Morgan, Lewis & Bockius LLP
1111 Pennsylvania Avenue, NW
Washington, DC 20004
Tel: 202.739.3000
Fax: 202.739.3001
www.morganlewis.com

Morgan Lewis
COUNSELORS AT LAW

Steven W. Stone
Partner
(202) 739-5453
sstone@morganlewis.com

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VIA E-MAIL (rule-comments@sec.gov)

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: Certain Broker-Dealers Deemed Not to be Investment Advisers; Release Nos. 34-50980; IA-2340; File No. S7-25-99

Dear Mr. Katz,

Thank you for giving us the opportunity to comment on the Commission's release addressing the application of the Investment Advisers Act of 1940, as amended ("Advisers Act"), to certain brokerage programs, specifically discretionary brokerage arrangements. Although we agree that the Commission needs to develop better and clearer guidance on when a broker-dealer's advisory activities are "solely incidental to" its brokerage business, we strongly believe that discretionary brokerage accounts should not be treated as advisory accounts when charged traditional transaction-based fees. This is supported by the legislative history of the Advisers Act, existing regulation of discretionary accounts by the Commission and the self-regulatory organizations ("SROs"), and consideration of the types of transactions over which broker-dealers exercise discretion.

Over twenty-five years ago, the Commission considered whether it should (and could) change its then longstanding position and treat discretionary brokerage accounts as advisory accounts subject to the Advisers Act.[1] On due consideration, the Commission decided to stand by the position that broker-dealers exercising discretionary authority over customer accounts would not need to treat those accounts as advisory accounts so long as the broker-dealers did not receive

special compensation for those services and the broker-dealers' business did not consists almost exclusively of managing accounts on a discretionary basis.[2] We believe that the Commission's longstanding position on discretionary brokerage accounts is sound and that the reasons compelling the Commission's decision over twenty-five years ago remain just as valid today. Indeed, the nature of discretionary brokerage arrangements in the securities industry have not changed in any way that would justify, let alone compel, such a shift in longstanding position. Our reasons are threefold.

First, the proposal to recharacterize discretionary brokerage accounts as advisory accounts not only breaks with longstanding interpretation by the Commission and its staff on the scope of the broker-dealer exclusion provided by Advisers Act Section 202(a)(11)(C), but runs contrary to the language of that section and Congress' intent. The language of that section does not say *only* broker-dealers not exercising discretion are eligible for the exemption. Nor does the legislative history of Section 202(a)(11)(C) support the proposal (indeed, as the Commission previously acknowledged, commentators on the 1978 proposal questioned the Commission's statutory authority to limit the scope of the broker-dealer exclusion).[3]

Congress would have been plainly aware of discretionary brokerage arrangements, specifically those involving commission paying accounts, when it enacted the Advisers Act. As the Commission recognizes in the proposing release, "many broker-dealers exercised discretion over the accounts they serviced" in 1940, and the extent to which broker-dealers provided investment advice was "well understood in 1940 when Congress passed the Advisers Act."[4] Yet, Congress chose not to focus on the exercise of investment discretion as the line separating broker-dealers from investment advisers. And, this was not because they were unfamiliar with discretionary brokerage arrangements.

Indeed, not only was the exercise of discretion well established as a part of the brokerage business, but securities regulators had by then adopted specific rules to govern the exercise of discretion by brokers, and ample case law had developed defining the fiduciary obligations of brokers exercising investment discretion.[5] Specifically, the NYSE had by 1931 developed rules to ensure the proper supervision of this conduct.[6] The Commission had itself adopted Rule 15c1-7 in 1937 to proscribe excessive trading (*i.e.*, churning) in brokerage accounts.[7] Accordingly, Congress was well aware of discretionary brokerage when it decided to create the broker-dealer exclusion from the definition of investment adviser and not use the exercise of discretion as the dividing line between broker-dealers and advisers.

Second, the proposal to treat discretionary brokerage as investment advice is not needed given the framework of Commission and SRO regulation of discretionary accounts, which as noted had their origin in the years preceding the enactment of the Advisers Act. As the Commission correctly points out in the proposing release, "[t]he broker-dealer exception in the Act was designed

. . . to avoid additional and duplicative regulation of broker-dealers, which were regulated under provisions of the [Securities] Exchange Act [of 1934] that had been enacted six years earlier."[8] Indeed, the Commission has recognized that Commission and SRO rules "provide substantial protections for broker-dealer customers that in many cases are more extensive than those provided by the Advisers Act and the rules thereunder."[9] For example, the rules of the NYSE and the NASD govern discretionary brokerage accounts and impose heightened supervisory requirements for transactions effected on behalf of discretionary brokerage accounts.[10] Moreover, discretionary brokerage transactions are governed by the suitability and best execution standards for registered broker-dealers, which parallel those for registered investment advisers in many respects. Indeed, when formulating proposed Rule 206(4)-5 under the Advisers Act, which would have created an express suitability obligation for investment advisers, the Commission looked primarily to interpretations of the scope of a broker-dealer's suitability obligations under the Securities Exchange Act of 1934 ("Exchange Act").[11]

We are not aware, nor does the proposing release present any record, of investor protection problems that have arisen as a result of inadequacies in existing regulation of discretionary brokerage accounts. Even if such problems were perceived to exist, there is no explanation why they cannot be dealt with by modifying existing regulation of discretionary brokerage, rather than laying on another duplicative (and partially inconsistent) regulatory scheme.

