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TO: NAIFA

FROM: Scott Sinder  
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RE: SEC Interpretation of "Solely Incidental" Advice Exclusion for Broker-Dealers

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As part of its Regulation Best Interest package released last month, the SEC issued an interpretation designed to clarify the scope of permissible “advice” activities for broker-dealers (BDs) and their registered representatives (RRs) that will not subject them to regulation as investment advisers (IAs) under the 1940 Advisers Act. Below is a brief overview of the SEC’s interpretation and some background on the “solely incidental” exclusion for BDs/RRs under the Advisers Act.

### **Background on the “Solely Incidental” Advice Exclusion**

The Advisers Act excludes from the definition of “investment adviser” (and by extension, from the laws and regulations applicable to IAs) BDs:

“whose performance of such advisory services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation [for those services].”

The scope of this “solely incidental” exclusion has been addressed in prior SEC interpretations (from 2005 and 2007) and court decisions. Generally, to satisfy the “solely incidental” test:

- Services offered must be in connection with and reasonably related to the brokerage services provided to an account (put another way, offered “only in connection with the primary business of selling securities”);

- A BD’s “primary business” may not be providing investment advice;
- The importance or frequency of the advice is not determinative (rather, the connection to the primary sales activity is the key), but the advice cannot supersede the product sale as the “primary” goal or business of the BD; and
- Relatedly, the advice offered need not be trivial, inconsequential, or infrequent to be “solely incidental” to the primary brokerage/sales activity.

### **The SEC’s Latest Interpretation of the “Solely Incidental” Exclusion**

The interpretation issued last month does not seek to undo or change any of the historical rules outlined above. Rather, the interpretation is intended to reaffirm the existing structure, consolidate earlier authorities, and clarify that:

- A BD’s provision of advice
- as to the value and characteristics of securities or as to the advisability of transacting in securities
- is consistent with the solely incidental test
- if the advice is provided in connection with and is reasonably related to the BD’s primary business of effecting securities transactions (i.e., the primary business may not be providing such advice).

Ultimately, the SEC notes, whether this test is satisfied is a facts-and-circumstances analysis based on the BD’s business, services offered, and customer relationships.

The interpretation also seeks to provide additional clarity on how this test operates in certain real-world situations: exercising investment discretion and account monitoring. Those scenarios are discussed below.

#### **A. Exercising Investment Discretion**

A BD’s exercise of unlimited investment discretion over a client’s account would not satisfy the “solely incidental” test. However, the interpretation clarifies, in situations where a BD’s discretion is limited in time, scope, or other manner (i.e., is not comprehensive and continuous), the test may be satisfied.

Again, this analysis will depend on the totality of the facts and circumstances, but examples of discretionary authority that would not – standing alone and based on the parameters described above – generally run afoul of the solely incidental prong include discretion:

- as to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security;
- on an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time;

- as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent;
- to purchase or sell securities to satisfy margin requirements, or other customer obligations that the customer has specified;
- to sell specific bonds or other securities and purchase similar bonds or other securities in order to permit a customer to realize a tax loss on the original position;
- to purchase a bond with a specified credit rating and maturity; and
- to purchase or sell a security or type of security limited by specific parameters established by the customer.

The SEC also makes the following “refinements” to its existing guidance regarding discretionary situations:

- It will not include on its list of situations that generally do not violate the solely incidental test discretionary authority for a period “not to exceed a few months;”
- It is consistent with the solely incidental test for BDs to purchase or sell securities to satisfy margin requirements or other customer obligations that the customer has specified (e.g., sale to satisfy a collateral call); and
- It is consistent with the solely incidental test for BDs to sell specific bonds or other securities in order to permit a customer to realize a tax loss on the original position.

#### B. Account Monitoring

First, the SEC does not think that *any* account monitoring violates the solely incidental prong. The SEC states that a BD who has an agreement with the customer to periodically monitor an account for purposes of providing buy, sell, or hold recommendations may still satisfy the test. But a BD who, for purposes of deciding whether to make a recommendation, voluntarily reviews a customer’s holdings without such an agreement in place is not acting in connection with the primary business of effecting transactions and would therefore violate the solely incidental test.

The SEC does not provide a bright-line rule for when account monitoring pursuant to an agreement is or is not within the solely incidental realm. Instead, the SEC leaves it to BDs to establish in their policies and procedures when monitoring is conducted in connection with, and is reasonably related to, the primary business of transacting in securities (e.g., such policies may say that RRs may only agree to monitor at specific timeframes for the specific purpose of determining whether to recommend buying, selling, or holding securities in the account).