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Merrill Lynch

February 7, 2005

By Electronic Delivery

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Proposed Rule 202(a)(11)-1 Addressing the Application of the Investment Advisers Act of 1940 to Broker-Dealers Offering Fee-Based Brokerage Services, File No. S7-25-99

Dear Mr. Katz:

Merrill Lynch, Pierce, Fenner & Smith Incorporated is submitting this letter in response to a request by the Securities and Exchange Commission ("SEC" or the "Commission") for comments regarding proposed rule 202(a)(11)-1 under the Investment Advisers Act of 1940, as amended ("Advisers Act"), relating to the application of the Advisers Act to broker-dealers offering fee-based brokerage services ("Proposed Rule") and the proposed statement of interpretive position clarifying when certain broker-dealer advisory services, including financial planning, are solely incidental to the brokerage business.[1/]

We strongly support the Proposed Rule's objectives and commend the Commission for seeking to offer such guidance. In particular, we strongly agree with the Commission's conclusion that broker-dealers can offer fee-based brokerage services without being subject to the Advisers Act.

1/ *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Exchange Act Release No. 50980 (Jan. 6, 2005), 70 Fed. Reg. 2716-01 (Jan. 14, 2005) ("Proposing Release").

However, we urge the Commission to reconsider its proposed interpretation with regard to certain financial planning services. Brokerage firms have long been able to provide advice to clients and that advice is more important than ever before. We believe that planning is integral to the brokerage services that we offer and is of significant benefit to the investing public. Any hindrance to the offering of planning-based brokerage services would be a significant step backwards for the financial services industry and its clients. We therefore urge the Commission to permit the continued offering of such brokerage planning services without being subject to the Advisers Act, unless such services are offered for a separate, incremental fee.

A. Fee-Based Brokerage Is Appropriately and Extensively Regulated, Is Consistent with Commission Endorsed Best Practices and Should Not Be Subject to the Advisers Act

The Commission is absolutely right, once again, to repeat in this Proposed Rule an endorsement of fee-based brokerage services. Since first recommended by the Tully Report[2/] a decade ago, fee-based brokerage has become an accepted and important part of the brokerage services offered to clients, and many clients have selected it as an attractive pricing alternative.[3/] The Tully Report grew out of a special committee ("the Committee") organized at the request of the sitting Chairman of the Commission, Arthur Levitt, to examine brokerage practices in the United States. The Committee recommended fee-based brokerage services because the payment of a fee rather than a commission for traditional brokerage could help align customers' interests with those of the broker-dealer.[4/] The Commission's endorsement of the Tully Report is reflected in the Commission's original proposal of rule 202(a)(11)-1 in 1999 (the "Initial Proposal"). In that proposal, the Commission spoke favorably of the Committee's findings while expressly welcoming the introduction of fee-based brokerage services as a way to reduce potential conflicts of interests.[5/]

Consistent with the recommendation made in the Tully Report and the Commission's endorsement of fee-based brokerage, many firms, including ours, offer such pricing. The underlying premise behind the development and growth of fee-based brokerage is that broker-dealers, who historically have offered investment advice in connection with their traditional

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2/ Report of the Committee on Compensation Practices (Apr. 10, 1995), *available at* http://www.sec.gov/news/studies/bkrcomp.txt (last visited Jan. 26, 2005) ("The Tully Report").

3/ Fee-based compensation was one "best practice" identified as a way of responding to the potential conflicts of interest that may arise when using commission-based incentives with representatives that offer investment advice to customers. *See* Tully Report, *supra* note 2 at 7, 10.

4/ *See Id.* at 3 (stating that "[t]he most important role of the registered representative is, after all, to provide investment counsel to individual clients, not to generate transaction revenues. The prevailing commission-based compensation system inevitably leads to conflicts of interest among the parties involved.")

5/ *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Exchange Act Release No. 42099 (Nov. 4, 1999), 64 Fed. Reg. 61226-01 (Nov. 10, 1999).

brokerage services,[6/] continue to offer these same services with this alternative pricing mechanism.

