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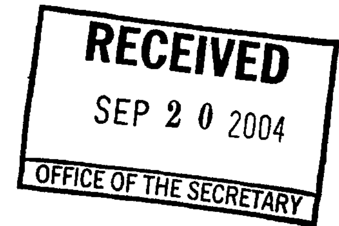
Consumer Federation of America

September 20, 2004



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

Re: File No. S7-25-99

Dear Mr. Katz:

The Consumer Federation of America[1] is gratified that the Commission has finally committed to taking action on the proposed rule expanding the broker-dealer exclusion from the Investment Advisers Act and appreciates this opportunity to submit additional comments. Since submitting a formal comment letter in opposition to the proposed rule in January 2000, CFA has written to the Commission and its chairmen on four separate occasions, both individually and with other organizations, to reiterate our concerns and to urge the Commission to adopt a more pro-investor approach.[2] Those letters, as well as our original comment letter, are included here.

This letter is not intended to restate the detailed arguments against the rule that we provided in our original comment letter. Instead, it is designed to highlight what we see as continued serious short-comings in the Commission's approach to this issue, as described in both the news release and formal rule release reopening the comment period. Specifically, we are concerned that the Commission:

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[1] The Consumer Federation of America (CFA) is a nonprofit association of 300 consumer groups, representing more than 50 million Americans. It was established in 1968 to advance the consumer interest through research, education, and advocacy.

[2] February 28, 2000 letter from CFA Director of Investor Protection Barbara Roper to then Chairman Arthur Levitt; May 31, 2000 letter from CFA, the Certified Financial Planner Board of Standards, the Investment Counsel Association of America, and the National Association of Personal Financial Advisors to Secretary Jonathan G. Katz; December 13, 2001 letter from Roper to then SEC Chairman Harvey Pitt; May 6, 2003 letter from CFA, Fund Democracy, the Investment Counsel Association of America, the Financial Planning Association, Certified Financial Planner Board of Standards, Inc., and the National Association of Personal Financial Advisors to Chairman William Donaldson.

- continues to maintain that the rule would make the "nature of services offered" the key factor determining the applicability of the Investment Advisers Act when this is clearly not the case;

- does not appear to be taking the steps necessary to create an effective functional distinction between brokerage services and advisory services; and

- continues to show a greater concern for the effect that failure to adopt the proposed rule would have on brokerage firms than it shows for the effect on investors of having financial professionals who are otherwise indistinguishable subject to two very different standards of conduct.

I. The Commission has mischaracterized the effects of the proposed rule.

The news release announcing the decision to re-open the comment period states that "[t]he proposed rule makes the nature of the services provided, rather than the form of compensation, the primary factor in determining whether the Advisers Act applies." This is simply not the case. If that statement were true, CFA would almost certainly be writing in strong support, since we firmly believe that function should determine the nature of regulation. By mischaracterizing the effects of the rule, the Commission circumvents an open and honest discussion of what steps are needed to achieve this goal of creating a clear, well understood functional distinction between advisory services and brokerage services.

In reality, the proposed rule simply gives lip service to the notion of making "the nature of services provided" the primary means of distinguishing between brokers and advisers. The rule reiterates a "solely incidental" standard the Commission has neither defined nor enforced. Its one advance on this front is its provision specifying that discretionary accounts for which an asset-based fee is charged would be subject to the Advisers Act, because these accounts "bear a strong resemblance to traditional advisory accounts." Even here, however, the Commission has made method of compensation the key factor determining applicability of the Advisers Act, since commission-based discretionary accounts would continue to be regulated as brokerage accounts under the proposed rule. If the nature of services provided were in fact the determining factor, then those two types of accounts would have to be treated the same. Furthermore, other services, such as financial planning, that are offered by both advisers and brokers would continue to be given different regulatory treatment under the proposed rule, depending not on the nature of services provided, but rather on the nature of the firm providing those services.

Clearly, then, the effect of the proposed rule is not to make nature of services provided the primary factor in determining whether the Advisers Act applies. Rather, it simply erodes the one factor on which the Commission has previously relied – method of compensation – while erecting no new functional distinctions to take its place. The result has been a further blurring of the already fuzzy lines between brokers and advisers and an erosion of the protections investors have a right to expect when they sign up for what they believe to be advisory services.

II. The Commission does not appear to be taking the necessary steps to create a clear functional distinction between advisory services and brokerage services.

The fact that method of compensation, rather than nature of services provided, has been the primary factor used to determine regulation under the Investment Advisers Act has nothing to do with any shortcomings of the act itself and everything to do with shortcomings in the SEC's implementation of the act. The statutory language makes clear that the primary distinction between a broker and an investment adviser is intended to rest on the extent of any advice being provided. But the SEC has failed to enforce that standard. Nor has it provided clear guidance on what services are brokerage services, appropriately regulated under a sales standard, and what services are advisory services, requiring the added protections contained in the Investment Advisers Act.

The full service brokerage firms have taken full advantage of the Commission's passive approach. More and more of these firms have over the years adopted titles for their salespeople, such as financial consultant or financial adviser, designed to portray them as advisers first and salespeople second. And they aggressively market their accounts as if advice were the primary service being offered. The predictable result is that financial professionals who are subject to two very different standards of conduct – one with an obligation to disclose conflicts of interest and one without, one with an obligation to place their clients' interests ahead of their own and one with a weaker obligation simply to make generally suitable recommendations – are nonetheless indistinguishable to the investors who must choose among them. The recent mutual fund sales scandals – from inappropriate sale of B shares to recommendations based on revenue sharing payments and directed brokerage agreements – make clear the serious harm that can befall investors when a sales pitch masquerades as advice and when advice is offered without the appropriate regulatory protections.

If the Commission wants the "nature of services provided" to be "the primary factor in determining whether the Advisers Act applies," it must bite the bullet and define what it means for a broker to offer advice that is "solely incidental" to its primary business of effecting transactions in securities. In doing so, it must define "solely incidental" in a way that hews closely to Congress's clear intent to provide only a very narrow exclusion. It is not enough that the advice be loosely related to the broker's primary business of buying and selling securities from and to customers. Financial planning, for example, cannot reasonably be considered solely incidental advice. It is not even enough that the advice be related directly to a specific securities transaction, although that is a start. Rather, the advice must be directly related to a specific transaction, and the transaction must drive the advice, rather than the other way around. In short, solely incidental advice in our view would sound something like this: "I've looked over your portfolio, and I think you're a little heavily concentrated in your company stock. I advise you to sell off half your shares of company stock and invest the proceeds in the following diversified portfolio of mutual funds ..."

Once it defines what is meant by solely incidental advice, the Commission should conduct a thorough review of the services being provided by brokers and should determine which are correctly classified as brokerage services and which cross the line into advisory services. As a further step, it should prohibit brokers from promoting brokerage services based

on the advice offered. Brokers would then be faced with a choice. They could continue to offer advisory services, but, in doing so, they would have to comply with the requirements of the Advisers Act. If they are not willing to accept regulation under the Advisers Act, then they would have the option of refraining from offering advisory services. If this approach were adopted, investors would be assured that, regardless of the nature of the firm offering advisory services, they would be entitled to the same level of investor protections.

III. The Commission continues to express greater concern for the rule's effects on brokers than for its effects on investors.

