ES1091FU

Consumer Federation of America

1502

October 5, 2004

S7-25-99

William H. Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

RECEIVED
OCT 29 2004
OFFICE OF THE SECRETARY

Dear Chairman Donaldson:

I am writing on behalf of the Consumer Federation of America to respond to comments submitted to the Commission by the Securities Industry Association (SIA) regarding the proposed rule to expand the broker-dealer exclusion from the Investment Advisers Act (File No. S7-25-99). The SIA's comment letter relies on deeply flawed reasoning to arrive at what we believe to be a false conclusion – that failure to approve the proposed rule would harm investors by depriving them of the benefits of fee-based compensation. One purpose of this letter is to identify the flaws in the SIA's reasoning that lead to its false conclusion. A second purpose is to suggest an alternative approach that would allow the Commission to achieve its stated goal of making nature of services provided the key factor in determining the applicability of the Advisers Act – a goal that CFA shares, but one that the current rule proposal does not achieve.

First, however, I would like to thank you for putting this important issue back on the Commission's agenda and for pledging to take formal action on the rule proposal by the end of the year. I am sure that, when the Commission adopted its no action position upon first proposing this rule, it never anticipated that the rule would languish for nearly five years without formal Commission action. Admittedly, extraordinary events have helped to keep this issue sidelined – the attack on the World Trade Center; the collapse of Enron and the subsequent epidemic of accounting scandals; and, in the last year, the trading and sales abuse scandals that have rocked the mutual fund industry. All demanded and received the immediate, close attention of the Commission.

That much of the delay in acting on the current rule proposal is understandable does not change the fact that the Commission should never have adopted its no action position prior to receiving comments on what has proved to be a highly controversial proposal. Instead, it clearly illustrates the risk the Commission takes when it adopts this approach, that what is intended to be a stopgap measure will become, in essence, a "final" rule without the procedural protections designed to ensure transparency and accountability in the operation of our federal agencies. Such an occurrence inevitably undermines confidence in the integrity of the agency by creating the impression that industry groups are able to circumvent standard rule-making procedures to achieve their ends without allowing a fair and open debate on the issues. That is a mistake we urge the Commission never to repeat.

On the other hand, it would in our view be an equally grave mistake for the Commission, in the name of acting quickly, to simply adopt the rule as proposed or with only minor revisions. This is, of course, exactly the course of action that the SIA urges on the Commission. To help explain why we believe this approach to be misguided, we have analyzed the SIA's reasoning, as presented in its most recent comment letter on the proposed rule. The SIA urges approval of the rule based on two basic arguments:

- that approval of the rule is needed to provide brokerage firms with the flexibility they need to offer fee-based accounts and, therefore, that failure to approve the rule would harm investors by depriving them of this option; and
- that the accounts are brokerage accounts that are already appropriately regulated as such, and therefore that any additional regulation under the Investment Advisers Act is "unnecessary and duplicative."

On closer examination, neither argument holds water.

1) SIA argues that the rule is needed to provide brokerage firms with the flexibility to offer fee-based accounts and, therefore, that failure to approve the rule would harm investors by depriving them of this option.

This argument is founded first on the view that fee-based compensation benefits investors by reducing conflicts of interest, expanding investors' pricing choices, and enhancing price transparency. In this, we generally agree with the SIA. It is important to remember, however, that there are limits to these benefits. Changing the sales representative's method of compensation does nothing to reduce those conflicts that operate at the firm level, such as pressure to sell in-house mutual funds because of the profits they generate for the firm or selection of mutual funds based on revenue sharing payments received. On the other hand, fee-based compensation may encourage the sales rep to neglect existing accounts if his or her compensation depends on attracting new clients rather than on serving existing ones. While we agree with the SIA that the latter is largely a regulatory issue that does not bear directly on whether the accounts should be considered advisory accounts, both these examples illustrate the benefits investors would receive if the fiduciary duty and disclosure requirements that accompany Advisers Act regulation were applied to these accounts.

More central to the SIA's argument is the question of whether the rule is necessary to promote fee-based compensation. The SIA offers no support for its assertion that brokerage firms would cease to offer fee-based accounts if these accounts were regulated as advisory accounts. In fact, its letter offers strong evidence that no such retreat from fee-based compensation would occur. After all, regulating fee-based discretionary accounts and wrap accounts as advisory accounts did not cause brokerage firms to stop offering such accounts. Instead, as the SIA notes, "more than three-quarters of all fee-based accounts maintained at broker-dealers are already treated as advisory accounts." There is no reason to think that brokerage firms that can live comfortably with advisory regulation of fee-based discretionary accounts or wrap accounts couldn't similarly accommodate advisory regulation of non-discretionary fee-based accounts. Thus, there is every reason to believe that brokers would continue to offer such accounts, even if the accounts were regulated as advisory accounts.

