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Court Overturns Exemption for Fee-Based Brokerage Accounts from Advisers Act Coverage

In a 2–1 decision issued on March 30, 2007, the U.S. Court of Appeals for the District of Columbia Circuit vacated Rule 202(a)(11)-1 of the Investment Advisers Act of 1940 (the "Advisers Act").[1] The rule expands the category of broker-dealers exempt from the definition of investment adviser under the Advisers Act by exempting broker-dealers who offer fee-based or discount brokerage accounts, provided that certain conditions are met. The Court held that the SEC does not have the authority to expand the category of broker-dealers exempt from the Advisers Act beyond the category of broker-dealers already expressly exempted by Congress in the statute.

Unless the SEC requests a rehearing or appeals the decision, the court's decision will become effective 45 days after the date of the decision. Although the decision is not yet final and a different result could ensue on rehearing or appeal, broker-dealers who offer fee-based or discount brokerage accounts in reliance on Rule 202(a)(11)-1 should begin now to consider what changes they may need to make to their business model if the court's decision becomes final.

The Rule. In April 2005, the SEC adopted Rule 202(a)(11)-1 in order to exempt broker-dealers who offered "fee-based" and "discount" brokerage programs from the definition of investment adviser.[2] Under the rule, a broker-dealer providing advice that is solely incidental to its brokerage services is exempt from the Advisers Act even if it charges an asset–based or fixed fee (rather than a commission) for its services.[3] The rule also excludes from the Advisers Act broker-dealers that offer both full service and discount brokerage services to their customers.[4] The SEC adopted the rule pursuant to its authority under Subsection (F) of the definition, which gives the SEC the authority to exempt by rule, "such other persons not within the intent of [the definition]," as the Commission may designate.[5]

The Court's Decision. The Financial Planning Association ("FPA"), an industry group representing financial planners, sought judicial review of the

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1 Fin. Panning Ass'n v. S.E.C., Nos. 04-1242, 05-1145, 2007 U.S. App. LEXIS 7356 (D.C. Cir. March 30, 2007).

2 See Certain Broker-Dealers Deemed Not to Be Investment Advisers, Investment Advisors Act (hereinafter, "Certain Broker-Dealers"), Release No. 2376 (April 15, 2005). Section 202(a)(11) of the Advisers Act defines "investment adviser" in relevant part as "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing or selling securities . . . ." 15 U.S.C. § 80b-2(a)(11) (2000).

3 17 C.F.R. § 275.202(a)(11)-1 (2007).

4 Id.

5 Certain Broker-Dealers, at 114; 15 U.S.C. § 80b-2(a)(11)(F) (2000). The Investment Advisors Act was amended in 2006 to include a new exception to the definition of "investment adviser" in § 202(a)(11) for statistical rating organizations. As a result, subsection (F) referenced in the court's opinion is now found in subsection (G) of the definition.

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rule, claiming that the SEC had exceeded its authority. In analyzing the SEC's authority under Subsection (F), the court applied the two-step Chevron analysis, which requires a court to determine first whether Congress has "directly spoken" on the matter, and if not, then to determine whether the agency's interpretation of the statute is reasonable.[6] The court found that Congress had directly spoken on the issue when it exempted certain, specified broker-dealers in Subsection (C) of the definition. Subsection (C) of the definition excludes "any broker or dealer whose performance of such [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." [7] The court held that the SEC exceeded its authority when it expanded the statutory exemption beyond the category of broker-dealers already expressly exempted by Congress.[8]

The court's analysis relied principally on the text of the statute. The court noted that the SEC's exemptive authority under Subsection (F) of the definition only applied to "such other persons not within the intent of [the definition]." The court reasoned that since exemptions for broker-dealers were already expressly addressed under Subsection (C) of the definition, broker-dealers could not be "other persons" for purposes of Subsection (F).[9] In addition, the court concluded that an exemption for fee-based brokerage programs was not consistent with the intent of the definition. Subsection(C) of the definition only exempted broker-dealers if they did not receive special compensation for investment advice. The rule, however, exempted broker-dealers who received special compensation, such as fee-based brokers.[10]

