



September 22, 2004

*Via Electronic Filing*

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, DC 20549

**Re: Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment  
Advisers, Release Nos. IA-2278, 34-50213; File No. S7-25-99**

Dear Mr. Katz:

The Investment Counsel Association of America<sup>1</sup> appreciates the opportunity to submit supplemental comments on proposed rule 202(a)(11)-1 under the Investment Advisers Act of 1940.<sup>2</sup>

The proposed rule is intended to address the application of the Advisers Act to brokers offering their customers full-service brokerage, including investment advice, for an asset-based fee instead of traditional commissions, mark-ups, and mark-downs. Under the proposed rule, a broker-dealer providing investment advice to customers, regardless of the form of compensation, would be excluded from the definition of investment adviser as long as: (1) the advice is provided on a non-discretionary basis; (2) the advice is solely incidental to the brokerage services; and (3) the broker-dealer discloses to its customers that their accounts are brokerage accounts. The rule would also prevent a broker-dealer providing advice to customers from being subject to the Advisers Act solely because it also offers execution-only brokerage services at reduced commission rates.

The ICAA applauds the Commission for moving to address this rule proposal, which has been pending for nearly five years. The proposal involves issues that are of fundamental

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<sup>1</sup> The ICAA is a not-for-profit association that exclusively represents the interests of SEC-registered investment advisers. Founded in 1937, the Association's membership today consists of approximately 350 investment advisory firms that collectively manage in excess of \$4 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at [www.icaa.org](http://www.icaa.org).

<sup>2</sup> *Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers*, SEC Release Nos. IA-2278, 34-50213; File No. S7-25-99 (Nov. 4, 1999) ("Proposal"). The comment period was re-opened on August 18, 2004.

importance to investors, as well as to the investment advisory profession and the brokerage industry. In light of many profound changes that have occurred in recent years, we strongly believe the Commission needs to clarify the distinctions between advisory and brokerage accounts. In doing so, we urge the Commission to consider the issue from the viewpoint of an investor and to craft a rule – including appropriate disclosures – that will enable investors to make informed decisions about the types of services and products that are being provided.

During the initial comment period, the ICAA expressed concern that the proposed rule fails to give appropriate and definitive guidance regarding the circumstances under which a broker will have to treat an account as an advisory account.<sup>3</sup> We subsequently joined with other trade and consumer organizations to discuss serious problems with the rule as proposed,<sup>4</sup> as well as to express disagreement with the no-action position taken by the Commission pending final rule adoption.<sup>5</sup> We incorporate these letters by reference and take this opportunity to highlight our most significant concerns and to respond to the Commission’s additional requests for comment.

*All Discretionary Accounts Should Be Treated Consistently.*

The Commission’s proposed rule focuses primarily on the “nature of the services provided,” rather than on the form of compensation charged, to determine whether an account is an advisory account or a brokerage account. We concur that a functional test that examines whether the services provided are advisory in nature is appropriate. Functional regulation is consistent with the Commission’s position that “the same rules should apply to the same activities in the financial marketplace – particularly when the rules are designed to protect investors.”<sup>6</sup>

Rather than examining each type of arrangement to determine whether the services provided are advisory in nature, or delineating factors that would lead to such a determination,

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<sup>3</sup> Letter from David G. Tittsworth, ICAA Executive Director, to Jonathan G. Katz, Secretary, SEC, re: Release Nos. 34-42009; IA-1845; File No. S7-25-99: *Certain Broker-Dealers Deemed Not To Be Investment Advisers* (Jan. 12, 2000).

<sup>4</sup> Letter from Consumer Federation of America (CFA), Certified Financial Planner Board of Standards (CFP Board), ICAA, and National Association of Personal Financial Advisors (NAPFA) to Jonathan G. Katz, Secretary, SEC, re: Release Nos. 34-42009; IA-1845; File No. S7-25-99: *Certain Broker-Dealers Deemed Not To Be Investment Advisers* (May 31, 2000); Letter from CFA, Fund Democracy, ICAA, Financial Planning Association, CFP Board, and NAPFA to the Honorable William Donaldson, Chairman, SEC (May 6, 2003).

<sup>5</sup> “Until the Commission takes final action on the proposed rule, the Division of Investment Management will not recommend, based on the form of compensation received, that the Commission take any action against a broker-dealer for failure to treat any account over which the broker-dealer does not exercise discretion as subject to the Act.” Proposal at 4.

