August 23, 2004

Jonathan Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth St. NW
Washington D.C. 20549
By Email to rule-comments@sec.gov

Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, File No. S7-25-99

To the Commissioners:

I am pleased to submit this comment letter on the above-captioned rule proposal. For the reasons discussed below, I strongly support the Commission's proposal, with a handful of suggested modifications discussed below. I am a partner at the law firm of Bingham McCutchen LLP, where I represent broker-dealers, investment advisers, investment companies and other participants in the securities markets. I was previously the Commission's Assistant General Counsel for Market Regulation, and later I was General Counsel for a major national dual registrant broker-dealer/investment adviser. I submit this comment letter solely on my on behalf, and not on behalf of any current or former clients, my law firm, or any partners or associates at my law firm.

Clients Do Not Lose Any Relevant Protections When Their Financial Institution Is Regulated as a Brokerage Firm Rather than as an Investment Adviser

Before elaborating on my comments, I believe it is important to correct certain misconceptions put forth by opponents of the Commission's proposal. The first misconception is the idea that clients somehow obtain a greater level of regulatory protection by obtaining securities advice from a registered investment adviser than through a broker-dealer.[1] This argument is usually framed in terms of the greater fiduciary duties to which investment advisers are subject. But this premise is false. The Commission has made it clear that broker-dealers are often subject to fiduciary duties in dealing with their clients, for example the fiduciary duty of best execution when handling their clients' orders. Moreover, when giving clients advice, broker-dealers are subject to a well-developed suitability duty, which is very similar to a fiduciary obligation. Indeed,

[1] In my view, the issues of the level of duties to clients and the level of regulatory scrutiny are distinct from the issue of compensation incentives. As discussed below, I believe fee-based compensation (which is how most investment advisers are paid and how brokerage firms increasingly are paid), has some important advantages over commission-based compensation (which is how brokerage firms have historically been paid). But as the Commission found in its proposing release, the form of payment should be conceptually distinct from the issue of whether an entity should be required to be registered as a broker-dealer, an investment adviser, or both. The Commission can and should encourage the benefits of fee-based compensation for brokerage firms as well as investment advisers.

when the Commission attempted to articulate a suitability duty for investment advisers, it largely drew on the clearer precedents concerning suitability it had already established in the broker-dealer context.[2] Clients of broker-dealers are also protected by a variety of other customer protection rules (such as SEC net capital, reserve calculation and books and records rules) which are more stringent that those applicable to investment advisers. Broker-dealer clients are also protected by self-regulatory organization rules (for example, rules requiring filing and pre-clearance of many advertisements) that have no counterpart at all in the regulation of investment advisers.

Moreover, in practice, broker-dealers are subject to a substantially higher degree of regulatory scrutiny than are investment advisers. Since the 1984 amendments to the 1934 Act, all brokerage firms, in addition to being subject to Commission jurisdiction, are required to be members of at least one self-regulatory organization. These SROs inspect every broker-dealer at a minimum of once a year, in addition to the Commission's regular cycle of examinations. Many broker-dealers are members of multiple SROs and are inspected by several SROs each year. Moreover, all broker-dealers are subject to state regulation in every state in which they do business, and are regularly subject to surprise examinations at any branch office in any state. By contrast, there is no SRO (even on a voluntary basis) for investment advisers. Investment advisers under $25 million in assets are not subject to SEC registration or inspection, while investment advisers over $25 million in assets are exempt from state examinations and are subject only to the most cursory of state notice filings. Broker-dealers are subject to at least three levels of regulatory oversight (SEC, SRO and state), which investment advisers are subject only to one.

The Commission staff has been notoriously unable to examine SEC-registered investment advisers on anything more frequent than (at best) a six or seven year inspection cycle. Though the Commission had promised to shorten that cycle to three or four years with its new post-Sarbanes-Oxley staff increase, it has made no apparent progress on achieving that goal. I would be the first to concede that despite this greater degree of regulatory oversight, a troubling number of enforcement actions have been necessary against broker-dealers in recent years. But there have also been a very troubling number of enforcement actions against investment advisers: the Commission and the states have had to bring scores of enforcement actions against investment advisers in recent years, many of them involving wholesale intentional fraud and criminal looting of assets. And the potential magnitude of these frauds is much greater when the investment adviser may be subject to examination only once or twice per decade, rather than annually as at broker-dealers.

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[2] *See* Investment Advisers Act Release No. 1406 (March 16, 1994).

