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THE FINANCIAL PLANNING ASSOCIATION

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BY ELECTRONIC MAIL

February 7, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549-0609

Re: Release Nos. 34-50980; IA-2340; File No. S7-25-99

Dear Mr. Katz:

The Financial Planning Association ("FPA"®)[1] appreciates the opportunity to comment on the rule entitled "Certain Broker-Dealers Deemed Not To Be Investment Advisers" (the "reproposed rule"). We are gratified by the increased emphasis the Securities and Exchange Commission ("SEC" or "Commission") has placed on important new interpretative issues in this proposal, in particular critical distinctions between financial planning and brokerage services.

FPA wishes to incorporate by reference for the current comment period our letters dated January 14, 2000, December 7, 2002, June 21, 2004, and September 22, 2004, as well as a joint letter submitted with other interested parties on May 6, 2003.[2]

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[1] The Financial Planning Association™ is the largest organization in the United States representing financial planners and affiliated firms, with approximately 28,500 individual members. Not all are investment advisers. Approximately 41 percent are affiliated with SEC-registered investment adviser firms and 25 percent with state securities administrators. Seventy percent of members hold at least one securities license, such as the Series 6, 7 or 24. FPA is incorporated in Washington, D.C., with administrative headquarters in Denver.

[2] *See* May 6, 2003, letter from Certified Financial Planning Board of Standards, Inc., Consumer Federation of America, FPA, Fund Democracy, Investment Counsel Association of America, and National Association of Personal Financial Advisors to SEC Chairman William Donaldson.

I. Summary of FPA Comments and Position.

This is the fifth comment letter in five years submitted by FPA on the rulemaking. We attempt to briefly summarize some of our earlier comments explaining our main concerns with the SEC's conceptual approach to the rulemaking, and also attempt to address the most important questions posed by the Commission in its latest release.

Following is a summary of our principal concerns.

1. ***Investor protection diluted under reproposed rule.*** Disclosure of material broker conflicts is virtually absent in the fee-based programs under the amended rule. The rule also creates a "confused marketplace" in which identical advisory services are offered under two disparate sets of market conduct.
2. ***Legislative history of the Advisers Act suggests narrow broker exemption.*** The argument in the reproposing release that Congress exempted brokers to avoid duplicative regulation of advice-givers is nowhere to be found in the legislative history of the Advisers Act.
3. ***'Solely incidental' standard guts Advisers Act.*** The Commission fails to provide adequate precedent or logic in defining a solely incidental standard for investment advice offered by a broker. While we commend the SEC for restricting brokers from holding out as financial planners, the narrow restriction still gives brokers a virtual blank check to sell investment advice.
4. ***Revised disclosure allows 'bait-and-switch' tactics by brokers.*** The attempt to create a 'buyer beware' warning label will not clearly inform brokerage customers of the differences between the fiduciary obligation of advisers and divided loyalties of stockbrokers, who would be permitted to sell products under the guise of trusted advisers.
5. ***Existing broker disclosure inadequate substitute to Form ADV.*** The argument that current broker-dealer regulation is sufficient falls short on further examination.
6. ***Financial planners would be harmed by rule that erodes value of their services.*** The clear legislative intent of Congress was to protect investors and to safeguard the honest investment adviser. The creation of a lower standard for advisory services diminishes the public perception of the integrity of registered investment advisers, who are subject to a higher fiduciary standard.
7. ***Purported concern with market disruptions if the rule is withdrawn is unwarranted.*** Market data shows that even if the SEC were to precipitously withdraw the rule, such action would not disrupt the capital markets.

Based on these concerns, FPA respectfully recommends that, in the interest of investor protection, the Commission initiate the following steps:

- Allow the temporary rule to expire on April 15th;

- Adopt an interim rule provision for the transition of fee-based accounts where the broker-dealer is providing advisory services to a registered investment adviser subsidiary, or to register dually as an investment adviser;
- Conduct a special study to reevaluate the current approach taken to broker-dealer and investment adviser regulation when the two perform similar activities; and
- In light of continuing confusion over the distinctions between brokerage and advisory services, improve investor awareness content on the SEC web site by highlighting the differences.

II. Background.

Five years ago, the SEC proposed a rule (the "original rule") to exempt certain fee-based programs of broker-dealers from the registration, fiduciary and disclosure requirements of the Investment Advisers Act of 1940 ("Advisers Act"). The Commission was responding to an appeal from several wire houses for regulatory relief from the Advisers Act due to increased pricing competition from on-line brokerage firms.[3] The request was cloaked in the context of its benefit to investors, consistent with the recommendations of the "Tully Report,"[4] i.e., that aligning stockbroker interests more closely with customers by charging fees instead of commissions would discourage unsuitable trades and churning.

In its original proposing release, the Commission adopted an embedded staff "no-action" recommendation not to enforce the provisions of the Advisers Act as long as broker-dealers complied with the proposed rule. The no-action position became effective on publication of the original proposing release and applied retroactively.

FPA and other adviser organizations objected because the interpretation resulted in two disparate standards of market conduct in the delivery of comprehensive advisory services to the public. One was a fiduciary standard for persons registered under the Advisers Act or equivalent state statutes; the second was a lower suitability standard for broker-dealer agents acting as financial consultants or advisers. Under the original

[3] Our Jan. 14, 2000, letter to the Commission, as well as comments filed by others, noted the brokerage industry's motivation for lobbying the Commission was driven by self-interest, not concern for investor protection. At the time, pricing pressure from online trading firms was growing steadily, and a contemporary report by Morgan Stanley Dean Witter & Co. perceived the overall reduction in execution costs as "just the beginning of a slippery slope as commissions head toward zero." (*See* "Online Trading Fees Headed Lower," *Wall Street Journal,* page E1, Nov. 18, 1999.)

Wall Street also monitored with growing interest the explosion in share values for online trading firms like Ameritrade and E*Trade (406 percent and 236 percent respectively in the first half of 1999). When Merrill Lynch announced on June 1, 1999, that it would expand into the online trading business (after previously denouncing Internet trading "as a serious threat to Americans' financial lives") Merrill's shares dropped 11 percent. According to analysts, the market questioned whether Merrill would be able to offset the $150 average commission per trade with the new $29.95 online cost per trade. *See* "Strong Half for Online Brokers and Banks," by Bill Barker, *The Motley Fool* at http://www.fool.com/specials/1999/sp990721bank.htm.

[4] "Report of the Committee on Compensation Practices," Apr. 10, 1995.

and temporary rules, brokerage firms continued to be allowed to heavily market financial advisory services without disclosing their divided commercial loyalties, unlike investment advisers.[5] Major consumer groups also cited similar concerns with the proposals.

In July 2004, FPA filed suit against the Commission in the U.S. Court of Appeals for the District of Columbia, alleging that the SEC's failure to adopt a final rule and reliance on an embedded no-action position to create an exception to the definition of broker-dealer violated the requirements of the Advisers Act and the Administrative Procedure Act and was arbitrary and capricious.[6] The litigation served to rekindle the public debate regarding what kind of disclosure and fiduciary standards should govern persons who provide comprehensive financial planning. In response, on December 22, 2004, the SEC terminated the no-action position, withdrew the original proposed rule, and adopted a temporary rule. In addition, the Commission solicited public comment on the issue for the second time in four months with a commitment to take final action on the reproposed rule no later than April 15, 2005.

