ICAA

February 7, 2005

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-2340, 34-50980; File No. S7-25-99

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to submit comments on re-proposed rule 202(a)(11)-1 under the Investment Advisers Act of 1940.[2] The rule addresses the application of the Investment Advisers Act of 1940 to broker-dealers offering various types of services. We applaud the Commission for its careful and thorough consideration of the important issues raised by this rule. While we still have a number of comments and concerns, we believe the reproposal represents a significant improvement from the original proposal.

Under the reproposed rule, a broker-dealer providing investment advice to customers and charging asset-based 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 and not advisory accounts, and that as a consequence, the customer's rights and firm's duties and obligations to the customer may differ. The broker would be required to identify an appropriate person at the firm with whom the customer can discuss the differences. 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. Significantly, the

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[1] 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 400 investment advisory firms that collectively manage in excess of $4.5 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

[2] *Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers,* SEC Release Nos. IA-2340, 34-50980; File No. S7-25-99 (Jan. 6, 2005) ("Reproposal").

reproposed rule provides that discretionary advice provided on a commission basis is not "solely incidental" to brokerage services.

The ICAA Applauds the Commission for Addressing Our Previous Comments

During the initial comment period, the ICAA expressed concern that the proposed rule failed to give appropriate guidance regarding the circumstances under which a broker will have to treat an account as an advisory account.[3] Specifically, the ICAA agreed "with the Commission that a functional test focusing on the nature of services provided (rather than the form of the broker-dealer's compensation) is appropriate in determining whether and under what circumstances a brokerage account may be excluded from provisions of the Advisers Act." [4] The ICAA requested, however, that the functional test be modified as follows:

- The rule should treat discretionary brokerage accounts that charge commissions in the same manner that it treats discretionary brokerage accounts that are fee-based.

- The rule should clarify that an account that receives discretionary advisory services is by definition not "solely incidental" to a broker-dealer's business.

- The rule should prohibit broker-dealers from advertising advisory services that are "solely incidental" to the conduct of the broker's primary business. Alternatively, the rule should require more meaningful disclosure in advertisements and any other materials that market advisory services of broker-dealers – and in contracts and agreements governing such accounts – in order to inform consumers of the significant differences between advisory and brokerage accounts, functions, and legal responsibilities.[5]

In subsequent comment letters, we also urged the Commission to address more fully the definition of "solely incidental" and to withdraw its longstanding no-action position permitting broker-dealers to treat certain asset-based accounts as brokerage accounts.[6]

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[3] 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).

[4] Contrary to the implication of the SEC's reproposal (*see* n.28), the ICAA does not believe that the form of compensation should be the decisive indicator of whether an account is an advisory account. The ICAA, throughout its comment letters, consistently has supported functional regulation based on the nature of the services provided. Indeed, we opposed the original proposal to deem discretionary commission-paying accounts as brokerage accounts based on the nature of the service provided rather than the form of compensation.

[5] *Supra* n.3.

[6] 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).

We are pleased that the Commission has proposed to adopt many of our recommendations. The reproposed rule will treat discretionary brokerage accounts consistently regardless of the form of compensation charged. The reproposal states that the provision of discretionary advisory services is not "solely incidental" to the conduct of brokerage business. The Commission has enhanced the disclosure proposed for asset-based brokerage accounts. Further, the Commission intends to issue an interpretation tackling the previously uncharted seas of the "solely incidental" definition and has withdrawn its no-action position in favor of more formal rulemaking. We commend the Commission for all of these significant improvements.

The "Discretionary" Account Test Should Not Contain Loopholes

We strongly agree with the SEC's decision to treat all discretionary accounts as advisory accounts regardless of the compensation charged, for the reasons stated in our prior comment letters. Having made this decision, the Commission should consistently apply it. Thus, in response to the SEC's request for comment, we do not believe the Commission should create exceptions, such as situations where the broker has discretion over an account during a client's vacation or other limited period of time. Creating exceptions would defeat the utility of a bright-line test in favor of a more vague facts-and-circumstances analysis. Further, a client's decision to grant such authority to a broker even for a limited period is indicative of the type of relationship of trust and confidence that may confer a fiduciary duty on the broker.[7]

