SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release Nos. 34–50979; IA–2339; File No. S7–25–99]

RIN 3235–AH78

Certain Broker-Dealers Deemed Not To Be Investment Advisers

AGENCY: Securities and Exchange Commission.

ACTION: Adoption of temporary rule.

SUMMARY: The Securities and Exchange Commission is adopting a temporary 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 nondiscretionary advice that is solely incidental to its brokerage services is excepted from the Investment 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 temporary rule also provides that broker-dealers are not subject to the Investment Advisers Act solely because they offer full-service brokerage and discount brokerage services, including execution-only brokerage, for reduced commission rates. The temporary rule will expire on April 15, 2005.

DATES: Effective Date: Section 275.202(a)(11)T will be effective from January 6, 2005 to April 15, 2005.

FOR FURTHER INFORMATION CONTACT: Robert L. Tuleya, Senior Counsel, or Nancy M. Morris, Attorney-Fellow, at (202–942–0719), or *Iarules@sec.gov,* Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth St., NW., Washington, DC 20549–0506.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission (''Commission'' or ''SEC'') is adopting temporary rule 202(a)(11)T under the Investment Advisers Act of 1940 (''Advisers Act'' or ''Act'').[1]

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I. Discussion

On November 4, 1999, the Commission issued a release proposing for comment a new rule under the Advisers Act that responded to the introduction of two new types of brokerage programs offered by full-service broker-dealers—''fee-based brokerage programs'' and ''discount brokerage programs.'' [2] Under the proposed rule, a broker-dealer providing investment advice to customers would be excluded from the definition of investment adviser in the Act regardless of the form that its compensation takes, as long as: (i) The advice is provided on a nondiscretionary 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. In addition, we proposed that a broker-dealer would not be deemed to have received special compensation solely because the broker-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. The Proposing Release included a statement that, ''until the Commission takes final action on the proposed rule, the Division of Investment Management will not recommend, based on the form of compensation received, that the Commission take any action against a broker-dealer for failure to treat any account over which the broker-dealer does not exercise investment discretion as subject to the Act.'' [3]

These new brokerage programs responded to changes in the marketplace for retail brokerage. They also addressed 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.

The comments we received on the Proposing Release have raised complicated and significant issues, including what is solely incidental to brokerage and how a broker-dealer can hold itself and its services out to the public. These issues extend beyond those originally contemplated by the Proposing Release, and suggest the need to repropose the rule in the full context of what is ''solely incidental'' to brokerage. Accordingly, we are today issuing a companion release that requests additional comment on these issues, as well as other issues associated with the scope of the broker-dealer exception in the Act.[4] We direct interested parties to that rulemaking.

As a result of the adoption of this temporary rule, we note that the staff no-action position announced in the Proposing Release has terminated. Since rule 202(a)(11)–1 was proposed, broker-dealers have relied on the staff no-action position. Today, fee-based programs are offered by most of the larger broker-dealers and hold over $254 billion of customer assets.[5] 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.[6] In order to avoid the disruption to broker-dealers offering these programs and to their customers who invest through them, and to provide time for further consideration of the proposal in the Companion Release, we are today adopting temporary rule 202(a)(11)T under the Advisers Act.[7]

A. Temporary Rule

Under temporary rule 202(a)(11)T, 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. The rule is available to any broker-dealer registered under the Securities Exchange Act of 1934 [8] that

[1] 15 U.S.C. 80b–1. Unless otherwise noted, 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.

[2] *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''). We reopened the period for public comment on the proposed rule in August 2004. Investment Advisers Act Release No. 2278 (Aug. 18, 2004) [69 FR 51620 (Aug. 20, 2004)]. The comment letters 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). 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 covered by this rule.

[3] Proposing Release, *supra* note 2.

[4] Investment Advisers Act Release No. 2340 (Jan. 6, 2005) (''Companion Release'').