A review of this rulemaking's troubled history, both substantive and procedural, suggests that what may have been viewed in 1999 as a relatively uncomplicated process of allowing brokerage firms to re-price so-called "traditional services" was not so simple when subjected to a vigorous and open public examination.[7] FPA welcomes the renewed analysis of the exemption and appreciates the Commission's efforts in once again making resolution of this issue a priority. However, by continuing to assert that "broker-dealers offer[ing] advisory services as part of the traditional brokerage services…ought not to be subject to the Advisers Act merely because they re-price those services,"[8] the Commission will be unable to promulgate a workable solution.

Having begun with a flawed assumption in 1999, it necessarily follows that the Commission, in reproposing the rule without substantive alteration, must reach a flawed conclusion. By continuing to ignore congressional intent that "special compensation" is part and parcel of the two-prong test for exempting broker-dealers ("solely incidental advice" being the second prong), we do not believe that the attempt to define one without the other will work. Nor do we believe that future interpretive guidance tied to a weak or almost non-existent solely incidental standard will prohibit stockbrokers from providing comprehensive financial advice.

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[5] *See* Executive Summary in the Tully Report, *id.*, noting that the broker is "not just a representative of the customer," but must also balance the interests of the employer and his or her own well-being.

[6] *Financial Planning Ass'n v. Securities and Exchange Commission,* No. 04-1242 (D.C. Cir. Filed July 20, 2004).

[7] The Nov. 5, 1999, Proposing Release frequently characterizes the fee-based programs as "re-pricing" of traditional full service brokerage programs without fundamentally changing their nature. *See* Release Nos. 34-42099; IA-1845; File No. S7-25-99 at 2, 4, 5, 6, 8 and 9. FPA strongly disagrees with that interpretation.

[8] Reproposing release at 14.

We offer comment below on specific areas of the rulemaking detailing why this approach does not work and why it would be in the best interest of the SEC to simply withdraw the rule from further consideration.

III. Discussion.

A. Investor Protection Diluted Under Reproposed Rule.

Pursuant to its request for comment on certain issues, the Commission requested comment regarding the investor protection implications of a final rule excepting fee-based brokerage accounts from the Advisers Act.

First and foremost, the Commission's primary mission is to protect investors. The SEC should not be excessively preoccupied with the compliance costs and attendant liabilities of broker-dealers, or with perceived disruptions to the capital markets. The overriding question is a fundamental one: Does the reproposed rule enhance or diminish investor protection? We believe the rule significantly dilutes current investor protections.

The two primary areas where investors lose protection are:

1. A lack of disclosure of the stockbroker's conflicts and other critical information about their role as "financial adviser"; and
2. The rule contributing more confusion to an already confused marketplace where many investors believe the stockbroker is a fiduciary adviser and acts accordingly throughout the relationship.

It is a mistake for the Commission to focus on ever more technical rules to define who is an advice-giver instead of considering the broader public policy implications of loosening the standards for investment advice. The brokerage execution services offered in the fee-based programs are clearly subordinate to the investment advice, and the advice is not subject to a fiduciary standard.[9] At a time when the Pension Benefits Guaranty Corporation is in trouble, Americans continue to save at an abysmal rate, and Congress is embarking on a national debate over partial privatization of Social Security, the SEC should err cautiously on the side of mandating uniform fiduciary standards for all advice-givers. The Commission plays a critical role in this national debate by regulating the quality of the investment advice that millions of investors will rely upon in meeting their retirement goals. We concur with the view of *The New York Times* regarding this misguided proposal: "It's the S.E.C.'s job to protect individual investors, not to reassure the securities industry that its brokers are safe from regulatory standards."[10]

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[9] *See* letter of Securities Industry Association to the SEC, Sept. 22, 2004, at 4: "While broker-dealers are not fiduciaries, they are nonetheless required to deal fairly with customers…."

[10] *New York Times* editorial, "Stockbrokers Fail the Duck Test," Jan. 4, 2005.

i. Lack of Transparency in Fee-Based Accounts.

The Commission's 1999 Mission Statement noted that one of its primary objectives was to promote "informed investment decisions by requiring full and fair disclosure of material information to investors."[11] The instant rule falls far short of full and fair disclosure of material information in a fee-based program.

In a later section, we look in greater detail at the inadequacy of disclosure under broker regulation and the problems with a consumer warning label under the reproposed rule. We also offer comparisons to the more comprehensive disclosure requirements provided to consumers under the Advisers Act.

ii. Loss of Fiduciary Status for Similar Advisory Services.

The Advisers Act holds advisers to a clear fiduciary standard in all their activities.[12] Notwithstanding the panoply of brokerage regulation, suitability is a lower standard of consumer protection. Brokers may be held to be fiduciaries in certain fact-specific situations, but they have no overriding duty of loyalty to the customer. For the most part, brokers' counsel vigorously object to a fiduciary duty in arbitration proceedings.[13] In this regard, nowhere in the reproposing release or in any of the 1,700 comment letters does anyone point to a clear, unequivocal, blanket fiduciary standard for a stockbroker providing brokerage services.

We offer several examples of how investors are harmed by lower standards. First, brokers are increasingly entering the personal retirement planning business at a time when baby boomers nearing retirement are playing catch-up. Most investors have no margin of error in meeting their retirement goals, even if they receive unbiased, competent investment advice. Even a buy-and-hold strategy, which has been characterized by the NASD as a suitability problem in some fee-based accounts because of less costly alternatives,[14] could result in ruinous losses for investors during an extended bear market. In addition to suitability issues, NASD noted a larger problem where accounts were not assigned.[15] If the latter occurred during the historic bear market of 2000-2002, soon after the rule was put into effect, retirees relying on monthly distributions from the fee-based accounts could have realized catastrophic losses. We have heard such reports from financial planners whose clients were previously in such programs.[16]

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[11] *See* SEC mission statement at http://www.sec.gov/about/gpra1999-2000.shtml#secmiss.

[12] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

[13] *See,* e.g, comment letter of NASD arbitrator Mitchell B. Goldberg, Esq., to the SEC, Aug. 25, 2004.

[14] *See* NASD Notice to Members 03-68, November 2003.

[15] *Id,* "Fee-Based Questions and Answers," at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_010282&ssSourceNodeId=394.

[16] Most of the fee-based accounts offer a limited menu of mutual fund options with a retirement plan. These options typically include a single bond and money market option, with the remainder equity

Another example involves the quality of education planning advice in a fee-based program. Next to purchasing a home, the largest expenditure by a couple is their children's college education. A state 529 plan may be the most appropriate investment, but if the most suitable 529 plan is not on the broker-dealer's approved list, the stockbroker would be barred under NASD selling-away rules from recommending the plan. Thus the customer may not benefit from a state plan's tax deduction, a plan with a better selection of investment options, or a plan with lower expense fees. An investment adviser, on the other hand, has a fiduciary duty to act in the client's interest and make the most appropriate recommendation -- a professional judgment reserved under the Advisers Act to advisers, but not to brokers under sales regulation.

