-dealers function, arguing that the rule is "anti-consumer" in that broker-dealers are not subject to the same obligations to disclose conflicts as are advisers. See, e.g., FPA Letter, supra note 27. As noted above, however, Congress was well aware of these conflicts when it passed the Advisers Act. See, e.g., Hearings on S. 3580, supra note 40 at 736 ("Some 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"); INVESTMENT COUNSEL REPORT, 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 intending to sell particular securities 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 or broker can be relied upon always to give 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 securities, 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 to 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 intermingling 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 the broker-dealer and/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 to the broker (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, 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]

Act Release No. 8358 (Jan. 29, 2004 [69 FR 6438 (Feb. 10, 2004)] 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. 34-50910 (Dec. 22, 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 regarding overall rate of return for purchase of Class A shares rather than Class B shares).

94 An entity that wishes to act as a broker-dealer, and that does not qualify for an exemption, 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 broker-dealers to disclose 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 anti-fraud provisions in Sections 9(a), 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 fair dealing, have 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 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. 51 - 52 and accompanying text.

95 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

Some commenters opposed to the rule asserted that the Commission, by providing the proposed exception in the rule, would relieve broker-dealers of the fiduciary responsibility to clients that 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,

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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 continues to be 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.

96 AICPA Letter, supra note 31; CFA Letter, supra note 28; CFP Board Letter, supra note 28; FPA Letter, supra note 28; Fund Democracy Letter, supra note 28; NAPFA Letter, supra note 31. See also AICPA Sept. 22, 2004 Letter, supra note 21; CFA Jan. 13, 2000 Letter, supra note 19; FPA Jan. 14, 2000 Letter, supra note 19.

97 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 184 (1963) (quoting Prosser, LAW OF TORTS (1955), 534-35). See also Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

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 incident to their brokerage unless they have placed themselves in a position of trust and confidence), aff'd sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951 (E.D. Mich. 1978), aff'd, 647 F. 2d. 165 (6th Cir. 1981) (recognizing that broker who has de facto control over non-discretionary account generally owes customer duties of a fiduciary nature; looking to customer's sophistication, and the degree of trust and confidence in the relationship, among other things, to determine duties owed); Paine Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d. 508 (Colo. 1986) (evidence "that a customer has placed trust and confidence in the broker" by giving practical control of account can be "indicative of the existence of a fiduciary relationship"); MidAmerica Federal Savings & Loan v. Shearson/American Express, 886 F.2d. 1249 (10th Cir. 1989) (fiduciary relationship

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 are registered, but upon the role they are playing.

We acknowledge that the lines between full-service broker-dealers and investment advisers continue to blur. But we do not believe requiring most or all full-service broker-dealers to treat most or all of their customer accounts as advisory accounts is an appropriate response to this blurring. Nor do we believe that Congress would have intended the Advisers Act to apply to all brokerage accounts receiving advice even when that advice is substantial. Congress did not mandate that the nature or amount of the advice rendered by broker-dealers remain static in order for broker-dealers to avail themselves of the statutory exception. Instead, Congress required only that such advice be performed "solely incidental to" a person's "business as a broker or dealer" and not for "special compensation." The exception does not foreclose – but, instead, accommodates – the foreseeable likelihood that the "business" of broker-dealers, including the rendition of advice, would evolve. Thus, the emergence of these new fee-based brokerage accounts does not mean that broker-dealers have ceased to offer the

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existed where broker was in position of strength because it held its agent out as an expert); SEC v. Ridenour, 913 F.2d. 515 (8th Cir. 1990) (bond dealer owed fiduciary duty to customers with whom he had established a relationship of trust and confidence); C. Weiss, A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty, 23 Iowa J. Corp. Law 65 (1997). Cf. De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1302-03, 1308-09 (2d Cir. 2002) (noting that brokers normally have no ongoing duty to monitor non-discretionary accounts but that "special circumstances," such as a broker's de facto control over an unsophisticated client's account, a client's impaired faculties, or a closer-than-arms-length relationship between broker and client, might create extra-contractual duties).

99 Reproposing Release, supra note 6, at n. 53 - 54 and accompanying text.

general package of brokerage services they have traditionally provided to their customers or to dispense advice as part of that package.[100]

That is not to say, however, that broker-dealers can or should be "excluded from the purview of the Act merely because [they] are engaged in effecting market transactions."[101] The rule we are adopting today provides for an exception to the definition of investment adviser for broker-dealers only in circumstances in which the Commission believes that Congress did not intend to apply the Advisers Act, and clarifies certain circumstances in which we believe the Advisers Act is intended to apply.[102]

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.[103] The rule is available to any broker-dealer registered under the Exchange Act that satisfies two conditions: (i) any

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100 For this reason, we disagree with the arguments of those commenters (e.g., Letter of CFP Board, supra note 28) that merely because the level and type of advisory services included in the package of brokerage services offered today may differ from what was provided in 1940, Congress could not have intended to except such services from the Advisers Act.

101 Advisers Act Release No. 2, supra note 5.

102 To the extent that statements made in Release Number 626 may be interpreted to be inconsistent with our conclusion that excepting broker-dealers from the Advisers Act under the conditions established in the rule is consistent with the purposes of the Act, we reject them. See Advisers Act Release No. 626, supra note. At the time, we were not confronted with a situation in which broker-dealers had, in fact, migrated toward providing brokerage services for compensation other than commissions. Today, they have done so (in a manner consistent with the findings of the Tully Report) and, after careful consideration of the congressional intent underlying the broker-dealer exception, we do not believe that the incremental benefit of applying protections unique to the Advisers Act to full-service brokerage would justify applying the Act in circumstances in which Congress would have expected that the Act would not apply. See also discussion at Section III.E of this Release.