[5] The Cerulli Edge, Managed Accounts Edition (3rd Quarter 2004).

[6] The Cerulli Edge, Managed Accounts Edition (1st Quarter 2004). *See also* Robert D. Hershey, Jr., *Investing: The Rise of the Fee-Based Account,* N.Y. Times, Jan. 27, 2002, section 3, at 6; Sara Hansard, *Demand for advice spurs switch to fees; Investors expect more than just stock tips,* Inv. News, July 29, 2002, at 6.

[7] Because of these concerns, and because the rule provides an exception, the Commission believes that immediate effectiveness is appropriate. 5 U.S.C. 553(d).

[8] 15 U.S.C. 78(a) (''Exchange Act''). Unless otherwise noted, when we refer to the Exchange Act, or any paragraph of that Act, we are referring to 15 U.S.C. 78(a) of the United States Code in which the Exchange Act is published.

satisfies two conditions: (i) The broker-dealer must not exercise investment discretion over the account from which it receives special compensation; and (ii) any investment advice must be solely incidental to the brokerage services provided to the account. The Companion Release sets out certain proposed interpretations of what services we view as solely incidental to brokerage and, as noted above, seeks comment on other issues related to this topic.

The temporary rule differs from the rule proposed in the Proposing Release in that the temporary rule does not include a requirement that broker-dealers disclose to customers that their accounts are brokerage accounts.[9] We nevertheless encourage broker-dealers to make that disclosure.

The temporary rule will expire on April 15, 2005. The Commission intends to act on the proposal set forth in the Companion Release before that time. During the period of operation of the temporary rule, a broker-dealer receiving special compensation for advisory services provided to customers must satisfy *each* of the requirements of the temporary rule to avoid application of the Advisers Act. Unless another exception is available, the failure of a broker-dealer to meet any one of the requirements of the temporary rule will result in the loss of the exception, and the likely violation by the broker-dealer of one or more provisions of the Advisers Act.

The temporary rule also contains a provision that a broker-dealer will not be considered to have received special compensation solely because the broker-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.[10] This provision is intended to keep a full-service broker-dealer from being subject to the Advisers Act solely because it also offers electronic trading or other forms of discount brokerage. Conversely, a discount broker will not be subject to the Act solely because it introduces a full-service brokerage program.

B. Scope of Exception

A broker-dealer that is registered under the Exchange Act and registered under the Advisers 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. This interpretation will continue to permit a broker-dealer registered under the Advisers Act to distinguish its brokerage customers from its advisory clients during the term of the temporary rule.[11]

II. Cost Benefit Analysis

The Commission is sensitive to the costs and benefits of its rules. Under the temporary rule, broker-dealers will not be deemed to be investment advisers with respect to accounts for which they receive asset-based fees, fixed fees, or similar non-commission compensation, provided that they do not exercise investment discretion over the account and their investment advice is solely incidental to the brokerage services provided to the account. The temporary rule also provides 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. These provisions of the temporary rule are designed to permit broker-dealers to continue to offer these fee-based and discount brokerage programs without triggering regulation under the Advisers Act. As discussed above, the Commission is issuing the temporary rule to avoid disruption to broker-dealers who have begun offering these accounts after a staff no-action position relating to these accounts was announced in the Proposing Release in 1999. The temporary rule is effective until April 15, 2005. While the temporary rule is in place, the Commission will review the proposed exception and related issues set out in the Companion Release.

The temporary rule imposes no costs. Broker-dealers will benefit from the temporary rule in the form of saved compliance costs they would otherwise expend on Advisers Act compliance with respect to accounts excepted from such compliance by the rule. In light of the Commission's issuance of the Companion Release requesting comment whether the exception should be incorporated into a permanent rule, these broker-dealers would face the choice whether to incur the costs of bringing these accounts into compliance with the Advisers Act now—without knowing whether such costs will be avoidable in the near future—or terminating these fee arrangements with their existing customers. These customers will similarly benefit from not having their existing account arrangements disrupted pending the Commission's consideration of comments received on the Companion Release.