In summary, the reproposed rule will not provide clarity to the public on the duties of a broker offering fee-based advisory services or their limitations. While a brokerage firm's advertising will portray its registered representatives as trusted advisers, the true relationship is revealed in their lawyers' strenuous objections to any faint whiff of fiduciary status in a customer dispute. [17]

B. Congressional Record Contains No Evidence of Broad Exemption for Brokers.

The reproposing release strains to use legislative history as a substitute for the words of the statute. The Advisers Act expressly imposes two requirements for the broker-dealer exception – that the investment advice be *both* "solely incidental" *and* that the broker receive "no special compensation therefor." It is counterintuitive (if not flatly barred by normal rules of statutory construction) to imagine that when Congress articulated both requirements that it really meant only to have one, and that "special compensation" was meaningless. Yet the instant release reaches this result without offering any direct

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funds. During the three-year bear market, the S&P 500 benchmark dropped 43 percent. The equity portion of almost any asset allocation of a fee-based program would have experienced similar losses. However, the losses in the fee-based programs would have been magnified even more by steady monthly withdrawals in equal proportions from all funds in the portfolios. Over three years, the equity funds would have been reduced at a far higher rate than the bond or money market funds. After three years, investors in these unbalanced portfolios, now significantly out of kilter with original asset allocations, would have had trouble recapturing losses during the market rebound of 2003. In contrast, a portfolio carefully managed by an investment adviser and rebalancing quarterly would have maintained targeted asset allocations and as a result, protected principal more effectively during the distribution phase of a client's retirement plan.

[17] "When a Broker's Advice Isn't, Exactly," *Wall Street Journal*¸ page B14, Jan. 12, 2005. The article contrasts marketing practices of brokerage firms with defense claims in a customer dispute :

> "While advertisements and promotional brochures portray brokers dishing out advice that will lead to comfortable retirements and beach-front vacation homes, nearly every Wall Street firm sings a different tune in the private confines of mandatory arbitration, where customers must raise complaints far from the public eye.
>
> Once inside such closed-door hearings, investors learn something that isn't contained in any ad or brochure: Their brokers claim that legally, they don't have to give advice, don't have to monitor accounts, and aren't responsible for anything beyond accepting and completing trade orders."

evidence. Instead the release paints an inflated and largely speculative role for the investment advice provided by brokers in 1940 and thereafter. Its only evidence is a general reference to an historical description of brokerage services, and snippets of hearing testimony, to suggest the role of the broker was anything more than advice given in connection with stock trading.

To the extent that hearing testimony is supposed to be the litmus test for congressional intent, the hearing testimony was scarcely consistent. For example, an investment adviser, Charles Rose, noted that the intermingling of brokerage and advising functions was a significant part of the problem Congress was attempting to resolve – not a well-accepted solution. As he explained, the rise of the adviser profession in the 1920s was a result of "a growing recognition of the investor of his difficulty in obtaining… competent and unbiased guidance in the management of his investments." In his testimony, Rose characterized the investment advisory profession as fundamentally different from brokers and dealers noting that

> [advisers] would limit their efforts and activities to the study of investment problems from the investor's standpoint, not engaging in any other activity, such as security selling or brokerage, which might directly or indirectly bias their investment judgment; and second, that their remuneration for this work would consist solely of definite, professional fees fully disclosed in advance. [18]

Rose added that the growth of the profession in the 1920s was so successful that so-called "investment counsel" departments were started by "investment dealers, brokers, a few banks, and by others who did not adhere to these two basic principles, but they used the name,"[19] testimony to the fact that history sometimes repeats itself.

Far from referring to "special compensation" as some kind of redundant way of saying "solely incidental," the hearing transcripts repeatedly made references to investment advisers being paid fees for advice, as a way to clearly identify distinguishing characteristics for someone providing unbiased investment advice. There appears to be no direct evidence in the hearings or legislative debate in 1940 of concern over confusion with the two-prong test for brokers that required registration if they received special compensation and the advice was not incidental. In fact, the standards of the two professions were so different that one House member in a final debate on the bill, Rep. Sabath of Illinois – who at least voted on the bill and was not merely a witness – complained that

> [by] exempting bankers, brokers, and lawyers, the committee has perhaps made a mistake…. But let us see whether it will not nevertheless do a great deal of good and accomplish some of the things we have been seeking to accomplish; that is, bring about a

[18] Testimony of Dwight C. Rose, president, Investment Counsel Association of America, before a subcommittee of the Senate Banking and Currency Committee; 76th Congress, 3rd session, April 12-26, 1940. Reprinted in Legislative History of the Investment Company Act of 1940 and Investment Advisers Act of 1940, Vol. 4, at 723-725.

[19] *Id.*

> little more honesty and decency in all these investment matters so far as the investment brokers and bankers are concerned.[20]

The idea that "special compensation" would be a trigger for a fiduciary duty is scarcely surprising. Both before 1940 and since, the quintessential example of a "fiduciary" has been a professional who provides a service for a fee.[21]

There is no fair reading of the legislative history of the Advisers Act that would lead to the conclusion that a New Deal Congress, in passing a comprehensive series of financial services laws still in place today, passed a law regulating advisers in order to water down common law protections for the same advisory services provided by others. As noted above, the congressional reports *said* that the purposes of the statute were "to protect the public from…unscrupulous touts and tipsters and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful."[22] Further, there is no record of Congress saying that the Advisers Act was some kind of clever misdirection designed to permit the "touts and tipsters" to avoid their existing fiduciary standards, or expressing concern about setting higher standards for other persons providing investment advice.

Indeed, the SEC's argument – that in 1940 receiving "special compensation" was an appropriate litmus test for whether a broker-dealer was really an investment adviser – cuts in the exact opposite direction. Congress was obviously concerned that those receiving a fee for providing investment advice could not be treated merely as broker-dealers, even when they tried to maintain that the advice was "solely incidental" to their role as a broker-dealer. [23]

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[20] From Legislative History of the Investment Company Act of 1940 and Investment Advisers Act of 1940, Vol. 1, "H.R. 10065 debated," 76th Congress, 3d session, Aug. 1, 1940, at 9814.

[21] Prior to 1940, there was no question that brokers were considered to be fiduciaries within the scope of their agency. *See, e.g., In re Rosenbaum Grain Corp.,* 103 F.2d 656,661 (7th Cir. 1939) ("We find that the spirit of trust and fidelity necessarily pervades the entire dealing between broker and customer"); *Oliver Bros., Inc. v. FTC,* 102 F.2d 763, 768 (4th Cir. 1939) ("[t]he relation of the broker to his client is a fiduciary one"). Under black letter law, then as now, "[a]n agent is a fiduciary with respect to the matters within the scope of the agency," 3 Am. Jur. 2d § 205 at 594 (2002) (citing, among other authorities *Sim v. Edenhorn,* 242 U.S. 131 (1916); Restatement Agency § 376 (1933); fiduciary obligations also arise out of situations where a party claiming a special expertise assumes a position of trust. Restatement Agency § 379(1).

[22] S. Rep. No. 1775, 76th Cong., 3d Sesss., 21 (1940).