The Commission is well within its authority to determine that broker-dealers receiving an asset-based fee in lieu of per-trade commissions do not need to be regulated as investment advisers and that the form of compensation received is not an appropriate bright-line test to determine whether the Advisers Act should apply. The legislative history behind section 202(a)(11)(C)[7] does not in any sense contradict such a conclusion. As the Commission correctly described in the Proposing Release, Congress was well aware that broker-dealers provided investment advice as part of their traditional brokerage services and expressly excluded broker-dealers from regulation under the Advisers Act where the investment advice was "solely incidental to" their traditional brokerage services and they received no "special compensation" for such services. This express exclusion was not intended then, and should not be interpreted now, to mean that broker-dealers should not provide advice to their customers. Indeed, advice has always been understood to be an integral part of traditional full service brokerage.

Fee-based brokerage is merely a pricing alternative for customers who receive the same advice and guidance as part of traditional brokerage. The term "special compensation," read plainly, means a separately identifiable and incremental charge for advice that is in addition to traditional brokerage services. Since fee-based compensation is simply a pricing alternative to commissions for the same brokerage services, it does not constitute special compensation.

This payment method, now widely accepted by the investing public, should not be used as a pretext for subjecting brokerage services to an additional, duplicative regulatory regimen. Instead, we agree with the Commission's observations that brokerage services are appropriately regulated under the Securities Exchange Act of 1934, as amended, the Commission's rules thereunder, the rules of the various self-regulatory organizations, and state laws – these protections in many cases are considerably more extensive than those provided under the Advisers Act. For more than 70 years, this comprehensive body of law has regulated the brokerage industry. It is hardly rendered inadequate or irrelevant by the mere offering of a pricing alternative. The interests of fee-based brokerage customers are more than adequately protected under the current broker-dealer regulatory structure.

Finally, we note that the Commission should not disregard the substantial disruption that would occur if the Proposed Rule was not adopted. The Commission has observed accurately that the financial services industry has seen tremendous growth in fee-based brokerage as a result of customer acceptance and demand. The negative consequences of a Commission reversal of its

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6/ For purposes of this comment letter, we have adopted the term "traditional brokerage services" as the Commission has defined it in footnote 42 of the Proposing Release.

7 15 U.S.C. § 80b-2(a)(11)(C). Section 202(a)(11)(C) excludes from the definition of investment adviser any broker or dealer who provides advisory services solely incidental to the conduct of his business as a broker or dealer and does not receive special compensation for those services.

Initial Proposal cannot be overstated. Broker-dealers who relied on the Initial Proposal would incur significant expenses in seeking to convert fee-based brokerage accounts into either commission-based brokerage accounts or investment advisory accounts. Simply going out to all of our fee-based brokerage clients, explaining why their existing pricing structure was no longer available, obtaining their directions for new arrangements and implementing these directions with new documentation and other account requirements would be a major undertaking.

Just as challenging, if not more so, would be the necessary creation of new investment advisory programs as an alternative for these clients. Yet, under the Advisers Act, client activity that is commonplace in a brokerage account becomes problematic – for example, the purchase or sale of fixed income securities from a largely principal-oriented marketplace or simply the purchase of underwritten securities. The result would be an entirely new set of operating rules imposed on customers who did not want them, or need them, in the first place.

We think there would be considerable customer confusion and anger if the Proposed Rule is not adopted, and the denial of the benefits of fee-based brokerage relationships, as described in the Tully Report, would harm the interests of those investors. The failure to adopt the Proposed Rule would be detrimental both to broker-dealers and their customers.

For the foregoing reasons, we strongly endorse the Commission's view that broker-dealers who offer fee-based brokerage should not be precluded from the exclusion in section 202(a)(11)(C) (the "Exclusion") merely because they receive a different form of compensation from their clients for the same brokerage services.

B. Brokerage Planning Services Without A Separate Fee Have Long Been, and Should Continue To Be, An Integral Part of Brokerage Services

Broker-dealers have offered planning services to their clients for many years; such services facilitate understanding the clients' investment objectives, risk tolerances, and financial situation. These services vary in complexity, scope and purpose and are difficult to define as a single uniform type of service – but they all have their root in the broker-dealer's effort to help clients make informed and suitable investment decisions in a planned way.[8/] The offering of such planning services should not put broker-dealers under the umbrella of the Advisers Act.

