Securities Industry Association

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Marc E. Lackritz
President

August 5, 2004

Honorable Cynthia A. Glassman
Commissioner
U.S. Securities and Exchange Commission
450 5th Street, NW
Washington, D.C. 20549

S7-25-99

Re: Proposed Rule 202(a)(11)-1 Regarding Certain Broker-Dealers Deemed Not to Be Investment Advisers; Release IA-1845

Dear Commissioner Glassman:

In response to your request at our meeting last month, and the recent attention that has been focused on the above-referenced rule proposal, I am enclosing a memorandum which supplements prior submissions made by SIA in support of final adoption of the proposal. SIA strongly believes that the fee-based programs described in the rule proposal provide benefits to the investing public by better aligning their interests with those of their broker-dealers, as noted in the best practices suggested in the April 10, 1995 Report of the Committee on Compensation Practices chaired by former Merrill Lynch CEO Dan Tully.

I have also enclosed a chart which provides a side-by-side comparison of the regulatory oversight of investment advisor and broker-dealer activities. We believe the wide-ranging regulation, compliance and enforcement measures that are in place for broker-dealers clearly demonstrate that investor protection will in no way be compromised by allowing certain fee-based account relationships to be a permissible brokerage activity consistent with the terms of the proposed rule.

I would also like to call to your attention SIA's just published 2003 Report on Production and Earnings of Registered Representatives which clearly demonstrates that fee-based accounts are growing in acceptance by the investor community. The survey found that fee-based products now account for 31% of registered representatives' commissions and fees. Just eight years ago this share was well under 10 percent.

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Again, it was good to see you last month. If SIA can be of any further assistance to you and your colleagues in this matter, please do not hesitate to contact either me, SIA General Counsel Ira Hammerman (202-216-2045) or Associate General Counsel Mike Udoff (212-618-0509).

Sincerely,

Marc E. Lackritz
President

Enclosures

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel Campos
The Honorable Harvey Goldschmid
Cynthia M. Fornelli, Esq.
Annette Nazareth, Esq.
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Securities Industry Association

Background Memo on Fee based brokerage accounts

Background: In May, 1994 at the request of SEC Chairman Levitt, and in response to concerns about actual and potential conflicts of interest in the retail brokerage industry, a broad based Committee on Compensation Practices was formed, chaired by Daniel Tully, then Chairman and CEO of Merrill Lynch and Co. Inc. ("Tully Committee"). The Tully committee had three mandates:

1. Review of industry compensation practices for RR's and managers.

2. Identification of actual and potential conflicts.

3. Identification of the "best practices" used in the industry to eliminate, reduce or mitigate such conflicts.

Over the ensuing year, the Tully Committee conducted extensive panel discussions, interviews and field research, which included input from a broad array of industry and non-industry participants. Industry participants included numerous broker-dealers as well as the NASD, NYSE and SIA. Non-industry participants, among others, included, AARP, the Consumer Federation of America, the Office of the Public Advocate of New York City, NASAA, and the New York City Department of Consumer Affairs.

The Tully Committee issued its final report ("Tully Report") in April 1995, and among the best practices it identified, was compensating RR's based on client assets, regardless of transaction activity. In discussing this best practice the report states that "...basing a portion of RR compensation on client assets in an account is seen as one way to reduce the temptation for income-seeking RR's to create trading activity in an account..."[1]. The Tully report also observed that in many cases the best advice an RR can give a client at a point in time is to "do nothing." The report also noted that under a commission arrangement an RR received zero compensation for providing such advice. Clearly, the report saw this best practice as a means of better aligning the interests of RR's and clients.

The Tully report was well received by both the industry and regulators, and was a major impetus for broker-dealers to re-evaluate compensation practices. In numerous instances, this led broker-dealers to offer client fee-based accounts as an alternative to transaction based compensation arrangements. Fee based accounts were given further impetus when they were endorsed in SIA best practices issued in November, 1996.[2] However, as the use of fee-based brokerage accounts became more widespread, concerns