103 When the form of compensation demonstrates that the advice is not solely incidental to brokerage, however, as in the case of separate fees paid specifically for advice, the exception will not be available. See infra notes 144 - 147 and accompanying text.

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);[104] 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.[105]

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.[106]

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104 See Section III.E, infra.

105 As reproposed, the rule contained a third condition: that the broker-dealer must not exercise investment discretion over the account from which it receives special compensation. See Reproposing Release, supra note 6. Because that condition is unnecessary, given our interpretation of "solely incidental to" as not including investment discretion, we have eliminated that condition from the rule we adopt today.

106 Broker-dealers should pay careful attention to their obligations in relying on this rule and the consequences of their failing to satisfy these obligations. The Advisers Act authorizes the Commission to bring administrative proceedings and initiate civil actions for violations of the Act. Advisers Act section 209.

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.[107] 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. With that one difference, the Commission intends that this provision be interpreted consistently with the statutory provision, which is addressed in paragraph (b) of the rule and discussed in Section III.E of this Release.

As a result (and as proposed), the advice that a broker-dealer provides to fee-based brokerage accounts must be non-discretionary advice.[108] Commenters favoring the rule generally agreed that discretionary accounts that are charged an asset-based fee should be subject to the Advisers Act.[109] 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

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107 Rule 202(a)(11)-1(a)(1)(i).

108 See supra note 104.

109 See, e.g., SIA Letter, supra note 29; Morgan Stanley Letter, supra note 29; Comment Letter of Investment Company Institute (Feb. 7, 2005) ("ICI Letter").

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.[110]

As reproposed, 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.[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.[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.[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

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110 Reproposing Release, supra note 6.

111 ICI Letter, supra note 109; Morgan Stanley Letter, supra note 29; American Express Letter, supra note 33.

112 FPA Letter, supra note 27; CFP Board Letter, supra note 28; Joint Letter of Fund Democracy et al., supra note 28; ICAA Letter, supra note 28; AICPA Letter, supra note 31; T. Rowe Price Letter, supra note 28; Comment Letter of Government of the District of Columbia, Department of Insurance, Securities and Banking (Feb. 23, 2005) ("D.C. Securities Bureau Letter"); AARP Letter, supra note 28.

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").

between investment advisers and broker-dealers.[114] They thought it would be very unlikely that such a person would accurately describe the differences in legal rights and obligations.[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.[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.[117] Thus, we believe broker-dealers are in the best position to make the 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,[118]

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114 FPA Letter, supra note 27; CFP Board Letter, supra note 28; Joint Letter of Fund Democracy et al., supra note 28; AICPA Letter, supra note 31; T. Rowe Price Letter, supra note 28; D.C. Securities Bureau Letter, supra note 112; PIABA Letter, supra note 31; Comment Letter of the Consortium (Jan. 24, 2005) ("The Consortium Letter").

115 PIABA Letter, supra note 31; Northwestern Mutual Letter, supra note 29.

116 FPA Letter, supra note 27; CFP Board Letter, supra note 28.

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

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

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."[119] The ability to contact a person at the broker-dealer was considered to be a positive factor.[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."[121]

We believe it is appropriate to inform broker-dealer customers of the nature of the account they are opening.[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

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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/RIvestmentZAG_CFAFINAL_102704.ppt). 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.

119 Id.

120 Id.

121 Id. at 4 & 9.

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.

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[123] as follows:

> "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."[124]

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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 in a manner clearly intended to draw attention to it. In a televised or video presentation, a voice overlay must clearly convey the required information.

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 materially.

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, interactive websites, or multimedia

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.

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software cannot be used to substitute for the broker-dealer's obligation to provide a contact person under the rule. Of course, if a broker-dealer were to choose to treat an account as an advisory account, the disclosure would not be required.

125 The rule does not require the contact person to be specifically named; it is sufficient if a broker-dealer provides customers with a designated contact point that allows the customer to speak to a person within the firm who can answer customers' questions about the differences between fee-based brokerage accounts and advisory accounts. Because different broker-dealers will likely experience differences in the level and nature of customer inquiries and may choose differing approaches to responding efficiently within the firm's particular structure, we are not establishing qualifications or criteria for contact personnel at this time. Each broker-dealer is responsible for implementing and monitoring an approach designed to deliver answers that are accurate and not misleading.

126 Rule 202(a)(11)-1(a)(2).

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

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127 See, e.g., Advisers Act Release No. 2, supra note 5.

128 In 1978, our staff raised the possibility of such consequences and suggested, as a possible interpretation, the approach we are today adopting in this rule. See Advisers Act Release No. 626, supra note 6, at n.14.

129 Merrill Lynch Letter, supra note 29; UBS Letter, supra note 29; Wachovia Letter, supra note 29. See also Federated Letter, supra note 31; Charles Schwab Sept. 22, 2004 Letter, supra note 17; Comment Letter of NASD (Feb. 24, 2000). But see D.C. Securities Bureau Letter, supra note 112.

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

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130 Rule 202(a)(11)-1(c). Of course, applicability of the Advisers Act does not excuse the broker-dealer from compliance with the Exchange Act and its rules and applicable SRO requirements with respect to the account.

