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Transcript:

Investment Adviser Registration Implications of Client Commission (Soft Dollar) Arrangements, Part 1

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BEN: Section 202(a)(11) of the Advisers Act defines an "investment adviser" as person who, for compensation, "issues or promulgates analyses or reports concerning securities." A broker-dealer that distributes research reports on securities is acting as an investment adviser and would have to register as one but for the broker-dealer exception to the definition of investment adviser in the Act. Brokerage research is generally paid for in commissions on trades. But the definition of investment adviser specifically excludes "any broker or dealer whose performance of [investment advisory] services is solely incidental to the conduct of [its] business as a [broker-dealer] and who receives no special compensation [for the service]." There is no question that the distribution of research is incidental to the conduct of business as a broker-dealer, since the practice pre-dates the securities laws as a traditional means of marketing brokerage services. But for the exception to apply, the broker-dealer may not be compensated specially for the research. For the most part this was not an issue until the late 1970s.

ED: That was the end of the fixed commission era when all NYSE members generally charged the same commission rates. Research typically was distributed at no additional charge. More accurately, the cost was included in the commission price. Research was one way that brokers effectively competed on service in a fixed-rate regime.

BEN: Customers did not pay "specially" for the research because the cost for the service was not discernible in the commission charge. Therefore, the provision of research didn't render the broker-dealer an investment adviser for purposes of the Advisers Act.

ED: That wouldn't be true to the extent that the customer paid an identifiable amount for the research.

BEN: The idea was expressed in an early SEC staff opinion on tiered brokerage fees. In 1940, the SEC's general counsel issued an opinion to the National Association of Securities Dealers in which he advised that OTC brokers – not subject to NYSE rules on fixed commissions – that charged higher rates on trades in which they provided consultation or advice were investment advisers for purposes of the Advisers Act because the charge for advice was implicit in the commission scheme.

ED: Still, for quite a while, the issue was relegated to the relatively small number of NASD−only firms that offered tiered commission rates. Then, the SEC issued Rule 19b-3 which prohibited the national securities exchanges from having rules requiring fixed commissions. At the time, it was anticipated that competitive pressure from deregulation would lead to premium and discount commissions — that is with and without investment advice – and, perhaps, the separate sale of research. The SEC staff's position hadn't changed since its advice to the NASD: The Division of Investment Management still regarded special compensation as existing where there was an identifiable charge for investment advice. In the release adopting 19b-3, The SEC explained that the Division's position reflected the notion that "a client who perceives that he is paying a charge specifically for investment advice is entitled to the protections of the Advisers Act."

BEN: The Commission noted at the time of the adoption of Rule 19b-3, that the rule "if followed by the "unbundling" of brokerage commission charges and charges for research …could cause [broker-dealers] who unbundle to become investment advisers under the Advisers Act." In anticipation of the change, the SEC promulgated Rule 206(3)-1 to provide an exemption from the principal trading restrictions under Section 206(3) for registered broker-dealers that act as investment advisers on trades resulting from research.

ED: As a result, Congress enacted Section 28(e) of the Exchange Act to provide a safe harbor from breach of fiduciary duty for a money manager that causes its clients to pay more in commissions for combined brokerage and research services. Congress was concerned that once commissions were deregulated an investment adviser that paid up for research might run afoul of its duty to obtain the lowest brokerage cost for its clients.

BEN: In practice, however, 28(e) arrangements may raise investment adviser registration issues for the broker-dealer depending on whether the practice results in the unbundling of research charges. Most client commission arrangements take one of two forms. In the first, a broker-dealer executes a money manager's trades and provides the manager with its own research at an institutional rate of say 3 cents per share. Assuming that the broker doesn't have a lower execution only rate, there is no issue as to whether the advisory service is paid for specially because the charge for research is indistinguishable in the cost for brokerage. (This is true even if the rate is subject to negotiation based on factors other than the provision of research, such as trade volume or the absence of clearance and settlement services.) In the second scenario, the broker-dealer provides proprietary and third party research to the money manager and credits a portion of the commission − for example 1 cent per share − to a soft dollar credit account to be used to pay the producer of the research. The amount paid to the various producers may be a negotiated rate or an amount that's left to the discretion of the money manager based of his or her good faith assessment of the value of the research. In any event, because the arrangement contemplates payment of a specified portion of the commission for research, the brokers providing the research may be considered investment advisers for purposes of the Advisers Act.

ED: Some third party provider may try to avoid investment adviser implications by also contracting to perform trade execution inquiry or monitoring functions on behalf of the money manager in line with SEC guidance on the types of activities that constitute "effecting a securities transaction" for purposes of Section 28(e). The notion is that the third party provider is both effecting the transaction and providing research incidental to brokerage in contemplation of the broker-dealer exception under the Advisers Act. At the same time, the money manager can be said to have perfected the Section 28(e) safe harbor by using the third party provider to effect the trade. However, this can be form over substance where the third party provider does not, in fact, engage in any trade monitoring functions.

BEN: Moreover, this arrangement does not work where payment to the research provider is in the form of a fixed fee or discretionary payment. The point being that the law likely will look through the arrangement to see if the money manager is clearly paying a defined amount for research. If so the arrangement likely would trigger the registration and other substantive provisions of the Advisers Act. Before Dodd-Frank eliminated the de minimis exemption under the Advisers Act some research providers might have avoided registration by limiting these types of arrangements to less than 15 money managers. In a related presentation, we'll address some of the implications of advisers act registration in these circumstances.