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## Brokers and Advisers – What’s in a Name?

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## ARTICLES

### BROKERS AND ADVISERS — WHAT'S IN A NAME?

*Barbara Black\**

#### INTRODUCTION

More Americans than ever are currently investing in the securities markets and assuming greater responsibility for their financial future. This is particularly apparent with respect to the increasing number of workers who must invest for their own retirement and cannot count on pensions from their employers or the adequacy of social security payments. Yet, unfortunately, many investors lack sufficient knowledge about investment decisions<sup>1</sup> and find it difficult to obtain objective and reliable investment advice. Although they can find many professionals eager to sell them investment products, they frequently discover after time that those professionals are not willing to give them ongoing advice about how to manage their investments as market conditions and the investors' needs change. Compounding the problem, investors are confused about the roles and responsibilities of the various financial services professionals who are competing for their investment dollars. Unfortunately, two recent developments only serve to intensify investors' confusion.

First, major brokerage firms are aggressively marketing brokerage accounts that charge the customer a fee based on the value of the assets in his account in lieu of the traditional transaction-based fee structure. In recent years, substantial amounts of customers' assets have moved

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1. According to the NASD, 97% of investors realize that they need to be better informed about investing. Press Release, NASD, NASD Announces \$10-Million Education Fund (Dec. 2, 2003), *available at* [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW\\_002816](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002816).

into these fee-based accounts or fee-based programs.<sup>2</sup> In an era of competition from discount brokerage firms and diminished profits from commissions, fee-based accounts benefit brokerage firms by providing them with a steady, predictable revenue stream.<sup>3</sup> Firms assert that the shift away from commission income also promotes the customers' best interests by divorcing investment advice from a sales transaction because "in many cases the best advice [a registered representative] can give is to 'do nothing.'"<sup>4</sup> Accordingly, fee-based accounts better align the customers' and the brokers' interests, because brokers are not financially motivated to give advice to generate a sales commission.<sup>5</sup>

Second, prime time television advertising extolling the services of brokerage firms has become part of American culture. In the euphoria of the 1990s, advertisements from discount brokerage firms dominated the airwaves and encouraged investors to believe that they could accumulate fabulous wealth through online trading and their own investment acumen.<sup>6</sup> With the bursting of the stock market bubble, the sales pitch has changed. Advertising now heavily promotes the image of the broker as a trusted family adviser, with both the financial expertise and the concern to attend to the long-term financial well-being of the customer and his or her family.<sup>7</sup> The Securities and Exchange

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2. The Securities and Exchange Commission (SEC) quotes an industry source which estimates that assets in fee-based accounts grew by 60.9 percent in 2003-2004. *See* Certain Broker-Dealers Deemed Not to Be Investment Advisers, Exchange Act Release No. 51,523, Investment Advisers Act Release No. 2376, 70 Fed. Reg. 20,424 at 20,431 (Apr. 19, 2005) [hereinafter Final Rule Release].

3. Final Rule Release, *supra* note 2, at 20,431.

4. SEC, REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,614, at 86,508-09 (Apr. 10, 1995) [hereinafter Tully Report].

5. Final Rule Release, *supra* note 2, at 20,425 n.12.

6. Advertising by the discount brokerage firm, E\*Trade, best exemplifies this trend. In one advertisement that was frequently aired at the time, a "regular-guy" auto mechanic bought his own country with his investment proceeds; in another, an unattractive woman in a luxurious home summons a younger man to massage her bunions.

7. Morgan Stanley has run a series of advertisements that promote this image, showing the broker at the hospital when his customer's baby is born, at soccer games cheering for his customer's child, giving the toast at the wedding of his customer's daughter, and relaxing at the beach with his customers while telling the wife that he thinks she can buy the summer house she's always wanted. Other brokerage firms run similar advertisements.

Commission (SEC) recognized the dangers of this kind of advertising almost fifty years ago, noting that it “may create an atmosphere of trust and confidence, encouraging full reliance on broker-dealers and their registered representatives as professional advisers in situations where such reliance is not merited, and obscuring the merchandising aspects of the retail securities business.”<sup>8</sup>

Until 1999, it was clear, under the SEC’s prevailing interpretation of the Investment Advisers Act (IAA),<sup>9</sup> that the marketing of fee-based accounts subjected broker-dealers to regulation under the IAA. A broker-dealer is excluded from the IAA’s definition of “investment adviser” only if both (1) his performance of advisory services is “solely incidental to the conduct of his business as a broker or dealer” and (2) he receives “no special compensation” for his services.<sup>10</sup> A broker did not receive “special compensation” if he was compensated for his services through payment of a commission or other transaction-related fee. If, however, the broker received a fee irrespective of activity in the account, then he was receiving a fee for investment advice, or “special compensation.”<sup>11</sup> At that time the SEC believed that dual registration was “not overly burdensome”<sup>12</sup> and that the additional protections available to investors under the IAA made it worth the cost.<sup>13</sup>

In 1999, however, when major brokerage firms began to offer fee-based accounts, the SEC proposed a rule to prevent broker-dealers from being regulated as investment advisers solely because of what it described as a “re-pricing” of their services.<sup>14</sup> The SEC also granted informal approval to the marketing of fee-based accounts pending adoption of a final rule. Finally, on April 12, 2005, after a controversial and prolonged rule-making process,<sup>15</sup> the SEC gave its formal approval

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8. SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 88-95, pt. 1, at 248 (1963) [hereinafter SEC Special Study].

9. Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-2(a)(11)(C) (2001).

10. *Id.*

11. Final Extension of Temporary Exemption from the Investment Advisers Act for Certain Brokers and Dealers, Exchange Act Release No. 14,714, Investment Advisers Act Release No. 626, 1978 WL 196894, at \*1 (Apr. 27, 1978).

12. *Id.* at \*2.

13. *Id.*

14. Certain Broker-Dealers Deemed Not to Be Investment Advisers, Exchange Act Release No. 42,099, Investment Advisers Act Release No. 1845, 70 SEC Docket 2486 (Nov. 4, 1999).

15. For a brief summary of the rule’s history, see Final Rule Release, *supra* note 2,

to the marketing of fee-based accounts with its adoption of Rule 202(a)(11)-1 (the “Rule”) by eliminating “no special compensation” as a requirement for exclusion from the statutory definition.<sup>16</sup> The Rule excludes broker-dealers that offer fee-based accounts from the definition of “investment adviser,” so long as any investment advice given is “solely incidental to the brokerage services” provided to the fee-based accounts and certain disclosure requirements are met.<sup>17</sup>

While approving the marketing of these fee-based accounts that emphasized investment advice, the SEC acknowledged a further blurring of the distinction between full-service broker-dealers and investment advisers,<sup>18</sup> and the attendant investor confusion. It was also aware of abuses by brokerage firms in marketing fee-based accounts.<sup>19</sup> SEC Commissioner Cynthia A. Glassman recognized that “investor confusion about the obligations their financial service provider owes to them” was widespread.<sup>20</sup> Furthermore, both Commissioner Glassman and SEC Chair William H. Donaldson questioned what impact brokerage firms’ advertising should have on broker-dealer regulation.<sup>21</sup> In short, the debate over the appropriate regulation of broker-dealers that increasingly promote their advisory services to attract customers is far from over.

