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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, 17 CFR Part 275; Release Nos. 34-50980; IA Release No. 2340; File No. S7-25-99

Ladies and Gentlemen:

This letter is supplemental to our February 7, 2005 comment letter on the above-referenced rule proposal. In our letter, we expressed our view that existing broker-dealer regulation is sufficient to protect full-service brokerage clients who may receive advice incidental to brokerage. We argued that the delivery requirements for disclosure, including conflicts disclosure, provided under broker-dealer regulation may be more effective at informing clients of relevant issues than those provided by regulations applicable to advisers. We pointed out that broker-dealers are, in a number of situations, required to provide specific disclosure, tailored to the particular transaction, at the point of sale. We contrasted this with the disclosure regime under the Investment Advisers Act of 1940 ("Advisers Act") which, while robust in terms of content, relies on a comprehensive listing of disclosures, each item of which may or may not be relevant to a particular transaction or relationship, in an adviser's Form ADV. We also pointed out that the Form ADV is required to be delivered to a client only at inception of the advisory relationship and, thereafter, only if the client specifically requests a copy.

In order to explain the basis for our view, we have described below several examples of situations where a broker-dealer would be required to provide specific disclosures, particularly in respect to conflicts, at the point of sale while an investment adviser would either not be expressly required to make disclosure or could provide disclosure only in the Form ADV.

1) *Confirm Disclosure.* Rule 10b-10 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), requires a broker-dealer to send to any client, by completion of each securities transaction, a confirmation that contains prescribed information as well as any other information that is material to the transaction. Lofchie, *A Guide to Broker-Dealer Regulation*, p. 167. Under the Rule, a broker-dealer must

disclose the capacity in which it acted as well as remuneration received or to be received in connection with the transaction (including remuneration from third parties and payments for order flow), subject to specific requirements and exceptions depending upon the nature of the instrument and the capacity in which the broker or dealer is acting. *Exchange Act Rule 10b-10(a)(2).* This disclosure provides notice to the client, on a transaction-by-transaction basis, of applicable conflicts as well as information about the potential impact of those conflicts on compensation. Although Section 206(3) of the Advisers Act does require analogous disclosures regarding conflicts in certain situations, the required disclosures are more generic than those required by Rule 10b-10.

2) *Statement Disclosure.* Broker-dealers must send an account statement to every client that has a securities or cash position at the firm at least quarterly and, in the event there is activity in the account, monthly. *See Exchange Act Rule 10b-16; NYSE Rule 409 and NASD Rules 2340 and 2860(b)(15); NASD NTM 92-60. See also Rule 15c3-2 under the Exchange Act (*requiring quarterly statements of free credit balances) *Rule 15g-6* (requiring quarterly statements in the context of certain penny stock transactions) and *Rule 15c3-2* (requiring periodic disclosure that client funds held are not segregated and may be used in the operation of the business of the broker-dealer and that client funds held are payable on the demand of the client). Statement rules applicable to broker-dealers require a substantial amount of information to be provided to the client. For example, the rules require inclusion of estimated values of client positions. Litigation and enforcement actions brought against broker-dealers relating to the use of security valuations provided to clients have effectively required broker-dealers to include explanations about potential conflicts relating to values provided in the periodic client statements. *See, e.g., In the Matter of BT Securities Corporation, December 22, 1994* (Finding Bankers Trust liable for securities fraud as a result of the fact that Bankers Trust provided Gibson Greetings with valuations which were below the value of the same positions reflected on Bankers Trust's books and Gibson, to Bankers Trust's knowledge, used the valuations in connection with its own public financial statements). The Advisers Act does not require provision of periodic statements or require specific disclosures regarding possible conflicts relating to valuations.

3) *Marketing Material.* NASD Rule 2210 regulates broker-dealer advertisements and sales literature (*i.e.*, "written or electronic communication distributed or made generally available to clients or to the public", including circulars, research reports, market letters, performance reports, form letters, telemarketing scripts, seminar texts and reprints or excerpts). The NASD interprets "sales literature" to include press releases concerning a firm's products or services. *See, e.g., NTM 99-79.* NASD Rule 2210(d)(1)(D) provides that materials will be misleading unless there is a balanced treatment of risks and

potential benefits. Both the substantive rule requirements and NASD Staff interpretations have resulted in the imposition of more detailed disclosure requirements for broker-dealers distributing funds than those required by the Advisers Act of the fund adviser or the fund itself. Advisers Act requirements are more general and, as a result, have often lead to less detailed disclosure by advisers.

One of the risks that the NASD has required broker-dealers to disclose in marketing materials has been conflicts of interest, including those inherent in a hedge fund's structure. *See, e.g., NASD Press Release 04-22-03 "NASD Fines Altegris Investments for Hedge Fund Sales Violations – Firm Failed to Adequately Disclose Risks of Investing in Hedge Funds" (*highlighting, among other risks that the broker-dealer failed to disclose, the risks and conflicts inherent in granting broad discretion to the fund manager). The NASD found that risk disclosure in offering documents did not cure violations of the NASD's advertising rules and that "each piece of sales literature [must] independently comply with the rules' standards."

