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Financial Planning Association v. SEC: The End of Fee-Based Brokerage Accounts?

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Effective October 1, 2007, broker-dealers who offer asset-based and fixed fee accounts lose the investment adviser registration exemption provided by Advisers Act Rule 202(a)(11)-1. Accordingly, broker-dealers have only a little more time to determine whether to avoid adding the complications of investment adviser registration and compliance by shuttering these accounts. Unfortunately, these decisions must be made uninformed by the findings of the RAND Corporation's study evaluating the marketing, sale and delivery of financial products and services, which are not due to be reported to the Securities and Exchange Commission until the end of the year.[1]

Ideally, the study will result in a holistic approach to regulating securities industry sales and account activities. For now, however, broker-dealers must make their decisions about fee-based accounts under a regime where investment adviser regulation and broker-dealer regulation are siloed and are not the result of a comprehensive analysis of the iterative benefits of multiple layers of regulation.

Advisers Act Rule 202(a)(11)-1 and the Financial Planning Association's Challenge

Section 202(a)(11) of the Advisers Act defines an "investment adviser" as:

> **any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the**

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> **value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities[.]**

Among the six exclusions from investment adviser status are broker-dealers whose performance of advisory services is solely incidental to the conduct of their brokerage activities and for which they receive no "special compensation." The SEC has further authority to exempt "other persons not within the intent of [the statute]."

In 2005, the SEC, citing its exemptive authority, adopted Advisers Act Rule 202(a)(11)-1, popularly referred to as "the Merrill Lynch Rule", to allow broker-dealers to offer asset-based and fixed fee accounts without being deemed "investment advisers"; provided that any investment advice furnished to customers was "solely incidental" to brokerage services and certain required disclosures and descriptions about the services were provided.[2] Arguably, had the SEC only sought to interpret the statutory exclusion for certain broker-dealer activity, rather than to promulgate an additional exemption, such interpretation might have withstood challenge.

As it is, the Financial Planning Association (FPA) successfully persuaded the U.S. Court of Appeals for the D.C. Circuit to vacate the rule on the grounds that the SEC had exceeded its authority under the Administrative Procedure Act.[3] Central to the FPA's argument was the contention that Section 202(a)(11) provided for additional exemptions from the IAA only for *other persons* not already beneficiaries of an exemption. The language of this statutory provision, argued the FPA, could not be read in any other way.

Subsection (F) of Section 202(a)(11) allows the SEC to exempt "such other persons not within the intent of this paragraph" while subsection (C) exempts "any broker or dealer" meeting certain tests. Because subsection (C) already provides an exemption for broker-dealers, the SEC could not use subsection (F) to craft an additional exemption for broker-dealers. A particular group of persons could get only one bite of the apple, and the broker-dealers had gotten theirs in subsection (C).

The court agreed, finding that "the plain text of subsection (C) exempts only broker-dealers who do not receive special compensation for investment advice." The D.C. Circuit rejected the SEC's contention that the changing nature of the broker-dealer business provided a sound basis for the new exemption. Only status as an "other person" could support an additional exemption. Accordingly, the SEC lacked authority to alter the scope of an extant exemption.

Implications for Broker-Dealers

As referenced above, the SEC was able to obtain a stay until October 1, to allow broker-dealers to evaluate their fee-based accounts and to assess their options, including shuttering these accounts or bringing them under the Advisers Act. In requesting the stay, the SEC indicated that it would provide a status report to the court prior to the stay's expiration, at which time the SEC might request a further delay before the Court's decision takes effect.[1]

It clearly would be beneficial if the results of the RAND study were available to inform the regulatory framework for client accounts before requiring broker-dealers to determine whether to shutter existing accounts. Any further delay in imposing Advisers Act requirements on fee-based brokerage accounts, however, is unlikely and undoubtedly would be challenged by the FPA.

Accordingly, broker-dealers offering fee-based and asset-based accounts will be well served to analyze the commercial realities of offering these accounts against the regulatory burdens of Advisers Act compliance. Note that even if a broker-dealer is currently dually registered as an investment adviser, its analysis needs to be made with respect to the area of its business offering these types of accounts.

In making this assessment, a broker-dealer might consider, among other things:

- Conducting an inventory of its account offerings to identify those having fees that could be considered "special compensation".

- Assessing whether any of the services offered through fee-based accounts, such as financial planning services, can be pared back and repackaged in order to be folded into the bundle of brokerage services paid for with commissions.
- If commercial reasons dictate continuing to provide fee-based accounts, determining whether non-discretionary (versus discretionary) advisory accounts offer efficiencies, including not having to pay fees to third-party managers.
- Evaluating whether the fee-based (i.e., investment advisory) accounts should be offered through the broker-dealer or moved into a separate affiliated entity.
- Assessing and implementing compliance with Advisers Act requirements, including registration, disclosure, supervisory and compliance controls, appointment of a Chief Compliance Officer and drafting and adopting written supervisory and compliance procedures.
- Obtaining a signed Advisers Act-compliant contract from each client.
- Reviewing controls and processes for obtaining any needed pre-trade consent for principal and agency-cross transactions.
- Evaluating whether more stringent procedures are required to meet investment advisers' fiduciary duty requirements versus broker-dealers' general suitability and "just and equitable" standards.

The upshot is that broker-dealers offering fixed fee and asset-based accounts have a significant amount of work to do evaluating these accounts and determining their strategy going forward. And, the clock is ticking. Barring any further extension of the deadline, solutions must be in place before October.

1. Press Release, SEC, Commission Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts (May 14, 2007), available at http://www.sec.gov/news/press/2007/2007-95.htm.
2. Certain Broker-Dealers Deemed Not to Be Investment Advisers; Final Rule. Investment Advisers Act Release No. 34-51523 (Apr. 12, 2005) *available at* www.sec.gov/rules/final/34-51523.pdf.
3. *Financial Planning Association v. SEC*, 482 F.3d 481, 492 (D.C. Cir. 2007).
4. Motion of the Securities and Exchange Commission for a Stay of the Mandate at 12, *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007) (Nos. 04-1242, 05-1145).