In this article, I first set forth a description of the three principal types of financial services professionals that provide advice to customers — broker-dealers, investment advisers and financial planners — and

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at 20,425–27. During the lengthy comment period, the SEC received over 2,000 comment letters on either the rule as originally proposed in November 1999 or the rule as repropoed in January 2005. Broker-dealers generally expressed strong support for the proposal; many investment advisers, particularly financial planners, and investor advocates vigorously opposed it.

16. SEC Investment Advisers Act of 1940, 17 C.F.R. § 275.202(a)(11)-1 (2005).

17. *Id.* § 275.202(a)(11)-1(a)(1)(i).

18. See Final Rule Release, *supra* note 2, at 20,434.

19. See *infra* notes 80–87 and accompanying text.

20. Cynthia A. Glassman, SEC Commissioner, Remarks Before the Open Meeting Regarding the IA/BD Rule (Apr. 6, 2005), <http://www.sec.gov> (follow “Speeches and Public Statements” hyperlink; then follow “Apr. 6, 2005: Remarks Before the Open Meeting Regarding the IA/BD Rule” hyperlink).

21. *Id.*; William H. Donaldson, SEC Chairman, Opening Statement at Commission Open Meeting of April 6, 2005, re: Broker-Dealer Rule, <http://www.sec.gov> (follow “Speeches and Public Statements” hyperlink; then follow “Apr. 6, 2005: Opening Statement at Commission Open Meeting of April 6, 2005, re: Broker-Dealer Rule” hyperlink).

outline the salient differences in the legal obligations that brokers, on the one hand, and investment advisers, on the other, owe to their customers. I next discuss the Rule as adopted by the SEC, the rationale for the Rule, abuses of customers in fee-based accounts, and remaining interpretive issues. I then argue that investors' confusion is likely to increase because the required disclosure under the Rule is inadequate in light of broker-dealers' intensive advertising campaigns, which are aimed at persuading investors that their brokers are not salespersons but rather trusted advisers. Finally, I propose recommendations. First, the SEC should amend the Rule to prohibit broker-dealers from holding themselves out as "financial consultants" or "financial advisers." Second, since it is unlikely that the SEC will revisit this issue, I urge courts and arbitrators to expand the obligations of broker-dealers to their customers when they hold themselves out as something more than salespersons who are marketing securities to investors. Specifically, they should be held to the investment adviser's duty to provide customers with "competent, unbiased and continuous advice."<sup>22</sup>

#### DESCRIPTION OF THE FINANCIAL SERVICES PROFESSIONALS

Federal securities regulation established two systems for regulating financial services professionals: one, under the Securities Exchange Act (SEA) regulating broker-dealers<sup>23</sup> and another, under the IAA, regulating investment advisers.<sup>24</sup> In addition, a third category of professionals — financial planners — is not specifically defined under either statute, but most financial planners are regulated as investment advisers. It is understandable that there is confusion among investors about the differences between broker-dealers, investment advisers, and financial planners. In the competition for customers' dollars, they all seek to provide the widest array of services, and the confusion is compounded by the generality of the relevant statutory definitions.

#### Broker-Dealers

The SEA defines a broker as a person "engaged in the business of

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22. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 187 (1963).

23. Securities Exchange Act of 1934 § 3, 15 U.S.C. § 78c (2004).

24. Investment Advisers Act of 1940 § 202, 15 U.S.C. §§ 80b-1 to 80b-15 (2005).

effecting transactions in securities for the account of others,”<sup>25</sup> and a dealer as a person “engaged in the business of buying and selling securities for [its] own account.”<sup>26</sup> Thus, the core function of a broker-dealer is executing transactions for customers; no other financial services professional can perform this function. In addition, broker-dealers have always provided their customers with a wide range of other services attendant to securities transactions. The SEC identifies “brokerage services” as including:

services provided throughout the execution of a securities transaction, including *providing research and advice prior to a decision to buy or sell*, implementing that decision on the most advantageous terms and executing the transaction, arranging for delivery of securities by the seller and payment by the buyer, maintaining custody of customer funds and securities and providing recordkeeping services.<sup>27</sup>

When making a recommendation to purchase a security, broker-dealers have obligations to make only recommendations that are suitable for the customer, based on the customer’s financial situation and financial objectives.<sup>28</sup> In addition, broker-dealers may be liable for fraud or negligence if a customer asks their advice about selling or holding a security, and the information provided is false or misleading.<sup>29</sup> A broker-dealer’s relationship with his customers is not, however, generally considered a fiduciary one, unless the broker exercises investment discretion over the customer’s account.<sup>30</sup> Broker-dealers, therefore, have no obligation to monitor their customers’ accounts or to provide updated information about previously recommended securities.<sup>31</sup>

In addition, since broker-dealers are salespersons, they are not bound by the fiduciary prohibition on self-dealing transactions without the principal’s informed consent. The broker-dealer’s obligations take

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25. 15 U.S.C. § 78c(a)(4)(A) (2004).

26. *Id.* § 78c(a)(5)(A).

27. Final Rule Release, *supra* note 2, at 20,428 n.37 (emphasis added).

28. See Barbara Black & Jill I. Gross, *Economic Suicide: The Collision of Ethics and Risk in Securities Law*, 64 U. PITT. L. REV. 490–92 (2003).

29. *Id.* at 495–96.

30. *Id.* at 487–89.

31. *Id.* at 504–05.

the form of disclosure only. Rule 10b-10<sup>32</sup> sets forth the information that must be disclosed to the customer before the completion of a transaction, usually at the time of the trade confirmation. This information is intended to protect investors by alerting them to potential conflicts of interest with their broker-dealers.<sup>33</sup> The firm must disclose in what capacity the firm is making the transaction and, if the broker-dealer is acting as a principal, whether it is a market maker in the security.<sup>34</sup> Additional disclosures relate to the firm's remuneration for the transaction.<sup>35</sup> Courts, however, have not held firms liable for failing to disclose that the firm's compensation system may give account executives incentives to sell particular securities.<sup>36</sup>

### *Investment Advisers*

The IAA defines an investment adviser 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

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32. SEC, 17 C.F.R. § 240.10b-10 (2005).

33. See Confirmation of Transactions, Exchange Act Release No. 34,962, 57 SEC Docket 2674, 1994 WL 635201, at \*3 (Nov. 10, 1994).

34. Specifically, “whether the broker or dealer is acting as agent for such customer, as agent for some other person, as agent for both such customer and some other person, or as principal for its own account; and if the broker or dealer is acting as principal, whether it is a market maker in the security (other than by reason of acting as a block positioner).” 17 C.F.R. § 240.10b-10(a)(2).

35. *Id.* § 240.10b-10(a)(2)(i) (agency transactions); *id.* § 240.10b-10(a)(2)(ii) (principal transactions).