[1] Report of the Committee on Compensation Practices, p.12-13.
[2] SIA "Best Practices: A Guide for the Securities Industry, November, 1996, p.19

arose among broker-dealers that compensation other than transaction-based, could be viewed as "special compensation" which is one of the components of the definition of an advisory activity under the Investment Advisers Act. The potential added layer of regulation that such interpretation would engender, discouraged a number of firms from offering fee-based compensation alternatives to clients. This was considered an unacceptable result, since the Tully Committee findings, which were broadly supported by the industry and the Commission, encouraged the offering of fee based arrangements to clients as a means of ameliorating a potential source of conflict between the best interests of RR's and clients. The SEC saw the importance of eliminating the regulatory uncertainty which was inhibiting the offering of fee-based arrangements, and in November, 1999 issued proposed rule 202(a)(11)-1 which, in effect, states that the form of compensation received by a broker shall not, in and of itself, be determinative of whether an account is advisory or brokerage in nature. In the proposing release the SEC underscored the importance of the proposal by stating that

> "..These fee-based programs benefit customers by better aligning their interests with those of their broker-dealers, and thus...are responsive to the best practices suggested by the Committee on Compensation Practices ("Tully Committee")...[3]

The SEC also underscored the need for regulatory certainty while the proposal was pending, by including a no-action position in the proposal.

SIA filed a comment letter strongly supporting the proposal.[4] FPA, the Consumer Federation of America, and certain others filed comment letters in opposition, citing reasons which we address below. SIA subsequently sent supplemental submissions to SEC Chairman Pitt and Commissioner Glassman[5]responding to further efforts on the part of FPA and others to prevent final adoption of the rule.

On July 20, 2004 FPA filed a petition in the U.S. Court of Appeals challenging the SEC's authority to propose the subject rule and the inclusion of a no action position in the proposing release.

SIA Position: SIA strongly believes that the SEC proposal serves the best interests of public investors, and that the positions of others opposing the proposal are inconsistent with that objective. Critics have attempted to obfuscate the rationale for the rule proposal, which is founded on the very sound findings of the Tully Committee, and which are designed to ameliorate potential conflicts of interest and better align the interests of clients and brokers. It does this by alleviating regulatory uncertainty in clarifying that the manner in which a broker is compensated should not be determinative of whether an account relationship is brokerage or advisory in nature. The rule is clearly limited to those situations where the other components of an advisory relationship do not exist. This is made clear from the fact that the proposal excludes fee based accounts

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[3] Release No. IA-1845, p.4.

[4] Letter to Jonathan G. Katz, SEC Secretary from Jean Margo Reid, Chair, SIA Investment Adviser Committee, January 13, 2000.

[5] These letters were respectively dated January 31st and September 13, 2002.

where broker discretion exists, and by the fact that disclosure must be made that the client has entered into a brokerage relationship (SIA supports stronger disclosure on this point than is provided for in the proposal).

There is no regulatory imperative for imposing Advisers Act requirements, in addition to the extensive, and more than comparable, broker-dealer regulatory framework to which brokerage accounts are subject.

Below we address specific issues raised by FPA and certain others regarding the proposal:

Reverse Churning Concerns: While reverse churning has been a recent focus of regulatory attention, there is little evidence that this is a widespread problem. While both transaction and fee based compensation arrangements have a potential for abuse if used inappropriately, such possibility should not deter final adoption of the rule, given the very positive contribution it will make to ameliorating conflicts of interest. Furthermore, the issue of whether a commission or fee based arrangement is more suitable for a given investor has no bearing on whether an advisory or brokerage account relationship exists. In fact, that is the very point the rule proposal is designed to clarify.

Also, as is pointed out in the Tully report, sometimes the best advice to a client is to "do nothing". SIA strongly believes that thousands of clients in fee-based accounts are far better off today because after the sharp market declines that occurred between 1999 and 2002, they were dissuaded by their brokers from selling positions in which substantial losses had been incurred.

