

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 275**

**[Release No. IA-2652; File No. S7-22-07]**

**RIN 3235-AJ97**

**Interpretive Rule Under the Advisers Act Affecting Broker-Dealers**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission is publishing for comment an interpretive rule that would address the application of the Investment Advisers Act of 1940 to certain activities of broker-dealers. The proposal would reinstate three interpretive provisions of a rule that was vacated by a recent court opinion. The first provision would clarify that a broker-dealer that exercises investment discretion with respect to an account or charges a separate fee, or separately contracts, for advisory services provides investment advice that is not “solely incidental to” its business as a broker-dealer. The second provision would clarify that a broker-dealer does not receive special compensation within the meaning of section 202(a)(11)(C) of the Advisers Act solely because it charges a commission for discount brokerage services that is less than it charges for full-service brokerage. The third provision would clarify 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.

**DATES:** Comments should be received on or before November 2, 2007.

**ADDRESSES:** Comments may be submitted by any of the following methods:

*Electronic comments:*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-22-07 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

*Paper comments:*

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-22-07. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site

(<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days from 10:00 am to 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** David W. Blass, Assistant Director, or Vincent M. Meehan, Senior Counsel, at (202) 551-6787 or [IArules@sec.gov](mailto:IArules@sec.gov), Office of

Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5041.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission (“Commission” or “SEC”) is proposing to amend rule 202(a)(11)-1 [17 CFR 275.202(a)(11)-1] under the Investment Advisers Act of 1940.

## I. INTRODUCTION

The Investment Advisers Act of 1940 (“Advisers Act” or “Act”)<sup>1</sup> regulates the activities of certain “investment advisers,” who are defined in section 202(a)(11) of the Act as persons who receive compensation for providing advice about securities as part of a regular business. Section 202(a)(11)(C) excepts from the definition of “investment adviser” 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.”

In 2005, we adopted the original rule 202(a)(11)-1 under the Advisers Act, the principal purpose of which was to deem broker-dealers offering “fee-based brokerage accounts” as not subject to the Advisers Act.<sup>2</sup> The rule also included several interpretations of section 202(a)(11)(C). On March 30, 2007, the Court of Appeals for

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<sup>1</sup> 15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. 80b of the United States Code, where the Advisers Act is codified.

<sup>2</sup> *See Certain Broker-Dealers Deemed Not to be Investment Advisers*, Investment Advisers Act Release No. 2376 (Apr. 12, 2005) [70 FR 20424 (Apr. 19, 2005)] (“2005 Adopting Release”). Fee-based brokerage accounts are similar to traditional full-service brokerage accounts, which provide a package of services, including execution, incidental investment advice, and custody. The primary difference between the two types of accounts is that a customer in a fee-based brokerage account pays a fee based upon the amount of assets on account (an asset-based fee) and a customer in a traditional full-service brokerage account pays a commission (or a mark-up or mark-down) for each transaction.

the District of Columbia Circuit (the “Court”), in *Financial Planning Association v. SEC* (the “*FPA* decision”), vacated the original rule 202(a)(11)-1 on the grounds that the Commission did not have the authority to except broker-dealers offering fee-based brokerage accounts from the definition of “investment adviser.”<sup>3</sup> Though the Court did not question the validity of our interpretive positions, it vacated the entire rule, leaving our interpretations potentially in doubt.

We have received requests from broker-dealers that we clarify the status of our interpretive positions.<sup>4</sup> Because of the significance of the interpretations, and in order to provide the public with an opportunity for meaningful comment on them in light of the *FPA* decision, we are re-proposing the interpretive positions.<sup>5</sup> Proposed rule 202(a)(11)-1 would clarify that (i) a broker-dealer provides investment advice that is not “solely incidental to” the conduct of its business as a broker-dealer if it exercises investment discretion (other than on a temporary or limited basis) with respect to an account or charges a separate fee, or separately contracts, for advisory services, (ii) a broker-dealer does not receive “special compensation” solely because it charges different rates for its full-service brokerage services and discount brokerage services, and (iii) a registered

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<sup>3</sup> 482 F.3d 481 (D.C. Cir. 2007).