36. See *Shivangi v. Dean Witter Reynolds, Inc.*, 825 F.2d 885 (5th Cir. 1987) (holding that plaintiffs failed to establish the requisite scienter on their Rule 10b-5 claims that the firm failed to disclose that account executives received higher compensation for sales of OTC stocks in which it made a market, and information may not be material); *Benzon v. Morgan Stanley*, 2004 WL 62747 (M.D. Tenn. 2004) (holding that firm had no duty to provide information about specific allocations or incentives given to sell Class B mutual fund shares); *Castillo v. Dean Witter Discover & Co.*, 1998 WL 342050 (S.D.N.Y. June 25, 1998) (holding that firm did not have a duty to disclose that account executives received more compensation for selling proprietary mutual funds than other funds; also finding no scienter). *Cf.* *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1173 (2d Cir. 1970) (holding that the firm violated Rule 10b-5, when it made a written evaluation of customer's holdings and recommended three stocks without disclosing that it made a market in these securities; “the evil . . . is that recommendations to clients will be based upon the best interests of the dealer rather than the client.”).



selling securities.”<sup>37</sup> The definition encompasses a wide range of persons that provide a disparate variety of investment advice to different customer bases, from publishers of stock tips on the internet<sup>38</sup> to those who manage investment portfolios for sophisticated institutional investors. According to the Supreme Court, the basic function of an investment adviser is “furnishing to clients on a personal basis *competent, unbiased and continuous advice* regarding the sound management of their investments.”<sup>39</sup> It is well established that the relationship between an investment adviser and his customer is a fiduciary one.<sup>40</sup> Accordingly, where the investment adviser’s duties include management of the account, he is under an obligation to monitor the performance of the account and to make appropriate changes in the portfolio.<sup>41</sup>

In addition, because he is a fiduciary,<sup>42</sup> an investment adviser cannot, either as principal or broker, knowingly engage in a securities transaction with a client unless he discloses in writing to the client the capacity in which he is acting and obtains the client’s consent to the transaction, prior to completion of the transaction.<sup>43</sup> The disclosure must include the facts necessary to alert the client to the adviser’s potential conflict of interest;<sup>44</sup> it is not sufficient for the investment adviser merely to provide a blanket disclosure and general consent.<sup>45</sup> This requirement

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37. Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-2(a)(11) (2001). In addition to the broker-dealer exclusion, the IAA also has exclusions for banks, other professionals (including attorneys and accountants), and publishers of bona fide publications of general circulation under certain circumstances.

38. *See, e.g.*, SEC v. Park, 99 F. Supp. 2d 889 (N.D. Ill. 2000) (denying defendants’ motion to dismiss since an Internet site called Tokyo Joe that dispensed stock tips may be an “investment adviser”).

39. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 187 (1963) (emphasis added; internal quotation marks omitted).

40. *Id.* at 191.

41. *See* Erlich v. First Nat’l Bank of Princeton, 505 A.2d 220, 235 (N.J. Super. Ct. Law Div. 1984); *see also* RESTATEMENT (SECOND) OF AGENCY § 425 (1958).

42. Congress recognized that transactions between the investment adviser and the client create the potential for self-dealing to the detriment of the adviser’s client. Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1732, 17 C.F.R. § 276 (July 17, 1998).

43. Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6(3) (2000).

44. Investment Advisers Act Release No. 1732 (July 17, 1998).

45. Opinion of Director of Trading and Exchange Division relating to § 206 of the Investment Advisers Act of 1940, § 17(a) of the Securities Act of 1933, and §§ 10(b) &

of prior, informed consent is based on the investment adviser's fiduciary status and the fiduciary's obligation of undivided loyalty to the client.<sup>46</sup>

### Financial Planners

"Financial planner" is not defined in the federal securities laws, although most financial planners are registered as investment advisers under the IAA.<sup>47</sup> The SEC recognizes financial planners as a distinct profession of recent origin<sup>48</sup> and describes financial planning services as:

assisting clients in identifying long-term economic goals, analyzing their current financial situation, and preparing a comprehensive financial program to achieve those goals. A financial plan generally seeks to address a wide spectrum of a client's long-term financial needs, including insurance, savings, tax and estate planning, and investments, taking into consideration the client's goals and situation, including anticipated retirement or other employee benefits. *Typically, what distinguishes financial planning from other types of advisory services is the breadth and scope of the advisory services provided.*<sup>49</sup>

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15(c)(1) of the Securities Exchange Act of 1934, Investment Advisers Act Release No. 40, 1945 WL 26361, at \*2 (Feb. 5, 1945).

46. *Id.* See also Arleen W. Hughes, Exchange Act Release No. 4048, 27 S.E.C. 629 at 638-39 (Feb. 18, 1948), *aff'd sub nom.* Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949). The SEC also observed that these disclosure requirements would not be imposed upon broker-dealers who render investment advice merely incidentally to their broker-dealer activities "unless they have by a course of conduct placed themselves in a position of trust and confidence as to their customers."

47. See Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092, 39 SEC Docket 494 (Oct. 8, 1987) (providing guidance for determining whether financial planners, pension consultants and sports/entertainment representatives are investment advisers, based on whether the person (1) provides advice, or issues reports or analyses, regarding securities; (2) is in the business of providing such services; and (3) provides such services for compensation).

48. Final Rule Release, *supra* note 2, at 20,438.

49. *Id.* (emphasis added).

## THE RULE

Rule 202(a)(11)-1 excludes broker-dealers who offer fee-based accounts from the definition of “investment adviser,” so long as any investment advice given is “solely incidental to the brokerage services” provided to the fee-based accounts.<sup>50</sup> In addition, advertisements and contracts for fee-based accounts must contain a “prominent statement” describing the account as a brokerage account, and not an advisory account; alluding to possible conflicts of interests; and identifying a person at the brokerage firm with whom the customer can discuss the differences.<sup>51</sup> The Rule also identifies three situations where investment advice would not be deemed solely incidental to the brokerage services. These situations are: independent advisory services,<sup>52</sup> financial planning services,<sup>53</sup> and discretionary accounts.<sup>54</sup> The Rule makes it clear that this is a non-exclusive list.

Rationale for the Rule

The SEC bases the broker-dealer exclusion on both legislative history and policy grounds. First, under its reading of the IAA’s legislative history, it is not consistent with congressional intent to regulate broker-dealers as investment advisers if the broker-dealers offer investment advice to customers with fee-based accounts, since broker-dealers are already regulated under the SEA.<sup>55</sup> Second, since broker-dealers may provide customers with better advice if their compensation is not transaction-driven, and since customers may perceive a benefit to fee-based accounts, additional regulation should not be imposed on firms that might discourage the firms from offering fee-based accounts.<sup>56</sup> I examine each of these premises below.

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50. SEC, 17 C.F.R. § 275.202(a)(11)-1(a)(1)(i) (2005).

51. The required language is set forth *infra* note 101.

52. 17 C.F.R. § 275.202(a)(11)-1(b)(1), discussed *infra* note 88.

53. *Id.* § 275.202(a)(11)-1(b)(2), discussed *infra* notes 89–95 and accompanying text.

54. *Id.* § 275.202(a)(11)-1(b)(3), discussed *infra* notes 96–99 and accompanying text.