131 See The Consortium Letter, supra note 114; PIABA Letter, supra note 31; UBS Letter, supra note 29.

132 Proposing Release, supra note 6. See also Advisers Act Release No. 626, supra note 6.

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

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133 See supra notes 65-73 and accompanying text.

134 Advisers Act Release No. 1 (emphasis supplied). See also Advisers Act Release No. 2, supra note 5; SEC 1941 Annual Report available at http://www.sechistorical.org/museum/papers/pdf/SEC_1941_AR.pdf ("Exempted from the provisions of the Act . . . are . . . brokers and security dealers whose investment advice is given solely as an incident of their regular business for which no special fee is charged.").

135 We discussed the statutory language at length in the Reproposing Release. Some commenters took issue with our discussion of the language, calling it "highly selective" and "strained," arguing that we have picked a secondary meaning of "incidental" and have ignored the word "solely." See, e.g., Joint Letter of Fund Democracy et al., supra note 28; FPA Letter, supra note 27. According to The American Heritage Dictionary of the English Language (4th ed. 2000), "solely" means alone, singly, entirely, or exclusively. In combination then, and as discussed in the Reproposing Release, the phrase "solely incidental to his business as a broker or dealer" means exclusively following as a consequence of his "business of effecting transactions in securities for the account of others" (see Advisers Act section 202(a)(3) and Exchange Act section 3(a)(4)(A) defining "broker") or of his business of buying and selling securities for his own account (see Advisers Act section 202(a)(7) and Exchange Act section 3(a)(5)(A) defining "dealer"). We believe another (and simpler way) of saying the same thing is to say that the "solely incidental to" requirement means that the advisory services must be rendered in connection with and be reasonably related to the brokerage services provided. Although we acknowledge that there are other definitions of "incidental," we believe that those definitions that indicate that the side occurrence (here the "performance of [advisory] services") is something that can be expected to arise in connection with the main action (here the "business as a broker or dealer") more closely reflect the pertinent historical practices of brokers and dealers than do those definitions that treat the side occurrence as something that merely happens "by chance" or on an "isolated," "unpredictable" and/or "occasional" basis. As we explain above, brokers do not render advice "by chance" or as "an unpredictable or minor accompaniment" of their businesses.

that is provided on an "isolated," "occasional," "unpredictable"or "limited" basis,[136] advice arising out of specific transactions,[137] or advice that that is not marketed by a broker-dealer.[138] 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) misapprehends the historical background, including the legislative history of the Act.[139] 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

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136 See, e.g., FPA Letter, supra note 27; CFP Board Letter, supra note 28; Joint Letter of Fund Democracy et al., supra note 28; CFA Letter, supra note 28; AARP Letter, supra note 28.

137 See, e.g., Joint Letter of Fund Democracy et al., supra note 28. See also CFA Letter, supra note 28; ICAA Letter, supra note 28.

138 See, e.g., Boyd Letter, supra note 28; CFA Letter, supra note 28; Joint Letter of Fund Democracy et al., supra note 28; FPA Letter, supra note 27; CFP Board Letter, supra note 28. See also T.Rowe Price Letter, supra note 28; ICAA Letter, supra note 28; Comment Letter of Austin Gallaher (Jan. 19, 2005) ("Gallaher Letter"); Comment Letter of Michael L. Jones (Jan. 20, 2005).

139 One commenter, for example, argued that our construction of "solely incidental to" in section 202(a)(11)(C) fails to take account of certain comments relating to the meaning of the exception for lawyers in section 202(a)(11)(B) made during the congressional testimony of Professor E. Merrick Dodd, which, the commenter argues, require a narrow construction of the broker-dealer exception. See CFA Letter, supra note 28 (citing testimony of Professor Dodd, Hearings on S. 3580, supra note 40, at 765-66). We disagree for several reasons. First, unlike the typical lawyer's business, a broker-dealer's business deals entirely with investments in securities, and the sort of investment advisory services that would be solely incidental to that business are logically broader than the sort of services that are solely incidental to the business of a lawyer. Second, the cited testimony appears to place few, if any, limits on the nature, extent, or duration of advisory services a lawyer might render and nevertheless be exempt from the Act, with the sole exception of a limit on holding out, which, given the securities-based nature of their business, cannot apply with equal force to broker-dealers. Finally, the commenter did not refer to other Congressional testimony suggesting that the "solely incidental to" limitation of section 202(a)(11)(B) embraces a substantial amount of advisory services and would result in extremely few lawyers who offer investment advice being subject to the Act. See Hearings on H.R. 10065, supra note 62, at 87; see also id. at 90. The view that the exception for lawyers – as well as the exceptions for broker-dealers and other professionals – made the Act inapplicable to most of the investment advice provided by these professionals was also expressed, without contradiction, by members of Congress during debate on the final version of the legislation. See 86 CONG. REC. 9813 (Aug. 1, 1940) (statements of Reps. Hinshaw and Sabath).

in amount and importance to the customer.[140] This has remained true throughout the following decades.[141] 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.[142]

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.

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140 See supra notes 41 - 49 and accompanying text.