[23] As an historical footnote, the legislative hearing record suggests only limited discussion of the exemptions from the definition of "investment adviser." What little discussion there was related predominantly to the exemption for attorneys, and for small investment advisers not engaged in interstate business. There were also several questions in Senate committee hearings regarding the conflicts of a broker acting as an investment counselor and being permitted to sell securities as principal to the account, but as a Commission staff attorney responded:

> On that matter I talked to the investment bankers who also act as investment counselors, and who are affected by this provision. We had a conference and spent a whole Saturday with them. Ordinarily they would not dream of taking any inventory of securities they have on their shelf and selling them to their clients…. [Investment bankers] do not want

C. Bright Line Standard Needed for Solely Incidental Advice.

FPA commends the Commission for attempting to delineate a solely incidental standard for brokerage firms under the reproposed rule, and for suggesting that financial planning be a prohibited holding out term. However, the delineation that the SEC provides makes the rule twice as troublesome. Having decided that "special compensation" can be ignored as being merely another way of saying "solely incidental," the Commission then defines "solely incidental" in a way that guarantees that, for the most part, it is not protection either. Taken together, the reproposed rule effectively gives broker-dealers a virtual blank check to sell investment advice unless it is related to a discretionary account.

i. 'Solely Incidental' Definition Guts the Advisers Act.

The reproposing release provides a highly selective interpretation of what "solely incidental" means as it relates to the broker exemption. This strained analysis reaches for obscure, secondary meanings in various dictionaries and latches onto the noun "incident" -- as it was used in an early Commission release -- instead of "incidental," an adjective used in the Advisers Act to describe a limitation. According to the Commission's interpretation in the reproposed release, however, "incident" means to be dependent upon, or pertinent to, something else, even if it is not essentially a part of that something else.[24] The reproposing release then goes on to suggest that since the advice given in connection with traditional brokerage was often "substantial in amount and importance to the customer," incidental advice is appropriate with the meaning of the brokers' exemption from the Advisers Act. In other words, virtually whatever a broker-dealer does is going to be solely incidental to being a broker-dealer simply because a broker-dealer does it.

The Commission's analysis cites no direct evidence from the legislative history of the Advisers Act; only that its reading is "based on the view" of, or an "understanding" about Congress' intent in 1940.

We would point to the more common and frequent usage of the term "solely incidental" in the Advisers Act, its legislative history, in industry, and staff commentary over the ensuing decades. The SEC should not grasp at straws in honing in on an isolated use of the term "incident." "Incidental" is defined in modern dictionaries as "occurring or likely to occur as an unpredictable or minor accompaniment"[25] and

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> that right [to conduct principal trades], really, although this provision may give them this right.

See Testimony of David Schenker, SEC Chief Counsel, Legislative History of the Investment Company Act of 1940 and Investment Advisers Act of 1940, Vol. 2, "Hearings Before a subcommittee of the Committee on Banking and Currency, U.S. Senate, 76th Congress, 3d session, April 2-10, at 321.

[24] Reproposed rule at 44.

[25] American Heritage® Dictionary, Fourth Edition, 2000.

"occurring by chance or in isolation."[26] "Solely" is defined as "alone" or "singly."[27] The legislative history of the Advisers Act also contains references to "merely incidental" advice by brokers. "Merely" appears to have been used interchangeably with "solely," and suggests a very similar result: "nothing else or more; only."[28] In combination, the plain-English meaning of the term "solely or merely incidental" strongly suggests that investment advice was to be dispensed only in isolated or limited circumstances – not as a regular part of brokerage where the customer paid for advice in connection with a stock purchase or sale.

Notwithstanding the complexity of the issue, the Commission seems to treat the problem lightly by asking to what extent broker-dealers should be permitted to compete for advisory business that <u>is</u> incidental to brokerage.[29] The Commission offers no examples of what might be incidental services. This conceptual approach to what is, and isn't, solely incidental advice is extremely confusing and not even close to an adequate bright line substitute for the special compensation test. If the Commission is unwilling or unable to clearly articulate the distinctions between basic brokerage and advisory services, then it should not attempt to construct a new rule on such a shaky foundation.

SEC staff in the past viewed the solely incidental exclusion more narrowly when it determined that a broker-dealer holding out as an "investment adviser" was not providing advisory services that were solely incidental to its business as a broker-dealer.[30] In summary, if the Commission wishes to regulate brokers and advisers based on the nature of the services, then it should reconcile its views with past interpretations.

ii. Distinctions Between Financial Planning and Traditional Brokerage Inadequate in Reproposed Rule.

FPA appreciates the Commission's determination that financial planning is not incidental to brokerage. This is consistent with earlier staff interpretations.[31] However,

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[26] Merriam-Webster Dictionary of Law, 1996.

[27] American Heritage Dictionary, Fourth Edition, 2000.

[28] *Id.*

[29] Reproposing release at 26.

[30] *In the Matter of R.E. Financials,* SEC staff no-action letter (avail. June 29, 1989) cited at SB 46, ALI-ABA 207, 223.

[31] *See*, e.g., SEC positions where payment to a broker of fees to cover the cost of providing financial planning services was deemed to be, among other things, special compensation and not solely incidental to the conduct of a broker-dealer's business. *In the Matter of CFS Securities Corp.,* SEC staff no-action letter (avail. Dec. 6, 1975) cited at SB 46, ALI-ABA 207, 217; and *In the Matter of Investment Management & Research, Inc*., SEC staff no-action letter (avail. Jan. 27, 1977), cited at SB 46, ALI-ABA 207,221. *See*, also *In the Matter of Townsend and Associates, Inc*., SEC staff no-action letter, (avail. Sept. 21, 1994): "The staff has taken the position that the following activities may not be solely incidental to the conduct of a broker-dealer's business: (1) advisory services offered as part of an overall plan that assesses the financial situation of a customer and formulates a financial plan…."

by relying on a holding out standard prohibiting the use of the term "financial planning" by brokers, the Commission has sought to avoid describing the functional differences between the two, which is at the heart of the matter if it is attempting to regulate based on the nature of the services provided. If brokerage execution and related transactional advice is a large part of traditional brokerage service, it also can be integrated within, and be a subset of, the financial planning process.

SEC Release IA-1092, in describing financial planning as it relates to the definition of "investment adviser," states that the "provider of …financial planning services in most cases assists the client in implementing the recommended program by, among other things, making specific recommendations to carry out the general recommendations of the program, or by selling the client insurance products, securities, or other investments."[32] By focusing on "the nature of the services provided and the relationship between the investor and his or her service provider" as a replacement to the brighter special compensation test,[33] it will be difficult if not impossible for the Commission to sort out brokerage services from financial planning.

To put this problem in an historical perspective, we note that the Advisers Act still prohibits the use of the term "investment counselor" by anyone who renders investment supervisory services and who is not registered under the Advisers Act.[34] The holding out restriction was a product of discussions in 1940 between Congress, the SEC and the Investment Counsel Association of America to preserve that designation for legitimate advisers who at the time catered to a high net worth clientele and determined it to be an important distinguishing characteristic. The term is still on the books, but it is not in vogue or used in national advertising campaigns. Nor does the SEC today prohibit its use by brokers or anyone else, as a practical matter.

The Commission noted in the original proposing release that the brokerage industry was marketing the programs based on the advisory, rather than execution services, "which 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."[35] In fact, brokerage ads have offered a variety of other ways of suggesting comprehensive advisory services, such as "wealth management," and calling its brokers "financial advisors" and "financial consultants." Without clearly adding other holding out terms to "financial planning," the Commission would be adopting an almost useless restriction.

We strongly encourage the Commission to look at other model acts for useful holding out terms, such as the market conduct rules for insurance producers. The Model Unfair Trade Practices Act, as adopted by the National Association of Insurance

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[32] IA Release 1092, at 2-3.

[33] Remarks of SEC Chairman William Donaldson at Dec. 22, 2004, public meeting.