III. Effects on Competition, Efficiency and Capital Formation

Section 202(c) of the Advisers Act mandates that the Commission, when engaging in rulemaking, consider whether an action is necessary or appropriate in the public interest, and to consider whether the action will promote efficiency, competition, and capital formation.[12]

As discussed above, rule 202(a)(11)T provides temporary relief from the Advisers Act to broker-dealers that offer certain fee-based brokerage programs or discount brokerage programs. Many broker-dealers have established these programs since 1999 when we issued our Proposing Release, which announced a staff no-action position relating to such programs.

As a result of the adoption of this temporary rule, we note that the staff no-action position announced in the Proposing Release has terminated. In order to avoid disruption to broker-dealers offering these programs, and to their customers who invest through them, rule 202(a)(11)T continues to except them under the Advisers Act until April 15, 2005. Given the brief duration of the temporary rule, and the fact that it does not expand the capability of broker-dealers to offer fee-based or discount brokerage programs, the temporary rule will have no effect on competition, efficiency, or capital formation.

IV. Paperwork Reduction Act

The temporary rule contains no ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995.[13]

V. Final Regulatory Flexibility Analysis

The Commission proposed rule 202(a)(11)–1 under the Advisers Act in the Proposing Release.[14] An Initial Regulatory Flexibility Analysis (''IRFA'') was published in the Proposing Release. No comments were received specifically on the IRFA. The Commission has prepared the following Final Regulatory Flexibility Analysis (''FRFA'') in accordance with 5 U.S.C. 604, regarding temporary rule 202(a)(11)T under the Advisers Act.

[9] The staff no-action position also was not conditioned on this disclosure.

[10] Rule 202(a)(11)T(a)(2).

[11] Proposing Release, *supra* note 2. *See also Final Extension of Temporary Rules,* Investment Advisers Act Release No. 626 (Apr. 27, 1978) [43 FR 19224 (May 4, 1978)].

[12] 15 U.S.C. 80b–2(c).

[13] 44 U.S.C. 3501 to 3520.

[14] Proposing Release, *supra* note 2.

A. Need for the Rule and Amendments

Section I of this Release describes the reasons for and objectives of the temporary rule. As discussed in detail above, the temporary rule is designed to permit broker-dealers to continue to maintain, on an interim basis, fee-based and discount brokerage programs which they have established in increasing numbers since our issuance of the Proposing Release in 1999, which announced a staff no-action position relating to such accounts. The temporary rule is effective until April 15, 2005, during which time the Commission will consider whether to adopt rules proposed in the Companion Release that would except these types of accounts, and related issues.

B. Significant Issues Raised by Public Comment

The Commission received over 1,700 letters from commenters in response to the Proposing Release and a subsequent request for additional comments. Most commenters addressed provisions under proposed rule 202(a)(11)–1 pertaining to fee-based brokerage programs. Among those commenting on proposed rule 202(a)(11)–1, broker-dealers strongly supported it, while a large number of investment advisers and, in particular, financial planners, strongly opposed the proposal. The Commission specifically requested comments with respect to the IRFA, but did not receive any comments addressing the IRFA. The Commission did, however, receive a limited number of comments that discussed the effect proposed rule 202(a)(11)–1 might have on smaller broker-dealers, although these commenters did not address whether their comments pertained to entities that would be small businesses for purposes of Regulatory Flexibility Act analysis. These commenters argued that the inapplicability of the fee-based account exception to discretionary accounts disproportionately affects the competitiveness of certain smaller broker-dealers that assertedly rely on discretionary services to set themselves apart from larger broker-dealers.