The current situation didn't arise by chance. On the contrary, it has evolved specifically because the Commission has been all too accommodating to the full service brokerage firms over the last few decades. Back in the late 1980s, for example, when the brokers first decided they needed to offer financial planning services to complete for retail clients, the Commission could and should have made clear that such services obviously exceeded the solely incidental advice that was excluded from the Advisers Act. In the early 1990s, when Shearson Lehman ads told investors to "[t]hink of your Shearson Lehman Financial Consultant more as an advisor than a stockbroker," the Commission could and should have put an end to misleading advertisements that portray salespeople as advisers. And as brokers began advertising their fee accounts based on the advice being offered, the Commission could have concluded that the advice must then be more than solely incidental. Instead, every time the full service firms tested the line, the Commission gave ground. The proposed rule currently under consideration is simply the latest example.

We are gratified that the Commission has finally committed to take formal action on this proposed rule. We are concerned, however, that the Commission continues to hint in its statements that changing course now would deal an unacceptably heavy blow to the brokerage firms that have been allowed to rely on the proposed rule for nearly five years. Specifically, the release reopening the comment period asks, "If the Commission determines not to adopt this rule as proposed, what would be the practical impact on broker-dealers?" This seemingly innocuous question invites the argument, which we have no doubt the Securities Industry Association and individual brokerage firms will make, that any change in the rules now would impose costly and disruptive changes on the firms' method of operations and must therefore be avoided. We categorically reject that argument, which rests on the notion that investor protection should play second fiddle to industry protection. This argument also underscores the Commission's imprudence in permitting brokers to rely on the rule, even before receiving public comments, and then delaying final action for almost five years.

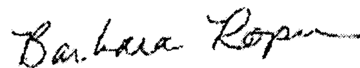
Furthering the impression that it favors retaining the rule is the Commission's failure to ask any comparable questions about the practical effects of the proposed rule on investors. One such question that needs to be answered is what has been the practical effect on investors of having financial professionals who are indistinguishable based on the titles they use and the services they claim to offer subject to two different standards of conduct. Another such question is what has been the practical effect on investors of having advisory services offered by brokers under a sales standard. Has it led investors to be misled about the nature of services offered or the basis for recommendations made by the broker? While the Commission does ask about the

adequacy of relying on disclosures that the accounts are brokerage accounts, there is no evidence that it has made any effort to determine whether investors, particularly the most vulnerable, unsophisticated investors, understand the difference between brokerage accounts and advisory accounts and the regulations that apply. Evidence from the recent mutual fund sales abuse scandals suggest that the answers to these questions would argue strongly against adoption of the proposed rule and for adoption of a meaningful functional distinction between advisory services and brokerage services.

IV. Conclusion

Through its inaction over a course of more than two decades, the Commission has all but erased the lines between brokerage services and advisory services. In order to rectify that situation, and ensure that application of appropriate investor protections is determined by the nature of the services provided and not by the nature of the firm providing the services, the Commission must as a first step scrap this ill-conceived rule. It must then quickly set about the more difficult task of defining an appropriate functional distinction between advisory services and brokerage services, analyze services currently being offered by brokers to determine where they fall along this continuum, and enforce the new standard. As a final step, the Commission must put an end to misleading brokerage firm ads and other practices that incorrectly portray salespeople as advisers and brokerage services as advisory services. Only then can it claim to have made the "nature of services provided" the key factor determining application of the Advisers Act.

Respectfully submitted,



Barbara Roper
Director of Investor Protection

May 6, 2003

The Honorable William Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Dear Chairman Donaldson:

The Consumer Federation of America,[1] Fund Democracy,[2] the Investment Counsel Association of America,[3] the Financial Planning Association,[4] Certified Financial Planner Board of Standards, Inc.,[5] and the National Association of Personal Financial Advisors[6] are writing to urge the Commission to give renewed consideration to a long-pending rule proposal that would inappropriately expand the broker-dealer exemption from the Investment Advisers Act. The Advisers Act excepts from the definition of "investment adviser" a broker or dealer "whose performance of advisory services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." In 1999, the Commission proposed that a broker-dealer would not be deemed an investment adviser based solely on its receipt of special compensation (such as fees based on managed assets) if it does not exercise investment discretion over the accounts from which it receives special compensation, any advice provided with respect to those accounts is solely incidental to brokerage services provided, and it employs

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[1] The Consumer Federation of America (CFA) is a nonprofit association of approximately 300 pro-consumer organizations. It was founded in 1968 to advance the consumer interest through advocacy and education.

[2] Fund Democracy is a nonprofit membership organization that acts as an advocate and information resource for mutual fund shareholders.

[3] The Investment Counsel Association of America is a not-for-profit association that represents the interests of investment advisory firms. Founded in 1937, the ICAA's membership today consists of about 300 SEC-registered companies that collectively manage in excess of $3 trillion for a wide variety of individual and institutional clients. See www.icaa.org for more information.

[4] The Financial Planning Association is the largest organization in the United States representing financial planners and affiliated firms, with approximately 29,000 members. Most FPA members are affiliated with investment adviser firms registered with either the SEC or state securities administrators, or both.

[5] Founded in 1985, Certified Financial Planning Board of Standards, Inc. (CFP Board) is a nonprofit professional regulatory organization that fosters professional standards in personal financial planning so that the public values, has access to, and benefits from competent and ethical financial planning. CFP Board currently authorizes more than 41,500 individuals to use its marks CFP® and Certified Financial Planner™ in the United States.

[6] NAPFA is the largest membership organization of independent, Fee-only, comprehensive financial advisors in the United States.

a disclaimer in advertising.

Although we approach this issue from very different perspectives, our organizations are united in our views: (1) that there are serious problems with the rule as proposed, and (2) that it is inappropriate for the Commission to continue to rely on the no action position it took, pending final adoption, when it issued the rule proposal more than three years ago.[7] We urge you to take up this issue without further delay.

Most of our organizations have submitted extensive and detailed comments to the Commission (copies of which are included in this packet) in response to the proposed rule. If you review those comments, you will see that, while we may disagree over various details, we agree on far more.

Most importantly, our organizations agree that, if the Commission wishes to rely on nature of services rendered rather than method of compensation as the key means of distinguishing between brokers and advisers, it must clarify what constitutes "solely incidental" investment advice by a broker-dealer. The recent blurring of lines between brokers and advisers, accelerated but certainly not initiated by the move toward fee-based broker compensation, has made action in this area imperative.

Emboldened by Commission inaction, brokerage firms aggressively advertise their services based on the advice offered and constantly seek to extend the reach of the solely incidental exemption, even to such clearly advisory services as financial planning. One result is that financial professionals who are indistinguishable to investors based on the titles they adopt, the way they market themselves, and the services they claim to offer are subject to very different regulatory regimes. Another result is that consumers are left in the dark about conflicts of interest that can exist, even with fee-based accounts, when those accounts are offered by a broker. Clearly, neither result is in investors' best interests.

The proposed rule combines this error of omission – failing to provide guidance on what constitutes solely incidental advice – with several errors of commission. These include its inconsistent treatment of discretionary accounts, its failure to rein in misleading advertising practices, and its weak advertising disclosure requirements. In revising the rule, we therefore urge you, at a minimum:

- to define what constitutes "solely incidental" advice by a broker and to do so in a way that is consistent with Congress' clear intent to limit the advice brokers can offer without triggering the protections of the Advisers Act;
- to require that all discretionary accounts be treated as advisory accounts, regardless of the method of compensation;

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[7] "Until the Commission takes final action on the proposed rule, the Division of Investment Management will not recommend, based on the form of compensation received, that the Commission take any action against a broker-dealer for failure to treat any account over which the broker-dealer does not exercise investment discretion as subject to the Act." Proposal at 4.

- to prohibit brokers who claim the "solely incidental" exemption from marketing their services as advisory services; and
- to require prominent disclosure of all material facts regarding any advice offered through the account, including but not limited to, the solely incidental nature of such advice.

