GOODWIN PROCTER

April 10, 2007
Vol. 10 No. 34

Financial Services Alert

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➢ Federal Court of Appeals for the D.C. Circuit Vacates SEC Rule Addressing Advisers Act Exception for Broker-Dealers

The United States Court of Appeals for the District of Columbia Circuit (the "Court") granted a petition to vacate a 2005 SEC Rule that created additional exceptions from the definition of "investment adviser" under the Investment Advisers Act of 1940, as amended (the "Act"), and therefore from regulation under the Act, for certain fee-based and discount brokerage programs. The petition was filed by the Financial Planning Association, a trade organization for financial planners. The Rule in question, Rule 202(a)(11)-1 under the Act (the "Rule"), which also addresses other issues affecting broker-dealers' ("BD") status under the Act, was discussed in detail in the May 31, 2005 *Alert*. The Rule remains in effect until at least May 14, 2007 during the period allowed for filing a petition for panel rehearing or rehearing *en banc*, which may be extended by the Court.

The "Broker-Dealer Exception." Subsection (C) of Section 202(a)(11) of the Act ("subsection (C)") provides a "BD exception" from the definition of "investment adviser." It states that "any broker or dealer whose performance of [advisory] services is solely incidental to the conduct of its business as a broker or dealer and who receives no special compensation therefor" is not an investment adviser for purposes of the Act. In the late 1990s, the SEC concluded that developments in the brokerage industry had begun to raise questions about the adequacy of existing SEC interpretations of the two elements of the BD exception. For example, there was concern that fee-based brokerage programs, where full service brokerage customers paid a fee that was a fixed dollar amount or a percentage of assets held on account with the BD could be deemed "special compensation" under Section 202(a)(11)(C) because the programs' fees differed from the traditional transaction based compensation, *e.g.*, commissions and mark-ups, cited in earlier SEC guidance. In order to address these issues, in 1999 the SEC proposed a new rule designed to avoid application of the Act to BDs solely because they offer a lower cost execution-only service, *i.e.*, discount brokerage, in addition to their full service brokerage service, that include an incidental advisory services component. Substantial response from the securities industry to this initial proposal and a subsequent reproposal led the SEC to broaden its focus to include issues such as wrap accounts and financial planning. The Rule was the result of these efforts.

Rule 202(a)(11)-1. In summary, the Rule provides in paragraph (a)(1) that a BD that receives special compensation, *e.g.*, a BD that offers a fee-based program, will not be deemed an investment adviser if

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(1) any advice provided is solely incidental to the brokerage services provided and (2) specific disclosure set forth in the Rule is made to the customer. Paragraph (a)(2) provides that a BD will not be deemed to have received special compensation merely because it charges one customer more (*e.g.*, for full service brokerage) or less (*e.g.*, for discount brokerage) than it charges another customer for brokerage services. Paragraph (b) lists three separate circumstances when advisory services are not "solely incidental to" the brokerage services: (1) a separate fee or contract exists for advice; (2) a customer receives certain financial planning services; or (3) where the BD has investment discretion over a client's account. Paragraph (c) states that BDs are investment advisers only with respect to those accounts that cause them to be subject to the Act. Paragraph (d) defines the term "investment discretion" as used in the Rule, and provides that it does not include "discretion granted by a customer on a temporary or limited basis."

The Court's Opinion. In reaching its decision, the Court applied the test in *Chevron USA, Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984) ("*Chevron*"), to the SEC's exercise of rulemaking authority and found that a proper construction of the statutory BD exception and the statutory provisions cited as the basis for the SEC's exercise of rulemaking authority precluded the SEC's promulgation of the Rule. The SEC adopted the Rule under Section 202(a)(11)(F) ("subsection (F)") of the Act (now subsection (G) after 2006 amendments to the Act). Subsection (F) appears at the end of a list of express exceptions, *e.g.*, for banks, including the BD exception. It allows the SEC to except "such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order." The SEC also relied on Section 211(a) of the Act, which gives the SEC authority to adopt rules that are "necessary or appropriate to the exercise of the functions and powers conferred on the SEC elsewhere in the Act."