Providing Advice on Securities Transactions Is a Core Function of Broker-Dealers, and Has Been Ever Since 1940

The second misconception is the idea that it is somehow unusual or novel for broker-dealers to provide advice concerning securities transactions. At the time Congress adopted the Investment Advisers Act in 1940, broker-dealers routinely provided recommendations concerning securities transactions on a daily basis. It was for exactly this reason that the Commission, at just that time, began to develop the suitability doctrine for broker-dealers: the concept that, by putting out a "shingle" as a broker-dealer, a brokerage firm implicitly represented to its clients both that it had a reasonable basis in general for the advice it gave concerning issuers, and that it had a reasonable basis in particular for believing that a particular security was appropriate for a given client's account.[3] The necessary corollary is that the brokerage firm was giving its clients investment advice about those securities transactions. Indeed, the very concept of "execution-only" brokerage, without advice from the brokerage firm, is an anachronism dating from the unfixing of commissions in 1975. In 1940, securities were thought of as complex merchandise usually suitable for purchase only upon the advice of a skilled market professional – Congress' and the Commission's assumption was that the large majority of brokerage transactions were based upon the broker's advice. There is no evidence that Congress, having required brokerage firms to register with the Commission only six years before, intended the same firms to register again as investment advisers in 1940 simply because they gave advice in connection with securities transactions. The Commission is wise to avoid such a duplicative, unnecessary and ahistorical result. Avoidance of unnecessary regulatory duplication is why Congress adopted the broker-dealer exception to investment adviser regulation in the first place.

Allowing Brokerage Firms to Offer Clients Non-Commission-Based Fee Arrangements Avoids Many Potential Sales Practice Abuses

Of course, there is no question that the traditional form of broker-dealer compensation – a high fixed commission compensating the broker both for advice and for trade execution services – could lend itself to abuse. For example, a broker could over-trade a client's account to generate commission income at the expense of the client's returns. As a result, the Commission used the "shingle" theory to develop the "churning" cause of action, which combats this potential abuse. But more generally, the Commission recognized that by aligning a broker's compensation incentives with the client's incentives, the brokerage industry could avoid many of its historic sales practice problems. Thus, the 1995 Tully Commission Report on broker compensation endorsed fee-based compensation for brokerage firms.[4] With fee-based compensation, if the

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[3] *See, e.g., Duker & Duker,* 6 S.E.C. 386 (1939); *Charles Hughes & Co. v. SEC,* 139 F.2d 434 (2d Cir. 1943), *cert. denied,* 321 U.S. 786 (1944).

[4] *See* Report of the Committee on Compensation Practices (April 10, 1995) (available at http://www.sec.gov/news/studies/bkrcomp.txt).

client's account rises in value, then the broker's compensation also rises; as a result, the client's incentives and the broker's incentives are aligned.[5] Fee-based compensation avoids many of the sales practice problems that have plagued commission-based brokerage accounts. And, while not all of the Tully Commission's recommendations gained wide acceptance, there has been a sharp increase in the number and size of fee-based brokerage accounts in the past decade – by some estimates now up to a third of all brokerage account assets.

The Commission Should Allow Brokerage Firms to Offer Clients Wide Choices in Compensation Arrangements

The Commission's proposal would allow clients to pay for advice from their brokerage firms in different ways: they can pay in the traditional way (a high commission covering the cost of both investment advice/research and trade executions), or they can unbundle these separate functions and pay for them separately. It is in the interests of customers to be able to unbundle, and pay only for the services and functions they want and need. The Commission's proposing release gives as examples two types of brokerage industry practices that would not trigger investment adviser registration: ongoing asset-based fees covering both advice and transaction execution services, and differential commissions for execution-only services and advised-investing services.

I suggest there are several other compensation arrangements that brokerage firms also should be able to offer without triggering investment adviser registration. For example, some firms now offer a one-time "snapshot" portfolio evaluation, together with a certain number of trades to implement the results of the evaluation, for a fixed fee or an asset-based fee. This type of offering is beneficial for investors who have had a recent life change or feel their portfolio is out of balance, but do not want the expense of an ongoing asset-based fee arrangement. Variations on this offering include annual or quarterly updates for clients but without ongoing advice in the interim (again, either on a flat-fee or asset-based pricing model, and with or without some trade executions as part of the package). The Commission should facilitate these different options for securities advice - greater choice benefits investors. Also, some brokerage firms offer securities research for a fee, unconnected with any trade execution services. Again, the Commission should facilitate the unbundling of securities advice from trade execution services. The Commission should clarify that these types of alternative fee arrangements also do not trigger investment adviser registration. While these pricing and service models may be relatively new, all of these activities are well within what Congress saw as core brokerage functions in 1940, and do not require additional regulation as

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[5] With fee-based compensation, there exists the possibility that the broker may neglect the client and not trade as often as is in the client's best interest. However, this possibility of "reverse churning" is one for which the SROs actively surveil. Moreover, the same possibility exists for fee-based investment advisers (without any active regulatory surveillance). Finally, assuming the client's assets were appropriately allocated at the outset, lack of trading is not likely to cause nearly as great harm to the client as over-trading (given the uncertainty whether more active trading would outperform the market in any event).

investment advisory services. Moreover, these many and various pricing arrangements have become pervasive in the brokerage industry in reliance on the "no-action" position embedded in the 1999 proposing release. It would cause enormous dislocation for both brokerage firms and their customers to withdraw the no-action position on which both have now relied for half a decade.

