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## SEC Publishes RAND Report on Investment Advisers and Broker-Dealers

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On January 3, 2008, the Securities and Exchange Commission published the text of a report on investment advisers and broker-dealers prepared by the RAND Corporation (RAND).[i] The RAND study was intended to provide the SEC with factual information about the current state of the investment advisory and brokerage industries, with a primary focus on the services provided to, and the way those services are perceived by, individual investors. The SEC requested the study to assist it in evaluating the current legal and regulatory environment surrounding investment advisers and broker-dealers, as some of the traditional distinctions between the different types of firms have blurred. In the press release announcing the publication of the report, SEC Chairman Cox said that the report will assist the Commission in its efforts to update the regulations to improve investor protections.

### **I. Background**

The RAND study came about largely as a result of the controversy surrounding the SEC's attempt to permit broker-dealers to charge asset-based fees for their services without thereby becoming subject to regulation as investment advisers. Section 202(a)(11)(C) of the Investment Advisers Act of 1940 excludes from the definition of "investment adviser" any broker-dealer whose investment advice about securities is "solely incidental" to its provision of brokerage services and who receives no "special compensation" for investment advice. So while the Act recognizes that broker-dealers commonly provide a certain amount of investment advice to their customers, the Act focuses on the form of compensation received as one of the two factors that would distinguish between a broker-dealer and an investment adviser.

The SEC proposed a rule in 1999 to permit broker-dealers to offer services for an asset-based fee without thereby becoming subject to the Investment Advisers Act.[ii] The SEC noted that some broker-dealers had already started offering customers this option, and that this had been identified as an industry "best practice" in 1995 by a committee that was formed at the behest of then-Chairman Levitt. The committee's report, commonly referred to as the "Tully Report," stated that traditional brokerage compensation "inevitably leads to conflicts of interest among the parties involved," noted that brokerage firms had already begun offering customers fee-based alternatives

to traditional commissions, and identified fee-based compensation as a best practice that would help align the interests of brokerage firms, registered representatives and their customers.[iii]

After reproposing the fee-based brokerage rule in 2005, the SEC adopted Rule 202(a)(11)-1 under the Investment Advisers Act, permitting broker-dealers to charge asset-based fees without becoming subject to the Investment Advisers Act.[iv] The Financial Planning Association (FPA), which had challenged the earlier proposal, petitioned the United States Court of Appeals for the District of Columbia Circuit for review of the final rule. The Court agreed with the FPA's argument that the SEC had exceeded its authority in adopting the final rule, and vacated the rule.[v]

In its release adopting the vacated rule, the SEC directed its staff to report on recommendations for a study concerning certain issues that had been raised during the course of the rulemaking. Thus, in 2006, the SEC retained RAND to conduct this study and provide the SEC with data for its use in assessing the current legal and regulatory environment.[vi]

## **II. Purpose**

The RAND report did not attempt to evaluate the regulatory requirements applicable to investment advisers and broker-dealers or make policy recommendations. Rather, RAND stated that its report was intended to address two principal issues:

- What are the current business practices of broker-dealers and investment advisers?
- Do investors understand the differences between and relationships among broker-dealers and investment advisers?

## **III. Methods**

To determine current industry practices, RAND reviewed various sources of information, including economic and business publications, trade journals and financial media, data derived from regulatory filings by investment advisers and broker-dealers, business documents used by a sample of firms, interviews of personnel at financial services firms, and interviews of other interested parties (including representatives of trade groups, consumer interest groups, and regulators knowledgeable about the financial services industry). To assess the perceptions and understanding of individual investors, RAND conducted a survey, which was completed by over 600 households, and focus groups of experienced and inexperienced investors.

## **IV. Findings**

### *A. The Firms*

RAND found that the ways in which financial services firms deliver advice are complex and varied: firms take many different forms; the relationships between investment advisers and broker-dealers vary; firms offer a varying mix of products and services; and firms provide varying amounts of disclosure to investors. RAND also found that retail investors typically fail to distinguish between broker-dealers and investment advisers, at least partly due to this diversity.

Many of RAND's factual findings were not surprising. Although relatively few investment advisers and broker-dealers are large firms providing a full range of services, RAND found that these large firms conduct an overwhelming proportion of the investment advisory and brokerage businesses. RAND also found that in recent years, the number of firms registering with the SEC as investment advisers has increased substantially, while the number of registered broker-dealers has declined. The number of dual registrants apparently has remained stable during the same time period, with an increase in the percentage of broker-dealer firms registering as investment advisers, and a decrease in the percentage of registered investment advisers reporting that they are dually registered.

Interestingly, RAND noted that, among broker-dealer firms, dual registrants generally appear to be more likely than other registered broker-dealers to have been subject to a past or pending enforcement action. RAND found this to be the case even after adjusting for size, scale, and other organizational characteristics. RAND did not, however, find sufficient evidence in the records to provide an explanation for why this would be the case and cautioned that there may be a variety of reasons.

RAND reviewed investment advisers' and broker-dealers' filings in the CRD, IARD, and FOCUS Report databases and noted that there were many inconsistencies and inaccuracies in the information disclosed. For example, RAND said that a number of investment advisory firms that were not sole proprietorships disclosed that they, as opposed to their associated persons, are registered representatives of broker-dealers. In other cases, RAND found that while certain investment advisory firms disclosed that they were also engaged in business as broker-dealers, RAND was unable to confirm that they were indeed dually registered, and concluded that most of them are affiliated with broker-dealers. RAND said that inconsistencies in details disclosed by investment advisers and broker-dealers across the different databases "suggest that many financial service professionals themselves are confused about how they should be reporting their activities."