Investor advocates and representatives of the investment adviser and financial planning communities are not alone in raising these concerns. These same issues were addressed by the state securities regulators in the North American Securities Administrators Association's comment letter on the proposed rule. Specifically, NASAA's comment letter: recommends that the Commission "set out factors for determining when advice is 'solely incidental;'" asserts NASAA's view that "all discretionary accounts of broker-dealers, regardless of how compensation is paid, should be treated as advisory accounts and subject the broker to the requirements of the Advisers Act;" and suggests that the Commission amend the proposed rule "to specifically preclude a broker-dealer from suggesting that the account is anything other than a brokerage account or that advisory services are also available."

We certainly understand that the Commission has had a full agenda of pressing matters to address in the past year and a half and that issues such as this were, of necessity, pushed to the back burner during that time. However, the Commission's no-action position on this issue cannot be allowed to stand indefinitely. We believe the time has come for the Commission to act. We look forward to working with you to achieve a final rule that ensures investors relying on financial professionals who offer investment advice will receive the vital protections Congress intended, regardless of whether the advice comes from a traditional money manager, a financial planner, or a broker.

We would greatly appreciate the opportunity to meet with you to discuss these issues in more detail. Meanwhile, thank you for your attention to our concerns.

Respectfully submitted,

Barbara Roper
Director of Investor Protection
Consumer Federation of America
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National Association of Personal
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603-569-1994

cc: Commissioner Cynthia Glassman
Commissioner Harvey Goldschmid
Commissioner Paul Atkins
Commissioner Roel Campos
Paul Roye, Director, Division of Investment Management
Cynthia M. Fornelli, Deputy Director, Division of Investment Management
Robert E. Plaze, Associate Director, Division of Investment Management

Consumer Federation of America

December 13, 2001

Harvey L. Pitt
Chairman
Securities and Exchange Commission
450 Fifth St., N.W.
Washington, D.C. 20549

Dear Chairman Pitt:

I am writing to you to seek your intervention on an issue before the Commission that I believe desperately needs a fresh viewpoint. The issue in question is the proposed rule on the broker-dealer exclusion from the advisers act. This is an issue of the highest priority for CFA, as it affects the most vulnerable of investors -- those who must rely on financial professionals for advice but who have little sophistication in judging the financial professionals who compete for their business.

Unfortunately, in developing its proposed rule, the Commission has been so focused on encouraging brokers to adopt fee-based forms of compensation (a goal we support) that it has failed to take into consideration the broader investor protection implications of its policy. The real issue is whether financial professionals who are indistinguishable to the average investor -- by virtue of the fact that they call themselves by the same titles and market themselves as providing the same services -- should continue to be regulated under very different standards. Clearly, that is not in investors' interests.

That said, we agree with the basic philosophy underlying the proposed rule, that method of compensation should not be, and was never intended to be, the primary factor determining whether a broker is also subject to regulation as an investment adviser. The primary test should be whether that broker provides advice that is more than merely secondary to product sales. If they do -- and just about all of the full-service brokerage firms advertise that they do -- then they are investment advisers, regardless of how they are compensated. Compensation only comes into play when the broker provides only advice that is solely incidental to product sales but nonetheless charges special compensation for that advice.

The problem is that the Commission has, to date, avoided the difficult job of defining what constitutes advice that is solely incidental, or merely secondary, to product sales. Instead, the commission has taken what up until now was the relatively easy way out, by using method of compensation as a convenient proxy in determining the application of the advisers act. The growth of fee-based compensation has forced a reevaluation, not because fee-based

compensation is by definition special compensation for advice, but because its growing use has forced the agency to come up with a new method for drawing a line between those financial professionals who are engaged strictly in securities sales and those who offer broader advisory services.

This reevaluation is long overdue. It should, for example, have been prompted when Shearson Lehman advertised itself in 1991 with a call to investors to "[t]hink of your Shearson Lehman Financial Consultant more as an advisor than a stockbroker." Or when then Merrill Lynch Chairman William A. Schreyer offered the following explanation to *Leaders* magazine for why the firm had decided to drop the title of "stock broker" in favor of a new title, "financial consultant":

> "The fact is that [the new title] reflects what they do. Back in the old days stock brokers sold stocks and bonds, and perhaps commodities. Today, we offer financial planning and profiling, packaged products, such as mutual funds, tax-advantaged retirement accounts, insurance, trust services, "wrap" fee accounts run by professional money managers, cash flow management and business valuation services for small business owners and self-employed professionals -- and this is just a small sample. So financial consultant more accurately reflects what we actually do for clients. It reflects a shift from a sales approach that is built around products to sell to a marketing approach built around profiling client needs."

While not all of the changes outlined by Schreyer reflect a transformation from salesperson to adviser, some clearly do. That transformation has only become more apparent over the last decade, as full-service brokerage firms have chosen to compete for retail clients by recasting themselves as financial advisers. Clearly, the firms have concluded that advice, not product sales, is what retail clients most want. While some of these changes have been beneficial, investors have not received the full potential benefits because brokers have been allowed to make the move toward increasingly advice-based services without also triggering the heightened fiduciary duty and disclosure requirements that go along with that role. And, with the issue finally coming to a head, the Commission has proposed a rule that ducks that central issue entirely.

Frankly, the proposed rule doesn't do a particularly good job on the question of compensation either. The question of what constitutes special compensation doesn't need a broad new rule because of the growth of fee-based compensation. Regardless of whether compensation comes in the form of commissions or fees, the question should be the same: is a portion of that compensation specifically identifiable as special compensation for advice. So, the fact that Prudential charges fees for its Prudential Advisor accounts should not automatically lead to the accounts' regulation under the advisers act. The fact that Prudential advertises that "you pay a fee for advice" should.

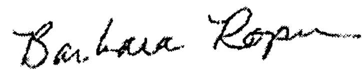
The point is that brokers haven't adopted fee-based compensation out of an altruistic desire to reduce conflicts of interest. Brokers have adopted fee-based compensation because it helps them to compete for clients who are looking primarily for advisory services. And they have promoted the accounts with that in mind. After all, the fee-based program at Prudential

isn't called "Prudential Broker," and the same ad that touts the fee for advice also states that "it's advice, not execution, that's at the heart of our relationships."

The question before you, then, is whether the Commission is going to perpetuate a system in which salespeople are free to promote themselves to clients as advisers without having to meet the fiduciary duty and disclosure requirements that accompany that role. So far, the Commission's proposals in this area have missed that central point. I hope that, by bringing a fresh viewpoint, you can get this issue back on the right track.

In case my somewhat long-winded letter has not already over-taxed your interest in this matter, I am enclosing a copy of CFA's initial comment letter on the proposed rule as well as a follow up letter we sent to Chairman Levitt. Let me know if I can be of assistance as you further develop your position on this issue.

Sincerely,



Director of Investor Protection
Consumer Federation of America

May 31, 2000

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

Re: Release Nos. 34-42009; IA-1845; File No. S7-25-99; Certain Broker-Dealers Deemed Not To Be Investment Advisers

Dear Mr. Katz:

The Consumer Federation of America[1], the Certified Financial Planner Board of Standards[2], the Investment Counsel Association of America[3], and the National Association of Personal Financial Advisors[4] submit the following group letter to supplement the comment letters our organizations submitted earlier on the proposed rule regarding the broker-dealer exclusion from the Investment Advisers Act. Although our organizations approach the issue from very different perspectives, we agree on a number of the key points related to the rule. We are writing to reiterate and reinforce those points and urge that they be incorporated into a rewrite of the rule proposal. Our failure to discuss here other issues mentioned in individual organizations' comment letters does not indicate any diminished concern regarding those issues.