Fully Discretionary Asset Management Should Trigger Investment Adviser Registration, and Custody of Customer Assets Should Trigger Broker-Dealer Registration

I do suggest one change to the Commission's 1999 proposal. That proposal would allow brokerage firms to engage in commission-based fully discretionary asset management without registering as an investment adviser. (Under the proposal, fee-based fully discretionary asset management would require investment adviser registration.) This part of the proposal is the only portion in which the Commission departs from principle-based regulation based on the function being performed, and focuses only on the form of the fee. The SEC should not encourage commission-based fully discretionary asset management, which presents substantial opportunities for conflict of interest, by giving it preferred regulatory status compared to fee-based fully discretionary asset management. I urge the Commission to require investment advisory registration for all fully discretionary asset management, whatever the fee arrangement.

Similarly, I suggest the Commission go further than the 1999 release in one other respect. Under a number of circumstances under current law, investment advisors may be deemed to have custody of customer assets. In my view, if an investment adviser has custody of customer assets, then the customer needs the protection of the Commission's rules concerning issues such as net capital and customer reserve calculation, and needs the protection of regular SRO examinations. I urge the Commission to require any investment adviser which takes custody of customer assets to register as a broker-dealer.

The Commission Should Not Try to Distinguish Between "Investment Advice" and "Financial Planning"

The Commission's recent re-solicitation of comments questions whether "financial planning" should be deemed to be within the broker-dealer exception to investment adviser registration. At a minimum, the Commission should clarify this point. In 1987, the Commission staff opined that "financial planning" activity requires registration as an investment adviser, even if undertaken by a broker-dealer.[6] The Commission did not mention this release when it proposed the rule now under consideration, and it is therefore uncertain the extent to which it still reflects the views of

[6] Applicability of Investment Advisers Act to Financial Planners, Pension Consultants and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Adviser Rel. No. 1092 (Oct. 8, 1987).

the Commission or the staff. The line between "investment advice" and "financial planning" is at best indistinct - for example, recommending sales of term life or disability insurance might be deemed to be "financial planning" because it is not directly tied to the execution of a securities transaction.[7] Brokerage firms often have affiliated insurance operations, which are subject to comprehensive regulation. Moreover, switching a client from a security to an insurance product triggers NASD and NYSE suitability duties, even if the insurance product is not itself a security. I suggest that allowing brokers to make recommendations regarding variable annuities or variable life insurance policies (because they are regulated as securities), but not term life or disability insurance policies, is too fine a distinction, and is likely to result in poorer quality financial advice for clients. I urge the Commission to abandon the "financial planning" trigger for broker-dealers to register as investment advisers from the 1987 interpretative release.

The Commission Should Encourage Brokerage Firms to Communicate About the Quality of their Research

The Commission's re-solicitation of comments also asks whether brokerage firms that advertise the quality of their investment advice should be required to register as investment advisers. Such a result would be strongly contrary to the NYSE and NASD research analyst disclosure rules recently approved by the Commission. These rules (as well as the Commission's research analyst enforcement settlements with many of the largest brokerage firms) require brokerage firms to provide "track records" for their research analysis picks. The Commission and the other securities regulators believed that greater transparency and accountability for research results would improve the overall quality of research - firms would be less likely to allow biases to affect their research if the results of that research could be easily compared to that at other competing firms. Discouraging brokerage firms from advertising[8] the quality of their research would be directly contrary to this interest in greater transparency and accountability. To require investment adviser regulation solely because a brokerage firm communicated to clients concerning the performance of its research recommendations would severely discourage the very transparency and accountability for research which the Commission has been striving to achieve.

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[7] Similarly, some estate planning recommendations could be deemed "financial planning". But again, brokers must be aware of estate-planning implications whenever they recommend many securities (for example, variable annuities, variable life insurance, or illiquid limited partnership interests). It is not possible to draw a bright line between securities advice and estate planning.

[8] Of course, in the brokerage context, "advertising" is broadly construed to include virtually any communication with any client or potential client.

Conclusion

In sum, I commend the Commission for its proposal to define more clearly the distinction between brokerage firms and investment advisers, and to avoid unnecessary duplication in these regulatory schemes. I would be happy to discuss these comments further or provide any other assistance on this important issue.

Sincerely,

W. Hardy Callcott