141 See, e.g., Current Quotations on Stockbrokers, N.Y. TIMES, May 10, 1953, at SM19 ("[W]hen the Korean War began . . . [c]ustomers then wanted to know whether to expect confiscatory taxes that would reduce corporate profits, how price controls might effect their securities, and whether some businesses would be squeezed out entirely for lack of materials. 'You have to talk to them,' one broker said. 'Buying and selling is the least part of the service we give them for our commissions.' "); SEC, SPECIAL STUDY OF THE SECURITIES MARKETS (1963) at 330 ("SPECIAL STUDY") ("Both the volume and the variety of the written investment information and advice originated by broker-dealers, who for the most part furnish it free to their customers as part of their effort to sell securities, are impressive."); id. at 386 (terming investment advice furnished by broker-dealers an "integral part of their business of merchandising securities" even if only "incidental" to that business); Interpretive Releases Relating to the Securities Exchange Act of 1934 and General Rules and Regulations Thereunder: Future Structure of Securities Markets (Feb. 2, 1972) [37 FR 5286, 5290 (Mar. 14, 1972)] ("In our opinion, the providing of investment research is a fundamental element of the brokerage function for which the bona fide expenditure of the beneficiary's funds is completely appropriate, whether in the form of high commissions or outright cash payments."); TULLY REPORT, supra note 12, at 3 ("The most important role of the registered representative is, after all, to provide investment counsel to individual clients, not to generate transaction revenues.").

142 For example, under the rules of self-regulatory organizations and consistent with Commission precedent, a broker must render advice that is based on a knowledge of the security involved and that is suitable for a customer in light of the customer's needs, financial circumstances, and investment objectives. E.g., NASD Rule 2310; NYSE Rule 405. In addition, under certain circumstances, such as when a broker-dealer assumes a position of trust and confidence similar to that of an adviser with its customer, it has been held to a fiduciary standard with its customer akin to that of an adviser and a client. See supra notes 97 - 98 and accompanying text.

Thus, it would extend the Advisers Act well beyond what we believe Congress intended when it enacted the broker-dealer exception.[143]

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

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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 reading the exception very narrowly. See CFA Letter, supra note 28; FPA Letter, supra note 27. 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 drafted 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 saw the 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 Sabath).

be solely incidental to brokerage. In addition, we are re-affirming 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.

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 provided 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

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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

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

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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 See, 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 (1) 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.

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, for example, 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]

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149 See Advisers Act Release No. 1092, supra note 4 ("Generally, financial planning services involve preparing a financial program for a client based on the client's financial circumstances and 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. Ciccotello 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 § 2:5.1 ("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").

151 See Jeffrey H. Rattiner, GETTING STARTED AS A FINANCIAL PLANNER at 1-6 (2000); Barriers to Professional Entry, supra note 150. See also FINANCIAL PLANNERS, SEC Staff Report to Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (Feb. 12, 1988) at 6-7 (noting an increase in the number of people engaged in financial planning).

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]

We received many comment letters from firms and individuals with strongly held views on this topic. Advisers, financial planners, and investor groups asserted that financial planning was not solely incidental to brokerage.[154] 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

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152 Reproposing Release, supra note 6, at n.113.

153 Our staff has previously expressed the view that advice provided in connection with financial planning is not solely incidental to brokerage. See, e.g., Townsend and Associates, SEC Staff No-Action Letter (Sept. 21, 1994) (advice is not incidental that is provided "as part of an overall financial plan that addresses the financial situation of a customer and formulates a financial plan."). See also Investment Management & Research, Inc., SEC Staff No-Action Letter (Jan. 27, 1977). It is also consistent with views expressed in two of the leading treatises on investment advisers. See Thomas P. Lemke & Gerald T. Lins, REGULATION OF INVESTMENT ADVISERS §1:20 (2004); INVESTMENT ADVISER REGULATION, supra note 150 at §2:5:1. It may, however, be inconsistent with statements made in a few of our staff's other letters. See, e.g., Nathan & Lewis Securities, SEC Staff No-Action Letter (Mar. 3, 1988) ("Nathan & Lewis No-Action Letter"); Elmer D. Robinson, SEC Staff No-Action Letter (Dec. 6, 1985).

154 See, e.g., FPA Letter, supra note 27; CFA Letter, supra note 28; Joint Letter of Fund Democracy et al., supra note 28; CFP Board Letter, supra note 28; AICPA Letter, supra note 31; T.Rowe Price Letter, supra note 28; ICAA Letter, supra note 28; ICI Letter, supra note 109.

obligations.[155] Some 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

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155 See, e.g., SIA Letter, supra note 29; Merrill Lynch Letter, supra note 29; Northwestern Mutual Letter, supra note 29; Wachovia Letter, supra note 29; CGMI Letter, supra note 29. At least one broker-dealer commenter, however, argued that financial planning services are unconnected from any securities transaction, are not solely incidental, and therefore should be provided only in accounts subject to full investment advisory registration. TD Waterhouse Letter, supra note 113.

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

generally informs us that investors understand financial plans and financial planning to mean something different from brokerage. Our investor focus groups 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 no 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

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"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.

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 are 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

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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 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.

161 See, e.g., T. Rowe Price Letter, supra note 28; CFA Letter, supra note 28; Joint Letter of Fund Democracy et al., supra note 28; ICAA Letter, supra note 28; The Consortium Letter, supra note 114; Gallaher Letter, supra note 138; Comment Letter of Daniel H. Foster (Jan. 17, 2005); Comment Letter of Meyer Advisory Services (Feb. 7, 2005); Comment Letter of Shawbrook (Feb. 7, 2005).

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.

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, 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 Act[164]

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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.

