InteractiveBrokers

SPOTLIGHT ON

The Broker-Dealer Exclusion from the "Investment Adviser" Definition

The contents of this Spotlight have been prepared for informational purposes only and should not be construed as legal or compliance advice.

OVERVIEW

On April 20, 2020, the Securities and Exchange Commission ("SEC") updated its frequently asked questions guidance[1] to state that, if a broker-dealer is not registered as an investment adviser with the SEC, the broker-dealer's use of the terms "adviser" or "advisor" in a name or title is presumed be a violation of Regulation Best Interest. The SEC also provided examples where the use of those terms is permitted, such as in the case of a municipal advisor or commodity trading advisor.

While broker-dealers routinely give investment advice as part of their brokerage activities, they are generally excluded from the definition of "investment adviser" under Section 202(a)(11)(C) of the Investment Advisers Act of 1940 ("Advisers Act").[2] The "Broker-Dealer Exclusion" is arguably the most frequently relied upon, yet most complex, exclusion from the "investment adviser" definition.

Section 202(a)(11)(C) excludes from the definition of "investment adviser" a broker-dealer that (a) provides investment advice that is "solely incidental" to the conduct of its broker-dealer business and (b) receives no special compensation for such advice. Note that this exclusion is conjunctive—that is, a broker-dealer must satisfy both prongs to rely on the exclusion, each of which is discussed with more detail below.

DETAILED DISCUSSION

I. The "Solely Incidental" Prong

A. Commission Interpretation

---

[1] *See Frequently Asked Questions on Regulation Best Interest* , (Feb. 11, 2019) available at https://www.sec.gov/tm/faq-regulation-best-interest#disclosure

[2] 15 U.S.C. §80b-2 (a)(11) (C).

Following the adoption of Regulation Best Interest, the SEC published the Broker-Dealer Interpretation[3] to confirm and clarify the Commission's position on the "solely incidental" prong.

A broker-dealer's investment advice—as to the value and characteristics of securities or as to the advisability of transacting in securities—is consistent with the solely incidental prong if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions. If, however, a broker-dealer's primary business is giving investment advice, or if the advisory services are not offered in connection with or are not reasonably related to the broker-dealer's brokerage services, the broker-dealer's investment advice falls outside of the "solely incidental" prong. [4]

The Commission affirmed the *Thomas* decision that "the quantum or importance" of a broker-dealer's advice is not indicative of a customer relationship that is primarily advisory in nature.[5] The investment advice needs not to be minimal, sporadic, or trivial to be incidental. Rather, the "solely incidental" prong hinges upon the investment advice's own relationship with broker-dealer's primary business.

To illustrate the application of this interpretation of "solely incidental", the Commission applied it to (i) exercising investment discretion over customer accounts and (ii) account monitoring.

B. **Commission Guidance on Application[6]**

i. Investment Discretion

Unlimited discretion. A broker-dealer's exercise of unlimited discretion is inconsistent with the solely incidental prong, as unlimited discretion indicates ongoing authority over the customer's account; the broker-dealer in such context is no longer providing advice but making investment decisions, an activity which is outside the scope of advice solely incidental to effecting securities transactions.

Limited discretion. Situations where a broker-dealer's discretion is limited in time, scope, or other manner and lacking the comprehensive and continuous characteristics

[3] *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser*, 84 Fed. Reg. 33681, 2019 WL 3043882 (July 12, 2019).

[4] *Id* at 33685, 33686.

[5] *Thomas v. Metropolitan Life Insurance Company*, 631 F. 3d 1153 (2011).