<sup>4</sup> See, e.g., Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, to Robert E. Plaze, Associate Director, Division of Investment Management and Catherine McGuire, Chief Counsel, Division of Market Regulation (June 27, 2007). This letter and the comment letters cited in this Release are available for viewing and downloading at <http://www.sec.gov/rules/proposed/s72599.shtml>.

<sup>5</sup> As a separate part of our response to the *FPA* decision, we have adopted a temporary rule on an interim final basis that establishes an alternative means for investment advisers who are registered with us as broker-dealers to meet the requirements of section 206(3) of the Advisers Act when they act, directly or indirectly, in a principal capacity with respect to transactions with certain of their advisory clients. See *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2653 (Sept. 24, 2007).

broker-dealer is an investment adviser solely with respect to accounts for which it provides services that subject it to the Advisers Act. We discuss these proposed interpretive positions below.

## II. DISCUSSION

### A. “Solely Incidental”

Section 202(a)(11)(C) of the Advisers Act, as discussed above, provides an exception from the Act for a broker-dealer “whose performance of [advisory services] is solely incidental to his business as a broker-dealer and who receives no special compensation therefor.” This exception amounts to a recognition that broker-dealers commonly give a certain amount of advice to their customers in the course of their regular business as broker-dealers and that “it would be inappropriate to bring them within the scope of the [Advisers Act] merely because of this aspect of their business.”<sup>6</sup>

In the 2005 Proposing Release, we explained our understanding that investment advice is “solely incidental to” the conduct of a broker-dealer’s business within the meaning of section 202(a)(11)(C) when the advisory services rendered to an account are in connection with and reasonably related to the brokerage services provided to that account.<sup>7</sup> We further explained that our understanding is consistent with the legislative history of the Advisers Act, which indicates Congress’ intent to exclude broker-dealers providing advice as part of traditional brokerage services. We also explained that it is consistent with the Commission’s contemporaneous construction of the Advisers Act as

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<sup>6</sup> *Opinion of 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”).

<sup>7</sup> *Certain Broker-Dealers Deemed Not to be Investment Advisers*, Investment Advisers Act Release No. 2340 (Jan. 6, 2005) [70 FR 2716 (Jan. 14, 2005)] (“2005 Proposing Release”).

excepting broker-dealers whose investment advice is given “solely as an incident of their regular business.”<sup>8</sup>

Many commenters responding to the 2005 Proposing Release urged us to clarify that certain practices are not solely incidental to brokerage services. Proposed rule 202(a)(11)-1(a) would re-codify two of the interpretations we announced in 2005 regarding activity that is not “solely incidental” to brokerage services for purposes of section 202(a)(11)(C). The situations addressed by these interpretations are not the only ones in which a broker-dealer provides advice that is not solely incidental to its business as a broker-dealer.<sup>9</sup> Commenters are invited to suggest other situations that should be addressed by the rule.

*1. Separate Contract or Fee for Advisory Services.* Proposed rule 202(a)(11)-1(a)(1) would provide that a broker-dealer that separately contracts with a customer for, or separately charges a fee for, investment advisory services cannot be considered to be providing advice that is solely incidental to its brokerage. We view a separate contract specifically providing for the provision of investment advisory services to reflect a recognition that the advisory services are provided independent of brokerage services and, therefore, cannot be considered solely incidental to the brokerage services.<sup>10</sup> Similarly, we have long held the view that when a broker-dealer charges its customers a separate fee for investment advice, it clearly is providing advisory services

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<sup>8</sup> *Id.*

<sup>9</sup> We have removed the text “(among other things, and without limitation)” from the introductory paragraph to proposed rule 202(a)(11)-1(a), though we included that text in 2005. We believe it is clear that the rule as we propose it today does not address all the situations in which a broker-dealer can provide advice that is not “solely incidental” to its business as a broker-dealer for purposes of section 202(a)(11)(C).

<sup>10</sup> 2005 Adopting Release, *supra* note 2 at n.145, and accompanying text.

and is subject to the Advisers Act.<sup>11</sup> In light of the *FPA* decision, brokerage firms and other interested parties may be unsure about whether we continue to hold these views. In order to provide certainty to those parties, the proposed rule would codify our interpretations.