In the first phase of the *Chevron* analysis, the Court sought to determine if the Act clearly speaks to the question of whether Section 202(a)(11)(F) empowers the SEC to except from the Act any group of BDs in addition to those already excepted by subsection (C), or whether the statute is ambiguous on that point. To do so, the Court looked to the text and structure of Section 202(a)(11), the overall statutory scheme of the Act and the problem being addressed. Under the Court's plain meaning analysis, the use of "*any* broker or dealer" in subsection (C) and the use of "such *other* persons" in subsection (F) are unambiguous in indicating that Congress' intent was that the only exception applicable to BDs should be the one provided by subsection (C). The Court found support for its conclusion in congressional committee reports relating to the enactment of Section 202(a)(11) stating that the "term 'investment adviser' is so defined as specifically to exclude … brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive *only* brokerage commissions)." The Court also found that the overall statutory scheme of the Act is inconsistent with a construction of the SEC's authority under subsection (F) that would enable persons Congress determined should be subject to the Act, BDs not within the exception provided by subsection (C), to escape the Act's restrictions. The Court's opinion also emphasized the fact that the Rule was inconsistent with the SEC's past interpretations of subsection (F), all of which the Court characterized as having been used to exempt persons not otherwise addressed in the five exemptions established by Congress in the statute.

The Court found that the SEC's general rulemaking authority under Section 211(a) of the Act is similarly insufficient to support the Rule because it "suggests no intention by Congress that the SEC could ignore either of the two requirements in subsection (C) for BDs to be exempt" from the Act. In the course of addressing SEC arguments referring to the agency's broad rulemaking powers under Section 6(c) of the Investment Company Act of 1940, as amended, the Court observed that the SEC did not rely on a parallel provision in the Act (Section 206A) in promulgating the Rule. Section 206A grants much broader rulemaking authority than either subsection (F) or Section 211(a) by allowing the SEC to exempt any person, transaction or class or classes of persons or transactions from any provision of the Act to the extent the exemption is "necessary or appropriate in the pubic interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Act]". The Court noted that it therefore had "no occasion to express an opinion on the SEC's authority" under Section 206A; in a later discussion justifying its interpretation of subsection (F), however, the Court observed that because its duty was to give meaning to each word of the statute, it could not properly treat one authorization, under subsection (F), as duplicative of another authorization, under Section 206A, thereby suggesting that the Rule could be within the SEC's rulemaking authority under Section 206A.

Scope of the Decision. The decision vacates the Rule in its entirety, including elements seemingly not at issue in the Court's review, *e.g.*, the portion of paragraph (b) designed to subject BDs engaged in certain financial planning activities to regulation under the Act, and paragraph (c), which confers investment adviser status on a BD solely with respect to the BD's advisory accounts. The Court noted, however, that on its own, paragraph (c) "merely restates the current law."

Dissent. One member of the three judge panel dissented from the decision. Circuit Judge Garland also conducted a *Chevron* analysis of the SEC's rulemaking. He found that in the first phase of the analysis, the statute was ambiguous as to the scope of the SEC's rulemaking powers under subsection (F). In particular, he viewed as equally legitimate a reading of subsections (C) and (F) under which the SEC could by rule adopt further exceptions from the definition of investment adviser with respect to any persons not within the existing statutory exceptions. Judge Garland also cited the lack of any evidence of legislative intent regarding the meaning of subsection (F), as opposed to subsection (C), which was the subject of the legislative history cited by the majority. In the second phase of the analysis, he found the SEC's construction of the statute was a reasonable one, and therefore would have upheld the Rule.

➢ SEC Proposes Amending Broker-Dealer Rules Regarding Free Credit Balance Sweeps; Reserves on Deposit at Banks; and Securities Finance Transactions

The SEC proposed amendments, among other things, to the broker dealer ("BD") rules regarding free credit sweeps, banks where reserve cash deposits may be held, and securities lending and repo transactions. Comments on the proposal are due by May 18, 2007.