The NASD has been rigorous about enforcing its marketing rules, both through the examination process and through enforcement actions. Beginning in 2002, during the course of NASD spot check reviews of marketing materials at a number of broker-dealers, examiners indicated that broker-dealers could not use "related performance" information to market private investment funds. *See* NASD Letter to the Securities Industry Association, dated October 2, 2003; B. Barbash and N. Greene, *Current NASD Issues for Hedge Funds, Their Sponsors and Marketers*, SIA Fall Conference, Sept. 22, 2003, p. 7). The NASD Staff subsequently provided additional guidance allowing broker-dealers to include "related performance" for hedge fund managers in marketing materials provided to "qualified purchasers" in connection with marketing funds exempt from registration under Section 3(c)(7) under the Investment Company Act of 1940, as amended. *Letter from T. Selman to Yukako Kawata, December 30, 2003*. Although use of related performance is common for hedge fund managers registered as investment advisers under the Advisers Act (and, indeed, is permitted under no-action letters issued by the Staff of the Division of Investment Management), broker-dealers are significantly more constrained in their ability to use such performance in connection with marketing of private investment companies as a result of the NASD interpretations.

NASD interpretations under Rule 2210 require additional disclosures and explanations by broker-dealers regarding the bases for certain targeted return and performance information. *See* NASD Letter of Acceptance, Waiver and Consent, Citigroup Global Markets, Inc., BD No. 7059 (Sales literature improperly used hypothetical returns, listed a targeted rate of return without providing a sound basis for evaluating the target and failed to include adequate risk disclosure) and NASD Letter of Acceptance, Waiver and Consent, UBS Financial Services, Inc., BD No. 8174 (Sales literature improperly listed a targeted rate of return without providing a sound basis for evaluating the target). As a result, broker-dealers generally must include more detail regarding performance and

targeted returns in connection with materials they use to market private investment companies.

NASD Rule 2210 and NYSE Rule 472 impose specific requirements on the use of rankings in advertisements and sales literature for investment companies registered under the Investment Company Act of 1940, as amended. *See also NASD Guidelines for the Use of Rankings in Investment Company Advertisements and Sales Literature; NASD NTM 00-21; NYSE Rule 472(i)* (providing rules for client communications and marketing, including specific requirements relating to performance, NYSE Rule 472(i)(2), projections and predictions, Rule 472(i)(3), and product comparisons, Rule 472(i)(4)).

4) *Disclosure of compensation to broker-dealers in connection with sale of mutual funds.* NASD Rule 2830(l)(4) bars a broker-dealer from entering into a "special cash compensation arrangement" not made available on the same terms to all broker-dealers that distribute a mutual fund's shares unless the prospectus or SAI for the fund discloses the broker-dealer's name and the details of the arrangement.

5) *Disclosure of Control Relationship.* NASD Rule 2240 requires conflicts disclosure by broker-dealers any time that the broker-dealer executes a trade for a client where the broker-dealer is controlled by, controlling or under common control with the issuer of a security purchased or sold for the client. Disclosure must be made "before entering into any contract with or for a client for the purchase of sale" and if the disclosure is made orally, it must be supplemented by written disclosure before completion of the transaction.

6) *Research Conflicts Disclosure.* NYSE Rule 472 and NASD 2711 were modified in July 2002 to require substantial and specific written disclosures in each research report distributed by broker-dealers (*see* Release No. 34-45908). The required disclosures are comprehensive and specific to the securities discussed in the report. Requirements include: (i) disclosure regarding all 1% or greater firm ownership positions in the stocks being discussed (NASD Rule 2711(b)(2) and (3) and NYSE Rule 472(k)(1)(ii)(a)); (ii) disclosure regarding the meaning of ratings used in the report (NASD Rule 2711(h)(5) and NYSE Rule 472(k)(2)(iv)); (iii) disclosure of investment banking compensation received from a subject company over the past 12 months as well as compensation expected to be received for investment banking services during the next 3 months (NASD Rule 2711(h)(2) and NYSE Rule 472(k)(1)(ii); and (iv) analyst holdings in the underlying securities (NASD Rule 2711(h)(1) and NYSE Rule 472(k)(1)(i)(b)). Under the rules, certain of these disclosures must also be made by analysts when they make public appearances (*see* NASD Rule 2711(h)(1) and NYSE Rule 472(k)(1)(i)). In addition certain of these disclosures must be continually updated on a real time basis. Advisers who publish research are not subject to these specific disclosure requirements that must be made when a research report is distributed to clients.

7) *Tender Offer Documents.* Exchange Act Regulation M-A, Item 1009, which is referenced by Schedule 14d-9, requires broker-dealers who act as dealer-managers to disclose success fees and proprietary holdings in the target company securities. These disclosure requirements generally do not apply to firms acting solely in an advisory capacity.

Thank you for giving us the opportunity to comment and to supplement our Comment Letter. Should you have any questions, please feel free to contact me at 914-225-5550.

Very truly yours,
MORGAN STANLEY DW INC.

Georgia Bullitt
Executive Director and Counsel

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