We request comment on our interpretation. In the 2005 Adopting Release, we explained our understanding that many broker-dealers already use the payment of a separate fee as a bright line test to distinguish their brokerage activities from their advisory activities and we have received no information since 2005 that would change our understanding. Are we correct? Do broker-dealers also already consider advisory services that are the subject of a separate contract not to be solely incidental to the brokerage services they provide? Commenters are invited to explain to us any situation in which a broker-dealer could charge a separate fee for, or separately contract for, advisory services in a manner that, consistent with the intent of the Advisers Act, is “solely incidental” to the brokerage services provided. For example, could a broker-dealer separately contract for advisory services, but receive no “special compensation” therefore, for purposes of section 202(a)(11)(C) of the Act?

2. *Discretionary Investment Advice.* We have long acknowledged that a broker-dealer’s exercise of investment discretion over customer accounts raises serious questions about whether those accounts must be treated as subject to the Advisers Act –

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<sup>11</sup> *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”). *See also* Advisers Act Release No. 2, *supra* note 6 (“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 [Advisers] Act merely because he is also engaged in effecting market transactions in securities”).

even where no special compensation is received.<sup>12</sup> In 2005, we adopted, and today we are re-proposing, a rule that would clarify that any account over which a broker-dealer exercises investment discretion is subject to the Advisers Act. Specifically, rule 202(a)(11)-1(a) would clarify that discretionary investment advice is not “solely incidental 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 (except that investment discretion granted by a customer on a temporary or limited basis is excluded).<sup>13</sup>

We believe that a broker-dealer’s authority to effect a trade without first consulting a customer is qualitatively distinct from simply providing advice as part of a package of brokerage services. When a broker-dealer exercises investment discretion, it is not only the source of investment *advice*, it also has the authority to make the investment *decision* relating to the purchase or sale of securities on behalf of its client. This, in our view, warrants the protection of the Advisers Act because of the “special

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<sup>12</sup> Advisers Act Release No. 626, *supra* note 11 (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.”).

<sup>13</sup> 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: (i) 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; (ii) 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; (iii) as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent; (iv) to purchase or sell securities to satisfy margin requirements; (v) to sell specific bonds and purchase similar bonds in order to permit a customer to take a tax loss on the original position; (vi) to purchase a bond with a specified credit rating and maturity; and (vii) to purchase or sell a security or type of security limited by specific parameters established by the customer.



trust and confidence inherent” in such a relationship.<sup>14</sup> Most commenters who addressed this aspect of our 2005 proposal, including those representing investors, advisers, and broker-dealers, generally agreed with us.

Under the proposed rule, the exception provided by section 202(a)(11)(C) of the Act 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. We believe our interpretation is appropriate for several reasons.<sup>15</sup> First, we believe it would apply the Advisers Act to the sort of relationship with a broker-dealer that the Act was intended to reach. Second, we believe the proposed rule is consistent with the interpretation 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 Advisers Act. Finally, we believe the proposed rule would provide a workable, bright-line test for the availability of the section 202(a)(11)(C) exception.

We request comment on our proposed interpretive provision. Do commenters agree with us that it addresses the sort of relationship that the Advisers Act should reach? One commenter to our 2005 proposal asserted it does not.<sup>16</sup> This commenter argued that Congress, when it adopted the Advisers Act, must have been aware that broker-dealers

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<sup>14</sup> See *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)].

<sup>15</sup> 2005 Adopting Release, *supra* note 2, at n.165 and accompanying text. In that release, we described our position as a change to the staff’s prior 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. For the reasons discussed in this Release and in the 2005 Adopting Release, we believe that the interpretation we are proposing today and adopted in 2005 better effectuates the purposes of the Act.

<sup>16</sup> Comment Letter of Morgan, Lewis & Bockius LLP (Feb. 7, 2005).

exercised discretionary authority 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. We disagree. As we explained in 2005, 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. 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. 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. Do commenters agree?

