1830

E5112066

**Fund Democracy**
The Mutual Fund Shareholder's Advocate

CFA Consumer Federation of America

April 4, 2005



BY FACSIMILE AND U.S. MAIL

The Honorable Michael G. Oxley
The Honorable Richard H. Baker
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

S7-25-99

Dear Chairmen Oxley and Baker:

We are writing to respond to your letter to the Securities and Exchange Commission regarding the Commission's proposal to exempt brokers who provide investment advice from the Investment Advisers Act. We respectfully note that your letter nowhere mentions the overwhelming opposition to the Commission's proposal from consumer groups. Our position on the broker exemption is well-documented in numerous letters to the Commission, and these letters fully respond to all of the points raised in your letter. We have attached, for your reference, our most recent comments on the SEC's proposal.[1]

We agree that regulations should not interfere with the structure of compensation paid to investment advisers, and that the expansion of fee-based accounts has largely been a positive development for investors. If the broker exemption would prevent brokers from offering fee-based accounts, we certainly would not support it.

The brokerage industry's argument that the broker exemption would restrict its ability offer fee-based accounts, however, is one of the more misleading claims that it has made in recent memory. As the Securities Industry Association has conceded, "more than three-quarters of all fee-based accounts maintained at broker-dealers are ***already treated as advisory accounts***."[2] For years, brokers have offered fee-based accounts subject to regulation under the Investment Advisers Act, and investors have been better protected from fraud and abusive sales practices as a result.

---

[1] For your convenience, we are sending the attachments, which are fairly lengthy, by U.S. Mail, but not by facsimile. They also are available at the SEC's web site at http://www.sec.gov/rules/proposed/s72599/s72599-1745.pdf and http://www.sec.gov/rules/proposed/s72599/s72599-1746.pdf.

[2] Letter from Ira D. Hammerman, General Counsel, Securities Industry Association to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Sep. 22, 2004) at 2 (emphasis added).

Over the last few years, we have seen a parade of charges involving sales abuses by the brokerage industry, many of which we commend your committees for attempting to address through hearings and legislation. Brokers have been charged with, among other things, inappropriately selling B class fund shares, failing to apply commission breakpoints to large mutual fund purchases, concealing side payments from fund managers designed to promote their funds, accepting illegal payoffs in the form of directed brokerage, and fraudulently selling systematic investment plans to military personnel. An underlying cause of these abuses is that brokers are subject to a lower legal standard than investment advisers.

The broker's obligation to provide suitable recommendations, in practice and in theory, falls far below the investment adviser's duty as a fiduciary to act solely in the best interests of the client. The SEC received a painful reminder of this fact in a recent, adverse administrative ruling, which was expressly based on the different standards applicable to brokers and investment advisers:

> [The defendant broker] was aware of the fiduciary obligations of investment advisers and attempted to warn advisory clients who also became brokerage customers that, in that role, ***he was a salesman with the self-interest that role implies.*** His advisory contracts specified that the client was free to select any brokerage firm to carry out [the defendant firm's] recommendations and, in meetings with the clients, [the defendant broker] attempted to convey ***the difference between the advisory and brokerage services he provided.*** There is no case precedent that holds that an associated person of an investment adviser cannot change hats, to use [the defendant broker's] metaphor, and ***act in the capacity of an associated person of a broker-dealer without the higher obligations of an adviser.*** In light of the Division's burden of proof, and [the defendant broker's] efforts to differentiate between his roles as investment adviser and as salesman, it is concluded that no violation of Sections 206(1) and 206(2) of the Advisers Act occurred.[3]

We respectfully disagree with your statement that brokers are subject to "comprehensive regulatory oversight" with respect to their advisory services. If this were the case, then why did Congress enact an entire statute to deal with investment advisers? Why did Congress specifically exempt only those brokers whose advice was solely incidental to their brokerage business and received no special compensation therefor? And, most importantly, why is it that the brokerage industry is so opposed to having to fully disclose all of their conflicts of interest and fee arrangements, as they would be required to do if regulated as investment advisers when providing non-incidental investment advice? The disclosure, suitability and other requirements of a broker simply

---

[3] In the Matter of IFG Network Securities, Inc., Admin. Proc. File No. 3-11179 (Feb. 10, 2005) at 39 – 40 (emphasis added).

are not an adequate substitute to the fiduciary duties and comprehensive disclosure requirements imposed under the Investment Advisers Act.

We believe that there should be a level regulatory playing field that is functionally related to the financial services provided. When brokers provide execution services, they should be subject to broker regulation; when they provide non-incidental investment advice, they should be regulated, as Congress decided 65 years ago, as investment advisers. The SEC's broker exemption would undermine this functional regulatory scheme by allowing virtually any broker to offer investment advice without being subject to the regulations that apply to financial planners and other professionals providing the same advisory services.

This issue is not merely theoretical, but is reflected in the very real confusion among America's investors about the protection afforded to them when dealing with brokers and advisers. The SEC has conceded that the very advisory programs offered by brokers that the rule would exempt have been "heavily marketed . . . 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."[4] Recent studies have confirmed the SEC's fears. For example, a recent study conducted ***by a broker*** found that a majority of investors:

> believe that both stockbrokers and investment advisors have a fiduciary responsibility to act in the investor's best interest in all aspects of the financial relationship, and 63% incorrectly believe that both stockbrokers and investment advisors are required to disclose all conflicts of interest prior to providing financial advice.[5]

This confusion is not surprising in light of another study's finding that, of investors who had any understanding of the basic services provided by brokers, an overwhelming majority believed that either financial advice was the primary service offered or financial advice and transaction assistance were equally important.[6] Investors rightfully expect that an advisory relationship will be accompanied by the fiduciary duties attendant upon the offering of similar professional services. The SEC's broker exemption contradicts this expectation and allows brokers to act like salesman in the guise of fiduciaries.

---

[4] Certain Broker-Dealers Deemed Not to be Investment Advisers, Advisers Act Release No. 2340 (Nov. 4, 1999) at Part II.A.1.

[5] TD Waterhouse 2004 U.S. Investor Perception Study.

[6] This study was conducted by Opinion Research Corporation International. Results are based on telephone interviews October 2004 with 1,044 investors. The margin of error at a 95 percent confidence level is plus or minus three percentage points. Complete results of the survey, including the actual questionnaire, are available at www.zeroalphagroup.com.

Finally, we have strongly supported the lawsuit that you characterize as seeking to "limit investor choice and preclude fee-based brokerage services." The lawsuit does no such thing. Rather, the lawsuit challenged the SEC's adoption of the broker exemption through a no-action letter, rather than complying with notice and comment requirements of the Administrative Procedures Act. The SEC apparently agreed with the premise of the lawsuit, as it promptly rescinded its no-action position and promised to take final action on its proposal by April 15 (it has announced that it will do so on April 6).

* * * * * * *

In summary, we believe that when a financial services professional offers non-incidental investment advisory services, those services should be subject to investment advisory regulation, regardless of whether the provider also happens to be a broker subject to another, very different regulatory regime. This is precisely the prescient position taken by Congress 65 years ago, a position that the SEC has unfortunately failed to enforce and that the interpretation in its pending rule proposal would effectively repeal.

We strongly encourage you to reconsider your position and are available discuss the broker exemption further with you or your staff at your convenience.

Respectfully submitted,

Mercer Bullard
Founder and President
Fund Democracy, Inc.

Barbara Roper
Director of Investor Protection
Consumer Federation of America

cc (U.S. mail only):

The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
Meyer Eisenberg, Director, Division of Investment Management
Robert E. Plaze, Director, Division of Investment Management