164 15 U.S.C. 78c(a)(35). Under section 3(a)(35) of the Exchange Act, 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

(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

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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 through 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." 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 an investment adviser only with respect to those accounts for which the broker-dealer provides services or receives compensation that subject the broker-dealer to the Act. Third, unlike the existing staff approach, the new rule provides a bright-line test for the availability of the section 202(a)(11)(C) exception, and thereby gives clarity to that provision at a time when, as we have discussed previously, the line between advisory and brokerage services is blurring and the original "bright line" – "special compensation" – has ceased to function as a reliable indicator of the services the Act was designed to reach. Finally, the new rule results in all discretionary accounts being treated as advisory accounts without regard to the form of compensation and is therefore consistent with the design of rule 202(a)(11)-1 as a whole. Reproposing Release, supra note 6.

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 from registering 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.

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 quintessentially 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

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167 Amendment and Extension of Temporary Exemption From the Investment Advisers Act for Certain Brokers and Dealers, Investment Advisers Act Release No. 471 (Aug. 20, 1975) [40 FR 38156 (Aug. 27, 1975).

168 See, e.g., CFA Letter, supra note 28; Joint Letter of Fund Democracy et al., supra note 28; AARP Letter, supra note 28.

169 See, e.g., ICAA 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 Creek Securities (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.

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

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173 Id.

174 Advisers Act Release No. 626, supra note 6.

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] We 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.[177] Given the inherently managerial

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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 merely acted to ensure proper supervision of such discretionary accounts. 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, but 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 the specific prior approval of the NYSE's Committee on Member Firms. See NYSE DIRECTORY AND GUIDE (1938), at C-359 (Rule 513). In addition to the NYSE's progressively more restrictive approach to such accounts, contemporary literature reflected the view that the exercise of broad investment discretion by broker-dealers – though not illegal in certain circumstances – was viewed by courts and respected firms within the brokerage industry with suspicion and disapproval. See, e.g., WALL STREET, supra note 37, at 241; SECURITY MARKETS, supra note 39, at 649-50; Charles H. Meyer, THE LAW OF STOCK BROKERS AND STOCK EXCHANGES (1931) at 306.

177 One commenter maintained that the legislative history showed that Congress 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

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.[178] 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.[179] 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:

- As to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security;

COUNCIL REPORT, supra note 66, at 1008, 1010, 1014. The same is true of the excerpt that the commenter quotes from a memorandum by 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).

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

179 Rule 202(a)(11)-1(d).

- On an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time not to exceed a few months;[180]
- As to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent;
- 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.[181]

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

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180 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 account during this time.

181 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.

brokerage transactions initiated by the portfolio manager and executed by the sponsor.[182] 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.[183] 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,[184] 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)(ii) 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.[185] 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.[186] Beginning on April 15, 2005, broker-dealers may rely on rule 202(a)(11)-1(a)(2) when they offer discount

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182 We have viewed broker-sponsored wrap fee programs as being subject to the Advisers Act. Disclosure by Investment Advisers Regarding Wrap Fee Programs, Investment Advisers Act Release No. 1401 (Jan. 13, 1994) [59 FR 3033 (Jan. 20, 1994)], at n.2 (proposing amendments to Form ADV); Investment Advisers Act Release No. 1411 (Apr. 19, 1994) (adopting amendments to Form ADV) [59 FR 21657 (Apr. 26, 1994)].

183 Reproposing Release, supra note 6.

184 AICPA Letter, supra note 31; The Consortium Letter, supra note 114; Fund Democracy Letter, supra note 28; ICI Letter, supra note 109; ICAA Letter, supra note 28; T. Rowe Price Letter, supra note 28.

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

186 See 5 U.S.C. 553(d)(3).

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)(ii). 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 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

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[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).

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

- Timeframes 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

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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.

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 also offer discount brokerage services, including execution-only brokerage, for reduced commission rates.

1. Benefits

a. Avoidance of Compliance Costs

The provisions of rule 202(a)(11)-1(a) are designed to permit broker-dealers to offer certain fee-based and discount brokerage programs without triggering regulation under the Advisers Act. Broker-dealers relying on rule 202(a)(11)-1(a) to continue offering these fee-based and discount brokerage programs will benefit in the form of saved costs they would otherwise expend in connection with Advisers Act compliance.

Broker-dealers, even those already dually-registered as investment advisers, will benefit in the form of costs saved by not having to convert their fee-based and full-service brokerage accounts into advisory accounts. For example, these accounts will not be subject to brochure delivery or other disclosure requirements under the Advisers Act, or to the principal trading restrictions under the Act. Other broker-dealers relying on rule 202(a)(11)-1(a) will not be subject to the Advisers Act at all. For these broker-dealers whose fee-based or discount brokerage programs would otherwise require adviser registration, we believe the rule's benefits will be significant in terms of avoiding an increased regulatory burden incurred as a result of changing the way they charge for their brokerage services. For example, if not excepted under rule 202(a)(11)-1(a), these

broker-dealers would be required to prepare, submit and update adviser registration statements,[189] and to prepare and distribute client disclosures under Part II of Form ADV.[190] These broker-dealers would also be required to modify their compliance programs to address the Advisers Act and its requirements,[191] and to establish codes of ethics required under the Act's rules.[192]

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-dealers 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.[193] We also note that the popularity of fee-based accounts is growing rapidly, so the extent of these benefits will grow accordingly. One broker-dealer commented that its holdings of fee-based accounts have

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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].

192 Rule 204A-1 [17 CFR 275.204A-1].

193 See infra notes 224 - 228, 233 - 237, and accompanying text, discussing commenters' assessments of the costs of complying with the Advisers Act in connection with financial planning and discretionary accounts.