We also are interested in understanding the impact on investors of these distinctions. We also request comment on our reference in the proposed rule to the definition of “investment discretion” in section 3(a)(35) of the Exchange Act. Is a different definition more appropriate? If so, what definition should we use? Are we correct in excluding investment discretion given on a temporary or limited basis? Have we correctly identified the circumstances in which a broker-dealer exercises temporary or limited discretion?

3. *Financial Planning.* The rule we adopted in 2005 also contained a provision stating that when a broker-dealer provides advice as part of a financial plan or in connection with providing financial 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, (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.<sup>17</sup>

We have decided not to propose this provision as part of this rule, which many financial services firms found difficult to apply.<sup>18</sup> Instead, we plan to consider issues relating to financial planning in light of the results of a study we commissioned by the RAND Corporation (“RAND Study”) comparing the levels of protection afforded customers of broker-dealers and investment advisers under the federal securities laws. The RAND Study is expected to be delivered to us no later than December 2007, several months ahead of schedule.<sup>19</sup>

#### **B. Full-Service and Discount Brokerage Programs**

As part of our 2005 rulemaking, we adopted an interpretive provision which clarified that a broker-dealer will not be considered to have received “special compensation” for purposes of section 202(a)(11)(C) of the Advisers Act (and therefore will not be subject to the Act) *solely* because the broker-dealer charges a commission, mark-up, mark-down or similar fee for brokerage services that is greater or less than one

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<sup>17</sup> 2005 Adopting Release, *supra* note 2, at Section III(E).

<sup>18</sup> Our staff attempted to address some of the interpretive issues that were raised by this provision in a staff interpretive letter. Securities Industry Association, SEC Staff Letter (Dec. 16, 2005), available at <http://www.sec.gov/divisions/investment/guidance.shtml>. That letter is terminated.

<sup>19</sup> *See Commission Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts*, SEC Press Release No. 2007-95 (May 14, 2007). The results of the RAND Study are expected to provide an important empirical foundation for the Commission to consider what action to take to improve the way investment advisers and broker-dealers provide financial services to customers. One option that will be available to the Commission will be making the RAND Study results available to the public and seeking comments on them.

it charges another customer.<sup>20</sup> We are re-proposing that interpretive position today as proposed rule 202(a)(11)-1(b).<sup>21</sup>

This interpretive position reflects the longstanding view that, with respect to brokerage commissions or other transaction-based compensation, broker-dealers receive “special compensation” where there is a clearly definable charge for investment advice.<sup>22</sup> But, if a firm negotiates different fees with its customers for similar transactions, the Commission would not conclude that the customer being charged the higher fee is paying “special compensation” for investment advice based solely on differences in charges, because whether the pricing difference is based on the presence or absence of investment advice is “too hypothetical.”<sup>23</sup> Similarly, if, for example, a broker-dealer had a general fee schedule for full service brokerage that included access to brokerage personnel, and

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<sup>20</sup> Discount brokerage programs, including electronic trading programs, give customers who do not want or need all the services that traditionally are provided in a full-service brokerage account the ability to trade securities at a reduced commission rate. Electronic trading programs provide customers the ability to trade on-line, typically without the assistance of a broker-dealer’s registered representative. Customers trading electronically may devise their own investment or trading strategies, or may seek advice separately from investment advisers.

<sup>21</sup> We have, however, modified the text of the rule to clarify that it is an interpretation of the phrase “special compensation.” In addition, in the 2005 rulemaking, we stated that the interpretive position was necessary to supersede past staff interpretations that would lead to a full-service broker-dealer being subject to the Advisers 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.” 2005 Proposing Release at n.88 and accompanying text. Having revisited those past staff interpretations, we conclude that they do not necessarily lead to the conclusion that a broker-dealer’s full-service accounts are advisory accounts subject to the Advisers Act merely because the broker-dealer also offers some form of discount brokerage.

<sup>22</sup> See Advisers Act Release No. 626 *supra* note 11. As the Commission’s general counsel opined in a 1940 letter responding to questions about “special compensation,” where the only difference in the services provided to two brokerage customers is that one receives advice and the other does not, and the firm always charges a higher amount to the customer that receives the advice, the customer paying the higher transaction amount is paying “special compensation.” Advisers Act Release No. 2, *supra* note 6.