[6] *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser*, 84 Fed. Reg. 33681, 2019 WL 3043882 (July 12, 2019), at 33686, 33687; This section as a whole is based on the guidance in *Commission Interpretation*.

of investment advisory discretion are consistent with the solely incidental prong, and therefore the broker-dealer is not subject to registration under the Advisers Act. This is a totality of facts and circumstances test. Based on the comment letters the Commission received, the following are some examples of limited discretion consistent with the solely incidental prong:

(1) 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;
(2) Discretion 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;
(3) Discretion as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent;
(4) Discretion to purchase or sell securities to satisfy margin requirements, or other customer obligations that the customer has specified;
(5) Discretion to sell specific bonds or other securities and purchases similar bonds or other securities in order to permit a customer to realize a tax loss on the original position;
(6) Discretion to purchase a bond with a specified credit rating and maturity; and
(7) Discretion to purchase or sell a security or type of security limited by specific parameters established by the customer.

ii. Account Monitoring

Continuous Monitoring. Similar to the unlimited discretion discussed above, an agreement between a broker-dealer and a customer to continuously monitor a customer's account is very likely to suggest an investment advisory relationship, which falls outside of the solely incidental prong.

Periodic Monitoring. Similar to the limited discretion discussed above, an agreement between a broker-dealer and a customer to periodically (e.g. quarterly or semiannually) monitor a customer's account is likely to be permissible, as the periodic monitoring may be considered to be still in connection with and reasonably related to brokerage services.

Voluntary Monitoring. Absent an agreement with a customer, a broker-dealer may voluntarily monitor a customer's account and even contact the customer for recommendations based on that voluntary review. The Commission does not consider voluntary review of a customer's account as "account monitoring", so it is consistent with the solely incidental prong.

The Commission declined to delineate every scenario where agreed-upon account monitoring is or is not consistent with the solely incidental prong. Instead, the

Commission called on broker-dealers to develop compliance policies and procedures to prohibit a broker-dealer entering into an agreement to monitor a customer's account in a manner that will create an investment advisory relationship.

II. Special Compensation

The second and last prong of the Broker Exclusion is special compensation. Generally, "special compensation" is defined as any compensation to a broker-dealer, other than brokerage commissions, specifically for the rendition of investment advice. [7] The focus of this prong is on the term "special", which indicates the compensation is received by the broker-dealer outside of its ordinary course of brokerage activities, i.e. commissions. For example, special compensation includes[8]:

(1) compensation for investment advice in a form other than commissions;
(2) brokerage commissions that include a clearly definable charge for investment advice;
(3) receipt of a specified percentage of the total advisory fees charged to the broker-dealer's customers by a separate investment adviser; and
(4) a portion of a wrap fee.

III. Specific Scenario

The following factual discussion is adapted from one relevant case and is intended to illustrate how this exclusion applies in practice.

Scenario: Thomas and Metropolitan Life Insurance Company[9]

Mr. and Mrs. Thomas met with Mr. Laxton, a broker-dear agent employed by Metropolitan in 2011. Mr. Laxton analyzed the couple's financial situation and advised them on fund allocation in their 401(k) accounts. Metropolitan required its agents to conduct a "suitability analysis" to ensure that they recommended appropriate investment and insurance products. Mr. Laxton was not compensated for this analysis. Two years later, the couple had a child and wanted to purchase financial products to secure the child's future. Based in part on his prior financial analysis, Mr. Laxton advised the couple to purchase a variable universal life insurance policy ("VULP") from Metropolitan and they did so promptly. The couple have since paid a $91 monthly premium and $2.25 of which were dedicated to compensating the broker-dealer

[7] See *Investment Advisers Act Release No. IA-2*, 1940 WL 975 (Oct 28, 1940).

[8] Thomas Lemke & Gerald Lins, *Regulation of Investment Advisers*, §1.21 (2018 ed); *American Cap. Fin. Servs., Inc.*, SEC no-Action Letter, 1985 WL 54220 (Apr. 29, 1985); Investment Company Act Release No. 21260 n.7, 1995 WL 447507 (July 27, 1995).

[9] *Thomas v. Metropolitan Life Insurance Company*, 631 F. 3d 1153 (2011) at 1157, 1167.

agent, according to the prospectus. After the sale, Metropolitan paid Mr. Laxton a $500 "production credit."

Metropolitan compensates agents based on their sales of investment products. If agents do not meet a sale quota, they may be terminated. Metropolitan's marketing policy also requires agents to provide investment advice to potential customers as a means to sell more investment products.