55. See *infra* notes 57–70 and accompanying text.

56. See *infra* notes 71–79 and accompanying text.

Legislative History

In the SEC's view,<sup>57</sup> the congressional intent behind the IAA was to regulate as investment advisers those persons whose activities were not already subject to federal securities regulation. Since broker-dealers were already regulated under the SEA, Congress carved out an exclusion to permit broker-dealers to provide investment advice to their brokerage customers without subjecting them to additional regulation. Congress used the statutory language, "solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor,"<sup>58</sup> because at that time all brokerage accounts were commission-based. Hence, the "no special compensation"<sup>59</sup> requirement served as a workable "bright-line" to distinguish between broker-dealers who were excluded from the definition of investment adviser and those who would be required to register; namely, those who offered advisory services for a separate fee, usually through a separate investment advisory department.

My own reading of the legislative history leaves me unconvinced that we can ascertain any congressional intent behind the statutory exclusion. The genesis of the IAA itself is clear. In response to a directive contained in the Public Utility Holding Company Act of 1935, the SEC conducted hearings and studied abuses in investment trusts and investment companies. In the course of that study, it became interested in learning more about investment advisers. It conducted a survey of investment counselors that were associated with investment companies, but also recognized that there were many others offering investment advisory services about whom it knew very little. The report, which the SEC transmitted to Congress in August 1939, stressed the need to improve the professionalism of the industry, both by eliminating tipsters and other scam artists and by emphasizing the importance of unbiased advice, which spokespersons for investment counsel saw as distinguishing their profession from investment bankers and brokers.<sup>60</sup>

The initial legislation that was the subject of hearings before a

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57. See Final Rule Release, *supra* note 2, at 20,430-32.

58. Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-2(a)(11)(C) (2001).

59. *Id.*

60. See SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES: INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES, H.R. DOC. NO. 477 at 27-30 (1939).

Senate subcommittee in April 1940<sup>61</sup> contained two titles, the first dealing with investment companies (which became the Investment Company Act) and the second dealing with investment advisers (which became the IAA). This bill contained one definition of "investment adviser," applicable to the regulation of both investment companies and investment advisers, which did not include an exclusion for broker-dealers.<sup>62</sup> The SEC testimony before the Senate subcommittee emphasized that the principal purpose of Title II was to require registration to find out more about "how many people are engaged in this business, what their connections are, what is the extent of their authority, what is their background, who they are, and how they handle the people's funds."<sup>63</sup> The focus of the Senate subcommittee hearing was on the appropriateness of regulating investment advisers, rather than on definitional issues, as many members of the investment counsel industry asserted that regulation was ill-advised.<sup>64</sup>

After the hearings before the Senate subcommittee, the SEC and representatives from the investment counsel industry worked out a new version of the legislation.<sup>65</sup> In this version, Title II had its own definitional section and its own definition of "investment adviser" that included the broker exclusion.<sup>66</sup> There was no commentary explaining the addition. Both the House and Senate reports accompanying the legislation simply stated that the definition excludes "brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions)."<sup>67</sup> The only comment on the definition before the full House or Senate was from a representative who objected to the exclusions because they exempted most of the persons from whom small investors receive investment advice.<sup>68</sup>

In short, we have little evidence from which to deduce

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61. S. 3580, 76th Cong. (1940).

62. *Id.* § 45(a)(16).

63. *Investment Trusts and Investment Companies: Hearing on S. 3580 Before a Subcomm. of the Comm. on Banking and Currency, 76th Cong.* 48,319 (1940) (statement of David Schenker, Chief Counsel, SEC Investment Trust Study).

64. *See generally, id.* at 736 (statement of Rudolf P. Berle, General Counsel, Investment Counsel Association of America, NYC).

65. H.R. 10065 and S. 4108, 76th Cong. (3d. Sess. 1940).

66. *Id.* § 202(a)(11).

67. H.R. Rep. No. 76-2639, at 28 (1940); S. Rep. No. 76-1775, at 22 (1940).

68. 86 CONG. REC. 9814 (1940) (statement of Rep. Hinshaw).

congressional intent. We are left with the plain meaning of the statutory exclusion, which sets forth two conditions: the investment advice must be “solely incidental to” the conduct of the broker-dealer’s business, and the broker-dealer must not receive “special compensation” for the advice.<sup>69</sup> In addition, the statute gives the SEC authority to provide further exemptions from the definition.<sup>70</sup> While the SEC’s view is a possible interpretation of congressional intent, it is by no means the only possible interpretation.

### Policy Reasons

The SEC gave two policy reasons for expanding the broker-dealer exclusion: to improve the brokers’ advice-giving function and to increase investors’ choice.

First, the SEC stated that broker-dealers may provide investors with better advice if their compensation is not transaction-based<sup>71</sup> and referred to the Tully Report and its “finding” that fee-based compensation would better align the interests of broker-dealers and their clients.<sup>72</sup> In 1994, SEC Chair Arthur Levitt created the Committee on Compensation Practices<sup>73</sup> and gave it three charges: review industry compensation practices for registered representatives and branch managers; identify actual and perceived conflicts of interest for both

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69. Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-2(a)(11)(C) (2001).

70. *Id.* § 80b-2(a)(11)(F). For this reason, I do not argue that the SEC exceeded its authority in adopting the Rule.

71. Final Rule Release, *supra* note 2, at 20,425-26. The SEC Special Study also pointed out the dangers of commission-based compensation:

The salesman is economically motivated to persuade customers to enter into as many transactions as possible, thereby creating the danger of excessive trading or churning; he also benefits most from sales of those securities for which the rate of commission is highest, and is thus motivated to recommend purchases of securities without sufficient regard for their merit or suitability for a particular customer.

SEC Special Study, *supra* note 7, at 254.

72. See Final Rule Release, *supra* note 2, at 20,426 n.12.

73. The members were Daniel P. Tully, Chairman and CEO of Merrill Lynch & Co. (Chair); Thomas E. O’Hara, Chairman of the Board of Trustees, National Association of Investors Corporation; Warren E. Buffett, Chairman and CEO of Berkshire Hathaway, Inc.; Raymond A. Mason, Chairman and CEO, Legg Mason, Inc.; and Samuel L. Hayes, Jacob H. Schiff Professor of Investment Banking, Graduate School of Business Administration, Harvard University. See Tully Report, *supra* note 4, at 86,510.

registered representatives and branch managers; and identify “best practices” used in the industry to eliminate, reduce, or mitigate these conflicts. The Committee’s discussion of fee-based versus commission-based compensation is only a small part of the Tully Report.

The Committee concluded that “the existing commission-based compensation system work[ed] remarkably well for the vast majority of investors,”<sup>74</sup> although an unidentified majority of the Committee expressed the view that “if the retail brokerage industry were being created today from the ground up [they] would not design a compensation system based only on commissions paid for completed transactions.”<sup>75</sup> This unidentified majority went on to assert that “[t]he most important role of the registered representative is, after all, to provide investment counsel to individual clients, not to generate transaction revenues.”<sup>76</sup> Notice that, under this view, a broker-dealer is an investment adviser that can execute securities transactions, which would essentially write the “solely incidental to” condition out of the statute.<sup>77</sup> While one of the eight specific “best practices” identified in the Report was “[p]aying a portion of [registered representative] compensation based on client assets in an account, regardless of transaction activity, so the [registered representatives] receive some compensation even if they advise a client to ‘do nothing,’”<sup>78</sup> these statements must be taken in the context of an examination of many practices at brokerage firms that create more serious, undisclosed conflicts of interest, such as sales contests and higher commissions for proprietary products, practices that regulators have been slow in eliminating.<sup>79</sup>

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74. Tully Report, *supra* note 4, at 86,508.