<sup>23</sup> This view is consistent with the staff position announced in Advisers Act Release No. 626, *supra* note 11.

had a separate fee schedule for automated transactions using an Internet Web site, we would not, absent other factors, view the difference as “special compensation.” As one commenter to our 2005 proposal noted, electronic brokerage programs offer “lower expenses and less overhead, [and it is] entirely appropriate, and necessarily competitive, for firms to have reduced their fees for such services, and this reduction is obviously in clients’ best interests.”<sup>24</sup>

The Commission would not look outside the fee structure of a given firm to determine whether special compensation exists. That is, just because a “discount” firm offered lower rates than a “full-service” firm, we would not consider the “full-service” firm’s charges “special compensation.”<sup>25</sup> We request comment on this interpretation. Do commenters support it? Should we consider any modifications and, if so, which ones?

### **C. Dual Registrants**

Finally, we adopted in 2005, and are re-proposing today, a rule providing that a broker-dealer that is registered under both the Exchange Act and the Advisers Act is an investment adviser solely with respect to those accounts for which it provides advice or receives compensation that subject the broker-dealer to the Advisers Act.<sup>26</sup> We received few comments regarding this provision of the original rule, and we are proposing it as adopted. The provision would codify a long-standing interpretation of the Act that

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<sup>24</sup> See Comment Letter of Merrill, Lynch, Pierce, Fenner & Smith (Feb. 7, 2005), at p. 7.

<sup>25</sup> *Id.*

<sup>26</sup> Proposed rule 202(a)(11)-1(c).

permits a broker-dealer also registered under the Act to distinguish its brokerage customers from its advisory clients.<sup>27</sup>

### **III. GENERAL REQUEST FOR COMMENT**

The Commission is proposing the interpretive provisions described above and we welcome your comments. We solicit comment, both specific and general, on each component of the proposals. We request and encourage any interested person to submit comments regarding:

- the proposals that are the subject of this release;
- additional or different revisions; and
- other matters that may have an effect on the proposals contained in this release.

Comment is also solicited from the point of view of broker-dealers and investment advisers, their customers and clients, other regulatory bodies (such as state securities regulators), and other interested persons. Any person wishing to submit written comments on any aspect of the proposal is requested to do so.

### **IV. COST-BENEFIT ANALYSIS**

The Commission is sensitive to the costs and benefits imposed by its rules, and is considering the costs and benefits of proposed rule 202(a)(11)-1. Proposed rule 202(a)(11)-1 would clarify that if a broker-dealer exercises investment discretion over customer accounts or contracts with a customer for, or charges a separate fee for, advisory services it is not providing advice that is “solely incidental” to its business as a broker-dealer. The proposed rule also would clarify that a broker-dealer does not receive

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<sup>27</sup> 2005 Adopting Release, *supra* note 2. *See also* Advisers Act Release No. 626, *supra* note 11.

“special compensation” solely because it charges a commission rate to one customer that is greater or less than one it charges another customer. Finally, proposed rule 202(a)(11)-1 would clarify that broker-dealers that also are registered as investment advisers are subject to the Advisers Act solely with respect to accounts for which they provide services or receive compensation that subject them to the Act.

As discussed above, in 2005 we adopted the original rule 202(a)(11)-1 under the Advisers Act. The original rule included, among other things, the interpretive rules we are proposing today. On March 30, 2007, the Court vacated original rule 202(a)(11)-1, though the Court did not question the validity of our interpretive positions. The rules we are proposing today are substantially identical to those interpretive positions. As requested by the Commission, the Court has stayed the issuance of its mandate until October 1, 2007, and thus the interpretive positions contained in original rule 202(a)(11)-1 remain in effect. Accordingly, we would expect that advisers’ conduct would have conformed to the interpretive positions contained in original rule 202(a)(11)-1 and therefore the proposed rules, if adopted, would have no effect on advisers’ conduct.