Third, the proposed shift in position will hinder broker-dealers' ability to service customers conducting ordinary brokerage transactions and will impose unnecessary burdens on broker-dealers. In this regard, the proposal fails to take into consideration the myriad circumstances where broker-dealers may be asked to exercise investment discretion over customer accounts, including where the customer remains significantly involved in the decision-making process. In these circumstances, the broker-dealer is not providing the kind of investment advisory services that would typically be viewed by customers as investment supervisory services where the broker-dealer or investment adviser makes decisions constrained only by investment guidelines or a description of the investment strategy. Examples of instances in which broker-dealers may commonly be given or exercise brokerage discretion include the following:

- Broker-dealers may be given brokerage discretion by customers who wish to be contacted only periodically to discuss trading ideas with their registered representative (for example, on a weekly basis) but still retain decision making authority over their investments.
- Broker-dealers may be given brokerage discretion by customers seeking to make "opportunistic" investments that could not otherwise be made due to timing or other constraints involved in the customers having to communicate with their registered representatives on a trade-by-trade basis. Trading may be idea-driven based on market news or events rather than managed to a stated investment advisory strategy over a set period of time. Opportunistic trades could be issuer, industry, sector or even asset class specific or could be driven by spe-

cific opportunities in the market, such as secondary block trades or fast moving markets. In such cases, the clients have authorized trades but are typically not contacted on a trade-by-trade basis due to timing and other constraints.

- Broker-dealers may be given brokerage discretion by customers who otherwise give them standing instructions to purchase a particular security among a list of issued or when-issued securities (such as when certain criteria (*e.g.*, maturity, interest ranges, type of issuer and amount or range are specified) or directions to liquidate positions if certain performance thresholds are hit or certain market or issuer events occur.
- Broker-dealers may be given brokerage discretion by customers who are corporate insiders desiring to trade his or her company's stock under a plan in accordance with Exchange Act Rule 10b5-1.
- Broker-dealers may be given brokerage discretion by customers in order to sell positions obtained in underwritten offerings (which purchases generally are not made on a discretionary basis).
- Broker-dealers may be given brokerage discretion limited by specific parameters, such as with cash management accounts, which typically have detailed guidelines as to appropriate investments (including requirements as to appropriate issuers, duration and credit quality). Customers may similarly provide other specific parameters with respect to other investments. In such cases, the customer is granting discretion primarily for execution purposes and is not seeking to obtain discretionary investment supervisory services from his or her broker-dealer.
- Broker-dealers may be given brokerage discretion by customers in the form of a good-till-canceled order in which the broker may have time and price discretion.
- Broker-dealers may be given brokerage discretion by customers to trade on an isolated or infrequent basis, such as where the customers are out of the country or otherwise unavailable for a period of time.
- Broker-dealers may be deemed to exercise discretion by voting proxies on securities held in customer accounts, as is permitted by SRO rules for routine matters.
- Broker-dealers may be deemed to exercise discretion by engaging in liquidating transactions, such as may occur in a customer's margin account.

In these regards, broker-dealers often exercise various types of investment discretion but do so in a way that does not involve what the SEC describes as services of "quintessentially supervisory or managerial character that we previously have recognized as a critical indicator of services that warrant the protection of the Advisers Act."

Subjecting the above kinds of discretionary brokerage arrangements to the provisions of the Advisers Act would impose unnecessary burdens on broker-dealers and would impede broker-dealers' ability to service customer accounts. Most significantly, were Section 206(3)'s prohibition against principal transactions construed as applying to broker-dealers engaged in discretionary brokerage activities, this would effectively preclude broker-dealers from effecting a broad

variety of trades because of the practical difficulties of obtaining trade-by-trade consent from customers, as required by current interpretations of the Commission's staff. The Commission's staff has previously acknowledged this issue, stating that "w[e] are concerned that unless we clarify these issues, advisers will unnecessarily avoid engaging in principal and agency transactions that may serve their customers' best interests."[12]

We understand other commenters have recommended that the Commission clarify that a broker-dealer is not exercising investment discretion when effecting transactions based on discretion limited by written customer instructions (*e.g.*, as to certain time periods, securities or types of securities or prices of securities). Although this approach may allay the concerns of some broker-dealers, we are concerned that any attempt to define the limited nature of such discretionary authority will inevitably omit important ways in which customers use, or may need to use, discretionary brokerage or disregard the fact that customers may prefer to grant a broker-dealer broad written discretionary authority to accomplish a variety of different trading objectives.