[34] Sec. 208(c) of the Advisers Act.

[35] Original release at 6.

Commissioners, restricts insurance producers from holding out as a "financial planner," "investment adviser," "consultant," or "financial counselor."[36] Similarly, Canadian model regulation prohibits an individual from holding out if using descriptive words such as "retirement," "wealth," "security," "asset," or "money," in combination with the words "adviser," "consultant," "specialist," "expert," "manager," or "counselor," or other term similar to "financial planner." [37]

D. Disclosure Requirements Must be Strengthened.

i. Revised Disclosure Requirements Fail to Inform Consumers of Conflicts and Nature of Services Provided.

The reproposing release would require a prominent statement that the account is a brokerage account and not an advisory account. The primary addition to the original disclosure requirement would amount to boilerplate language stating "that, as a consequence, the customer's rights and the firm's duties and obligations to the customer, including the scope of the firm's fiduciary obligations, may differ." It also would require broker-dealers to identify "an appropriate person" at the firm with whom the customer could discuss the differences. The release asks whether disclosure materials should specify the appropriate person at the firm, and their level of seniority.

The attempt to create a *caveat emptor*, or buyer beware, warning in the reproposed rule will not provide the disclosure necessary to inform the customer about what he or she really needs to know. The disclosure should include a discussion of "traditional full-service brokerage services" and give examples of what investment advice is not solely incidental. This addition to the disclosure requirements is important so that consumers have a plain-English description of what services are and aren't available. The Commission has been reticent in describing what those services are, but leaving it to the firm's discretion will only lead to greater consumer confusion. If re-pricing were the only problem, then we believe it is time for the Commission to clear the proverbial air and describe, perhaps in side-by-side comparisons, what advisory services may overlap between the two, and what advisory services are separate and distinct since there is significant confusion among consumers.

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[36] See Sec. 4 M (1) of the NAIC Model Unfair Trade Practices Act (2003). The operative language states:

M. Unfair Financial Planning Practices. An insurance producer:

(1) Holding himself or herself out, directly or indirectly, to the public as a "financial planner," "investment adviser," "consultant," "financial counselor," or any other specialist engaged in the business of giving financial planning or advice relating to investments, insurance, real estate, tax matters or trust and estate matters when such person is in fact engaged only in the sale of policies. This provision does not preclude persons who hold some form of formal recognized financial planning or consultant certification or designation from using this certification or designation when they are only selling insurance. This does not permit persons to charge an additional fee for services that are customarily associated with the solicitation, negotiation or servicing of policies.

[37] *See* Ontario Securities Commission, Notice of Rule Made Under the Securities Act, Multilateral Instrument 33-107, 24 O.S.C.B. 1107, Feb. 16, 2001, *available at* http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/33-107multilateralinsrumentnt33-107-107.pdf.

The other problem with the consumer-warning label is that the "appropriate person at the firm" may share the same conflicts as the broker, or have an even greater responsibility for production quotas. Yet the presumption of the reproposed rule is that the consumer will be provided with accurate, meaningful disclosure of the differences in regulation. It's not unlike asking a car salesman for information about conflicts, and being referred to the sales manager whose own compensation is based on the department's sales performance.

At an absolute minimum, we believe the Commission should require prominent disclosure language that directs the consumer to the SEC website for unbiased information on the differences in broker and adviser regulation, including a link to the NASD website for information on the broker's disciplinary history. The Commission should also specify in a final rule that the appropriate person providing information is a professional compliance person whose compensation is not tied directly to the fee-based programs. The person providing such information should be qualified to explain the differences between investor protections under adviser and brokerage regulation.

Notwithstanding these suggestions, we are not confident that the customer will receive more than just a superficial explanation, at best, given the brokerage industry's contention that broker regulation offers at least equal protection to the Advisers Act. We are also concerned that these contact persons will justifiably take their cue from statements made by the Commission in this release -- that "broker-dealer regulation is much more detailed and involves significantly more regulatory costs"[38] – a fig leaf already used extensively by Wall Street in defending the original rule.

We also doubt whether *pro forma* disclosure, as is suggested in the reproposing release, works without tying it to appropriate conduct. In a recent column in the *Wall Street Journal*, it was suggested that while the *caveat emptor* approach is appealing, upfront disclosure doesn't always work.[39] The results suggest blind faith that a disclaimer will provide effective disclosure may be misplaced.

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[38] Reproposing release at 26.

[39] The column quoted a Carnegie Mellon University researcher as suggesting that disclosure can "let people off the hook morally," even though a well-intentioned doctor or a stock analyst with business conflicts may not realize how much the advice is tainted.

In the experiment at Carnegie University, 150 college undergraduates guessed the value of coins in a jar, with the groups broken out into "advisers'" and "estimators" (i.e., clients). The estimators were always paid based on the accuracy of their guesses. The advisers' compensation was based on two different outcomes, one in which they were rewarded for the accuracy of the estimators' guesses, and the second where they received "performance" pay based on how high the estimates were of their "clients," not on their accuracy. In the second scenario, the test was performed twice, first without disclosure of the advisers' conflicts, the second time with disclosure. In the first performance scenario, the estimators predictably followed their advice and generally guessed too much. In the second performance scenario, however, the advisers disclosed the conflict, and as a result, the estimators discounted their advice to a certain extent, but their estimates were still further from the mark when the conflicts were disclosed than

Finally, a simple notice that there are two standards won't work, since consumers are only vaguely aware of the differences between brokers and advisers. Two recent surveys of consumers over this issue suggest widespread confusion over the true identity of their financial adviser, and an expectation that they will provide unbiased advice and work in their best interest. These surveys, one sponsored by the Consumer Federation of America and an advisory group, Zero Alpha Group, and the other by T.D. Waterhouse Institutional Services,[40] suggest the public is firmly persuaded that anyone advertising as an adviser always acts in their best interest and should disclose any conflicts. Most believe the same rules should apply to both stockbrokers and financial planners to the extent both offer the same services.

If the Commission takes the approach of offering a consumer warning, it should update its web site so that investors understand the distinctions between brokers and advisers, and not rely solely on brokerage firms as its surrogate for objective information. We note the extensive discussion by one rule commenter on the SEC's failure to distinguish between brokers and advisers on its own website.[41] Among the points made were that the Commission's literature adds to confusion by suggesting that "most brokers will not give you a detailed financial plan," and "generally are paid commissions."

The SEC web site should describe the differences in services and legal obligations of a broker and investment adviser. It should not resort to boilerplate legalese or regulatory mantras that brokers can provide only advice that is incidental to their brokerage services without explaining what it means in practical terms. At a time when the Commission is poised to require plain-English disclosure of an advisers services in Part 2 of Form ADV, it should follow its own mandate with a plain-English discussion of the differences between brokerage and advisory services, including a side-by-side comparison of services performed by each in consumer literature.

ii. Existing Broker Disclosure Inadequate.

The Commission also has suggested in the reproposing release that existing broker-dealer disclosure is largely sufficient. Broker-dealers, after all, are obligated to disclose elements of certain transactions under common law, antifraud provisions of the federal securities laws, and SRO rules. This argument is flawed for three principal reasons.

First, the reproposing release suggests that current broker-dealer disclosure is sufficient, when upon closer examination, it is a grossly inadequate substitute to Form ADV and almost devoid of comparison. It cites disclosure requirements under agency law, the

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when they weren't. *See* "Conflict-of-Interest Disclosures May Not Protect the Unsophisticated," by David Wessel, *Wall Street Journal*, Jan. 13, 2005, at A2.