75. *Id.* at 86,509.

76. *Id.* at 86,509.

77. Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-2(a)(11)(C) (2001).

78. Tully Report, *supra* note 4, at 86,508–09.

79. As one example, in 1999, the NASD proposed to prohibit many of the questionable sales practices enumerated in the Tully Report. After public comment, the proposals were not adopted. See NASD, Salesperson Compensation Practices, NASD Notice to Members 99-81 (Sept. 1999), available at [http://www.nasd.com/web/groups/rules\\_regs/documents/notice\\_to\\_members/nasdw\\_004080.pdf](http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_004080.pdf). The NASD recently solicited comments on another rule proposal to prohibit some of these practices. See NASD, Sales Contests and Non-Cash Compensation, NASD Notice to Members 05-40 (June 2005), available at [http://www.nasd.com/web/groups/rules\\_regs/documents/notice\\_to\\_members/nasdw\\_014347.pdf](http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_014347.pdf).

Second, the SEC stated that some investors may prefer a flat fee or asset-based fee structure and that investors should be allowed to make this choice.<sup>80</sup> It is difficult to argue against customer choice, provided that it is an informed one. However, if there is a mutual desire for fee accounts, it is not clear that treating these accounts as advisory accounts poses a significant regulatory disincentive.

*Abuses of Customers in Fee-Based Accounts*

The benefits of fee-based accounts are that they may deter some forms of classic broker-dealer fraud such as churning<sup>81</sup> and provide customers with some assurance that their brokers' advice is not given to generate more broker income. In addition, some customers may prefer a fee either because of its predictability or because of the expectation they will obtain better service from their account executive. On the other hand, costs for fee-based programs will be higher for customers who engage in infrequent trading activity, particularly for those who follow a buy-and-hold strategy, an investment strategy generally more appropriate for small or inexperienced investors. In addition, fee-based programs may encourage customers to engage in imprudent, excessive trading because of the volume discount.<sup>82</sup> For these reasons, the choice between the two types of accounts requires a careful assessment of the investor's needs, and fee-based accounts are not appropriate for many investors.

The SEC's adoption of the Rule came at a time when there was considerable evidence that some brokerage firms had placed customers in fee-based accounts where their interests would be better served in commission-based accounts. The firms had also failed to monitor customers' trading activity to assure that a fee-based account remained appropriate for the customer; and, in some instances, had even failed to

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80. See Final Rule Release, *supra* note 2, at 20,426.

81. Excessive trading in an account by the broker to generate commission income. See Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1010–11 (2002).

82. The New York Stock Exchange (NYSE) identifies the "primary advantage" to customers of fee-based accounts as a "volume discount." NYSE, Non-Managed Fee Based Account Programs, NYSE Information Memo 05-51 at 1 (June 2005), available at <http://www.nyse.com> (follow "Regulation" hyperlink; then follow "Information Memos" hyperlink; then follow "05-51" hyperlink).



assign an account executive to handle the customer's account. The broker-dealers' motivation, unfortunately, seemed to be "all about the money" rather than providing improved service to the customer.<sup>83</sup> Both the NYSE and NASD have brought enforcement actions against firms for inappropriately placing customers in fee-based accounts and for failing to assign an account representative to some fee-based accounts.<sup>84</sup>

In addition, the NYSE and NASD have taken regulatory action to curb the over-selling of fee-based accounts. As with securities and trading strategies, broker-dealers must have reasonable grounds for believing that a fee-based account is appropriate for a customer in light of the services provided, cost and customer preference.<sup>85</sup> NYSE Rule 405A<sup>86</sup> requires pre-account opening disclosures designed to enable a customer to make an informed decision about the account's appropriateness; a determination by the firm that the fee-based account is appropriate for the customer prior to opening the account; ongoing monitoring of the customer's transactional activity to assure that a fee-based account continues to be appropriate for the customer; and follow-up with those customers whose level of trading activity indicates that a fee-based account is not appropriate.<sup>87</sup>

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83. The SEC alluded to these problems in the Final Rule Release, *supra* note 2, at 20,433 n.95.

84. See Press Release, NASD, NASD Fines Raymond James \$750,000 for Fee-Based Account Violations (Apr. 27, 2005) available at [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW\\_013876](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013876); see also Press Release, NASD, NASD Orders Morgan Stanley to Pay over \$6.1 Million for Fee-Based Account Violations (Aug. 2, 2005) available at [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW\\_014804](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_014804).

85. Memorandum, NASD, Fee-Based Compensation: NASD Reminds Members That Fee-Based Compensation Programs Must be Appropriate, NASD Notice to Members 03-68 (Nov. 2003), available at [http://www.nasd.com/web/groups/rules\\_regs/documents/notice\\_to\\_members/nasdw\\_003079.pdf](http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003079.pdf).

86. Adopted in Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendments No. 2 and No. 3 Thereto to Adopt Rule 405A ("Non-Managed Fee-Based Account Programs - Disclosure and Monitoring"), Exchange Act Release No. 51,907, 70 Fed. Reg. 37,458 (June 29, 2005).

87. See NYSE Rule 405A (Non-Managed Fee-Based Account Programs—Disclosure and Monitoring), available at [http://rules.nyse.com/nysetools/ExchangeViewer.asp?SelectedNode=chp\\_1\\_5&manual=/nyse/nyse\\_rules/nyse-rules/](http://rules.nyse.com/nysetools/ExchangeViewer.asp?SelectedNode=chp_1_5&manual=/nyse/nyse_rules/nyse-rules/) (follow "Conduct of Accounts (Rules 401-414)" hyperlink).

*Remaining Interpretive Difficulties under the Rule*

While the controversy over the broker-dealer exclusion was heated and rancorous, a consensus did emerge that the problem was not broker-dealers charging asset-based fees. Rather, the problem was whether broker-dealers were holding themselves out as something other than traditional full-service brokers, and, if so, whether the investing public would be misled and harmed by this. Since broker-dealers are marketing the fee-based accounts on the quality of their investment advice, it would seem obvious that they could not meet the statutory requirement of “incidental” advice.<sup>88</sup> The SEC, however, did not adopt this view and declined to adopt a narrower construction urged by some commentators<sup>89</sup> to limit the exclusion to “minor, insignificant, or infrequent” advice.<sup>90</sup> Rather, the SEC took the position that investment advice is “solely incidental to” brokerage services when the services are “in connection with and reasonably related to” the brokerage services<sup>91</sup> or when the advisory services are “liable to happen as a consequence of” or “follow as a consequence of” the conduct of the broker’s business.<sup>92</sup>

Prior to 1999, the SEC had little occasion to consider the “solely incidental to”<sup>93</sup> statutory language. Instead, regulatory guidance on the broker-dealer exclusion focused on the requirement of no “special compensation,”<sup>94</sup> since, particularly in the era of fixed rates and bundled brokerage services, this appeared to provide a clear distinction between

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88. Indeed, the SEC itself expressed reservations about whether the advice provided in fee-based accounts can be considered “solely incidental to” brokerage services when these accounts are marketed principally based on the quality of the advisory services. *See* Certain Broker-Dealers Deemed Not to be Investment Advisers, Exchange Act Release No. 42,099, Investment Advisers Act Release No. 1845, 70 SEC Docket 2486, 1999 WL 999763, at \*5 (Nov. 4, 1999) and Certain Broker-Dealers Deemed Not to be Investment Advisers, Exchange Act Release No. 50,980, Investment Advisers Act Release No. 2340, 84 SEC Docket 2208, 2005 WL 38804, at \*19 (Jan. 6, 2005).