The Commission's Proposed Disclosure Should Be Strengthened Further

The Commission originally proposed that brokers charging asset-based fees be required to disclose only that the account is a brokerage account. We and many other commenters found this proposed disclosure to be seriously inadequate. The reproposal substantially enhances that disclosure by requiring that advertisements for, and contracts and other forms governing, accounts for which the broker receives asset-based or other non-commission-based compensation include a prominent statement that:

- accounts are brokerage accounts and not advisory accounts;
- as a consequence, the customer's rights and firm's duties and obligations to the customer, including the scope of the firm's fiduciary obligations, may differ; and
- identifies an appropriate person at the firm with whom the customer can discuss the differences.

Although the reproposed disclosure is significantly improved, we believe that it does not go far enough. A 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 led 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 is not subject to an investment adviser's overarching fiduciary duty. Further, the disclosures regarding duties made in marketing or advertising material should be consistent with duties undertaken in the

[7] *See* Reproposal at n.54.

brokerage agreement. In other words, the marketing should not tout a relationship of trust and confidence while the contract is disclaiming fiduciary duty.

The Commission has requested comment whether the rule should designate the level of seniority of the person identified with whom customers may discuss the differences between a brokerage account and an advisory account. We believe that the person identified should be sufficiently senior and knowledgeable about the regulatory differences to provide useful and accurate information to customers. In addition, the disclosure should include the person's phone number and e-mail address. The firm and the Commission should conduct reviews, including interviews of customers, to determine whether the information provided is accurate and sufficient.[8] In addition, we respectfully submit that the Commission should set standards for the definition of "prominent" disclosure. Disclosure that is in materially smaller font than the substance of the advertisement should not be deemed "prominent."

The Commission Should Recognize the Fundamental Differences Between Brokers and Advisers in Issuing "Solely Incidental" Guidance

We strongly support the Commission's intention to issue an interpretation clarifying what constitutes "solely incidental" advice by a broker. An interpretive release is particularly necessary because the SEC proposes to define "solely incidental" advice as "in connection with and reasonably related to the brokerage services provided to that account."[9] This proposed definition on its face is overly broad and appears to be inconsistent with both the plain meaning of the term and with the legislative history of the Advisers Act.[10] If the Commission does not issue a limiting interpretation, "any or all types of advisory services" could be rationalized to fall within that broad definition, contrary to the Commission's intent and the plain language of the statute.[11] Appropriate interpretation of the term is critical to a test that is truly based on the "nature of the services provided." As the Commission states, brokers and advisers "should be held to similar standards depending not upon the statute under which they are registered, but upon the role they are playing."[12] Thus, the Commission must consider the fundamental differences between brokerage services and advisory services in issuing its interpretation.

One important starting point in examining the roles played by advisers and brokers is fiduciary duty. Investment advisers are subject to a strict fiduciary duty, flowing from a

[8] Ideally, the Commission would publish guidelines regarding the information to be provided by the individual designated by the broker-dealer, as well as post similar information for the public on the SEC's web site.

[9] Reproposal at 43.

[10] *See* Letter from Barbara Roper, Consumer Federation of America re File Number S7-25-99 to Jonathan G. Katz (Feb. 7. 2005).

[11] Reproposal at 46 (an interpretation that any or all types of advisory services are part of a brokerage account "would have the effect of negating any limitation inherent in the 'solely incidental' standard, and we propose not to read 'solely incidental' so broadly.").

[12] Reproposal at 23.

relationship of trust and confidence between advisers and their clients.[13] Similarly, when brokers assume "positions of trust and confidence with their customers similar to those of advisers," brokers have been held to fiduciary standards.[14] Thus, as the Commission recognizes, there are circumstances where brokers are held to a fiduciary duty outside of the discretionary management context. These circumstances are more likely to occur when a broker moves beyond the traditional role of securities salesman providing brokerage services and begins to assume the role of trusted adviser.

In their traditional role, registered representatives provide 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 considered to be solely incidental to brokerage transactions.[15] Such services are core investment advisory services that should be subject to the fiduciary protections of the Advisers Act.[16] These services have a "quintessentially supervisory or managerial character" that the Commission recognizes "as a critical indicator of services that warrant the protection of the Advisers Act because of the 'special trust and confidence inherent' in such relationships."[17]

Consistent with these general concepts, we support the Commission's intention to affirm that certain financial planning services and wrap fee sponsorship are not solely incidental to brokerage services. We also urge the Commission to consider issues raised by brokers holding out as "financial advisers," as well as providing other advisory services.