Free Credit Sweeps. The preamble to the proposal notes that recently BDs have sometimes changed the product to which customers' free credit balances are swept, often from money market funds to interest bearing bank accounts. The SEC wants to ensure that customers have an opportunity to make an informed decision about whether to permit such changes. Accordingly, the proposal would amend Rule 15c3-3 to permit a BD to have the ability to change the sweep option of a *new* customer from a money market fund to a bank account, and vice-versa, provided that (1) the customer agrees to permit the BD to switch the sweep options between the 2 accounts; (2) the BD provides all information regarding the investment of free credit balances required by the relevant exchange; (3) the BD provides notice in the customer's quarterly statement that the customer can demand that the money market fund or deposit account be liquidated and turned back into a free credit balance; and (4) the BD provides the customer at least 30 days notice before changing from one product to the other, or the terms and conditions under which the BD will sweep free credit balances, and affords the customer the opportunity to opt out. For an existing customer, the BD would be able to change the sweep option provided that it satisfies requirements 2-4 above.

Banks for Reserve Deposits. Under Rule 15c3-3(e), BDs must deposit cash or "qualified securities" into the customer reserve account maintained at a bank. Whereas securities deposits should be readily available to a BD, the preamble expresses concern that cash balances could be lost or inaccessible if the bank experiences financial difficulties, and that a BD may not exercise the same due diligence in evaluating the creditworthiness of an affiliated bank. Accordingly, the proposal would amend Rule 15c3-3 to provide that a BD must exclude cash deposits at an affiliated bank when determining whether the BD maintains the minimum reserve deposits required. Moreover, even with respect to unaffiliated banks, the BD would have to exclude cash deposits to the extent that the deposit exceeded (1) 50% of the BD's excess net capital, or (2) 10% of the bank's equity capital (as stated in its Call Report).

Securities Lending and Repurchase Transactions. The preamble states that the failure of MJK Clearing, Inc., in part because of its conduit lending activities, raises concerns as to whether BDs are taking required net capital charges related to their securities lending activities. More specifically, the

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preamble notes that a BD conceivably may not take the required charge "on the theory that it was arranging loans as agent, rather than principal, notwithstanding the fact that there was no express disclaimer of principal liability." To address this concern, the proposal would amend Rule 15c3-1 to assume that BDs are acting as principals in securities lending transactions, and thus are subject to applicable capital deductions, unless (1) the BD discloses the identity of the borrower and lender to each other and obtains written agreements from both acknowledging that the BD is acting exclusively as agent and assumes no principal liability. Moreover, the proposal would amend Rule 17a-11 to require BDs to notify the SEC whenever, subject to a limited exclusion for government securities, the total amount of money payable against all securities loaned, or subject to a repurchase agreement, or the total value of all securities borrowed or subject to a reverse repurchase agreement, exceeds 2,500% of tentative net capital.

➢ Federal Bank Regulatory Agencies Issue Interim Rules Extending Examination Cycle for Smaller Financial Institutions

The FRB, FDIC, OCC and OTS proposed interim rules (the "Interim Rules") that expand the range of small financial institutions ("FIs", and each an "FI"), that are eligible for an extended 18-month on-site examination cycle. The Interim Rules, which implement Section 605 of the Financial Services Regulatory Relief Act of 2006, allow well-capitalized and well-managed FIs with up to $500 million in total assets (increased from $250 million prior to the Interim Rules) and a composite CAMELS rating of 1 or 2 to qualify for an 18-month (rather than a 12-month) on-site examination cycle. To be eligible for the extended 18-month cycle, the FI, among other things, must not have undergone a change-of-control over the prior 12-month period and must not be subject to a formal enforcement proceeding or order. FIs that are eligible for the extended examination cycle do not have a legal right to the 18-month cycle, and even if a regulatory agency does not conduct an on-site examination during an 18-month period, the agency may continue to conduct off-site monitoring of the FI if the agency believes such oversight is needed to evaluate whether there are safety and soundness concerns at the FI. The Interim Rules take effect today, April 10, 2007, and comments may be submitted until May 10, 2007.

Other Item of Note

➢ Basel News Available on Goodwin Procter Website

For the latest news and information on Basel IA and Basel II, please visit our Basel Web Page at: http://www.goodwinprocter.com/basel.html.

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