Purported Regulatory Gap: SIA strongly objects to the suggestion of FPA, and certain others, that investor protection will somehow be eroded, or a regulatory gap will be created, if the proposed rule is adopted. Nothing could be further from the truth. These commentators totally ignore the full panoply of rules and regulations to which broker-dealers are subject under the provisions of the Securities Exchange Act of 1934, as well as pursuant to extensive self-regulatory organization ("SRO") requirements governing broker-dealer activities. For example, the Exchange Act requires disclosure under Rule 10b-10 of extensive information regarding various matters, including potential conflicts of interest, and Rule 15c3-3 contains extensive customer protection provisions. SRO rules, such as those administered by the New York Stock Exchange and NASD, address, among other things, know your customer duties, suitability, net capital and fidelity bonding requirements. We note that independent investment advisers and financial planners are subject to neither bonding or net capital requirements, nor to a comparable self-regulatory regimen, which regimen includes frequent regulatory examinations. It is noteworthy, that the conflict of interest disclosures which FPA cites as a core investor protections under the Advisers Act are, in many cases, only made at the inception of an advisory relationship and annually thereafter. On the other hand, conflict disclosure under the Exchange Act, such as those relating to third-party compensation, market making activity and principal transactions, are provided on a transaction-by-transaction

basis. A chart providing a more comprehensive comparison of the regulatory oversight of investment advisers versus broker-dealers is attached to this memorandum.

Incidental Advice: FPA, and others seeking competitive advantage seek to portray the rule proposal as somehow modifying, or attempting to redefine the concept of incidental advice. The proposal does nothing of the sort, and merely recites the obvious fact that all of the other characteristics of a brokerage account, (including incidental advice) must still exist to be exempt from the application of the Advisers Act. We do not believe that the instant proposal, which is motivated by the desire to minimize potential conflicts, is an appropriate forum for exploring issues not within its scope or purpose.

REGULATORY OVERSIGHT OF BROKER-DEALERS AND INVESTMENT ADVISERS

Overview

The Securities and Exchange Commission and its staff have recognized that investment advisers are fiduciaries that must avoid conflicts of interest with their clients, or fully disclose those conflicts. Similarly, a broker-dealer is required to deal fairly with customers. One element of a broker-dealer's obligation to deal fairly with customers requires a broker-dealer to have a reasonable basis for believing that their securities recommendations are suitable for the customer in light of the customer's financial needs, objectives and circumstances. In addition, broker-dealers must have a reasonable basis for believing that a particular security being recommended is appropriate.

A corollary to the difference in duties of investment advisers and broker-dealers is the difference in scope of regulation of investment advisers and broker-dealers. The Commission has recently observed that the Investment Advisers Act of 1940 imposes only minimal burdens. Its most significant provision requires full disclosure of conflicts of interest and prohibits fraud against clients and applies to both registered and unregistered advisers However, the Advisers Act does not require or prohibit: (i) an adviser to follow any particular investment strategies; or (ii) specific investments. Rules promulgated under the Advisers Act require registered investment advisers to comply with Rule 206(4)-6, the proxy voting rule, and Rule 206(4)-7, the investment adviser compliance rule. By contrast, a broker-dealer cannot even begin to conduct a business until: (a) it has registered with the SEC; (b) it has become a member of a self-regulatory organization and (in most cases) the Securities Investor Protection Corporation; (c) it complies with state requirements; and (d) its "associated persons" have satisfied qualification requirements. The chart set forth below compares and contrasts substantive regulation of broker-dealers and investment advisers.

CATEGORY	BROKER-DEALERS: PROTECTION OFFERED	INVESTMENT ADVISERS: PROTECTION OFFERED
REGULATORY PHILOSOPHY	Both SEC and self-regulatory organization (SRO) rules impose anti-fraud and suitability obligations on broker-dealers that are specific and detailed. For example, the NASD requires that a broker-dealer recommending a securities purchase to a customer satisfy two separate suitability obligations: • Reasonable Basis Suitability - the broker-dealer must believe that the recommended security is suitable for any investor. To satisfy this obligation, broker-dealers must conduct due diligence any security that they recommend to potential investors; and • Customer-Specific Suitability. the broker-dealer must believe that its recommendation to invest in the security is suitable for that particular investor. To reach this determination, a broker-dealer must, in accordance with NASD Rule 2310, examine the investor's financial status, tax status and investment objectives, as well as any other pertinent information. In addition, NYSE's "Know Your Customer Rule"	The SEC says of the Advisers Act, "instead of prescribing a set of detailed rules, the Act contains a few basic requirements." The Advisers Act is deliberately unspecific so as to regulate as many diverse kinds of investment advisers as possible; by necessity, however, this results in less guidance and oversight of regulated investment advisers than more specific and detailed regulations.