Financial Planning Services

We support the Commission's proposed interpretation that "if a broker-dealer holds itself out as a financial planner or as providing planning services, it cannot be considered to be giving advice that is solely incidental to brokerage." Financial planners generally prepare a

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[13] *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963); *In re Arleen Hughes*, Exchange Act Release No. 4048 (February 18, 1948).

[14] Reproposal at 22.

[15] 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.

[16] 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.

[17] Reproposing Release at 36.

program for a client based on the client's financial circumstances and goals, which involves a wide range of subjects, typically including investments, insurance, savings, and tax considerations. This is a separate type of service that should not be deemed to be inherently "connected with and reasonably related" to brokerage services. In addition, a financial planner's provision of such wide-ranging advice and access to such extensive information about a client may well lead the client to believe he or she is in a relationship of trust and confidence with the planner.

While we understand the Commission's questions regarding suitability, we believe the "holding out" element of the interpretation will serve to distinguish provision of financial planning services from the suitability analysis that is required as part of traditional full-service brokerage. This analysis could apply to both the firm's registration requirements as well as treatment of each account as a brokerage or advisory account. Thus, if the broker holds out as providing financial planning services, any accounts that are part of the marketed program would be subject to the Advisers Act. Further, any financial planning that is the subject of a separate contract or fee would also be subject to the Advisers Act because it would not necessarily flow from the brokerage relationship.

Wrap Fee Sponsorship

Wrap fee programs offer clients a combination of brokerage services, asset allocation, adviser selection, and portfolio management for a bundled or "wrapped" fee. The portfolio management services may be offered by the broker-sponsor or its affiliate or by an independent investment adviser. Under the current regulatory structure, broker-dealers that sponsor wrap fee programs are required to be registered as investment advisers and to treat such programs as being subject to the Investment Advisers Act. The Commission has traditionally regarded the portfolio manager selection and asset allocation services involved in such programs as advisory services that are not solely incidental to brokerage services.[18] We strongly urge the Commission to reaffirm this interpretation, as well as to apply it more broadly, as discussed below.

Holding Out As an Investment Adviser

The Commission requests comment on whether a broker's use of the terms "financial consultant" or "financial adviser" is inconsistent with the broker-dealer exception. We believe it is. In our view, the opportunity for investor confusion persists where a broker is permitted to use terms that imply a relationship of trust and confidence but, in effect, disclaims fiduciary responsibility for such relationships. Part of the confusion fostered by brokers marketing advisory services stems from testimonials from actual or simulated clients regarding their "trusted" adviser. Ironically, investment advisers – who actually do have a fiduciary relationship of trust with their clients – are prohibited from using such testimonials, while brokers, who disclaim such a relationship, are permitted to do so. At a minimum,

[18] Reproposal at 53. *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.").

brokers should be prohibited from holding themselves out as financial consultants or advisers/advisors in combination with a testimonial that implies such an advisory relationship.

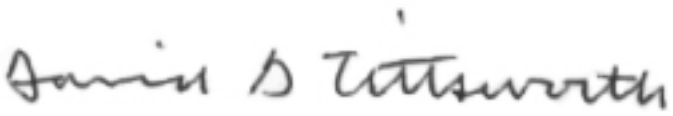
Other Interpretive Questions

The Commission's interpretation of "solely incidental" should provide additional guidance sufficient to address new services and programs as they are developed. Undoubtedly, over time broker-dealers will create new programs and services involving non-discretionary accounts that test the limits of the current interpretation and rule. The Commission's interpretation should make clear that non-discretionary advice bearing the core characteristics of investment advisory services is not solely incidental to brokerage services. As discussed above, this includes relationships of trust and confidence (from the client's perspective, not the broker's), ongoing supervisory or managerial services, portfolio management, asset allocation services, and advice regarding selection of investment advisers.

CONCLUSION

We would be pleased to work with the Commission's staff in drafting language to modify appropriately the reproposed 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