

# The Court's Rejection of the Broker-Dealer Exemption Rule (The So-Called "Merrill-Lynch Rule):

What Does This Mean for Investors and Financial Advisors?

Web Seminar

July 11, 2007



**PRESENTED BY:**

**Ronald M. Amato, Esq.**

[RAmato@SNSFE-law.com](mailto:RAmato@SNSFE-law.com)

# ABOUT YOUR HOST AND SPEAKER

## Ronald M. Amato, Esq.

- SNSFE associate attorney
- Representing investors, registered representatives, investment advisers, and securities broker-dealers in securities arbitration & litigation matters involving investment-related and securities industry disputes
- Representing investors in matters involving unsuitable investments, violations of state and federal securities laws, breach of fiduciary duty, and negligence.

## SNSFE

- Established in 1960
- Full service business law firm
- Representing closely-held businesses, entrepreneurs and individuals
- From start-up to succession planning
- “A-V” Peer-Review Rated\*

\* Martindale-Hubbell is the facilitator of a peer-review process that rates lawyers. An “A-V” rating is the highest rating for “Legal Ability” and “General Ethical Standards.”

## A Historical Perspective

- 1940 – Congress enacts Investment Adviser Act (the “Act”) for the protection of investors
  - Act generally applies to anyone who, for compensation, advises others as to the value of securities or as to the advisability of investing in securities, or
  - who, for compensation, and as part of a regular business, issues analyses or reports concerning securities

## A Historical Perspective (Continued)

- Act requires investment advisers to register and to maintain records, limit the types of contracts into which they enter, and prohibits deceptive and fraudulent transactions.
- Act imposes fiduciary standard to govern advisers.
- Act requires full disclosure of all conflicts of interest.

## A Historical Perspective (Continued)

- The Act contains six exemptions, including, of note, an exemption (from registration) for:
  - **Any broker or dealer (1) whose performance of such [investment advisory] services is solely incidental to the conduct of his business as a broker or dealer and (2) who receives no special compensation therefor [i.e., fees]**

## A Historical Perspective (Continued)

- 1999: SEC Rule 202(a)(11) expressly exempts broker-dealers from registration under the Act, *even if* they receive “special compensation” (i.e., fees), provided that:
  - Any investment advice provided by the broker or dealer with respect to accounts from which it receives special compensation is solely incidental to the brokerage services provided to those accounts (including, in particular, that the broker or dealer does not exercise investment discretion), *and*
  - The broker-dealer discloses to its customer that he/she has a brokerage (and not advisory) account

## Practical Impact of SEC Rule 202(a)(11) (November 1999 - March 30, 2007)

- SEC took “no-action” position with regard to Rule 202(a)(11).
- Broker-dealers expressly exempt from registration with regard to fee-based pricing platform for non-advisory accounts.
- Broker-dealers could, indefinitely, continue to offer fee-based programs, without coming under the definition of investment adviser.

## Financial Planning Association ("FPA") Challenged Rule 202(a)(11)

- In June 2004, FPA files lawsuit to challenge SEC's "no-action" position with regard to the rule.
- In April 2005, SEC moves to adopt the rule, in order to clarify the meaning of Section 202(a)(11) of the Act, particularly the meaning of "special compensation."
- Final SEC rule, as contemplated, would have exempted broker-dealers who receive special compensation "solely incidental" to brokerage services and make specific disclosure.

## U.S. Court of Appeals for D.C. Circuit Vacated Rule 202(a)(11)

- March 30, 2007: Federal Court of Appeals sides with FPA.
- Held that SEC overstepped its authority with seeking to adopt Rule 202(a)(11)
- Held that the legislative intent behind the Act does not support SEC's broader exemption for broker-dealers
- SEC cannot use its authority to broaden the exemptions for broker-dealers
- May 15, 2007: SEC announced will not appeal court's decision

# WHAT NEXT??

Industry/SIFMA Appeal to Congress?

## Implications of D.C. Court's Decision

- Fee-based accounts to become advisory accounts, or convert to commission-based platform.
- Brokers handling these accounts to register as Investment Adviser Representatives (IARs).
- Paperwork, paperwork, paperwork!
  - Accounts will need to be “re-papered”

## Implications of Court's Decision (Continued)

- Opportunity for broker-dealers and their representatives.
- Increased exposure/liability, heightened responsibilities to clients (e.g. fiduciary status).
  - Greater litigation risk
- No principal transactions.
- No proprietary products.

## Implications of Court's Decision (Continued)

- Movement of assets to “wrap-fee” programs and separately managed accounts.
- Increased compliance and regulatory burden.
- Increased competition from independent advisers and financial planners.
- Breakaway brokers will go independent, leaving behind big wirehouses.

## Implications for Investors

- Examine current pricing model
- Evaluate all available options
- Do you need the advice?
- Registered rep vs. Investment Adviser?

## SEC Has Requested 120-day “Stay” to Give Firms Transition Period

- Firms/representatives given additional time to adapt.
- FPA will not object to request.
- SEC to issue notice to firms regarding compliance.

# Questions?

If we are unable to get to your question, we will contact you shortly with your answer.

For more information on the securities practice group and its services, please contact Ron at:

**Ronald M. Amato, Esq.**  
**RAmato@SNSFE-law.com**

**312.621.4400**

Shaheen, Novoselsky, Staat,  
Filipowski & Eccleston, P.C.  
20 N. Wacker Drive, Suite 2900  
Chicago, IL 60606-9719

[www.SNSFE-law.com](http://www.SNSFE-law.com)  
[www.FinancialCounsel.com](http://www.FinancialCounsel.com)

*Thank you!*

To review this presentation or any of our other recorded events, go to:  
<http://www.snsfe-law.com/lawyer-attorney-1096383.html>