[40] Zero Alpha/Consumer Federation of America study at http://zeroalphagroup.com/headlines/RIvestmentZAG_CFAFINAL_102704.ppt; T.D. Waterhouse survey, Nov. 22, 2004 news release, at http://www.tdwaterhouse.com/home/press/index.html#rec.

[41] Comments of Ron A. Rhoades, Joseph Capital Management, August 30, 2004, at 25-26.

shingle theory, and the antifraud provisions of the federal securities laws which the reproposing release appears to suggest results in three separate layers, or at least three sources, of effective disclosure. A more accurate view would be that the requirements of the federal securities laws incorporate and have been judicially interpreted to encompass the more limited disclosure obligations that exist under agency principles and the shingle theory.

The shingle theory holds simply that a broker-dealer at arm's length implicitly represents that when it hangs out a "shingle" it will deal fairly with the public.[42] The shingle theory was first articulated in connection with a case that held that it was fraud under Section 17(a) of the Securities Act of 1933 to sell securities to a customer without disclosing that the price bore no relation to the current market.[43] NASD requirements governing mark-ups and mark-downs are broader as they require not only disclosure but specific limits on permissible mark-ups and mark-downs, and thus wholly incorporating any disclosure obligation under the shingle theory. The same is true for other applications of the shingle theory, such as unauthorized trades, suitability requirements, and broker-dealer insolvency.

Second, and of far greater importance, is the sparse and muddy disclosure that the Commission permits under the antifraud rules for broker-dealers compared to the affirmative and clear disclosure that is required under the Advisers Act. Broker-dealer disclosure has been marked by a history of disclosure-only-when-absolutely required and, even when required to do so, broker-dealers are permitted to make only the most tepid passes at disclosure to customers. These disclosures, unlike Form ADV, are opaque, turgid, and at the end of the day unhelpful to the very investors that rely upon it. The Commission, we would suggest, has fostered and bears some responsibility for the poor disclosure that broker-dealers make to their accountholders today, and has been forced to play "catch-up" over the past several years as a result of industry scandals.

The Commission suggests that the antifraud rules under the Exchange Act set out "detailed requirements for information that broker-dealers must provide their customers at or before the completion of securities transactions."[44] A closer examination of those requirements, and broker-dealers' means for complying with those requirements, strongly suggests that these requirements offer little if any specifics or practical assistance in identifying serious conflicts of interest that a broker-dealer may have when filling the customer's order. [45]

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[42] *See* Loss & Seligman, Securities Regulation 3814 (2004).

[43] Duker & Duker, 6 SEC 386, 388-389 (1939).

[44] Reproposing release, supra n. 52, at 21.

[45] In an earlier Commission release, the staff of the Division of Investment Management offered a different view about broker regulation. In Advisers Act Release No. 626 (Apr. 26, 1978), the staff noted that the protections afforded to investors under Section 10(b) and Rule 10b-5 or the Exchange Act may not be as broad as the disclosure provisions of Section 206 of the Advisers Act. Important differences include

Exchange Act Rule 10b-10 requires, for example, that broker-dealers disclose information relating to whether the broker-dealer received payment to route the customer's order to a particular market maker or dealer. Payment for order flow has long been recognized as a serious conflict of interest, with some arguing that the payments are kickbacks and therefore prohibited under commercial bribery statutes.[46] The Division of Market Regulation staff in fact recommended heightened disclosure to investors in its Market 2000 report. Current disclosure is completely and utterly lacking with respect to this serious and near-universally recognized conflict. A review of a confirmation statement for a major broker-dealer firm simply states that:

> [T]he brokerage firm receives remuneration from the broker-dealer or market center through which the transaction was executed. The nature or source of such remuneration may vary and will be disclosed to you upon request.

This is not meaningful disclosure, merely timid notice of a revenue stream. It does not specifically disclose that the receipt of payment for order flow creates a conflict, explain how the broker-dealer addresses the conflict, or what if any procedures the broker-dealer has adopted to address such a conflict.

In stark contrast, the Commission has taken a much different approach to conflicts under the Advisers Act. A conflict that is analogous to payment for order flow is the receipt by advisers of soft dollars. Here, the SEC has proposed (and in doing so argued that advisers would be under the same disclosure obligations because of their roles as fiduciaries even absent the proposal) that advisers provide far more robust disclosure of the conflict. Advisers are required to disclose:

- the types of conflicts that arise when the adviser accepts soft dollar benefits;
- the adviser's procedures for directing client transactions to brokers in return for soft dollar benefits;
- whether the adviser uses soft dollars to benefit all clients or just those accounts whose brokerage "pays" for the benefits;
- whether the adviser seeks to allocate the benefits to client accounts proportionately to the brokerage credits those accounts generate; and
- whether the adviser "pays up" for soft dollar benefits.[47]

We continue to be at a loss as to why the Commission would continue to require advisers to make detailed, pro-active and clearly written disclosure of conflicts and how

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a presumption under Rule 206(4)-4, adopted in 1987, that an investment adviser must disclose any material disciplinary events from his past, including criminal or civil proceedings that resulted in convictions, judgments or consents. Broker-dealers are not subject to a similar rule.

[46] *See, e.g.*, Frank Evangelist v. Fidelity Brokerage Services, Inc., 637 N.Y.S. 2d 392 (N.Y. App. Div. 1996) (alleging violation of state commercial bribery statute).
[47] Release IA-1862 at 173-176.

the adviser addresses them while permitting the brokerage industry to make opaque and largely meaningless disclosure to their accountholders. Given the confusion over the legal responsibilities owed to the customer by a "financial consultant" holding him or herself out as providing "one stop financial services shopping," the Commission must go beyond the insufficient disclosure regime it has fostered in the brokerage industry to-date. The disclosure by financial consultants and their broker-dealer firms must actually impart meaningful information to clients. Clients advised by financial consultants deserve to understand in plain-English terms what it means if they purchase investment advice through an asset-based fee as opposed to engaging a financial planner.

Moreover, broker-dealers selling asset-based fee programs should be required to disclose the obvious conflicts of interest associated with selling products and loans outside of the asset-based fee program. While proponents of these accounts tout the virtue of a supposedly conflict-free fee structure as envisioned by Tully, they are noticeably silent with respect to the myriad of commission-based products that broker-dealers sell to these very same customers with what amount to bait-and-switch tactics. Fixed and variable annuities, variable life products, and mortgages, margin, and other types of loans are among the commission-based broker's products pitched to fee-based customers who may not recognize the transformation from quasi-consultant to sales person.

The distinctions between broker and adviser regulation is vastly different and too important to be addressed by a simple statement that one is not the same as the other, as the Commission has proposed. Asset-based fee accounts, in many respects, are indistinguishable from mutual fund wrap fee programs that are common in today's wirehouse firms. Since 1994, wrap fee clients, who receive bundled services for bundled fees have been entitled to the detailed, substantive disclosure required by Schedule H of Form ADV. As the Commission stated, "[t]he wrap fee brochure is intended to address the special disclosure needs of clients participating in programs that offer investment advice and brokerage for a single fee …."[48] We agree. There is no reason that the same disclosure regimen should not be imposed on fee-based accounts, which also deliver investment advice and brokerage for a single fee.

iii. Recommendations on Changes to the Disclosure Requirement.