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[1] The Consumer Federation of America (CFA) is a non-profit association of more than 260 pro-consumer organizations which in turn represent more than 50 million individual consumers. CFA was founded in 1968 to advance the consumer interest through advocacy and education.

[2] Founded in 1985, the Certified Financial Planner Board of Standards, Inc. (CFP Board) is a non-profit professional regulatory organization whose mission it is to benefit the public by fostering professional standards in personal financial planning. The CFP Board owns the marks CFP and Certified Financial Planner and the CFP design mark and licenses individuals who meet its certification standards to use them. The CFP Board also serves as an educational resource to federal and state lawmakers and regulators on personal financial planning issues.

[3] The Investment Counsel Association of America (ICAA) is a not-for-profit trade association that exclusively represents the interests of federally registered investment advisory firms. Founded in 1937, the ICAA today consists of more than 250 firms that collectively manage in excess of $2 trillion for a wide variety of individual and institutional clients. For more information, please see www.icaa.org.

[4] The National Association of Personal Financial Advisors was founded in 1983 based on the principal that third party payments for client services created conflicts of interest. NAPFA has taken a strong supportive role in advocating consumers' rights to obtain unbiased assistance in making important financial decisions. The 650 member professional organization adheres to strict membership criteria including a peer review process, a fiduciary oath, principles of full disclosure and continuing education standards. NAPFA is headquartered in Buffalo Grove, IL.

Instead, our purpose in this letter is to point out the broad consensus for changes to the current rule proposal in the following three areas.

1. **The Commission must clarify what constitutes "solely incidental" investment advice by a broker-dealer.**

In the 60 years since the Investment Advisers Act was adopted, the Commission has provided little meaningful guidance on what it means for a broker to provide investment advice that is "solely incidental to the conduct of his business as a broker or dealer." At the time the law was written, it may have been reasonable to assume that the differences between broker-dealers and investment advisers were so obvious to the average investor that they needed no further legal clarification. Since then, however, dramatic changes have swept the financial services industry, blurring those once clear distinctions. Recent changes in brokerage compensation structures -- despite the benefits they may offer in reducing potential conflicts of interest -- serve to confuse the picture further. An average investor today would be hard-pressed to distinguish a broker-dealer from an investment adviser based, at least, on how they present themselves and describe their services to clients.

In light of these developments, our organizations believe strongly that the Commission can no longer afford to ignore its responsibilities in this area. It must clarify what advisory activities by broker-dealers will be considered solely incidental to sales transactions and what activities will be subject to regulation under the Advisers Act. Further, the Commission must continue to update those guidelines as the full service brokerage industry evolves and changes. We recognize that this will not be a simple task, but it is an important one. First and foremost, it will determine whether the advisory clients of broker-dealers receive the legal protections appropriate to that relationship. Second, it will provide a clear basis for distinguishing between the services offered by brokers and investment advisers that can then be relied on with confidence by compliance departments and, as an added benefit, can be used in educating investors about the differences between these two types of financial professionals.

2. **All discretionary accounts should be treated as advisory accounts, regardless of the method of compensation.**

In perhaps its most glaring inconsistency, the rule proposal would treat fee-compensated discretionary accounts as advisory accounts while continuing to treat commission-compensated discretionary accounts as brokerage accounts. Our organizations believe strongly that these two types of accounts should be treated alike. A broker-dealer with discretionary authority is entrusted with responsibility for selecting the securities to buy and sell on behalf of an account without first obtaining the investor's consent. By definition, then, the investment advice offered through a discretionary account cannot be considered "solely incidental" to the execution services. The fact that the broker receives no special compensation for advice becomes irrelevant when the advice is more than solely incidental. Indeed, in a recent speech, Paul F. Roye, Director of the SEC's Division of Investment Management, agreed that this "anomaly" in the rule proposal

"does not make sense to me ..."[5]

3. Broker-dealers who claim the exclusion should be precluded from marketing their services as advisory services.

It seems self-evident that brokers who claim an exclusion from the Advisers Act based on the notion that any advice they offer is solely incidental to sales transactions should not be able to turn around and advertise those same services as primarily advisory in nature. Our organizations believe strongly, therefore, that the rule should be amended to preclude brokers who claim the exclusion from marketing their accounts as advisory accounts or based on the advisory services provided.

We also recognize that such distinctions will not always be simple and that broker-dealers can be expected to test the boundary, that is, to come as close as they can to portraying the accounts as advisory accounts without actually crossing the line. To help combat any confusion that may arise as a result, our organizations believe mandatory disclosures in advertisements must be prominent and must make a clearer, stronger statement than that suggested in the rule proposal. Thus, we applaud Mr. Roye's suggestion that the Commission is "considering more specific disclosure requirements for the final rule."[6] A simple statement that the account is a brokerage account will not be meaningful to the average investor. The disclosure must make clear that any investment advice provided through the account is merely secondary to sales transactions. The SEC and others will need to reinforce this message with an educational campaign designed to alert investors to the differences between brokers and investment advisers.

It is worth noting that all three of these points are also raised by the North American Securities Administrators Association in its comments on the rule proposal. Specifically, NASAA's comment letter includes the following relevant statements:

- "NASAA recommends that the Commission set out factors for determining when advice is 'solely incidental.'"
- "Discretionary authority allows a broker-dealer to execute trades without first obtaining the client's consent. Under such circumstances, the broker is performing the essential functions of an adviser and should be treated as such. NASAA believes all discretionary accounts of broker-dealers, regardless of how compensation is paid, should be treated as advisory accounts and subject the broker to the requirements of the Advisers Act."
- "Several states' laws provide that if a person holds out in any manner as providing advisory services or otherwise suggests through marketing that advisory accounts are

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[5] *2000 and Beyond: SEC Priorities for the Investment Adviser Profession*, Remarks by Paul F. Roye, Director, Division of Investment Management, SEC, Before the Investment Counsel Association of America (April 6, 2000).

[6] *Id.*

> available then such persons are treated as investment advisers. This approach creates a level playing field for offering advisory services between broker-dealers and investment advisers and narrows the confusion factor for investors ... We would recommend that the Commission consider revising the proposed language of 202(a)(11)1(a)(3) to specifically preclude a broker-dealer from suggesting that the account is anything other than a brokerage account or that advisory services are also available."

* * *

In short, while there may be other areas where we disagree over details, there is a strong consensus among investor representatives, the investment adviser and financial planning communities, and state securities regulators that these three areas should, at a minimum, be addressed. We urge you to take these concerns into account as you review and revise the rule proposal.

Again, we appreciate your attention to our concerns. Please feel free to contact any or all of us individually if you have questions or if we can be of additional assistance.

Respectfully,

Barbara Roper
Director of Investor Protection
Consumer Federation of America
(719) 543-9468)

Robert P. Goss, CFP
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Consumer Federation of America

February 28, 2000

Arthur Levitt
Chairman
U.s. Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

Since CFA submitted its comments on the proposed rule regarding the broker-dealer exclusion from the Investment Adviser Act, we have had a chance to review some of the other comment letters submitted. Despite the fact that widely diverging opinions were expressed on the merits of the rule proposal, we believe there is a way to produce a final rule that could satisfy the key concerns of brokers, investment advisers and financial planners, and investors.

Although different parties want different things out of the rule proposal, their objectives are not necessarily incompatible. Brokers want an assurance that they can adopt fee-based compensation without automatically being regulated as investment advisers. Investment advisers and financial planners want to know that they will not be subject to unfair competition from brokers who market themselves as advisers without having to meet the higher standard of conduct that implies. And investors want a clear standard that ensures that all those who hold themselves out as offering investment advice are subject, among other things, to a fiduciary duty to place clients' interests ahead of their own and to disclose any and all conflicts of interest.