## *B. Individual Investors*

RAND found that retail investors generally had difficulty understanding the distinctions between investment advisers and broker-dealers, including their duties, the titles they use, the services they offer, and the fees they pay for those services. RAND also found that investors had difficulty distinguishing between investment advisers and broker-dealers and understanding the varying affiliations and other relationships among the different firms. Significantly, RAND found that

Even though we made attempts to explain fiduciary duty and suitability in plain language, focus-group participants struggled to understand the differences between the standards of care. Furthermore, even after explaining to them that a fiduciary duty is generally a higher standard of care, focus-group participants expressed doubt that the standards are different in practice.

Despite investors' evident confusion, most of the investors that RAND surveyed or who

participated in the focus groups were happy with their own financial service provider.

Investors who responded to RAND's survey indicated that they particularly valued their financial service providers' attentiveness and accessibility, while focus group participants most often said that they sought trustworthiness in a financial service provider. RAND did not try to link investors' satisfaction levels to the investment performance attained by their providers.

### *C. Financial Services Firms*

RAND's interviews of representatives of financial services firms reached similar results. Many interviewees commented that retail investors do not understand the difference between broker-dealers and investment advisers, and that they do not care, as long as their financial service needs are met. Some interviewees opined that investors may be confused about the differences between investment advisers and broker-dealers, in part, due to advertisements suggesting that firms do everything. RAND also reported that many interviewees believe that financial knowledge among retail investors generally is quite low. As to the regulatory system, RAND reported that most of the firms it interviewed favored continuing to distinguish between investment advisers and broker-dealers based on their distinct business activities, though some firms suggested that dual registrants need more guidance from regulators when new rules are adopted.

### *D. Other Interested Parties*

RAND interviewed representatives of a number of industry trade groups, consumer interest groups, academic experts, and regulators in connection with the study. In discussing the results of these interviews, RAND did not break down the responses according to the type of respondent.

RAND reported that most of those interviewed agreed that whether a financial service professional is a broker-dealer or an investment adviser is indistinguishable to investors. The majority of interviewees expressed the view that disclosures regarding the nature of investment advisory or brokerage accounts do not help protect or inform the investor, primarily because few investors actually read the disclosures. RAND also reported that many of the interviewees said that the disclosures themselves are part of the problem in that they are not easily understandable to the average investor. While some interviewees apparently felt that investment advisers' disclosures are more complete than those of broker-dealers, the interviewees generally felt that both should provide more information to investors, and in plainer language. Some interviewees opined that the firms do not take enough time to help investors understand the disclosures. RAND also reported that many of the interviewees expressed the view that providing disclosure at the point of sale often is too late in the process to make a difference in an investor's level of understanding.

Alluding to the controversy surrounding the vacated fee-based brokerage rule under the

Investment Advisers Act, a majority of the interested parties interviewed expressed the view that differences in regulation of broker-dealers and investment advisers should be based on the type of service provided, rather than the form of compensation received. Interviewees differed in how they would respond to this, however, with some being wary of additional regulation and the chilling effect it could have on business, and others favoring making certain changes, such as clarifying the meaning of "solely incidental" as used in the Investment Advisers Act's exclusion of broker-dealers from the definition of investment adviser, providing guidance regarding the regulation of principal trades under Section 206(3) of the Investment Advisers Act, and adopting a uniform disclosure statement for use by broker-dealers and investment advisers.

## V. Conclusion

It is too soon to know whether the RAND report will have any effect on the regulation of investment advisers or broker-dealers. The SEC has indicated that its staff is reviewing the report's findings with a view to recommending policy initiatives, and it has been reported that the recommendations are due by the end of April. It seems unlikely that the SEC would attempt to make radical changes to the regulation of broker-dealers and investment advisers without Congressional action. However, the SEC may use the results of the RAND study to propose regulatory changes affecting financial services firms' client disclosure and marketing practices. In addition, the SEC might examine the filings that financial services firms make in an effort to address the sorts of inconsistencies that the RAND report discussed. The SEC also may undertake investor education efforts based on the report's findings. Finally, it seems likely that the SEC will take the RAND findings into account as it considers other ongoing regulatory controversies, such as financial planning services offered by broker-dealers and principal trading by investment advisers.

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[i] Angela Hung, et al., RAND Corp., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (2007) (pre-publication copy available at [http://www.sec.gov/news/press/2008/2008-1\\_randiabdreport.pdf](http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf)).

[ii] Certain Broker-Dealers Deemed Not To Be Investment Advisers, Investment Advisers Act Release No. 1845 (Nov. 4, 1999).

[iii] Report of the Committee on Compensation Practices, Apr. 10, 1995, at 3, 10 (available at <http://www.sec.gov/news/studies/bkrcomp.txt>).

[iv] Certain Broker-Dealers Deemed Not To Be Investment Advisers, Investment Advisers Act Release No. 2376 (April 12, 2005).

[v] FPA v. SEC, 483 F.3d 481 (D.C. Cir. 2007).

[vi] Press Release 2006-162, Securities and Exchange Commission, SEC Awards Contract for Study to Compare Roles of Investment Advisers, Broker-Dealers (Sept. 26, 2006) (available at <http://www.sec.gov/news/press/2006/2006-162.htm>).

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