If the Commission adopts a strengthened disclosure requirement, we recommend that it should contain, at a minimum, the following:

1. A prominent disclaimer in fee-based account material provided to the customer that goes further than the boilerplate statement that the brokerage account is <u>not</u> an advisory account. The disclosure should provide additional, meaningful information on the following obligations (or lack thereof) of a broker:

[48] Investment Advisers Act Release No. 1411 (Apr. 19, 1994).

- that your broker's investment advice is limited to the purchase and sale of securities;
- that your broker is prohibited under federal regulations from providing financial planning or comprehensive investment advice unless subject to the jurisdiction of federal or state investment adviser laws;
- that your broker has divided loyalties between you and the firm, and as a result your broker may be rewarded special incentives that are not disclosed in the buy/sell recommendations, oral or written, that are made to you prior to the transaction;
- that the advice provided is deemed by the U.S. Securities and Exchange Commission to be incidental to the advice provided by a financial planner or registered investment adviser;
- that information on your broker's disciplinary history may be accessed at [NASD web link];
- that your broker, unlike a registered investment adviser, has no obligation to disclose past violations of securities laws to you or any other information regarding his or her qualifications; and
- that your broker, unlike a registered investment adviser, has no blanket fiduciary obligation to act in your best interest, and is instead obligated only to make suitable investment recommendations.

2. The final rule should prohibit marketing and advertising materials promoting the financial advice of a brokerage firm (unless touting advice clearly associated with its execution services), unless it includes a prominent disclaimer that disclosure and the legal responsibilities of the broker may differ in providing financial advice. [49]

   Because earlier broker ads flagrantly disregarded the original rule requirement that disclaimer is "prominent," we strongly suggest that the Commission stipulate an appropriate, minimum type size for such disclaimers. Such ads should also reference a link to the SEC's investor education website with more information on the differences between advisers and brokers.

3. Finally, we reiterate our concern that referring a customer to someone in the firm for more information on the differences in protection is insufficient without additional safeguards. We believe that such person should be a full-time compliance officer of the firm who has no financial incentives tied directly to the fee-based program, and who is knowledgeable about investment adviser regulation.

[49] We note that the 1999 proposing release expressed concern with the marketing practices of brokerage firms touting advisory and not execution services, but we are not aware of any enforcement of the original disclosure requirement that the "brokerage account" disclaimer be prominently featured in ads.

E. Purported Concern Over Market Disruptions Has No Basis in Fact.

It has been suggested by proponents of the Rule, and in the reproposing release, that withdrawing the rule might adversely affect the liquidity of the nation's capital markets. We find this suggestion ironic, in that the rule allows brokers to engage in self-interested, principal transactions without disclosure, something that could not be more foreign to the intent of the Advisers Act. We have heard reports, that we also believe the Commission is aware of, of brokerage firms providing their financial advisers enormous incentives to place shares underwritten by the brokerage house in retail accounts and getting the clients to hold the shares for 90 days so that the underwriting clients can be assured that the firm has helped reduce churning and created a stable market for the stock. No reasonable reading of the Advisers Act should lead to the conclusion that it is designed to encourage and institutionalize self-dealing.

Even if the SEC were to withdraw the rule without notice, such an action would not disrupt trading on the national exchanges. Brokerage firms would seek to transfer these accounts internally to an affiliated adviser; they would not abandon them to the competition.[50] If there were any risk, it would be through flipping products by a broker during the internal transfer of accounts. Nonetheless, the Commission could assess the impact on market sectors by analyzing portfolio holdings in fee-based accounts to determine if a significant portion was concentrated in a particular industry sector, fund family or investment style.[51]

In order to assess the impact on capital markets if the rule were withdrawn, the SEC should look not only at the number of firms offering fee-based services, which it analyzed in the reproposing release, but also at the:

1. Total number of fee-based accounts;

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[50] Notwithstanding the steady growth in the fee-based programs, these accounts are only a minor part of overall market capitalization. Based on a $15 trillion capital market, and excluding 71 percent of overall market share held by institutional investors and the public companies, approximately $3.9 trillion is held by individuals. Fee-based accounts, variously estimated at $250-260 billion in assets, in fact are only about 6.4 percent of this amount, and only about 1.6 percent of overall market capitalization

[51] With respect to the actual transfer of accounts from one broker within a firm to another, the NASD and state securities administrators are well-versed with the procedure, including the more complicated situation of transferring customer accounts between different broker-dealers.

Brokerage firms were, in fact, well positioned to handle the transition to fee services well before 1999 and are even better situated to do so today. The current argument that fee-based accounts give customers flexibility in choices is contradicted by the fact that most proponents have offered this flexibility for years under the auspices of wrap-fee and advisory accounts. In the early 1990s, many broker-dealers became dually registered in order to offer popular wrap-fee programs or separate advisory and financial planning services.

A recent industry report by Tiburon Strategic Advisors on fee accounts noted an interesting correlation between the declining growth in broker wrap account assets when the SEC's original rule went into effect. The Tiburon study noted "[wrap accounts] lost steam with the emergence of the non-discretionary fee-based brokerage accounts…" http://www.tiburonadvisors.com/04.12.31%20-%20Tiburon%20Research%20Release%20-%202004%20Year-End%20Letter.html.

2. Total number of broker-dealer agents handling those accounts (as well as the subset who are also investment adviser representatives ("IARs"); and
3. Number of IARs in the firm or an affiliate or subsidiary that could accept transfers if the rule were withdrawn.[52]

F. Evaluate Enforcement Data Concerning the Rule's Impact on Investors.

Rather than consider the cost to the brokerage industry, we implore the Commission to assess the effectiveness of the rule in costs to the investor. Only the SEC is positioned to address this issue quantitatively because of the confidential enforcement data necessary to answer this question.

We believe that there is abundant information on problems with fee-based brokerage, as cited by NASD in Notice 03-68 more than a year ago. The problems with fee-based accounts included "reverse churning," where brokers receive ongoing asset management fees but neglect the account by failing to recommend timely rebalancing of the portfolio. NASD raised concerns that such inactivity may be more costly to the customer than transaction expenses incurred in a buy-and-hold strategy. NASD also detected other problems such as a lack of training for these "traditional" brokerage services; switching products into fee-based accounts and double-charging both a load and fee; and weak or non-existent documentation that the fee-based account is appropriate to the customer. As mentioned earlier, NASD noted that some firms even failed to assign a broker to these accounts.[53] In hindsight, some of these problems sound strikingly similar to the suitability and churning issues that the Tully Report wanted to eliminate with fee-based services.

We believe an examination of the systemic problems with the rule would help shed light on the overall cost to investors. We encourage the Commission to provide data on the scope of the problem in light of its question asking whether broker-dealers' lack of compliance with the NASD notice suggests that it ought not to adopt the rule.

It is ironic that we have heard of complaints in the securities industry -- not about the costs of adviser compliance if the rule were withdrawn -- but about uncertainty in complying with the present rule. One major independent broker-dealer, in a recent memorandum to its brokers, called the rule a "nearly unnavigable mine field" and has recommended that its agents become registered as investment adviser representatives to handle their fee-based accounts in the future. According to industry reports, other broker-dealers are apparently also considering converting the programs to adviser accounts.[54]

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[52] As of Jan. 1, 2005, there were 186,737 investment adviser representatives registered on the Investment Adviser Registration Depository ("IARD"), according to the NASD. We believe there is a large pool of broker-affiliated advisers who would be available to accommodate internal account transfers.