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.[194]

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.[195] Principal transactions are an important source of liquidity in some market sectors.[196] While one commenter 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,[197] continuing growth in fee-based accounts could, absent rule 202(a)(11)-1, eventually extend principal trading restrictions to many brokerage accounts, thereby expanding the effects.[198] Another commenter suggested the Commission could moderate

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194 Morgan Stanley Letter, supra note 29; Cerulli Edge 1st Quarter 2005, supra note 79.

195 Section 206(3) of the Advisers Act prohibits an adviser, acting as principal for its own account, from knowingly selling any security to or purchasing any security from a client, without disclosing to the client in writing the capacity in which it (or an affiliate) is acting and 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].

196 See Merrill Lynch Letter, supra note 29; Morgan Stanley Letter, supra note 29; UBS Letter, supra note 29.

197 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.

198 See supra note 82 and accompanying text.

the effects of principal transaction restrictions by creating exceptions as necessary to maintain market efficiency.[199]

b. Investor Benefits

By eliminating regulatory disincentives to re-pricing of brokerage services, rule 202(a)(11)-1(a) is expected to yield benefits for individual investors as a result of such re-pricing. Under the fee-based programs discussed above, a broker-dealer's compensation does not depend on the number of transactions or the size of mark-ups or mark-downs charged, thus reducing incentives for the broker-dealer to churn accounts, recommend unsuitable securities, or engage in high-pressure sales tactics. As such, these programs may better align the interests of broker-dealers and their customers. The rule will also benefit customers by enabling them to choose from among these new programs and other traditional brokerage services to select the program best for them.[200] While it is difficult to quantify the value of these benefits, we believe they are substantial. One broker-dealer estimates that, during the last five years, its fee-based account customers would have paid nearly $2 billion more using commission-based brokerage instead of their fee-based accounts.[201]

2. Costs

While we believe the benefits of rule 202(a)(11)-1(a) are substantial, we believe the incremental costs associated with this provision of the rule are small. The only

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199 D.C. Securities Bureau Letter, supra note 112.

200 SROs 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 03-68, supra note 95.

201 Morgan Stanley Letter, supra note 29 (estimating commission savings for all fee-based accounts opened at the broker-dealer from 2000-2004).

incremental cost associated with this provision of the rule will be 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.[202] In addition, we estimate that the total

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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 $45, this is $3.75 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 x 3,850 firms = $14,437.50.

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.[203]

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

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203 This estimate is premised on next year's growth of fee-based accounts continuing at current annual growth rates of approximately 30 percent, 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 $211,600 (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 account customers contacting their broker-dealer and the contact person spending an average of 15 minutes to respond to their questions, for a total of 70,875 hours. At an estimated hourly wage rate for a compliance manager of $45, the estimated industry-wide cost is 70,875 x $45 = $3,189,375. See supra note 202.

204 Wachovia Letter, supra note 29.

205 UBS Letter, supra note 29.

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, 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

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206 Some commenters argued the rule does competitive harm to financial planners in particular. These commenters expressed concerns that many broker-dealers market advice that is confusingly similar to financial planning, even though it is not the same comprehensive advice prepared under a financial plan by persons such as Certified Financial Planners (CFPs) acting under CFP professional standards. According to these commenters, brokers operating under suitability standards are able to provide this advice more efficiently than CFPs acting under their professional standards, often giving it to customers at no cost, and this erodes the value of financial planning and the emerging financial planning industry in the minds of the investing public. See, e.g., FPA Letter, supra note 27; Comment Letter of David W. Demming (Jan. 16, 2005) ("Demming Letter"). On the other hand, several broker-dealers commented that they make higher-level comprehensive financial plans available for an additional fee, treating customers that elect this option as advisory clients. See, e.g., Merrill Lynch Letter, supra note 29; Morgan Stanley Letter, supra note 29; UBS Letter, supra note 29. Other broker-dealers also commented that many of their registered representatives are CFPs. See, e.g., Northwestern Mutual Letter, supra note 29. We note that in focus groups of investors we convened recently, investors generally understood financial planners to have a wider scope of responsibilities for planning, to assist an investor in meeting longer-term goals and to address other issues such as insurance and estate planning. Some investors also believed financial planners would ordinarily have special credentials. Focus Group Report, supra note 118, at 9, 13.

207 See supra notes 87 - 90 and accompanying text.

208 See supra notes 94 and 98 and accompanying text.

regulation under the Exchange Act 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.[210] While these commenters argued that the fiduciary duties of an adviser outweigh the duties of a broker-dealer, their comments do not fully recognize the extent of broker-dealers' obligations.[211] In addition, 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

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209 Comment Letter of Sennet Kirk (Feb. 4, 2005). In addition, one broker-dealer expressed concerns that financial planners not, in effect, be granted the exclusive right to offer planning services, thereby placing broker-dealers at a competitive disadvantage. UBS Letter, supra note 29.

210 See, e.g., Comment Letter of Bayard Bigelow (Jan. 4, 2005), whose experience in connection with underwriting errors and omissions ("E&O") insurance policies for broker-dealers and investment advisers leads him to infer that the standards of conduct for investment advisers result in better investor protection. Mr. Bigelow commented that E&O insurance claims against broker-dealers were twice as frequent and twice as severe as comparable claims against investment advisers.

211 As we discuss supra in notes 94 and 98, and accompanying text, broker-dealers are subject to their own obligations to disclose conflicts, and are subject to an extensive investor protection regime.