The principal benefit of the proposed rule would be to clarify the validity of these interpretations in light of the *FPA* decision.<sup>28</sup> We believe that broker-dealers that currently rely on the interpretation that a broker-dealer would not be deemed to be an investment adviser solely because the broker-dealer charges a commission, mark-up, mark-down, or similar fee for brokerage services that is greater or less than one it charges another customer would benefit because it will be clear that they can continue to offer the

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<sup>28</sup> The Commission previously solicited comment on the benefits of these interpretations. 2005 Proposing Release, *supra* note 7. *See also* 2005 Adopting Release, *supra* note 2, for a discussion of the benefits of each of these proposed interpretations.

same services under the same regulatory regime. Similarly, we believe that broker-dealers relying on the interpretation that permits dually-registered broker-dealers to distinguish their brokerage accounts from their advisory accounts would benefit because it will be clear that they can continue to make these distinctions among their accounts.

We do not believe that the proposed rule would require broker-dealers or investment advisers to incur new or additional costs.<sup>29</sup> As noted, proposed rule 202(a)(11)-1 would re-codify substantially identical interpretations of section 202(a)(11)(C) that were contained in the rule vacated by the *FPA* decision. Prior to that decision, broker-dealers operated with the understanding that contracting with a customer for, or charging a separate fee for, advisory services or exercising investment discretion (other than on a temporary or limited basis) would not be considered “solely incidental” to the brokerage services they provide for purposes of section 202(a)(11)(C) of the Advisers Act. Similarly, broker-dealers operated full-service and discount brokerage programs relying on the interpretation that they were not subject to the Act solely because they offered different rate structures for those services. Furthermore, dually-registered broker-dealers already distinguish their brokerage customers from their advisory clients in reliance on our previous interpretation contained in the vacated rule. We, therefore, believe the proposed rule would not change existing obligations or relationships. Accordingly, we do not believe that broker-dealers or investment advisers would need to take steps or alter their business practices in such a way that would require them to incur new or additional costs as a result of the adoption of the proposed rule.

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<sup>29</sup> The Commission previously solicited comment on the costs of these interpretations. 2005 Proposing Release, *supra* note 7. *See also* 2005 Adopting Release, *supra* note 2, for a discussion of the costs associated with each of these proposed interpretations.



We request comment on the assumptions on which we base our preliminary conclusion that broker-dealers and investment advisers would not incur new or additional costs if we determined to adopt the rule as proposed. We encourage commenters to discuss any costs and benefits that we did not consider in our discussion above. We request commenters to provide analysis and empirical data to support their statements regarding any costs or benefits associated with proposed rule 202(a)(11)-1.

## **V. PAPERWORK REDUCTION ACT**

Proposed rule 202(a)(11)-1 would not impose any new “collections of information” within the meaning of the Paperwork Reduction Act of 1995.<sup>30</sup> The proposed rule would not create any new filing, reporting, recordkeeping, or disclosure reporting requirements for broker-dealers or investment advisers. The proposed rule would re-codify three interpretive provisions. First, the rule would clarify that a broker-dealer that exercises investment discretion with respect to an account or contracts with a customer for, or charges a separate fee for, advisory services provides investment advice that is not “solely incidental to” its business as a broker-dealer. Second, the rule would clarify that a broker-dealer does not receive “special compensation” solely because it charges a commission rate to one customer that is greater or less than one it charges another customer. Third, the rule would clarify that a registered broker-dealer is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subject it to the Advisers Act. We believe the proposed rule contains no new “collections of information” under the Paperwork Reduction Act that requires the approval of the Office of Management and Budget under 44 U.S.C. 3501.

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<sup>30</sup> 44 U.S.C. 3501 to 3520.

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.

In our 2005 releases, we estimated that the interpretive provisions we adopted then in the original rule 202(a)(11)-1, and which we are re-proposing today as revised rule 202(a)(11)-1, would have the effect of requiring certain broker-dealers that contract with customers for, or charge a separate fee for, advisory services or provide discretionary brokerage to register under the Advisers Act.<sup>31</sup> We estimated that the rule, which we are proposing today as rule 202(a)(11)-1(a), therefore increased the number of respondents under several existing collections of information, and, correspondingly, increased the annual aggregate burden under those existing collections of information.<sup>32</sup> Accordingly, we submitted to the Office of Management and Budget (“OMB”), in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11, and the OMB approved, amending these collections of information for which we estimated the annual aggregate burden likely increased as a result of the 2005 adoption of rule 202(a)(11)-1. 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 approved collections of information numbers appear under OMB control numbers 3235-0049, 3235-0313, 3235-0538, 3235-0240, 3235-0278,

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<sup>31</sup> See 2005 Proposing Release, *supra* note 7, at Section VII; 2005 Adopting Release, *supra* note 2, at Section VIII.