Analysis

Mr. Laxton and Metropolitan qualifies for the Broker Exclusion. First, Mr. Laxton's investment advice, as a sales strategy per Metropolitan's marketing policies, was given only in connection with selling the VULP to the Thomases. Mr. Laxton's advice was closely related to the sale of the VULP, and selling the VULP was the primary goal of the transaction. Therefore, **Mr. Laxton's advice was solely incidental to his conduct as a broker agent**. Second, Mr. Laxton was compensated for the sale of the VULP, not for the investment advice. He was not compensated for rendering a mandated "suitability analysis," but after the VULP was sold. Further, Mr. Laxton's compensation was tied to selling products, as he would have been terminated had he not met his sales quota (which was measured by the sale of investment products). Therefore, **Mr. Laxton did not receive any special compensation for his investment advice**.

IV. Other Considerations

Discount Brokerage Programs.[10] 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.

Separate Contract or Fee.[11] If a broker-dealer separately contracts with a customer for investment advisory services, those services are not solely incidental to its brokerage. A separate contract specifically providing for the provision of investment advisory service reflects a recognition that the advisory services are provided independently of brokerage services.

Financial Planning.[12] If a financial plan is incumbent in a broker's suitability analysis, it is considered as the broker's investment advice solely incidental to its brokerage service.

[10] See *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, 70 Fed. Reg. 20424-01, 2005 WL 881922 (Apr 19, 2005) at 20436.

[11] *Id* at 20438.

[12] *Id* at 20439.

However, if the broker portrays itself to the general public as a financial planner or as providing financial planning services, the Broker Exclusion is not applicable.

State Registered Representatives. Although the Broker Exclusion does not address the status of a broker-dealer's state registered representative, the Commission has clarified that a registered representative may rely on the Broker Exclusion if the representative meets the following requirements: (1) is giving investment advice within the scope of his employment with the broker-dealer; (2) such advice is solely incidental to the employer's brokerage activities; and (3) there is no special compensation for the advice. The representative may apply the two-prong analysis discussed above to determine his/her status. However, if a representative provides investment advice independently from his/her employment with the broker-dealer, the representative cannot rely on the exclusion. [13]

Foreign Broker-Dealers. Foreign broker-dealers generally are not eligible for this exclusion, as they are not registered with the SEC under the Exchange Act. Given their particular practices in the US, foreign broker-dealers may need to seek no-action relief from the SEC. The Commission has stated that it would grant such requests where a foreign broker-dealer otherwise meets the Broker Exclusion under the Advisers Act and certain conditions in Rule 15a-6 under the Exchange Act (which exempts foreign broker-dealers from registration with the SEC). In one stance, the Commission would permit a foreign broker-dealer to rely on the Broker Exclusion where the foreign broker-dealer provides research reports to major US institutional investors in a manner not designed to induce transactions in the securities issued in the report or otherwise being executed through the foreign broker-dealer. [14]

TAKEAWAY

The Commission has strictly construed the two prongs in the Broker Exclusion and has set out clear boundaries for this exclusion mainly through regulatory interpretations. As the compliance deadline for Regulation Best Interest approaches, broker-dealers are encouraged to conduct a comprehensive review of their compliance policies and procedures and make necessary adjustments to ensure their rendition of investment advice is provided in a manner consistent with the Broker Exclusion.

[13] Thomas Lemke & Gerald Lins, *Regulation of Investment Advisers*, §1.22 (2018 ed); see also *Institute of Certified Financial planners*, SEC no-Action Letter (Jan 21,1986); *Elmer D Robinson*, SEC No-Action Letter (Dec. 6, 1985); *Amherst Financial Services Inc.*, SEC No-Action Letter, 1995 WL 335722 (May 23, 1985).

[14] *Id* §1.23 (2018 ed); *Securities Exchange Act Release No. 27017* (July 11, 1989); *Charterhouse Tilney*, SEC No-Action Letter, 1993 WL 277798 (July 15, 1993); *James Capel*, SEC No-Action Letter, 1989 WL 246587 (Dec. 6, 1989).