[53] NASD NTM 03-68, supra n. 18, at 12.

[54] *See* Inside Information, by Robert Veres, January 2005, at 5:

Withdrawing the rule would restore clarity in an exceptionally gray area of regulation for the industry and investors. The Commission and staff concede there is "confusion that exists regarding differences between brokerage and advisory accounts"[55] and a need "to clear up some of that confusion."[56]

G. Anti-Competitive Effects of the Rule on Financial Planners.

The legislative intent of Congress in adopting the Advisers Act was "to protect the public from . . . unscrupulous touts and tipsters and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful."[57]

Most financial planners are registered as investment advisers with either the SEC or a state securities administrator. FPA believes that the rule is anti-competitive and harmful to the long-term growth of the financial planning profession for three basic reasons:

1. The SEC ignores the mandate of the Gramm-Leach-Bliley Act of 1999[58] to retain functional regulation in the financial services industry by allowing the brokerage industry to compete with registered investment advisers without being subject to the same liability and regulatory costs.
2. The lower regulatory standard under which the brokerage industry operates allows stockbrokers, with few exceptions, to provide a less than adequate advisory program that devalues the higher quality services offered by CFP® practitioners, consistent with their code of ethics and practice standards requirements.
3. And finally, the proposed rule adds to the public's confusion over the identity of a financial consultant and thereby damages the goodwill and reputation of an emergent financial planning profession.

Independent studies have concluded that the public generally has a highly favorable, albeit fuzzy, picture of the benefits of financial planning. The brokerage industry clearly has sought to capitalize on this view. Notwithstanding the favorable perception of financial planning as a benefit, many Americans are reluctant to pay directly for

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"Several BDs, including Raymond James Financial Services, are quietly discontinuing their fee-compensated, non-advisory trading accounts; in the future, representatives will have to be registered as RIAs or open commission-based trading accounts for customers and clients."

[55] Remarks of Paul Roye, Director of the Investment Management Division, at Dec. 22, 2004, SEC public meeting.

[56] *Id.* Remarks of Commissioner Cynthia Glassman.

[57] S. Rep. No. 1775, 76th Cong., 3d Sess., 21 (1940).

[58] The Financial Modernization Act of 1999, Publ. L. No. 106-102, (Nov. 12, 1999).

financial planning.[59] Nearly half of those polled in an industry survey paid nothing for their plan but instead perceived it as a perk of patronage. As a result, the costs of planning across the financial services industry are typically offset by larger profit margins realized during plan implementation, i.e., in the sale of specific investment or insurance products. As the report cautions, these 'free' plans might not be objective or comprehensive. Plans from brokers and other non-independent financial planners, according to the study, are often generic, computer-based models not tailored to clients' goals.

FPA believes that a financial planning engagement should adhere to professional standards of conduct.[60] Comprehensive financial planning, when performed according to the CFP Board of Standards' practice standards, can be time-consuming and labor-intensive, notwithstanding the abundance of software available for certain financial planning calculations. The CFP *Code of Ethics and Professional Responsibility* requires, in a financial planning engagement, adherence to an integrated, six-step process that ultimately provides the client with an overall financial analysis and strategy for meeting their goals and needs.

In summary, under the rule the brokerage industry can more efficiently market an advisory service, at a lower cost, and without being subject to higher professional standards of conduct. The result is a rule that erodes the value and integrity of the financial planning process over time for the public and harms ethical practitioners.

IV. Conclusion.

If the brokerage services permitted under the reproposed rule are indeed traditional functions offered for many decades, then why are consumers so confused as to the nature of the services provided? If the services are the same, shouldn't the disclosure simply state it is the same service, but that a fee is charged in lieu of commissions? Why are the NASD and New York Stock Exchange proposing additional guidance on fee-based accounts if it is merely a continuation of a traditional service?

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[59] "Conflicts Seen In Affluent Investors' Finance Plans," by Louise Story, *Wall Street Journal,* August 10, 2004. Source of article was a survey of 500 people by the Spectrem Group, a Chicago-based financial-services consulting firm. The margin of error in the survey was plus or minus 4.4 percentage points.

[60] Standards in a financial planning engagement should embrace full disclosure, place the client's interests ahead of the adviser, and meet certain examination, experience and ongoing education requirements consistent with the CFP® *Code of Ethics and Professional Responsibility* and related practice standards. With respect to qualifications and experience, a CFP® candidate must either challenge the two-day, 10-hour exam as attorneys or CPAs, or else enroll in approved classes prior to taking the exam, the latter alternative adding up to $5,000 or more in initial educational costs. Maintaining certification and 30 hours of continuing education requirements every two years add to the ongoing professional costs of doing business compared to someone who is not subject to similar requirements.

See CFP Financial Planner Board of Standards, Inc. web site at http://www.cfp.net/default.asp to review the *Code of Ethics* and Financial Planning Practice Standards.

We would suggest that these questions arise, and are difficult to answer, because the nature of the services and relationship of the adviser and broker are significantly different as reflected in the starkly different positions taken by industry groups on the attendant rule.

There is no evidence or logical reason to believe that now, after years of experience with fee-based pricing, wirehouses would suddenly go back to commission-based pricing if the Advisers Act were enforced in connection with fee-based programs. The wirehouses made the change simply because it was profitable, not out of civic duty.[61] They will follow the money and the market trends. There is little doubt that they would continue to offer the flexibility of fee-based programs under the Advisers Act if so required by the SEC.

Nor is there any evidence offered that the current rule enhances investor protection or that the legislative history of the Advisers Act permits a departure from the statutory exemption for broker-dealers. The reproposing release utterly fails to make a convincing case that a common-sense view of the standards for advisers Congress decided upon in 1940 have changed so much that these shouldn't apply to brokers engaged primarily in the identical business. Without significantly expanding the holding out restriction from "financial planning" to add similar advisory-like terms, broker-dealers will essentially have a green light to provide <u>any</u> investment advice unless associated with a discretionary account or marketed specifically as financial planning.

We note that it would have been far easier years ago for FPA to join other organizations that benefited from the exemption in supporting the rule, since two-thirds of its members are registered representatives and many have available to them fee-based programs sponsored by their broker-dealers. Our concern is not, however, with the method of compensation received in delivering competent and ethical financial planning services, but in the standards under which it is provided. FPA also is not concerned with the size of the financial institution offering financial planning services. In order to serve those segments of the public who are currently unable to afford it, and who are most in need of competent and ethical advice, the business models by necessity will ultimately range from online Internet advisers and small, independent financial planner shops to large conglomerates.

Based on the SEC's premise that fee-based brokerage is business as usual with a pricing twist, investors clearly would benefit from a uniform regulatory environment. The most favorable result is to simply withdraw the rule and place the investor's interest ahead of the broker.

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[61] The transition to fee-based pricing inside certain firms was referred to as "annuitizing" brokerage accounts, meaning the revenue stream became an annuity to the firm by not having to contend with market fluctuations.

We would be pleased to respond to any questions in connection with these comments. Please do not hesitate to contact the undersigned at 202.626.8770.

Sincerely,

Duane R. Thompson
Group Director, Advocacy