<sup>32</sup> In 2005, as today, we estimated that the provisions now contained in proposed rule 202(a)(11)-1(b) and 202(a)(11)-1(c) did not contain any collections of information within the meaning of the Paperwork Reduction Act.

3235-0047, 3235-0596, 3235-0242, 3235-0345, 3235-0571, and 3235-0585, respectively.

We have determined not to modify these burden estimates because we continue to believe they were appropriate and, with respect to the proposals in this release, that there is no additional paperwork burden.

We request comment on whether our assumption that there is no additional paperwork burden is correct.

## **VI. INITIAL REGULATORY FLEXIBILITY ANALYSIS**

Section 3(a) of the Regulatory Flexibility Act requires the Commission to undertake an Initial Regulatory Flexibility Analysis of the proposed rule on small entities unless the Commission certifies that the proposed rule, if adopted, would not have a significant economic impact on a substantial number of small entities.<sup>33</sup> Pursuant to section 605(b) of the Regulatory Flexibility Act, the Commission hereby certifies that proposed rule 202(a)(11)-1 would not, if adopted, have a significant impact on a substantial number of small entities.<sup>34</sup>

Proposed rule 202(a)(11)-1 would re-codify three interpretive provisions. First, the rule would clarify that a broker-dealer that exercises investment discretion with respect to an account or contracts with customers for, or charges a separate fee for, advisory services provides investment advice that is not “solely incidental to” its business as a broker-dealer. Second, the rule would clarify that a broker-dealer does not receive “special compensation” solely because it charges a commission rate to one customer that is greater or less than one it charges another customer. Third, the rule would clarify that a registered broker-dealer is an investment adviser solely with respect to those accounts

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<sup>33</sup> 5 U.S.C. 603(a).

<sup>34</sup> 5 U.S.C. 605(b).

for which it provides services or receives compensation that subject it to the Advisers Act. Proposed rule 202(a)(11)-1 would re-codify substantially identical interpretations of section 202(a)(11)(C) of the Advisers Act that we adopted in 2005. Therefore, we do not believe that the proposed rule would have an economic impact on broker-dealers or investment advisers, regardless of whether these broker-dealers or investment advisers are small entities, because these entities would likely have conformed to the interpretive positions previously adopted. Accordingly, the Commission certifies that proposed rule 202(a)(11)-1 would not have a significant economic impact on a substantial number of small entities.

The Commission encourages written comments regarding this certification. We request that commenters describe the nature of any impact on small businesses and provide empirical data to support the extent of the impact.

## **VII. STATUTORY AUTHORITY**

The Commission is proposing to amend Rule 202(a)(11)-1 pursuant to section 211(a) of the Advisers Act.

### **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 proposed to be amended as follows:

#### **PART 275 -- RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940**

1. The general authority citation for Part 275 is revised to read as follows:

Authority: 15 U.S.C. 80b-2(a)(11)(G), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a,

80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

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

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

(a) *Solely incidental.* 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 (15 U.S.C. 80b-2(a)(11)(C)) if the broker or dealer:

- (1) Charges a separate fee, or separately contracts, for advisory services; or
- (2) Exercises investment discretion (as that term is defined in section 3(a)(35) of the Securities Exchange Act of 1934 (“Exchange Act”) (15 U.S.C. 78c(a)(35))), except investment discretion granted by a customer on a temporary or limited basis, over such account.

(b) *Special compensation.* A broker or dealer registered pursuant to section 15 of the Exchange Act (15 U.S.C. 78o) does not receive special compensation within the meaning of section 202(a)(11)(C) of the Advisers Act 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.

(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-dealer to the Advisers Act.

By the Commission.

Nancy M. Morris  
Secretary

September 24, 2007