One reason we believe it should be possible to reconcile these concerns is that there seems to be broad consensus on two issues that are central to the rule proposal:

1) that the nature of services rendered should be the primary factor that determines when a broker will also be regulated as an investment adviser; and

2) that brokers should be free to offer fee-based services without automatically triggering regulation as investment advisers.

Using these principles as a starting point, we offer the following suggestions on how to adapt the rule proposal to meet the key objectives outlined above.

I. Allowing fee-based compensation without undermining the special compensation test for the broker-dealer exclusion.

As we discussed in our comment letter, we do not believe that receipt of non-commission compensation for brokerage services should automatically trigger regulation as an investment adviser. Where the rule proposal goes wrong, in our view, is in equating fee-based compensation for brokerage services with special compensation for advice. Once that step has been taken, the Commission can only exclude fee-compensated brokers from the investment adviser definition if it compromises the special compensation test for the exclusion.

The comments of the Securities Industry Association offer a helpful starting point for resolving this issue. The SIA suggests that references to "special compensation" in the rule proposal be changed to "compensation other than brokerage commissions." By removing the language that equates fee-based compensation with special compensation for advice, the Commission can maintain the integrity of the special compensation test for the exclusion while clarifying that brokers will not be regulated as investment advisers solely because they adopt non-traditional compensation arrangements.

At the same time, the Commission can and should reiterate the position it has taken in previous interpretations of the statute, that, in determining whether a broker has received special compensation for investment advice, "the essential distinction ... is ... between compensation for advice itself and compensation for services of another character to which advice is merely incidental." In keeping with this interpretation, brokers would be free to adopt fee-based compensation arrangements for traditional brokerage services, of which investment advice is an incidental component, without being regulated as investment advisers. On the other hand, brokers who offer more than incidental advice or who charge fees that they specifically identify as fees for advice would be precluded from relying on the exclusion.

II. Defining the differences between brokerage services and investment advice.

For such an approach to work, the Commission must define what it means for a broker to offer investment advice that is "solely incidental to the conduct of his business as a broker or dealer." Having acknowledged that the nature of services offered should be the primary factor that distinguishes a broker from an investment adviser, however, the Commission has unfortunately provided almost no guidance on this central issue. This is particularly troubling in light of the dramatic changes that have swept the securities industry over the last several decades, blurring the lines between investment advisers and brokers. With changes in compensation structures further confusing these distinctions, the Commission can no longer ignore its responsibilities in this area.

Instead of clarifying what if means for a broker to offer incidental investment advice, the rule proposal seems to take it on faith that the advisory services being offered by full-service brokers today qualify for the exclusion. We believe the issue requires greater attention before such a sweeping conclusion can be drawn. We therefore urge the Commission to undertake a study that examines the nature of investment advice being offered by full-service brokers. Based on the results, the Commission should issue clear guidelines on what constitutes "incidental" investment advice by brokers and what crosses the line into full-fledged investment advice.

As it undertakes that study, the Commission should keep the following questions at the center of its deliberations:

- Do full-service brokers limit themselves to advice that is "merely incidental to brokerage transactions?"

- What is the primary service being marketed by full-service brokers -- advice or transactions?

- Are investors able to distinguish between the incidental advice offered by brokers and that offered by investment advisers and financial planners?

- What services offered by brokers can be adequately regulated under a sales standard?

- What services offered by brokers should be subject to the heightened fiduciary duty that applies to investment advice?

We believe such a study will lead the Commission to conclude that many full-service brokers today offer investment advice that goes far beyond the incidental advice Congress intended to exclude from regulation under the advisers act. If the Commission concludes, however, that full-service brokers today are limiting themselves to incidental advice, it has another question to explore: are brokers accurately portraying the services they offer to customers? Put another way, if brokers offer investment advice that is "merely incidental to brokerage transactions," should they be allowed to market themselves as if the primary service they offer is advice?

It is this issue which is central to investment advisers' and financial planners' concerns about unfair competition and to investors' concerns about a lack of reglatory uniformity. The Commission can address those concerns by limiting the ability of brokers to rely on the exclusion when they offer extensive investment advice and by reigning in advertising that exaggerates the degree of advice offered. Brokers will then have a choice, either to offer the advice-driven services they seem to believe clients want and register as investment advisers or refrain from offering such services and retain their exclusion from the advisers act. We do not expect brokers to relish making such a choice, since they are currently being given the best of both worlds. However, we do believe this is a fair and reasonable approach that is consisent with the law and that promotes investor interests.

We hope these comments are helpful to you as you consider this rule proposal. Please feel free to contact me directly (at 719-543-9468) if you have additional questions of if I can be of any assistance.

Sincerely,

Barbara L. N. Roper
Director of Investor Protection

Consumer Federation of America

January 13, 2000

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

Re: File No. S7-25-99
Certain Broker-Dealers Deemed Not To Be Investment Advisers

Dear Mr. Katz:

The Consumer Federation of America[1] appreciates this opportunity to comment on the Commission's proposed rule regarding broker-dealer's exclusion from the Investment Advisers Act. We agree that new developments in the brokerage industry -- including changes in broker-dealers' compensation methods -- make it appropriate to reexamine their exclusion from the Advisers Act. We also share the Commission's conviction that investors will benefit if broker-dealers can be encouraged to compensate their sales representatives in ways that minimize conflicts of interest. However, we do not support this proposed rule as a means of accomplishing that goal.

The Commission proposes to allow brokers who receive "special compensation" for investment advice to qualify for the broker-dealer exclusion, so long as the advice offered is "solely incidental" to the conduct of the broker-dealer's primary business, the advice is provided on a non-discretionary basis, and the broker-dealer discloses to clients that the account is a brokerage account. We believe this proposal conflicts with legislative language, reverses the Commission's own past interpretations of that language, and does so in a way that could have negative repercussions for investors beyond the issues raised in this particular rule proposal. The rule proposal is particularly troubling in light of the Commission's failure to enforce the exclusion's requirement that any advice be solely incidental to the broker-dealer's primary business, a failure that has left receipt of special compensation as virtually only test for the broker-dealer exclusion. Finally, by pursuing a different approach, the Commission could accomplish its goal of allowing new compensation practices without these potentially negative consequences for investors.

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[1] The Consumer Federation of America (CFA) is a non-profit association of more than 260 pro-consumer groups founded in 1968 to advance the consumer interest through advocacy and education.

I. Changing conditions in the financial services industry necessitate a new analysis of the broker-dealer exclusion.

The full service brokerage industry today finds itself at a crossroads. For two decades, full service firms have faced growing competition both from traditional investment advisers and from the financial planning industry, whose claim to offer comprehensive, objective financial advice has been an attractive selling point with the public. More recently, upstart on-line brokerage firms, with their rock bottom prices and high level of convenience, have begun to offer serious competition for self-directed investors. The result is that full service firms are being pulled in two very different directions. On the one hand, they must seek to satisfy those investors who want to complete their transactions quickly and conveniently at the lowest possible price. On the other hand, they must continue to attract those customers who want objective, professional financial advice.

Full service firms have adopted a number of strategies to compete for advice-seeking customers -- selling wrap accounts and offering computerized financial plans, for example. For more than a decade, however, their primary competitive strategy has consisted of aggressively marketing themselves to the public as if the principle service they offered were objective financial advice. While those campaigns would appear to have been at least partially successful, the firms' commission-based system of compensation conflicted with the image they were attempting to convey. Driven by a number of factors, then -- not least Chairman Levitt's leadership in raising issues of compensation-related conflicts of interest -- several full service firms have recently adopted fee-based services. In these programs, brokerage services are offered for a fixed fee or fee based on the amount of assets on account with the broker-dealer rather than being compensated through traditional commissions, mark-ups, and mark-downs. Meanwhile, to compete for self-directed investors, many of these same full service firms have begun to offer their own on-line execution-only services at reduced commission rates.