If, given the existing regulatory framework for discretionary brokerage, the ultimate concern is customer confusion, any such confusion (if it truly exists) can be addressed best by additional disclosure to customers about the type of accounts they have and the related implications. For example, broker-dealers could be required to add explicit disclosure on their trading authorizations (or elsewhere) indicating that discretionary brokerage accounts are brokerage accounts not subject to the Advisers Act, including the protections thereunder relating to principal and agency cross trades and the various disclosure requirements under the Advisers Act. Dual registrants, in particular, could be required to particularize distinctions between investment advisory and discretionary brokerage accounts or required to inform clients what services are available from them on an advisory basis as compared to a discretionary brokerage basis. We believe these sorts of disclosure-based approaches are best suited to dealing with any concerns the Commission may have and reflect the legislative history of the Advisers Act, existing regulation of discretionary brokerage accounts, and consideration of the types of transactions over which broker-dealers exercise discretion and their usefulness to customers.

Thank you for giving us the opportunity to comment.

Very truly yours,

Steven W. Stone

cc: The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner

The Hon. Cynthia A. Glassman, Commissioner
The Hon. Harvey J. Goldschmid, Commissioner
The Hon. Roel C. Campos, Commissioner
Paul F. Roye, Director, Division of Investment Management
Robert L. Tuleya, Senior Counsel, Division of Investment Management
Nancy M. Morris, Attorney-Fellow, Division of Investment Management

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[1] Final Extension of Temporary Exemption from the Investment Advisers Act for Certain Brokers and Dealers [Interpretation of the Term "Special Compensation"] Release Nos. 34-14717, IA-626, April 27, 1978.

[2] *See* Applicability of Investment Advisers Act to Certain Brokers and Dealers [Interpretation of the Term "Special Compensation"] Release Nos. 34-15215, IA-640, October 5, 1978.

[3] *Id.*

[4] Certain Broker-Dealers Deemed Not to be Investment Advisers; Release Nos. 34-50980; IA-2340, January 6, 2005 ("Proposing release"), text preceding footnote 85; *id.* text following footnote 39.

[5] *See* Charles H. Meyer, The Law of Stock Brokers and Stock Exchanges (1931) § 62 (Discretionary Accounts).

[6] While the proposing release characterizes the NYSE's initiatives as seeking to "significantly limit the exercise of investment discretion by broker-dealers," they were, more accurately, designed to ensure proper supervision of discretionary activity by ensuring that discretion could only be conferred on member firm's partners, who then could "delegate their discretionary authority to a customer's man to a reasonable extent provided that the customer gives his written consent." Charles H. Meyer, The Law of Stock Brokers and Stock Exchanges (1931), at 309.

[7] The proposing release misreads the historical context to suggest that discretionary brokerage was preponderantly conducted on a fee basis separate from ordinary brokerage activity. In fact, regulations and case law of the time pertained to the exercise of discretion over commission-based customer accounts and focused on churning concerns. Surely, this provides the best reflection of how discretionary business was conducted then. Moreover, the record before Congress clearly reflected the provision by broker-dealers of investment advice to commission paying customers. *See, e.g.*, Investment Trusts and Investment Companies, Hearings before the Subcomm. of the Senate Comm. on Banking and Currency, 76th Sess. (1940) at 1014 (reprinting Illinois Legislative Council's Statutory Regulation of Investment Counselors, "brokers who act as investment counselors . . . are in a position, by advising buying and selling, to make a commission on the transactions, in addition to any fee that may be charged for the investment advice which they render.") Even the Commission's own internal memoranda, which became part of Congress' record, reflected the provision of discretionary advisory services to commission paying customers. *See id.* at 1024 (reprinting a memorandum to the Commission from its General Counsel, stating "It is not uncommon for investment advisers to accept . . . discretionary powers over [client] accounts. Such powers imply the making of ultimate determination with respect to the sale and purchase of securities for the client's portfolio. In an appreciable number of cases investment advisers are broker and/or dealers in securities, and as such they not only order the execution of purchases and sales for their clients' accounts, but themselves execute the orders on national securities exchanges or over-the-counter markets."). While the proposing release is correct that the Commission's anti-churning rule for discretionary accounts, Rule 15c1-7, "does not distinguish between commission-based brokerage accounts and the advisory accounts broker-dealers serviced for a fee through their separate advisory departments," it

is ludicrous to say that a churning rule is directed at non-commission paying clients. To the extent that the legislative history fails to distinguish or contrast discretionary versus non-discretionary arrangements involving broker-dealers, this only illustrates that the distinction was not important to Congress when enacting the Advisers Act.

[8] Proposing release at text accompanying footnote 41 (footnotes omitted).

[9] *Id.* at text accompanying footnote 52.

[10] *See, e.g.*, NYSE Rule 408 and NASD Rule 2510 (requiring heightened supervision of discretionary brokerage accounts); NYSE Rules 722 and 724 and NASD Rule 2860(b) (requiring supervision of discretionary options accounts); and NYSE Rule 414(i) and NASD Rule 2845 (stating that the rules governing supervision of discretionary accounts in options govern discretionary accounts in currency warrants, currency index warrants, and stock index warrants).

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

[12] *See* Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Advisers Act Rel. No. 1732, July 17, 1998.