89. For contrasting views of the dictionary meanings, *see* Final Rule Release, *supra* note 2, at 20,436 n.135.

90. Final Rule Release, *supra* note 2, at 20,437.

91. *Id.* at 20,436.

92. Certain Broker-Dealers Deemed Not to be Investment Advisers, 2005 WL 38804, at \*18.

93. Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-2(a)(11)(C) (2001).

94. *Id.*

brokerage and advisory services.<sup>95</sup> Thus, shortly after the enactment of the IAA, the SEC stated:

that portion of clause (C) which refers to "special compensation" amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities . . . . *The essential distinction to be borne in mind in considering borderline cases . . . is the distinction between compensation for advice itself and compensation for services of another character to which advice is merely incidental.*<sup>96</sup>

SEC No-Action Letter positions interpreting the "solely incidental to" exclusion are inconsistent<sup>97</sup> and unhelpful.<sup>98</sup> The staff appeared to find the exclusion unavailable when it determined that the investment advisory services predominated over the brokerage services.<sup>99</sup> Thus, it

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95. In the view of the SEC, "special compensation" was included in the statute for the express purpose of identifying advice that was not provided as part of the package of traditional brokerage services. *Certain Broker-Dealers Deemed Not to be Investment Advisers*, 2005 WL 38804, at \*7.

96. See Opinion of General Counsel relating to Section 202(a)(11)(C) of the Investment Advisers Act of 1940, *Investment Advisers Act Release No. 2*, 1940 SEC LEXIS 1466 (October 28, 1940) (emphasis added).

97. Compare, e.g., their inconsistent positions on market timing services—*Calton & Assoc.*, SEC No-Action Letter, 1988 SEC No-Act. LEXIS 1348 (Oct. 11, 1988) (holding that the services were not solely incidental) with *Toney Reed*, SEC No-Action Letter, 1985 No-Act. LEXIS 2346 (July 15, 1985) (holding that the services were solely incidental) and compare, e.g., their inconsistent positions on financial planning services—*Roney & Co.*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2016 (Apr. 3, 1985); *Financial Planning & Advisory Services*, SEC No-Action Letter, 1979 WL 13190 (Feb. 11, 1979) (holding both services not solely incidental) with *Nathan & Lewis Sec.*, SEC No-Action Letter, 1988 SEC No-Act. LEXIS 434 (Apr. 4, 1988); *Elmer D. Robinson*, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 1610 (Jan. 6, 1986) (holding both services may be solely incidental).

98. See, e.g., *Gunter Kaiserauer*, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2916 (Sept. 20, 1982) (holding seminars and book on investment strategy not solely incidental).

99. The following were found not to be solely incidental: general partner/managing agent of an investment company (*John Terwilliger*, SEC No-Action Letter, 1977 WL 10504 (June 27, 1977)); selection of an investment adviser for a fund (*A.I.L. Sec. Co.*, SEC No-Action Letter, 1976 WL 10391 (Apr. 3, 1976)); evaluation of performance of investment manager (*William Bye Co.*, SEC No-Action Letter, 1973 WL 6670 (Apr.

had previously identified financial planning and investment supervisory/investment management services as not solely incidental to brokerage services.<sup>100</sup> In addition, it consistently warned that holding oneself out as a financial planner, financial adviser, or financial consultant to induce the sale of securities may violate the anti-fraud provisions.<sup>101</sup>

In the Final Rule, the SEC set forth three instances where the advice is not solely incidental to the brokerage relationship.<sup>102</sup> Two of them<sup>103</sup> are relevant for this discussion. First, the broker-dealer exclusion is not available to a broker-dealer that provides advice as part of a financial plan or in connection with providing financial planning services and (i) holds itself out generally to the public as a financial planner, (ii) delivers to the customer a financial plan, or (iii) represents to the customer that the advice is provided as part of a financial plan or in connection with financial planning services.<sup>104</sup>

Commentators on both sides saw problems with this carving-out of “financial planning” services. Broker-dealers asserted that it could interfere with their obligation as broker-dealers to make suitable recommendations to their customers.<sup>105</sup> Others pointed out that broker-dealers could use a different title, such as “financial consultant,” to achieve the same result.<sup>106</sup> Both these objections make valid points about the lack of certainty associated with the phrase “financial

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26, 1973)); selection and monitoring of investment adviser (Capital Asset Program, SEC No-Action Letter, 1974 WL 10950 (Dec. 1, 1974)).

100. See Townsend & Associates, SEC No-Action Letter, 1994 SEC No-Act. LEXIS 739 (Sept. 21, 1994); Investment Management & Research, Inc., SEC No-Action Letter, 1977 SEC No-Act. LEXIS 184 (Jan. 27, 1977).

101. See Security Sources, Inc., SEC No-Action Letter, 1989 SEC No-Act. LEXIS 664 (May 18, 1989); Elmer D. Robinson, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 1610 (Jan. 6, 1986); Haight & Co., Exchange Act Release No. 34,9082, 44 S.E.C. 481 (Feb. 19, 1971).

102. Final Rule Release, *supra* note 2, at 20,437. See also SEC Investment Advisers Act of 1940, 17 C.F.R. § 275.202(a)(11)-1(b)(1) (2005); 17 C.F.R. § 275.202(a)(11)-1(b)(2); 17 C.F.R. § 275.202(a)(11)-1(b)(3).

103. In addition, a broker-dealer that charges a separate fee, or separately contracts, for advisory services cannot claim the broker-dealer exclusion. 17 C.F.R. § 275.202(a)(11)-1(b)(1). This is a “bright-line” test consistent with industry practice. See Final Rule Release, *supra* note 2, at 20,440.

104. 17 C.F.R. § 275.202 (a)(11)-1(b)(2).

105. Final Rule Release, *supra* note 2 at 20,438.

106. *Id.* at 20,439.

planning.” The SEC did not adequately address these concerns, but made three assertions. First, it did not want to interfere with the broker-dealer’s suitability analysis.<sup>107</sup> Second, it believed that investors understand the difference between “financial planning” and brokerage services<sup>108</sup> (a debatable proposition). Finally, a broker-dealer would be subject to the IAA if it holds itself out as providing financial services, “whether it uses those terms or not.”<sup>109</sup> However, the Rule does not prohibit broker-dealers from calling themselves “financial advisors” or “financial consultants.” In the view of the SEC, these are “generic terms” descriptive of what many persons in the financial services industry do.<sup>110</sup>

Second, broker-dealers are not excepted from the IAA for any accounts (commission-based or fee-based) over which they exercise investment discretion.<sup>111</sup> This is a change in the staff position; previously, a broker-dealer would be considered an investment adviser only if his business consisted almost exclusively of managing accounts on a discretionary basis.<sup>112</sup> In the SEC’s view, the discretionary power is “qualitatively distinct”<sup>113</sup> from simply providing investment advice; “this quintessentially supervisory or managerial character warrants the protection of the Advisers Act because of the ‘special trust and confidence inherent’ in such relationships.”<sup>114</sup> Where the broker-dealer controls the account, it is an investment adviser.