Planning services are an integral part of traditional, full service brokerage. Indeed, in recent years, broker-dealers have developed a wide variety of planning tools to meet a growing demand for such assistance from an investing public more and more in need of assistance. Yet, the Commission now proposes to preclude broker-dealers from offering such services to clients (or to hold themselves out as offering such services) even if they are available without additional charge. In the Tully Report, the Committee recognized that adhering to the Know Your

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8/ *See Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services*, Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987), 52 Fed. Reg. 38400-01 (Oct. 16, 1987) ("Financial Planners Release").

Customer Rules was only the first step in a two-step process – the second crucial part of which is recommending appropriate investments to the customer.[9/]

A re-characterization of all financial planning services as investment advisory would be unwise as a matter of policy and damaging to the interests of investors. Planning services are offered, without a separate fee, to assist the customer in developing and implementing a method of investing that is intended to meet the customer's long-term investment objectives. The growth of computer assisted planning tools has enabled broker-dealers to offer these planning services without any cost to customers other than those costs associated with securities transactions. The advice is clearly "solely incidental to" full service brokerage, i.e., advice provided in connection with and reasonably related to brokerage services furnished to clients. We do not believe the Commission should discourage broker-dealers from providing this type of education and assistance. Investors would be short-changed, indeed significantly harmed, if they were compelled to view their relationship with their broker-dealers as one characterized solely by one-shot recommendations regarding purchases or sales. With today's investor in serious need of planning assistance, cutting off this important avenue of help would be truly an unwise policy.

Moreover, as discussed in the Proposing Release, the term "financial planning services" is used very broadly and, thus, could include planning services that are not specifically focused on securities at all – a deviation from the Commission's historical interpretation of the financial planning services that should be governed by the Advisers Act.[10/] We believe that it would be inappropriate, and in direct conflict with the interest of the investing public, for the Commission to adopt a "one size fits all" approach and to prevent broker-dealers from relying on the Exclusion on the basis that they offer a broad menu of planning services to clients.

Broker-dealers who offer financial planning services of the magnitude and scope about which the Commission appears to be concerned generally offer such services for a separate planning fee. Adopting an interpretation that the Advisers Act applies only to those planning services offered for a separate incremental fee would capture those products and services. At the same time, it would create a bright line test between investment advisory and brokerage services that could be understood and monitored in practice. We believe that most firms charging such a separate fee for financial planning are already treating it as an investment advisory service. Once again, we think this is a bright line test that makes sense, is clear and understandable, and provides appropriate customer protections.

We note that in addition to permitting the offering of financial planning services pursuant to the "solely incidental to" standard,[11/] the SEC staff also has taken the position in the past that a

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9/ Tully Report, *supra* note 2 at 12.

10/ *See* Financial Planners Release, *supra* note 8 (defining advice or analyses concerning securities as financial planning services that would be subject to the Advisers Act.)

11/ *See* Financial Planners Release, *supra* note 8; Nathan and Lewis Securities, Incorporated, SEC No-Action Letter (Apr. 4, 1988) (stating that "[w]here a BD provides financial planning services that are solely incidental to its

registered representative of a broker-dealer who holds himself or herself out to the public as a financial planner can rely on the Exclusion provided the financial planning activities are conducted solely in the capacity as a registered representative of the broker-dealer.[12/] In reliance upon these interpretations, broker-dealers have offered planning services as part of traditional brokerage (and customers have come to expect such services) without concern that the advertising of these services could jeopardize broker-dealer status. We strongly oppose any proposed interpretation that the holding out of planning services by itself invokes the Advisers Act. The proposed interpretation would require many broker-dealers to re-characterize their business although the underlying services would not change – a result that would appear to be illogical as well as confusing to customers. Indeed, we think it is important that actual and potential customers understand just what products and services are available, and that firms need to be able to tell them publicly.

Finally, we believe that broker-dealers should be permitted to use such terms as "financial advisor" or "financial consultant" to describe their representatives. Those titles are fully consistent with the services provided to our customers, whether fee-based or commission based. Said more directly, these titles accurately describe what a registered representative in a full service brokerage firm does, and should, provide. Moreover, those terms are not closely associated with investment advisory services in the same manner as terms such as "portfolio manager," "investment advisor" or "investment counselor." We see no reason for the Commission to take action to restrict the use of the former terms. Further, any perceived confusion is best addressed by the disclosure described below.