These new forms of compensation naturally raise questions about whether broker-dealers can be said to be earning "special compensation" for investment advice and whether they should therefore be subject to the Investment Advisers Act. It is these questions that the current rule proposal is designed to address. Specifically, the Commission has concluded that broker-dealers who adopt fee-based services and who charge lower commissions for on-line execution-only services are receiving special compensation for investment advice. In order to permit them to do so without triggering coverage under the Advisers Act, the proposed rule would eliminate receipt of special compensation for advice as an absolute test that precludes a broker-dealer from relying on the exclusion.

CFA does not share the Commission's interpretation that the compensation practices described in the rule proposal necessarily constitute special compensation for advice. Even if we did share that interpretation, we would not support this rule proposal as the best way to address that issue.

II. New compensation methods can be accommodated within the existing broker-dealer exclusion.

When Congress adopted the Investment Advisers Act in 1940, it offered an exclusion from the definition of investment adviser -- and thus from the regulatory requirements of the act -- to any broker or dealer "whose performance of [advisory] services is solely incidental to the conduct of his business as

a broker or dealer and who receives no special compensation therefor."[2] In crafting this exclusion, Congress made it clear that they did not want all broker-dealers to be subject to the Advisers Act simply because they recommend the purchase and sale of securities. On the other hand, Congress made it equally clear that broker-dealers should not automatically be excluded from the act simply because they are already regulated as brokers. Specifically, Congress stipulated that broker-dealers should be subject to the Advisers Act under either of the following circumstances:

- they offer investment advice beyond that which is incidental to their regular business of effecting transactions in securities; or

- they receive special compensation for offering advice, even if the advice for which they are compensated is solely incidental to their regular business.

This language raises two questions, both of which are pertinent to the issues currently under consideration by the Commission. 1) What does it mean for a broker to offer investment advice that is "solely incidental" to its regular business? And 2) What constitutes special compensation for investment advice? In providing guidance on Congress's intent, the Senate Committee on Banking and Currency specified that the exclusion was available to brokers only "insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions."[3] It is clear from this explanation both that Congress intended only a very narrow exclusion for broker-dealers and that Congress viewed the primary business of broker-dealers to be effecting transactions, not offering advice.

It appears to be this early Senate report language, rather than the legislative language itself, which has led to the focus on method of compensation in determining broker-dealers' right to rely on the exclusion. We do not believe, however, that this reference by the committee to "brokerage commissions" was intended to distinguish between commission-based compensation for brokerage transactions and fee-based compensation for the same transactions. Rather, it simply reflects the fact that, at the time the law was passed, broker-dealers were compensated for selling securities through commissions.

In an early decision on a related issue, the Commission reached the same conclusion. Shortly after the law passed, a question arose about "the status under the Investment Advisers Act of 1940 of over-the-counter brokers who charge an 'overriding commission' or 'service charge' on transactions involving the purchase or sale of listed securities through correspondent brokers who are members of a national securities exchange."[4] Because these over-the-counter brokers were being compensated

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[2] Section 202(a)(11)(C) of the Advisers Act.

[3] Committee on Banking and Currency, U.S. Senate, Investment Company Act of 1940 and Investment Advisers Act of 1940, Report No. 1775, 76th Congress, 3rd Session (June 6, 1940), pg. 22.

[4] Opinion of General Counsel Relating to Section 202(a)(11)(C) of the Investment Advisers Act of 1940, Investment Advisers Act Release No. 2 (Oct. 28, 1940), pg. 1. ("SEC Rel.

through something other than standard "brokerage commissions," and because the compensation covered, at least in part, their advice with regard to those transactions, there was a question as to whether they were receiving "special compensation" for advice and thus should be subject to the Advisers Act. In deciding the matter, then SEC General Counsel Chester T. Lane made it clear that it was not the method of compensation that was the determining factor. Rather, he suggested:

> "The essential distinction to be borne in mind ... is the distinction between compensation for advice itself and compensation for services of another character to which advice is merely incidental."[5]

We believe this interpretation both accurately reflects the intent of Congress in crafting the broker-dealer exclusion and offers a model for determining how that exclusion relates to new compensation structures.

Following this reasoning, the first question the Commission should ask itself in deciding whether broker-dealers offering fee-based services should be excluded from the Advisers Act is whether the broker-dealer in question is offering investment advice through its fee-based program that fits within the solely incidental exclusion. In other words, is the advice being offered "merely incidental to brokerage transactions?"[6] If this is *not* the case -- if the broker-dealer is offering investment advice that goes beyond merely recommending the purchase and sale of securities -- then that broker-dealer is not offering "solely incidental" advice, as that phrase was meant by Congress, and is not entitled to rely on the exclusion, regardless of the method of compensation.[7]

No. IA-2.")

[5] Ibid., pg. 3. In elaborating on that interpretation, Lane concluded that a broker who "charges the overriding commission or service charge in every instance in which he transmits such an order to a member broker," and whose additional charges are "the same for all transactions of the same size, no matter who the customer is or how much consultation or advice the over-the-counter broker has given him," would be free to rely on the broker exclusion. His basis for drawing that conclusion was that, "[w]hile the time and expense involved in giving advice to customers may be among his motives for charging the overriding commission or service charge, they represent only one part of his general expenses, and are no more directly related to the charge which he makes than is similar advice given customers with respect to over-the-counter transactions for which the broker receives a regular commission."

[6] It is worth noting, in this context, that Congress specified that the advice had to be secondary to the transaction. It is not enough that the advice be generally related to the broker's primary business of effecting transactions. And, certainly, if the advice is the primary service being sold, it would not qualify as solely incidental.

[7] This is the same test that should apply to broker-dealers that charge commissions for their services. Being compensated by commissions should not automatically qualify the broker-dealer for the exclusion. The special compensation test is in addition to the solely incidental test, not a substitute for it.

If, on the other hand, the broker-dealer is offering only advice that is "merely incidental to brokerage transactions," the fact that a fee is charged rather than a commission should not automatically lead the Commission to conclude that "special compensation" has been received. Instead, the Commission should look at whether the fee is being charged for "advice itself" or for effecting transactions in securities, "to which advice is merely incidental."[8] As part of that determination, the Commission should follow Lane's example and examine: 1) whether the charges are "the same ... no matter who the customer is or how much consultation or advice" is provided and 2) whether there is any greater relation between the advice and the fee than there is between the advice and a standard brokerage commission.[9] If the fee charged is for effecting transactions in securities, and if it is applied uniformly to all customers in the fee-based program regardless of the level of advice offered the client, then the broker who offers a fee-based service should not be precluded from relying on the broker-dealer exclusion from the Advisers Act simply because of its method of compensation.[10]

The Commission should apply a similar deliberative process to brokers who charge lower commissions for on-line execution-only services. In this case, the question the Commission should ask is whether the key factor determining the difference in commission levels is the investment advice offered the customer who deals with a registered representative. The Commission appears to have concluded that investment advice is the key differential. We do not agree that this is typically the case. The proof can be found in the fact that the customer who deals with a registered representative typically pays the same higher commission regardless of whether he initiates the trade or the broker makes a recommendation. Thus, it would appear that it is the privilege of dealing with a personal representative -- and the time that representative must spend servicing the account -- that justifies the higher commissions in most such cases.[11]

III. The proposed rule is ill-advised and could be harmful to investors.

As we have described above, we do not believe the proposed rule is necessary to permit broker-dealers to adopt new compensation methods without losing their Advisers Act exclusion. Even if the Commission rejects our analysis on this point, however, it should not pursue this proposed rule. The rule conflicts with the legislation it is intended to implement; it does not offer adequate additional protections in limiting the "special compensation" test under the broker-dealer exclusion; and it would undermine important investor protections by freeing broker-dealers to charge their clients for

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[8] SEC Rel. No. IA-2, pg. 3.