Even in the unlikely event that the SIA prediction proved true, however, and full service brokerage firms ceased to offer fee-based accounts, it does not follow that investors would be deprived of this pricing option. They would simply be deprived of this pricing option within full service brokerage firms. There are ample alternatives in the marketplace where investors who prefer the fee-based pricing model could obtain those services. In fact, it is the availability of these alternatives, along with the profitability for the firm of this pricing approach, that we believe all but ensures that the vast majority of brokerage firms who currently offer fee-based accounts would continue to do so, even if forced to accept regulation of those accounts as advisory accounts. After all, as the SIA also notes, the vast majority of them are already dually registered as investment advisers.

Finally, as we will describe in more detail below, there are pro-investor alternatives available that could be used to ensure that fee-based compensation does not automatically trigger Advisers Act regulation without the anti-investor effects of the current rule proposal.

2) The SIA argues that regulating fee-based accounts as advisory accounts is "duplicative and unnecessary."

The SIA goes to some lengths to point out that broker-dealers are already highly regulated by both the Commission and the self-regulatory organizations. This is both true and irrelevant. The fact that brokers are thoroughly regulated as salespeople does not mean that they shouldn't also be subject to the standards that govern advice when they serve in an advisory capacity. After all, the majority of financial planners – those who both give advice and sell products to implement their recommendations – are subject to regulation as both advisers and as registered representatives. No one, in our view, has yet offered a reasonable explanation why brokers shouldn't be subject to the same requirement.

It is equally irrelevant to this debate that "the vast majority" of SIA firms are dually registered as brokers and advisers. What is at issue in this rule, and more generally when brokers offer advisory services, is not whether the broker is also registered as an adviser, but rather whether a particular account or service is treated as a brokerage account, as an advisory account, or both. If the account or service is not considered an advisory account or service, then the protections of the Advisers Act do not apply, even if the firm is registered as an adviser.

The SIA understandably attempts to dodge the issue of why financial planners should be subject to dual regulation when they combine investment advice with product sales while brokers are not. Instead, they note that, "Brokers have long been permitted to offer investment advice and recommendations to investors in conjunction with the brokerage services they offer." It is interesting to note the language the SIA uses, specifically its reference to offering "investment advice ... in conjunction with ... brokerage services." Unfortunately for this argument, the Advisers Act does not provide an exclusion for investment advice offered "in conjunction with" the broker's primary business of effecting transactions in securities. Rather, the exclusion is only for advice that is "solely incidental" to product sales. In reality, however, the SIA got it right. To the detriment of investors, the Commission has for the better part of two decades treated the solely incidental exclusion as if it were an "in conjunction with" standard, allowing brokers virtually unlimited freedom to offer advisory services in conjunction with their primary business without triggering advisory regulation. It is this passive approach on the part of the Commission that has helped to erase the functional distinction between brokerage services and advisory services and that now needs to be rectified.

As an alternative justification for exempting brokers' fee-based accounts from Advisers Act regulation, the SIA suggests that advisers' fiduciary duty and disclosure obligations "flow from the fact that advisory accounts are overwhelmingly discretionary in nature." That this is not the case should be clear from the fact that advisers are subject to these requirements regardless of whether they have discretionary authority. In fact, while traditional money managers typically exercise discretionary authority, many financial planners do not.

Rather, these obligations flow from the relationship of trust that exists between an adviser and his or her client. Brokers who offer advisory services, such as financial planning, and who promote themselves to clients as advisers, as the full service firms routinely do, are creating that same relationship of trust. In doing so, they ought to be forced to abide by the professional standards that attach to that role – including a fiduciary duty to place the client's interests first and an obligation to disclose any and all conflicts of interest. (If one were to accept the SIA's argument, however, that these obligations flow from the discretionary nature of advisory accounts, then clearly the only conclusion to be drawn is that all discretionary accounts, and not just those where compensation is fee-based, should be treated as advisory accounts.)