C. Disclosure

We agree that broker-dealers offering fee-based brokerage services should provide clear and prominent disclosure in advertisements and account documentation. We have supported such disclosure from the outset and continue to do so. Thus, it seems reasonable and appropriate to state that a fee-based account is brokerage, not investment advisory, and that as a consequence, rights and duties will differ.

However, we would urge that legal terms not be mandated in such disclosure since they: (1) refer to complex topics, (2) vary in applicability and consequence depending upon the facts and circumstances of each client relationship and (3) are in fact defined differently and mean different things pursuant to different statutes, such as the Employee Retirement Income Security Act of 1974. Further, in response to the proposed requirement that a person be identified with whom customers can discuss the differences between brokerage and investment advisory accounts, we believe that customers should be directed to address such questions to their

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broker-dealer business and receives no compensation for those services, the BD would be able to rely on the [section 202(a)(11)(C)] exclusion.")

12/ *See* Nathan and Lewis Securities, Incorporated, *supra* note 11; Elmer D. Robinson, SEC No-Action Letter (Jan. 6, 1986).

financial advisors. Those individuals are best situated to have a full and thorough discussion with their clients about the various products and services offered by the firm, including their particular features, differences, costs and requirements.

We think this type of communication is likely to be more complete and satisfying for clients both because it can be done face-to-face (if they so desire) and because it would be with someone whom they have had an opportunity to interact with, and perhaps already know quite well. In contrast, a call center telephone conversation, with someone who does not know the customer or his/her particular circumstances, seems likely to be less effective, productive or, for that matter, informative. A written explanatory statement outlining the key differences between brokerage and investment advisory services could also be available to supplement any such conversation with a financial advisor.

D. Online and Discount Brokerage

We concur with the Commission's observations that offering online and other discount brokerage services should not cause traditional full service brokerage to be subject to the Advisers Act. Broker-dealers who offer such services have merely re-priced them at a lower level, and such re-pricing is not inconsistent with the Exclusion or the Proposed Rule.

Online and discount brokerage offer customers a wide array of services; however, such arrangements typically provide the convenience of around-the-clock Internet access to account and investment information. With lower expenses and less overhead, it was entirely appropriate, and necessarily competitive, for firms to have reduced their fees for such services, and this reduction is obviously in clients' best interests. Accordingly, we support the Commission's conclusion that broker-dealers should not become subject to the Advisers Act merely because they offer online or other discount brokerage accounts.

E. Use of Discretion As An Accommodation to Clients

As part of the adoption of rule 202(a)(11)-1(a)(1)(i) and (b) as proposed, we respectfully suggest that the Commission permit broker-dealers to rely upon the Exclusion where, at the request of the customer, investment discretion is either limited in scope or exercised for a period of reasonable limited duration. We think such a limited exemption could be important in meeting the needs of certain clients, such as those who are temporarily inaccessible.

Investment discretion is typically exercised with respect to a brokerage account as an accommodation to the customer at the customer's request. As the Supreme Court eloquently summarized, "the benefit of a discretionary account is that it enables individuals . . . who lack the time, capacity, or know-how to supervise investment decision, to delegate authority to a broker who will make decisions in their best interests without prior approval."[13/] If these accounts were subject to overlapping regulation under both the Exchange Act and the Advisers Act, the

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13/ SEC v. Zandford, 535 U.S. 813, 823 (Jun. 3, 2002).

regulatory burdens and the cost of compliance would be substantial and would outweigh the benefits of any additional protections – particularly when such arrangements are temporary. Accordingly, we believe that broker-dealers who, at client direction, exercise investment discretion that is specifically and significantly limited, either in scope or in duration, should be exempt from the requirements of the Advisers Act.

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Thank you for providing us with the opportunity to comment on the Commission's proposed rule 202(a)(11)-1 regarding the application of the Advisers Act to broker-dealers offering fee-based brokerage services. As noted above, we strongly support the stated goals of the Proposed Rule and offer our comments in furtherance of such goals. If you have any questions, or if we can provide any further information, please contact the undersigned at (212) 670-0212.

Sincerely,

Paul S. Gottlieb

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