Accordingly, a broker-dealer that holds itself out, in its advertising,

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107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.* The IAA prohibits the use of “investment counsel” unless the person’s “principal business is acting as an investment adviser and a substantial part of his business consists of rendering investment supervisory services,” Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-8(c) (2005); therefore broker-dealers avoid this term.

111. *See, e.g.*, where the broker-dealer “exercises investment discretion over the customer account,” SEC Investment Advisers Act of 1940, 17 C.F.R. § 275.202(a)(11)-1(b)(3) (2005), except where the investment discretion is granted on a temporary or limited basis, 17 C.F.R. § 275.202(a)(11)-1(d).

112. Applicability of the Investment Advisers Act to Certain Brokers and Dealers, Exchange Act Release No. 15,215, Investment Advisers Act Release No. 640, 43 Fed. Reg. 47176, 1978 SEC LEXIS 575 (Oct. 5, 1978).

113. Final Rule Release, *supra* note 2, at 20,440.

114. *Id.* (internal citations omitted).

as providing a broad range of planning services to its customers should be considered an investment adviser. In addition, a broker-dealer that exercises *de facto* control over the account should be treated as an investment adviser, because, just as with *de jure* discretionary accounts, the broker and the customer have agreed that the broker will manage the account. Courts and arbitrators have long recognized that a broker-dealer's responsibilities to its customer expand if the broker-dealer exercises *de facto* control over the account.<sup>115</sup> In both of these situations, the broker-dealer is inviting the customer to place his trust and confidence in the broker-dealer to manage the customer's financial affairs. The customer who relies on the broker-dealer to manage his account is acting reasonably in these circumstances.

#### INVESTORS ARE LIKELY TO BE MISLED

In the face of aggressive efforts to sell fee-based accounts and the firms' intensive advertising campaigns to sell their advisory services, investors' confusion is, unfortunately, only likely to increase. I examine here the disclosure required by the Rule and find it unlikely to cure investors' confusion.

Advertisements and contracts for fee-based accounts must contain a "prominent statement" describing the account as a brokerage, and not an advisory, account; alluding to possible conflicts of interest; and identifying a person at the brokerage firm with whom the customer can discuss the differences.<sup>116</sup> The required disclosure, however, is not likely to counteract the persuasive and misleading effects of the heavy advertising campaign promoting broker-dealer advisory services. First, the language is formalistic and jargon-laden and assumes that a customer will understand the distinctions between a brokerage and an advisory account. Second, while the disclaimer may alert customers to potential conflicts of interest between brokers and customers, it does not provide

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115. Black & Gross, *Economic Suicide*, *supra* note 28, at 488.

116. The required language is as follows: "Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons' compensation, may vary by product and over time." 17 C.F.R. § 275.202(a)(11)-1(a)(1)(ii).

any warning that the broker-dealer does not have any legal obligation to monitor its customers' accounts — the precise message that the ads are selling. Third, inviting the customer to “ask [the firm] questions”<sup>117</sup> unfairly puts the burden on the customer to figure out the questions he should be asking. Fourth, if the customer asked about “[his] rights and [the firm’s] obligations to [him],”<sup>118</sup> it is unlikely that a spokesperson of the broker-dealer would provide a clear and impartial explanation.

If the disclosure is not likely to counteract the effects of the advertising, are there effective regulatory curbs on misleading advertising? The NASD regulates broker-dealer advertising<sup>119</sup> and has asserted that “the standards imposed by the NASD advertising rules are perhaps the highest imposed upon any industry.”<sup>120</sup> Its advertising rules specifically prohibit an “exaggerated, unwarranted or misleading statement or claim.”<sup>121</sup> In a recent disciplinary proceeding, the NASD charged that a Long Island-based brokerage firm’s radio advertisements (aired heavily in the New York metropolitan area) were misleading because they purported to be about actual investors whose investments would have performed better if they had invested with the firm, but the firm could not substantiate the existence of these investors. In addition, its radio advertisements embodied the concept of “providing returns of 10 percent and more” to “tens of thousands” of customers.<sup>122</sup> In a press release announcing the charges, NASD Vice Chairman Mary L. Shapiro

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117. *Id.*

118. *Id.*

119. NASD Manual, Conduct Rule 2210 (2004), available at [http://www.nasd.complinet.com/nasd/display/display.html?rbid=1189&element\\_id=1159000466](http://www.nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000466) (follow “2200. Communications with Customers and the Public” hyperlink; then follow “2210. Communications with the Public” hyperlink).

120. NASD, REPORT OF NASD REGULATION, PUBLIC POLICY SESSIONS CONCERNING THE ADVERTISEMENT OF ONLINE BROKERAGE, (Sept. 21, 1999), available at [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW\\_006161&ssSourceNodeId=604](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_006161&ssSourceNodeId=604).

121. Conduct Rule 2210, *supra* note 119, at (d)(1)(B) and (d)(2)(C).

122. NASD, Disciplinary and Other NASD Actions (2004), available at [http://www.nasd.com/web/groups/enforcement/documents/monthly\\_disciplinary\\_action\\_s/nasdw\\_011982.pdf](http://www.nasd.com/web/groups/enforcement/documents/monthly_disciplinary_action_s/nasdw_011982.pdf). NASD subsequently fined the firm, barred it from conducting public seminars for thirty days, and ordered it to pre-file its sales literature with NASD for six months. Press Release, NASD, NASD Fines David Lerner Associates \$115,000 For Misleading Advertising and Communications With The Public (Sept. 30, 2005), available at [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW\\_015088](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015088).

specifically referred to the firm's "use of statements designed to appear as customer testimonials" as "misleading and an abuse of the investing public."<sup>123</sup> Apart from the guarantee of a specific rate of return,<sup>124</sup> the advertising campaigns by the major brokerage firms simply seem like a more sophisticated version of the conduct NASD alleged to be illegal in this case. The NASD thus has the regulatory power to curb misleading advertising, but at least to date it has not expressed publicly any interest in charging the major brokerage firms in connection with their "phony testimonials" advertising.<sup>125</sup>

The cynical rejoinder to these concerns is that everyone knows that advertising is puffery and reasonable investors should not be misled by sales talk.<sup>126</sup> This is a better argument when the advertising is preposterous or tongue-in-cheek; after all, reasonable investors probably should not expect that they (unlike the auto mechanic in the E\*Trade advertisement) could purchase their own country with their investment proceeds. The current advertisements, however, are not so far-fetched and communicate a believable, if misleading, message — that investors can rely on their financial advisers to manage their money over the long haul. Courts have long held that the misleading content of advertisements should be determined by their impact on the average investor.<sup>127</sup>

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123. Press Release, NASD, NASD Charges David Lerner Associates with Using Misleading Radio Spots, Investment Seminars, Other Ads (Oct. 6, 2004), available at [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW011623](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW011623). The press release also noted the firm's significant expenditures on advertising and marketing.