The SEC's Options. The SEC has not yet said whether it will request a rehearing or appeal the court's decision. A spokesman for the SEC noted only that the Commission intended to analyze the court's decision and "proceed appropriately in investors' best interests."[11] If the SEC does not request a rehearing or seek an appeal to the Supreme Court within 45 days, an order vacating the rule will be issued within 7 days thereafter.[12] Given the court's conclusion that Congress has already identified the categories of broker-dealers exempt from the Advisers Act, we believe that there is little possibility that the SEC can expand the current statutory exemption through a new or revised rule proposal, unless the decision is reversed.

If the SEC does not pursue a rehearing or appeal, we would expect it to offer interim guidance to those broker-dealers who relied on the rule. The FPA has urged the SEC not to appeal the court's decision and to give brokerage firms who do not register as an investment adviser 90 days to convert their fee-based accounts into commission-based accounts.[13]

One of the more interesting questions that remain open is whether a full-service brokerage firm will continue to be able to offer a discount brokerage program and vice versa. In its release adopting the rule, the SEC noted that the SEC staff had traditionally taken the view that the two-tiered fee structure created when a broker-dealer offered both a full-service and a discount brokerage program involved "special compensation" and triggered application of the Advisers Act.[14] The staff noted that this interpretation was not compelled by the statute and 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."[15] The rule was intended, in part, to supersede this earlier staff interpretation.[16] It is unclear whether the SEC will reinstate the earlier staff interpretation or adopt an interpretive position consistent with the rule with respect to broker-dealers who offer both full-service and discount brokerage programs.

The decision can be found at: http://pacer.cadc.uscourts.gov/docs/common/opinions/200703/04-1242a.pdf.

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6 Fin. Planning Ass'n, at *15. The Chevron test was first articulated in Chevron, USA, Inc. v. Natural Res. Def. Counsel, Inc., 467 U.S. 837, 842-43 (1984).

7 15 U.S.C. § 80b-2(a)(11)(C) (2000).

8 Fin. Planning Ass'n, at *17.

9 Id.

10 Id. at *31-32. The SEC also asserted its general rulemaking authority under § 211(a) of the Advisors Act. The court quickly dismissed this claim, however, stating that Congress did not intend for the SEC to ignore the requirements of Subsection (C).

11 Kara Scannell, Court Throws Out SEC Rule Protecting Certain Accounts, WALL ST. J., Mar. 31, 2007, at A6.

12 FED. R. APP. P. 40, 41.

13 Press Release, Financial Planning Association, Statement by FPA President Nicholas A. Nicolette, CFP (March 30, 2007).

14 Certain Broker-Dealers, at 46.

15 Id.

16 Id.

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Authors and Contributors:

Washington, DC

Mark J. Dorsey

Kimberley Cain

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New York

One New York Plaza
New York, NY 10004-1980
Tel: 212.859.8000
Fax: 212.859.4000

Washington, DC

1001 Pennsylvania Avenue, NW
Washington, DC 20004-2505
Tel: 202.639.7000
Fax: 202.639.7003

Frankfurt

Taunusanlage 18
60325 Frankfurt am Main
Germany
Tel: 49.69.870030.00
Fax: 49.69.870030.555

Hong Kong

In association with Huen Wong & Co.
11th Floor, Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
Tel: 852.3760.3600
Fax: 852.3760.3611

Fried, Frank, Harris, Shriver & Jacobson (London) LLP

99 City Road
London EC1Y 1AX
England
Tel: 44.20.7972.9600
Fax: 44.20.7972.9602

Fried, Frank, Harris, Shriver & Jacobson (Europe)

65-67, avenue des Champs Elysées
75008 Paris
France
Tel: 33.140.62.22.00
Fax: 33.140.62.22.29

Website

www.friedfrank.com

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