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 "rights" and "obligations" 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]

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212 See 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) ("CFA Survey") (available at http://www.zeroalphagroup.com/news/RIvestmentZAG_CFAFINAL_102704.ppt); TD Waterhouse Letter, supra note 113 (citing a survey conducted at the request of TD Waterhouse USA) ("TD Waterhouse Survey"). According to the CFA Survey, 53 percent of respondents indicated 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 favored 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 inferring what kind of investor protection 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 participants 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

In addition, other commenters argued that it would be unworkable to expand the disclosures to give additional detail about potential differences, since the duties of a broker-dealer are determined by, in large part, a customer's agreement with the broker-dealer and the circumstances of the relationship.[215]

One commenter urging withdrawal of the rule also encouraged us to assess the costs to investors that could arise if broker-dealers engage in abusive sales practices in fee-based accounts.[216] While fee-based brokerage accounts are not suitable for all broker-dealer customers, the NASD has issued a notice to members identifying potential problems and indicating that NASD members should have supervisory procedures in place to assess and monitor them.[217] Given that there are no forms of broker-dealer compensation that are immune to potential abuse, it is necessary to eliminate the costs of such abuse directly through preventative measures and remedial action against abusive market participants, rather than 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

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investors who, for example, held only mutual funds acquired directly from the fund complex (or in the case of the CFA Survey, who acquired them through an employer-sponsored 401(k) plan), acquired fund investments directly from a state 529 plan, or acquired Treasury securities through Treasury Direct.

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 FPA Letter, supra note 27.

217 See supra note 95 and accompanying text.

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). 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 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. 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)-1(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

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[218] See supra note 144 and accompanying text.

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)-1(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 will have to 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

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219 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.

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 over 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 requirements. For example, these broker-dealers are already subject to rules requiring designation of a chief

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221 As discussed above in Section VI.A.1.a of this Release, these costs include preparing and submitting Part 1 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.

compliance officer, establishment and maintenance of written compliance procedures, maintenance of books and records, and oversight of employee personal securities trading.[222] 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.

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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).

223 Rule 206(4)-2. See Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Rel. No. 2176 (Sept. 25, 2003) [68 F.R. 56692 (Oct. 1, 2003)] at n.23 and n.49, and accompanying text.

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-

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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.

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

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226 Morgan Stanley Letter, supra note 29; Letter of Steven K. McGinnis (Feb. 14, 2005); Demming Letter, supra note 206; Letter of Paul E. Coan (Jan. 11, 2005); Letter of Joseph F. Fessler (Jan. 18, 2005).

227 Comment Letter of Donald S. Loveless (Jan. 20, 2005); Comment Letter of Nicholas B. Rowe (Jan. 17, 2005).

228 Commenters did not supply any data concerning these costs.

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] These broker-dealers will ordinarily also be in compliance with the adviser custody rule.[232]

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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

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 dually-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

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further mitigated by the fact that their operations are unlikely to be complex or widespread.

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

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:[235]

- 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.[236] Nonetheless, we believe these costs would be

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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

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.[237] However, we believe the exceptions we discuss above for limited discretion will accommodate these investors, if they wish to grant their broker-dealers limited types of discretion focused on obtaining the benefits of efficient execution or access to types of securities not widely available in the market, as opposed to the kind of supervisory or managerial discretionary authority we have concluded is properly subject to the Advisers Act.[238]

- In many instances, broker-dealers that are not dually registered are affiliated with investment advisers. Based on staff experience, we believe that many of these broker-dealers have refrained from engaging in the discretionary brokerage business, and have instead looked to their advisory affiliates to provide portfolio management to investors seeking this kind of service. Other broker-dealers that have not refrained from accepting discretionary brokerage services could

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clients). SIA Letter, supra note 29. Dually-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.

implement the requirements of rule 202(a)(11)-1(b) by shifting these customers to their advisory affiliates.[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) will result in costs associated with registration under the Advisers Act and compliance with the Act's requirements.[240] Although we acknowledge (as discussed above in connection with separately-contracted-for advisory services and financial planning services in Section VI.B.1.b and VI.B.2.b of this Release) that the costs of registration and compliance under the Advisers Act are significant,[241] 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,

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239 In the Reproposing Release, we estimated that there are only 145-290 broker-dealers (approximately) that are not dually-registered as investment advisers and accept 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 able to reach agreements with their customers that allow the firms to operate their accounts on a non-discretionary basis.) See Reproposing Release, supra note 6, at n. 139-142 and accompanying text. We received no comments on these estimates.

240 In the Reproposing Release, we estimated that approximately 95 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, at n. 138-142 and accompanying text. We received no comments on this estimate.

241 See supra note 221.

maintenance of books and records, and oversight of employee personal securities trading.[242] These broker-dealers will ordinarily also be in compliance with the adviser custody rule.[243]

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.[244]

A. Fee-Based and Discount Brokerage Programs

Rule 202(11)(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

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242 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.

243 See supra note 223.

244 15 U.S.C. 80b-2(c).

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.[245]

We do not anticipate that rule 202(11)(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(a)(11)-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.[246] The availability of fee-based brokerage programs may better align the interests of broker-

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245 Rule 202(a)(11)-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.

246 See supra note 12 and accompanying text.

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.[247]

If rule 202(a)(11)-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(a)(11)-1(a) may open the door to greater investor participation in the securities markets.

B. Discretionary Brokerage and Financial Planning

Rule 202(a)(11)-(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(a)(11)-1(a) or the exception from the definition of an investment adviser in section 202(a)(11)(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

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247 Northwestern Mutual Letter, supra note 29.

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(a)(11)-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(a)(11)-1(b), so we expect the effects of the rule will not be widespread.[248] 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(a)(11)-1(b) will have any measurable effect on efficiency or capital formation.