For those who do not accept the argument that Advisers Act obligations flow from the discretionary nature of advisory account, the SIA offers yet another alternative. It suggests that the suitability requirement and disclosure obligations that apply to brokerage accounts are equivalent to the fiduciary duty and disclosure requirements that govern advisers. This is simply not true. As the SIA acknowledges, brokers are not fiduciaries. And, although both the SEC and NASD have recently made progress in applying the suitability standard more stringently, the requirement that brokers make suitable recommendations does not, as the SIA implies, "require that the interests of investors always come first." Similarly, the disclosure of conflicts brokers are required to provide is neither as timely nor as complete as the disclosure of conflicts advisers are required to provide.

Clearly then, investors who are receiving advisory services from brokers – whether within or outside a fee-based account – are not being offered the same level of regulatory protections in certain key areas as those receiving the same type of services from financial planners and investment advisers. This is a grave concern, because the protections provided by the Advisers

Act are all the more important when advisory services are combined with product sales. The potential conflicts of interest are greater, as is the capacity to harm clients, when advice and product sales are combined, as the recent mutual fund sales abuse scandals made all too clear.

A Pro-Investor Alternative

CFA fully supports the notion that method of compensation should not determine the applicability of the Advisers Act. It is clear from even a cursory reading of the Act that Congress intended that nature of services provided would determine the nature of regulation. In fact, the main shortcoming of the proposed rule is that it tackles the wrong problem, and as a result does not achieve its stated goal. As we have previously noted, it is the Commission's past approach of allowing brokers to offer virtually unlimited advice without triggering Advisers Act regulation, and not the advent of fee-based compensation, that has been primarily responsible for erasing the distinction between brokerage services and advisory services. If the goal truly is to make nature of services provided the key factor in determining applicability of the Advisers Act, then that is the problem that must be tackled.

In our view, the only way for the Commission to accomplish that goal is to define what brokerage services qualify for the "solely incidental to practice" exclusion. In doing so, the Commission should keep in mind that Congress clearly intended only a very narrow exclusion for the kind of "buy this, sell that" recommendations that are an integral part of the broker's primary business of effecting transactions in securities on behalf of customers. That is why they offered an exclusion for advice that *solely* incidental or *merely* secondary to that primary business and not for advice that is offered *in conjunction with* that business.

Once the Commission has arrived at a definition of "solely incidental" advice, we urge the Commission to conduct a thorough study of the services being offered by brokers to determine which are truly brokerage services, and which ought to be regulated as advisory services. A few things would seem to be self-evident. Financial planning is not solely incidental advice by any stretch of the imagination, and neither is discretionary authority. In both cases, advice is not merely a secondary component of the services being sold, it is the primary reason for using the service. Doubtless there are other such examples. Once the Commission determines which services are advisory services, it should prohibit brokers from promoting any but these services based on the advice offered.

Finally if, in order to promote fee-based compensation, the SEC feels it is necessary to clarify that fee-based compensation does not automatically result in regulation under the Advisers Act, it can easily do so without adopting this rule. All that is necessary is for the Commission to issue a rule or policy statement explaining that fee-based compensation is not, by definition, special compensation for advice and, thus, that method of compensation does not determine the applicability of the Advisers Act. Under such an approach, the Commission could clarify that the standard for both fee-based and commission-based compensation is the same – does an identifiable portion of that compensation represent compensation for advice? If so, then the broker has received special compensation for advice and is subject to the Advisers Act, regardless of whether that compensation comes in the form of a commission or a fee. If not, no special compensation has been received, and the Advisers Act would only apply if the broker is giving more than "solely incidental" advice. Chester T. Lane, General Counsel at the SEC when the Advisers Act was adopted, did an admirable job of elucidating these issues in SEC Release IA-2.

If the Commission adopts such an approach, and only if it adopts such an approach, it will at long last rectify a situation that has been allowed to develop over the past two decades. That is the situation in which financial professionals who are indistinguishable to the average investor are regulated under two different standards, and the nature of the firm providing the services, rather than nature of services provided, determines applicability of the Advisers Act. We simply do not understand how anyone who looks at this situation objectively, with the interests of investors in mind, can fail to recognize that such a situation must not be allowed to persist. We urge you to finally correct this situation by adopting and enforcing a real functional definition of advisory and brokerage services.

Thank you for your attention to our concerns.

Sincerely,

Barbara Roper

Barbara Roper
Director of Investor Protection

cc: Commissioner Paul Atkins
Commissioner Roel Campos
Commissioner Cynthia Glassman
Commissioner Harvey Goldschmid
Paul F. Roye, Esq.