124. This is a specific violation of Conduct Rule 2210, *supra* note 119, at (d)(1)(D) prohibiting predictions of performance.

125. A recent search on both Westlaw and Lexis databases found no disciplinary proceedings against Merrill Lynch, Morgan Stanley or Salomon Smith Barney involving Conduct Rule 2210 violations.

126. Corporations successfully assert the puffery defense in Rule 10b-5 claims for false and misleading statements. See Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697 (1998).

127. See, e.g., SEC v. C.R. Richmond & Co., 565 F.2d 1101, 1104-05 (9th Cir. 1977) (stating that statements about investment performance are to be measured from the viewpoint of a "person unskilled and unsophisticated in investment matters"); *Marketlines, Inc. v. SEC*, 384 F.2d 264, 266 (2d Cir. 1967) (holding that the SEC has a duty to protect gullible investors); *SEC v. Lindsey-Holman Co.*, Fed. Sec. L. Rep. (CCH) ¶ 96,704, 1978 U.S. Dist. LEXIS 15991 (M.D. Ga. 1978) (holding that the effect



## RECOMMENDATIONS

In the release announcing the Rule, the SEC gave the SEC staff the task of further study of the policy issues raised during the lengthy rulemaking process. It specifically asked whether the broker-dealer advertising rules should be enhanced.<sup>128</sup> I would like to answer the SEC's question. It made a serious mistake in allowing broker-dealers to hold themselves out as "financial advisers" or "financial consultants."<sup>129</sup> Registered representatives are salespersons, and the firm's advertisements should make this clear, so that investors will not be misled. Accordingly, broker-dealers should be prohibited from holding themselves out as "financial advisers" or "financial consultants," as these terms convey (as the firms surely intend them to) a relationship that is more conducive to trust and confidence on the part of an investor than an arms-length relationship between a salesperson and a customer. While the problem is broader than fee-based accounts, a first step in tackling it would be to amend the Rule to condition the promotion of fee-based accounts on prohibiting use of these terms.

I recognize, however, that after a six-year rulemaking process, with a thorough airing of all viewpoints,<sup>130</sup> the SEC is unlikely soon to consider amending the Rule. Accordingly, if broker-dealers are allowed to hold themselves out as "financial advisers" or "financial consultants" in order to sell their services, their legal obligations should be commensurate with those of investment advisers. Courts and arbitrators<sup>131</sup> should deem it misleading for broker-dealers to hold

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of advertising would be measured from the viewpoint of an unskilled and unsophisticated person). These cases all involved violations of the advertising rules applicable to investment advisers and promulgated by the SEC pursuant to its authority under the IAA. These rules specifically prohibit testimonials, references to past specific recommendations (unless it is a list of all past recommendations in the preceding period of at least a year), and representations that any graph or formula can determine which securities to buy or sell. SEC Investment Advisers Act of 1940, 17 C.F.R. § 275.206(4)-1 (2005).

128. Final Rule Release, *supra* note 2, at 20,442. See also *supra* notes 20–21 and accompanying text for concerns expressed by Commissioner Glassman and Chair Donaldson about broker-dealer advertising.

129. Final Rule Release, *supra* note 2, at 20,439. See also *supra* notes 67–68.

130. See *supra* note 12.

131. Today virtually all disputes between customers and broker-dealers are arbitrated before the SRO arbitration forums. See Black & Gross, *Making It Up As*

themselves out as being advisers without accepting the legal responsibilities attendant to that title. In disputes between customers and broker-dealers, a customer should be permitted to introduce as evidence the firm's advertising and explain how it affected his understanding of his relationship with his broker. In turn, the firm or registered representative will have an opportunity to demonstrate that they made it clear to the customer that the registered representative was a salesperson and did not owe a fiduciary duty to the customer. The judge or the arbitrator should carefully consider the evidence presented by both sides and make an assessment of the likely impact of the firm's advertising on the customer's understanding and expectations about his relationship with his broker-dealer. Specifically, if the advertising created a reasonable expectation that the broker-dealer was more than a salesperson, then it should be responsible for monitoring the customers' accounts and providing updated information so that the customer and broker together can reevaluate the customer's financial situation in light of changing market conditions — just as the advertisements promise.<sup>132</sup>

The principle that broker-dealers who act as investment advisers should be held to heightened standards is not new. The SEC previously understood that an investor was likely to become confused if he was dealing with a broker-dealer who was also an investment adviser; because he would expect that an investment adviser to be independent of the business of selling securities. In recognition of this, the SEC previously held dual registrants to high fiduciary standards and to enhanced disclosure requirements relating to conflicts of interest.<sup>133</sup>

Adoption of the Rule should not immunize broker-dealers from the consequences of their misleading conduct. They should not be permitted to hold themselves out as dispensing investment advice and yet assert that they are not investment advisers and are not fiduciaries. The SEC previously recognized that it is misleading for broker-dealers to hold themselves out as financial planning experts as a sales tactic.<sup>134</sup>

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*They Go Along*, *supra* note 81, at 991.

132. Courts will enforce a broker's promise to monitor the customer's account. See *Ahluwalia/Shetty v. Kidder, Peabody & Co.*, 1998 U.S. Dist. LEXIS 3286 (S.D.N.Y. 1998), *aff'd mem.*, 173 F.3d 843 (2d Cir. 1999).

133. *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949).

134. See *Haight & Co.*, Exchange Act Release No. 34,9082, 44 S.E.C. 481 (Feb. 19, 1971) (involving radio advertisements not dissimilar from those airing today on television); Security Sources Inc., SEC No-Action Letter, 1989 SEC No-Act. LEXIS

This principle is even more true today where the combined force of the marketing of fee-based accounts and of the broker-dealers' heavy advertising campaigns create conditions that unfortunately are almost certain to result in increased investor confusion.

A practical objection to finding that the broker has a responsibility to monitor the account and provide updated information is that it may be unworkable for the broker to provide this service and hence it is unrealistic for investors to expect it. The answer to this is that broker-dealers should not promise to provide something they cannot deliver. Perhaps it is unrealistic for retail investors to believe that they can obtain continuous, unbiased investment advice — but they should not be deceived into thinking that they will be getting it.

#### CONCLUSION

This article seeks to demonstrate that the SEC made a mistake in adopting the Rule. Because the firms market fee-based accounts on the basis of the quality of the investment advisory services that the customer will receive, they are exceeding the boundaries of excluded brokerage advice under the IAA,<sup>135</sup> the investment advisory services are not “solely incidental to”<sup>136</sup> the brokerage services. In addition, in their advertisements, the firms are holding themselves out as providing financial planning or investment management services to their customers — which exceeds the exclusions set forth in the Rule itself.

Since it is unlikely that the SEC will reconsider the Rule, it will fall to the courts and arbitrators to deal with the disputes that will arise when customers' expectations are not fulfilled. I propose that the courts and arbitrators should simply take the brokerage firms at their word. Since they promised continuous, unbiased investment advice, they should be held to that standard.

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664 (May 18, 1989); Universal Heritage Inv. Corp., SEC No-Action Letter, 1971 WL 7544 (June 19, 1971).

135. Investment Advisers Act § 202, 15 U.S.C. § 80b-2(a)(11)(C) (2001).

136. *Id.*