<sup>6</sup> Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization and H.R. 10, the Financial Services Competition Act of 1997, before the House Committee on Commerce, Subcommittee on Financial and Hazardous Materials (July 17, 1997). See also *Final Rule: Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, SEC Rel. No. 34-47364; File No. S7-41-02 (Feb. 13, 2003) (endorsing functional regulation).

the Commission attempts to provide a bright line test based on whether investment advice is provided on a discretionary basis. We agree with the Commission that by their very nature, discretionary accounts “bear a strong resemblance to traditional advisory accounts, and it is highly likely that investors will perceive such accounts to be advisory accounts.”<sup>7</sup> This makes it all the more puzzling why the Commission would carve out from this bright line test discretionary accounts that are charged commissions. A broker has full authority to buy and sell securities in a discretionary account without the investor’s prior consent to each transaction. A commission-based discretionary account should invoke *greater* investor protection concerns because of the potential incentive for a broker to churn the account without consultation with the investor on a transaction-by-transaction basis.

In deciding to eliminate “special compensation” as a factor in this analysis, the Commission obviously determined that the form of compensation should not be the deciding factor in determining whether an account is an advisory account. It offers no justification from departing from that principle in providing a loophole for discretionary accounts charging commissions.<sup>8</sup> We urge the Commission to treat *all* discretionary accounts as advisory accounts.

*The Commission Should Clarify What It Means by “Solely Incidental.”*

The Commission should clarify what constitutes “solely incidental” advice by a broker. Historically, distinctions were drawn between brokerage and advisory accounts based principally on special compensation, while the “solely incidental” prong of the test was virtually ignored. If the Commission continues to provide no meaningful guidance regarding the term “solely incidental,” this purported condition will essentially be eliminated from the exemption.

In the proposing release, the Commission emphasizes that in offering asset-based fees, brokers are simply “re-pricing” traditional brokerage services. The Commission must define what these traditional brokerage services are. Clearly, brokerage services include executing transactions and providing custodial and recordkeeping services. Traditionally, registered representatives have also provided periodic or intermittent advice with respect to particular securities being considered by the investor or that the broker recommends for consideration by the investor. We believe that such advice is part of traditional brokerage services and should continue to be considered to be solely incidental to such services.

On the other hand, portfolio management, selection of portfolio managers, and asset allocation services, even where performed on a non-discretionary basis, should not be

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<sup>7</sup> Proposal at 10.

<sup>8</sup> The Commission could also avoid such an anomalous result by considering the alternative offered by the Consumer Federation of America (CFA). The CFA has suggested a theory under which new forms of compensation could be accommodated under the existing broker-dealer exemption, section 202(a)(11)(C). *See* letter dated January 13, 2000 to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Barbara L. N. Roper, Consumer Federation of America (CFA letter).

considered to be solely incidental to brokerage transactions.<sup>9</sup> Such services are core investment advisory services that should be subject to the fiduciary protections of the Advisers Act.<sup>10</sup> We respectfully request that the Commission confirm that these core investment advisory services are not solely incidental to traditional brokerage services.

*Broker-Dealers Relying on the Rule Should Not Be Permitted to Market Advisory Services Prominently.*

We strongly urge that the rule prohibit a broker-dealer claiming an exclusion from the Advisers Act from marketing accounts primarily based on the quality of advisory services provided. In the proposed rule, the Commission noted that broker-dealers offering fee-based advisory services have heavily marketed them and that this “raises troubling questions as to whether the advisory services are not (or will be perceived by investors not to be) incidental to the brokerage services.”<sup>11</sup> This marketing of advisory services - which may use testimonials from customers that would not be permitted for advisory accounts - has not abated in the past five years. It is clearly misleading for a broker-dealer to market its advisory services prominently while at the same time avoiding responsibilities and duties under the Advisers Act by claiming that such services are “solely incidental” or a minor component of the brokerage services offered. An investor responding to such marketing materials would undoubtedly expect the account offered to be an advisory account.

*The Proposed Disclosure Should Be Enhanced.*

The Commission requests comment on whether prominent disclosure that an account is a brokerage account is sufficient to alert an investor to the nature of the account. Such disclosure is not merely insufficient, but woefully inadequate. Virtually all commenters to the proposal, even strong proponents of the proposal, agreed that disclosure that an account is a brokerage account “does not provide sufficient information to customers.”<sup>12</sup> Where a broker-dealer provides advice that is not subject to the Advisers Act, the disclosure needs to be clear and phrased in a manner that can be readily understood by a typical investor. The broker must delineate the implications of an account being a “brokerage account” and the solely

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<sup>9</sup> For example, the Commission may wish to consider the factors used in determining accounts over which the broker exercises “continuous and regular supervisory or management services” for purposes of Form ADV. The instructions to Item 5F of Part 1A of Form ADV indicate that a firm does not provide continuous and regular supervisory management to an account if the firm provides advice on a periodic or intermittent basis, such as in response to a client request or market event. On the other hand, a firm does exercise such management if it has ongoing portfolio management responsibility even on a non-discretionary basis.