VIII. PAPERWORK REDUCTION ACT

Rule 202(a)(11)-1(a) contains "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[249] The title of this new collection is "Rule 202(a)(11)-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).

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

249 44 U.S.C. 3501 to 3520.

Rule 202(a)(11)-1(b) will have the effect of requiring certain broker-dealers to register under the Advisers Act.[250] 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, 3235-0278, 3235-0047, 3235-0596, 3253-0242, 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.

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250 Rule 202(a)(11)-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(a)(11)-1(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 exceptions. Second, a broker-dealer that holds itself out generally to the public as a financial planner or as providing financial planning services may not generally 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).

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.[251] Therefore, 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[252] and contracts or agreements for the account must contain a prominent disclosure statement. The disclosure consists of a brief plain English statement that

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[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)(3) 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)(1)(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.

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.[253] 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

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[253] Rule 202(a)(11)-1(a)(1)(ii).

compliance is five minutes per broker-dealer taking advantage of the rule.[254] 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.[255] 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.[256] 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 information. All of these collections of information are mandatory, and respondents in each case are investment

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

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

256 See supra note 250.

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 Reproposing Release, we set out our analysis that an estimated 195 broker-dealers would be required to register, and requested public comments.[257] We received no comments on this analysis, and have encountered no information since the time of the Reproposing 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

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

conflicts of interest. Rule 203-1 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[258] 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

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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 x 22.25) + (195 x 0.75) + (195 x (670 x 0.1) x 0.1) = 5,791.5.

202(a)(11)-1(b) will increase the annual aggregate information collection burden under Form ADV-W and rule 203-2 by 16 hours[259] 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 and rule 203-3 by 2 hours[260] for a total of 13 hours.

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

260 2 filings at 1 hour each.

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[261] 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 generally kept confidential.[262] The records that an adviser must keep in accordance with rule 204-2 must generally be

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261 1 filing at 1 hour each.

262 See section 210(b) of the Advisers Act [15 U.S.C. 80b-10(b)].

retained for not less than five years.[263] 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[264] 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.[265] 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

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263 See rule 204-2(e).

264 195 broker-dealer/advisers x 191.78 hours per adviser = 37,397 hours.

265 We note that the average number of clients per adviser reflects a small number of advisers who have thousands of clients, while the typical SEC-registered adviser has approximately 76 clients.

annual aggregate information collection burden under rule 204-3 by 135,330 hours[266] 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[267] 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

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266 195 broker-dealer/advisers x 694 hours per adviser = 135,330.

267 195 broker-dealer/advisers x 117.95 hours per adviser annually = 23,000.

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 275 hours[268] 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[269] for a total of 11,638 hours.

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[268] 39 respondents (195 x 0.2) x 7.04 hours annually per respondent = 275.

[269] 34 respondents (195 x 0.173) x 7.5 hours annually per respondent = 255.

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[270] 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 275.206(4)-7. The currently approved collection of information for rule 206(4)-7 is 701,200 hours, or 80 hours annually per registered

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270 We estimate that 195 broker-dealer/advisers would spend 10 hours each annually documenting their voting policies and procedures, and would provide copies of those policies and procedures to 10 percent of their 670 clients annually at 0.1 hours per response. (195 x 10) + 195 x (0.1 x 67) = 3,257.

adviser. We estimate all 195 broker-dealer/advisers that will be new registrants will be required to maintain compliance programs under rule 206(4)-7. Accordingly, we estimate rule 202(a)(11)-1(b) will increase the annual aggregate information collection burden under rule 206(4)-7 by 15,600 hours[271] for a total of 716,800 hours.

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.[272] 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 regulation 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)-

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271 195 broker-dealer/advisers at 80 hours per adviser annually = 15,600.

272 5 U.S.C. 603(a).

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]

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273 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).

274 Section X of this Release lists the statutory authority for the proposed rule and rule amendments.

275 See Sections II and III of this Release, supra.

276 17 CFR 240.0-10(c).

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]

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277 This estimate 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 See supra note 273 for a description of these three categories of advisory services.

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

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 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.

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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.

281 For Paperwork Reduction Act purposes, we have estimated that approximately 195 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.

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 investors from being confused about the nature of the services they are receiving. To specify less prominent disclosures for small entities would only serve to diminish investor protection to customers of small broker-dealers. Such a course would be inconsistent with the purposes of the Advisers Act. With respect to rule 202(a)(11)-1(b), the compliance and recordkeeping requirements are those generally applicable to any

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[282] 5 U.S.C. 603(c).

adviser registered under the Act. In developing these requirements over the years, the Commission has 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. It would be inconsistent with this design, and contrary to its purpose, to create special rules for small broker-dealers who would be subject to the Act as a result of proposed rule 202(a)(11)-1(b).

With respect to the second alternative, the Commission presently believes that clarification, consolidation, or simplification of the compliance and recordkeeping requirements under proposed rule 202(a)(11)-1(a) for small entities unacceptably compromises the investor protections of the rule. As discussed above, the rule's prominent disclosure requirement 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.

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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.

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 in part as follows:

AUTHORITY: 15 U.S.C. 80b-2(a)(11)(F), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

* * * * *

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

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[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 203A(b)(1)(B) of the Act provides that "[n]o 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.

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

(a) Special compensation. A broker or dealer registered with the Commission under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) (the "Exchange Act"):

(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); and

(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):

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

(2) 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; or

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

(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.

By the Commission.

Jill M. Peterson
Assistant Secretary

April 12, 2005