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Transcript:

Investment Adviser Registration Implications of Client Commission (Soft Dollar) Arrangements, Part 2

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BEN: In an earlier video we discussed the circumstances in which a broker-dealer distributing research under a client commission arrangement in accordance with Section 28(e) of the Exchange Act might be required to register as an investment adviser. The issue turns on whether the customer receiving the research appreciates how much of the commission paid to brokerage services is applicable to research under the arrangement. Client commission credit accounts or special payments by customers based on the pre-determined or good faith valuation of the research are some of the mechanisms that might lend to this understanding. If a client commission arrangement is carried out in a way that effectively "unbundles" the cost of brokerage and research services, the broker-dealer providing the research likely would be deemed to be an investment adviser subject to registration with the SEC or the states, as appropriate.

ED: In these circumstances, most firms usually would prefer registration with the SEC over multiple state registrations. Registration with the Commission now requires at least $100,000,000 in assets under management. An advisory relationship based entirely on the provision of research ordinarily would not count toward meeting this threshold. However, some firms might already be registered advisers with regard to their wealth management businesses. (These firms need only update their registrations to account for their CCA research activities.) Other firms may be able to rely on an exception from the assets under management test where they share offices with an affiliated adviser that's an SEC registrant. Also, there is an exception for foreign investment advisers.

BEN: For firms permitted to register with the SEC, the process will center on the completion and filing of Form ADV. (We've advised firms on the disclosures in Parts I and II of Form ADV pertaining to CCA arrangements.) There are additional requirements including the preparation of a Code of Ethics, written supervisory procedures, recordkeeping and other responsibilities; however, the broker-dealer regulatory framework should provide a foundation for meeting most of these requirements.

ED: Principal trading is permitted under the Rule 206(3)-1 provided the appropriate disclosures are made on the research.

BEN: Some firms may be nervous about the potential application of the anti-fraud provisions under Section 206 of the Advisers Act, which have been described as having a heightened “fiduciary” standard of performance. There is no private right of action under Section 206. Moreover, any SEC enforcement rights under Section 206 should apply only to the broker-dealer’s CCA research activities and any other investment advisory services it provides. (Brokerage and other activities performed outside of the advisory relationship are not subject to the Advisers Act provisions.) In any event, it should come as no surprise that the standard of performance incumbent on investment advisers under Section 206 of the Advisers Act is substantially the same as the standards imposed on broker-dealers under analogous provisions in Section 17(a) of the Securities Act and Section 10(b) Exchange Act, on which Section 206 is modeled. More about the liabilities of broker-dealers and investment advisers under these provisions at a later time. Please feel free to visit the “Investment Adviser Regulation” and “Research” sections of our web site for more, useful information on investment adviser registration and soft dollar research arrangements.