[9] Ibid., pg. 2.

[10] Charging a lower percentage rate to customers with a higher level of assets on account would not constitute special compensation, since the difference in fee is not determined by the level of advice offered. If anything, the higher asset customer will require more advice, not less.

[11] If, on the other hand, a broker-dealer charged lower commissions for all execution-only services -- regardless of whether they are conducted on-line or through a registered representative -- then the Commission would be justified in concluding that the provision of advice was the key factor determining the different commission rates. In that case, the broker-dealer would clearly be receiving "special compensation" for advice and should therefore be subject to the Advisers Act.

investment advice without being regulated as advisers.

A. The proposed rule conflicts with the law it is intended to implement.

As we have noted above, Congress clearly intended to provide broker-dealers with only a very narrow exclusion from the Advisers Act, an exclusion that was not to be made available to any broker-dealer who receives special compensation for offering investment advice. From its earliest days, the Commission has supported this interpretation of the act's language regarding special compensation. In 1940, for example, the Commission issued a release stating that: "... that portion of clause (C) which refers to 'special compensation' amounts to ... [a] clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities."[12] More recently, the Commission has concluded that if "a clearly definable part" of commissions received by the broker can be identified as compensation for investment advice, the broker is deemed to have received "special compensation" for advice and thus loses the right to claim the exclusion.[13]

In this proposed rule, the Commission has done an about face and now suggests that broker-dealers should, under certain circumstances, be allowed to receive special compensation for advice without being subject to regulation under the Advisers Act. However, the Commission cannot rewrite the law through the rule-making process, and should not attempt to do so. If, contrary to our analysis, the Commission determines that brokers who offer fee-based services or who charge lower commissions for on-line execution-only services are by definition receiving "special compensation" for advice, it has no choice but to implement the law as written and regulate those brokers as investment advisers or seek a legislative solution.[14]

B. The proposed rule does not offer adequate protections to substitute for the "special compensation" test.

For some time, the receipt of special compensation has been the primary characteristic

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[12] SEC Rel. No. IA-2, pg. 3.

[13] Both SEC Rel. No. IA-1092 and *Investment Adviser, Financial Planners, and Others -- An Overview of the Investment Advisers Act of 1940*, by Robert E. Plaze, Division of Investment Management (undated), refer to the conclusion reached by SEC staff in Robert S. Strevel (pub. avail. Apr. 29, 1985) that "brokerage commissions generally would not constitute special compensation unless a clearly definable part of the commission is for investment advice (emphasis added). Rel. No. IA-1092, footnote 12. Plaze, pg. 6.

[14] CFA would strongly oppose legislation to eliminate the special compensation test for the broker-dealer exclusion from the Advisers Act. Our point here is simply that the special compensation test is embedded in the law itself and, thus, it cannot be changed through the rule-making process. Legislation is necessary to change the law.

determining whether a broker-dealer could rely on the exclusion from the Advisers Act.[15] The proposed rule now suggests that "the nature of the services provided," rather than the receipt of special compensation, should be "the primary feature distinguishing an advisory account from a brokerage account."[16] While we agree that the nature of services offered should be a determining factor, the proposed rule does not follow this idea to its logical conclusion and clearly specify what types of activities should qualify for the exclusion and what should not. Instead, the rule proposal suggests only one type of account that would not qualify for the exclusion, discretionary accounts that are charged an asset-based fee.

Problems abound with this approach. Not least is the inconsistency with which it applies the "special compensation" test for the exclusion. Brokers who charge an asset-based fee to operate a discretionary account would be subject to the Advisers Act, because those accounts "bear a strong resemblance to traditional advisory accounts," while brokers who offer the identical services for commissions would be excluded from the act because they receive no "special compensation" for advice.[17] [18] But, if the nature of services offered, rather than the compensation method, is to be the primary feature distinguishing an advisory account from a brokerage account, then these two accounts should clearly be treated the same.[19] As written, the rule proposal creates the strong impression that, while receipt of special compensation does not always preclude a broker-dealer from relying on the exclusion, failure to receive special compensation automatically permits the broker-dealer to rely on the exclusion. This is clearly the exact opposite of what Congress intended.

The real problem, as the above example helps to demonstrate, is that the Commission has failed to clarify what does and does not constitute solely incidental advice. Worse, the Commission has over at least the last decade allowed broker-dealers virtually free reign to abuse this provision of the exclusion. An early example can be found in an old Shearson-Lehman ad, which told the reader to "Think of your Shearson-Lehman Financial Consultant more as an advisor than a stockbroker."[20] But one need not look so far back to find examples of how brokers market themselves to the public as if the primary service they had to sell were advice.

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[15] Plaze, pg. 6.

[16] Proposed Rule S7-25-99, pg. 5.

[17] Ibid.

[18] This would have the perverse effect of affording investors stronger protections when brokers use compensation systems that more closely align their interests with their customers' than those same investors would receive when the compensation system creates substantial conflicts of interest.

[19] Specifically, they should both be treated as advisory accounts, because they involve an extraordinary degree of reliance by the investor on the broker-dealer's advice. Advice in such circumstances is not, or should not be, merely incidental to sales transactions.

[20] See attached ad taken from the June 5, 1991 issue of *The New York Times*.

- A current Merrill Lynch ad quotes a Leading Discount Broker's Investment Tip # 3, "For some investors, particularly those with a large or complex portfolios who want on-going investment management, the services of a fee-compensated financial advisor may be appropriate," then concludes, "Amen."[21]

- A Morgan Stanley Dean Witter ad is headed with a quote from Proverbs, "A wise man listens to advice." The ad then continues: "Usually, when you buy a mutual fund, all you get is a mutual fund. But when you buy a Morgan Stanley Dean Witter mutual fund, you get something extra: sound financial advice. Because our funds are only available through our Financial Advisors. Before making any recommendations, they'll first help you identify your financial goals, then give you tailored advice to help you meet them."[22]

- A Prudential Securities ad proclaims that "it's advice, not execution, that's at the heart of our relationships ..."[23]

It is difficult to conclude from these ads that any advice being offered is "merely incidental to brokerage transactions." In short, either these broker-dealers are offering advice that far exceeds the "solely incidental" advice that Congress envisioned as qualifying for the broker-dealer exclusion, or they are misrepresenting their services to investors.

Traditionally, broker-dealers have argued that -- their advertisements to the contrary -- they do not in fact offer anything more than solely incidental advice. Therefore, they argue, they should be regulated according to what they actually do, not according to how they market their services. We disagree. The Commission has interpreted that such "holding out" to the public would preclude an accountant or attorney from relying on their solely incidental exclusion, since it creates the appearance that the investment advice is more than solely incidental.[24] Unfortunately, the Commission has not taken a similar position on holding out by brokers, where, as the above examples demonstrate, the potential for confusion is enormous and the need for action is pressing. Instead, the Commission has maintained that broker-dealers can hold themselves out to the public as financial planners or advisers, as

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[21] See attached ad taken from the December 15, 1999 issue of *The Wall Street Journal.*

[22] See attached ad taken from the October 1999 issue of *Smart Money*.