C. Small Entities

Temporary rule 202(a)(11)T under the Advisers Act applies to all brokers-dealers offering fee-based and discount brokerage programs on an interim basis that are registered with the Commission, including small entities. In developing the temporary rule we have considered its potential effect on 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.[15]

The Commission estimates that as of December 31, 2003, approximately 905 Commission-registered broker-dealers were small entities.[16] The Commission is not aware of any small entities that are re-pricing their brokerage services in a manner that rule 202(a)(11)T addresses, but assumes for purposes of this FRFA that all of these small entities could rely on the exception provided by the rule.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The provisions of rule 202(a)(11)T, pertaining to the new types of brokerage accounts, impose no new reporting, recordkeeping, or compliance requirements. Rule 202(a)(11)T is designed to prevent regulatory burdens from being imposed on broker-dealers under the Advisers Act on an interim basis, pending the Commission's consideration of the exception in the Companion Release.

E. Agency Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities.[17] In connection with the temporary rule the Commission considered the following alternatives: (a) The use of performance rather than design standards; and (b) an exemption from coverage of the rule, or any part thereof, for such small entities.[18]

With respect to the first alternative, the Commission believes that the compliance requirements contained in the temporary rule already appropriately use performance standards instead of design standards. The temporary rule is crafted to make regulation under the Advisers Act turn on the nature of the services performed by a broker-dealer rather than on the type of compensation involved. Thus, eligibility for the rule's exception hinges on the services performed by the broker-dealer.

With respect to the second alternative, the Commission believes that exempting small entities would be inappropriate. To the extent rule 202(a)(11)T allows broker-dealers to avoid regulatory burdens that might otherwise be imposed on broker-dealers during the Commission's consideration of comments received on the Companion Release, 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. The Commission also believes that commenters' suggestions to exempt small entities from one of the conditions for applicability of the fee-based account exception—that the broker-dealer not exercise investment discretion over the account—would be inconsistent with the Commission's objectives under the temporary rule.

VI. Statutory Authority

Our authority to adopt the temporary rule is based on section 202(a)(11)(F) of the Advisers Act, which expressly allows the Commission to except persons—in addition to those already excepted by sections 202(a)(11)(A)–(E)—that the definition of investment adviser was not intended to cover.[19] We are also acting pursuant to section 211(a) of the Advisers Act, which gives us the authority to classify, by rule, persons and matters within our jurisdiction and to prescribe different requirements for different classes of persons, as necessary or appropriate to the exercise of our authority under the Act. Additionally, section 206A of the Advisers Act gives us the authority, by rules and regulations, to exempt any person or transaction, or any class or classes of persons or transactions, from any provision or provisions of the Act or of any rule or regulation thereunder, if such exemption is necessary or appropriate in the public interest and

[15] 17 CFR 240.0–10(c).

[16] This estimate is based on the most recent information available, as provided 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.

[17] 5 U.S.C. 603(c).

[18] Rule 202(a)(11)T does not contain any reporting, recordkeeping, or compliance requirements. Accordingly, the Commission did not consider (a) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; or (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities.

[19] Because we are using our authority under section 202(a)(11)(F), broker-dealers relying on the temporary rule would not be subject to state adviser statutes. Section 203A(b)(1)(B) of the Advisers 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).

consistent with the protection of investors and the purposes of the Act.

List of Subjects in 17 CFR Part 275

Investment advisers, Reporting and recordkeeping requirements.

Text of Rule

■ 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)T is added to read as follows:

§ 275.202(a)(11)T Temporary rule regarding certain broker-dealers.

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

(1) Will not be deemed to be an investment adviser based solely on its receipt of special compensation, provided that:

(i) The broker or dealer does not exercise investment discretion, as that term is defined in section 3(a)(35) of the Exchange Act (15 U.S.C. 78c(a)(35)), over accounts from which it receives special compensation; and

(ii) 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; and

(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) 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.

(c) This temporary section shall expire on April 15, 2005.

By the Commission.

Dated: January 6, 2005.

J. Lynn Taylor,

Assistant Secretary.

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