<sup>10</sup> The Commission has already recognized that such functions are core advisory functions in requiring sponsors of wrap fee programs to treat wrap fee accounts as advisory accounts. See Proposal at 12. See also NASD Regulation: Fee-Based Account Questions and Answers (“Wrap accounts typically include services such as asset allocation and portfolio management for a fixed fee. Most wrap accounts with these features are subject to the Advisers Act”).

<sup>11</sup> Proposal at 11.

<sup>12</sup> Letter dated Jan. 13, 2000 from Jean Margo Reid, Chair, Investment Adviser Committee, Securities Industry Association to Jonathan G. Katz, Secretary, Securities and Exchange Commission.

incidental nature of the advice provided. For example, the Commission could require *prominent* disclosure along the following lines:

1. [Name of broker-dealer] is a registered broker-dealer. Our primary business is executing securities transactions.<sup>13</sup>
2. The accounts and services described here are *not* subject to the Investment Advisers Act of 1940 because we believe that any investment advice we provide is solely incidental to our primary/brokerage business.<sup>14</sup>
3. As such, [name of broker-dealer] provides advice only on a periodic basis or at your request and does not undertake a duty to manage your account on an ongoing and continuous basis.<sup>15</sup>

Indeed, the Commission may also wish to consider requiring full disclosure of conflicts of interest and any disciplinary history. These are critical disclosures under the Advisers Act for the protection of investors. Even investors receiving “incidental” advice should be entitled to these disclosures.

*The Commission Should Consider the Interests of Investors.*

The Commission requests comment regarding whether current fee-based programs more closely align the interests of investors with those of brokerage firms and their registered representatives than do traditional commission-based services. In a fiduciary environment of professional investment managers, fees based on assets under management do align the interests of the client with the interests of the firm. This may not necessarily be the case, however, in a sales-based culture. In citing the need for this rule, the Commission relies on the Tully Report,<sup>16</sup> which indicated that fee-based programs might be a best practice for brokers because they reduce the “incentives for registered representatives to churn accounts, recommend unsuitable securities, or engage in high-pressure sales tactics.”<sup>17</sup> However, as the NASD has noted, the Tully Report also indicated that fee-based compensation programs might not suit the needs of investors with low trading activity.<sup>18</sup> Indeed, the NASD has detected potential problems with respect to brokers’ fee-based accounts, including:

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<sup>13</sup> Alternatively, the disclosure could state that the firm is acting as a broker-dealer and not as an investment adviser with respect to the account.

<sup>14</sup> Similarly, the CFA suggests disclosure that “any advice being offered is solely incidental to sales transactions” and that the registered representative “is not subject to a requirement that the salesperson place the client’s interest ahead of his or her own.” CFA letter at 10.

<sup>15</sup> The broker should be required to identify the duty it has undertaken with respect to these accounts, whether fiduciary or otherwise, both in its marketing and its contracts with customers. A non-discretionary account holder should not be lead to believe that the broker is continuously supervising the account and proactively alerting the customer to market, economic, issuer or other changes that require action, if the broker has not taken on that overarching fiduciary duty.

<sup>16</sup> Report of the Committee on Compensation Practices (Apr. 10, 1995) (“Tully Report”).

<sup>17</sup> Proposal at 6.

<sup>18</sup> NASD Notice to Members 03-68 (Nov. 2003).

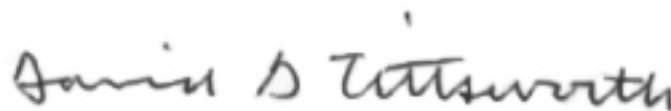
- ❑ Customers may not be receiving adequate disclosure about the distinctions and features of fee-based versus commission-based accounts, including that fees probably will be higher in a fee-based account if trading activity is modest;
- ❑ Training and education regarding these programs is “minimal” at some firms;
- ❑ Firms do not always have systems in place to reasonably ensure that mutual funds and other products are not inappropriately switched into a fee-based account;
- ❑ Some firms may lack systems or procedures to ensure a fee-based account is appropriate for the customer both initially and periodically thereafter; and
- ❑ Most troubling, “in some instances firms have not assigned a broker to customers with fee-based accounts.”<sup>19</sup>

The Commission should consider these potential problems in crafting a rule that ensures appropriate functional regulation of advisory services and best protects investors.

### CONCLUSION

We would be pleased to work with the Commission’s staff in drafting language to modify appropriately the proposed rule. Please do not hesitate to contact us if we may provide additional information or clarification to the Commission regarding any of these matters.

Sincerely,



David G. Tittsworth  
Executive Director

cc: The Honorable William H. Donaldson  
The Honorable Cynthia A. Glassman  
The Honorable Harvey J. Goldschmid  
The Honorable Paul S. Atkins  
The Honorable Roel C. Campos

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<sup>19</sup> NASD Regulation: Fee-Based Account Questions and Answers (last updated Aug. 23, 2004).