[23] See attached ad taken from the February 2000 issue of *Kiplinger's Personal Finance.*

[24] SEC Rel. No. IA-1092 states on page 12, "The staff's view is that the exclusion contained in Section 202(a)(11)(B) is not available, for example, to a lawyer or accountant who holds himself out to the public as providing financial planning, pension consulting, or other financial advisory services. In such a case it would appear that the performance of investment advisory services by the person would not be incidental to his practice as a lawyer or accountant." In *Investment Advisers, Accountants, and Others*, Plaze elaborates on the same question, as follows, "The key determination under this exception is whether advice is provided solely incidental to the profession, and the staff looks to the following factors: does this person hold himself out to the public as an advisor or financial planner or as providing pension consulting or other financial advisory [services] -- if so, the exception is not available." (Plaze, pg. 6)

long as they only offer advice in their capacity as registered representatives and don't receive special compensation for advice.[25] Under the proposed rule, broker-dealers would get a new benefit. They could hold themselves out to the public as advisers, they could offer advice or claim to offer advice that clearly exceeds that which Congress intended to exclude from the Adviser's Act, they could charge their customers a fee that they identify as being a fee for advice, and they would still be regulated as salespeople. This is so clearly inappropriate it is difficult to see how the Commission could even propose it.

The Commission does raise this issue in the rule proposal when it notes that: "Some broker-dealers offering these new accounts have heavily marketed them based on the advisory services provided rather than the 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."[26] Certainly this is the case in the Merrill Lynch ad mentioned above and even more so in the Prudential Securities ad for its Prudential Advisor℠ program, which states, "Get personal advice without the traditional sales commission. With Prudential Advisor℠ ... you pay a simple asset-based fee for the advice you get and a low price for trades."[27] When the primary service being sold in a broker-dealer's ad is advice, and when the ad specifies that the fee you pay is for advice, of course investors will expect that advice is more than just an incidental sideline to the broker-dealer's primary sales business.

Therefore, if the Commission proceeds with this rule proposal, it should, at a minimum, preclude advisers from relying on the rule if they market the accounts in ways that suggest they are advisory accounts. However, the problem is broader than the rule proposal suggests, and the solution should be as well. What is really needed is for the Commission to apply the same standards to brokers that it applies to accountants who wish to rely on their solely incidental exclusion from the Advisers Act: it should clarify that brokers who hold themselves out to the public as advisers or as providing advisory services will be regulated under the Advisers Act.[28]

Although the rule proposal includes a disclosure requirement designed to ensure that investors understand the nature of the account being offered and not confuse it with an advisory account, that requirement cannot adequately substitute for enforcement of the solely incidental portion of the exclusion. Based on our understanding of the knowledge and sophistication of the average investor, we are convinced most investors will not understand the significance of the disclosure. Specifically, we do not believe the average investor understands that a brokerage account is not an advisory account and that a broker is not an adviser. Certainly, they cannot be expected to understand this fact if the ad the

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[25] Plaze, pg. 7. "The SEC staff has stated that a registered representative who holds himself out to the public as a financial planner cannot rely on the broker-dealer exception *unless he receives no special compensation therefor and gives investment advice solely in his capacity as a registered representative.*" (Emphasis added.)

[26] Proposed Rule S7-27-99, pg. 5.

[27] See attached ad.

[28] The Commission should also examine these claims about the advisory services being offered to determine whether they are misleading.

disclosure is required to accompany either strongly implies or specifically states that the broker is an adviser and that the primary service being offered is advice.

If disclosure is to have a hope of being effective, then, it must clearly spell out the fact that any advice being offered is solely incidental to sales transactions and that it is not subject to a requirement that the salesperson place the client's interests ahead of his or her own. Even if the disclosure requirement were strengthened, however, we do not believe that disclosure alone offers adequate protections against misrepresentation and the investor confusion that inevitably results. Such a disclosure, no matter how prominent, cannot begin to outweigh the expectations raised by multi-million-dollar ad campaigns of the type described above.

C. The proposed rule would undermine investor protections by freeing brokers to offer investment advice for compensation without being regulated as advisers.

While the Investment Advisers Act of 1940 is a minimalist law, it does afford investors some important protections. At the heart of the act is "the notion that an adviser owes its clients a fiduciary obligation which is intended to eliminate conflicts of interest and to prevent the adviser from overreaching or taking unfair advantage of a client's trust."[29] As a fiduciary, the investment adviser "is held to something stricter than the morals of the market place. Not honesty alone but the punctilio of an honor the most sensitive, is then the standard of behavior."[30] This is clearly a far higher standard of conduct than that contained in the "suitability rule" that governs broker-dealers' sales recommendations. Similarly, the Advisers Act imposes an obligation to disclose material information -- such as the existence of conflicts of interest that may bias the adviser's recommendations, prior disciplinary problems that may reflect on the adviser's integrity, as well as extensive information regarding how the adviser conducts his or her business -- to which broker-dealers are not subject.

CFA believes that the broker exclusion crafted by Congress is a good one. Like the members of Congress who overwhelmingly approved it, we believe broker-dealers who are compensated as advisers should also be regulated as advisers, as should broker-dealers who offer advice that goes beyond simply recommending the purchase and sale of securities. The proposed rule offers no justification for holding broker-dealers to a lower standard of conduct when they offer advice that exceeds these limitations than the standard their competitors in the investment advisory and financial planning industries must meet. We believe such a distinction is unjustified and will result in harm to investors, particularly if broker-dealers remain free to compete by portraying themselves as advisers while being regulated as salespeople.

IV. Conclusion

Market forces are increasingly forcing broker-dealers to compete as investment advisers. This has the potential to benefit investors who want recommendations that are more than merely suitable and who want advice that is more than merely incidental to a sales transaction. Investors will only benefit,

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[29] Plaze, p. 14.

[30] Justice Cardozo's opinion in Meinhard V. Salmon, 249 N.Y. 458, as cited in Plaze, p. 15.

however, if the increasingly advice-driven services offered by full service brokers are held to an advisory standard -- particularly a fiduciary duty to place clients' interest ahead of their own and an accompanying responsibility to fully disclose any and all potential conflicts of interest. The proposed rule would impede this development by allowing broker-dealers greater latitude to compete as advisers without subjecting them to regulation as such. We strongly oppose its adoption.

Instead, we urge the Commission to identify those broker-dealers that offer investment advice that exceeds the solely incidental standard, or who hold themselves out as offering such advice, and subject them to regulation under the Advisers Act. As part of that effort, the Commission should clearly and comprehensively spell out what does and does not constitute solely incidental advice under the broker-dealer exclusion from the Advisers Act. In doing so, the Commission should remain true to the very narrow definition of solely incidental advice intended by Congress. If the Commission were to pursue this approach, we believe that most of those full service brokers offering fee-based services would be swept under the act, not because of any changes in their compensation method, but because the advice they offer and the way they promote that advice do not qualify for the solely incidental exclusion.

Finally, to clarify how the exclusion applies to new compensation methods, the Commission should simply specify that it is not the method of compensation that determines the right to rely on the exclusion but whether a specific portion of that compensation is clearly identifiable as special compensation for investment advice. We believe this could be accomplished through a policy statement without need for a new rule proposal. In fact, such a policy statement from the Commission, one that clearly lays out all the issues related to the broker-dealer exclusion, would offer substantial benefits for investors, by eliminating widespread abuses of the exclusion, and for industry members, by eliminating any confusion about what services qualify. Broker-dealers who offer only solely incidental advice would then be free to offer fee-based services without triggering regulation as advisers so long as those fees were not misidentified as fees for advice.

We appreciate your attention to our concerns. If a member of the Commission or the Commission staff would like to discuss these issues further, we would be happy to do so. You can contact me at 719-543-9468.

Sincerely,

Barbara L. N. Roper
Director of Investor Protection