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	requires members to use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by the member, and every person holding a power of attorney over any account. Other obligations include the business conduct rules specified in NASD Conduct Rule 2000 *et seq.* and the broker-dealer responsibilities listed in NASD Conduct Rule 3000 *et seq.*	
SUPERVISION OF REGISTERED REPRESENTATIVES	NASD Conduct Rule 3010(a)(5) requires that registered securities representatives be supervised by a principal of the broker-dealer who is also registered with the NASD. Both representatives and principals must pass examinations administered by the NASD in order to work for a broker-dealer, thus ensuring that customers are served by knowledgeable employees.	Screening for investment advisers and employees is only for past disciplinary history, not industry knowledge. Past experience is disclosed in Form ADV.
CONTINUING EDUCATION REQUIREMENTS	NASD Conduct Rule 1120 sets forth the continuing education requirements for registered persons. • **Firm Element** - requires each member firm to annually develop and implement a written plan for training its registered persons based on an assessment of its own specific training needs. • **Regulatory Element** - a computer-based education program administered by NASD to help ensure that registered persons are kept up-to-date on regulatory, compliance, and sales practice matters in the industry. Each registered person is required to complete the Regulatory Element initially within 120 days after the person's second registration anniversary date and, thereafter, within 120 days after every third registration anniversary date.	While certain trade associations may have education and qualification requirements for member investment advisers, the Advisers Act does not impose continuing education requirements on investment advisers.
REQUIRED CUSTOMER DISCLOSURES	Rule 10b-10 requires broker-dealers to disclose specific information to their customers about securities transactions at or before the completion of every securities transaction, including conflict of interest disclosures: a. the identity of the security b. the number of shares purchased or sold; c. the price at which the transaction was effected; d. whether the broker-dealer is acting as agent for the customer, as agent for some other person, as agent for both such customer and some other person, or as principal for its own account; e. if the broker-dealer acts as the customer's agent, the amount of the remuneration it receives from the customer;	Section 206(3) requires an investment adviser that wishes to engage in a principal transaction with a customer to: a. disclose in writing to a customer, before the completion of a transaction, that it is acting as principal for its own account; and b. obtain client consent to the transaction. Rule 206(3)-2 permits an adviser to act as broker for both its advisory

CATEGORY	BROKER-DEALERS: PROTECTION OFFERED	INVESTMENT ADVISERS: PROTECTION OFFERED
	f. for agency transactions in which the broker-dealer also participates in the distribution of the securities, it must disclose the source and amount of remuneration that it receives from third parties; and g. if the broker or dealer acts as principal, whether it is a market maker in the security. NASD Rule 2230 also requires that a confirmation disclose, among other things: • the capacity in which the member is acting; and • the source and amount of any commission or other remuneration received or to be received by such member in connection with the transaction. NASD Rule 2340 requires general members to send, at least quarterly, an account statement describing any securities positions, money balances, or account activity to each customer whose account had a security position, money balance, or account activity during the period since the last such statement was sent to the customer.	client and the party on the other side of the brokerage transaction ("agency cross transaction") without obtaining the client's prior consent to each transaction, provided that the adviser obtains a prior consent for these types of transactions from the client, and complies with other, enumerated conditions. Rule 204-3 requires registered investment advisers to deliver Part II of Form ADV or a brochure containing equivalent information at the beginning of an advisory relationship. In addition, advisers must offer to provide a Part II or brochure at least annually thereafter. Rule 206(4)-4 requires every SEC-registered investment adviser to disclose promptly to clients legal or disciplinary events that are material to an evaluation of the adviser's integrity or ability to meet its commitments to clients.
INVESTOR EDUCATION AND PROTECTION	NASD Conduct Rule 2280 requires members to provide each year in writing the following information to customers: a. NASD Regulation Public Disclosure Program Hotline Number; b. NASD Regulation Web Site Address; and c. A statement as to the availability to the customer of an investor brochure that includes information describing the Public Disclosure Program. This investor education program ensures that customers are encouraged to inform themselves about their brokerage firm and the regulations governing its behavior.	While certain trade associations may undertake investor education initiatives, the Advisers Act does not require investment advisers to attempt to educate investors.
ANNUAL COMPLIANCE MEETING	NASD Conduct Rule 3010(a)(7) requires each registered representative to attend a firm compliance meeting no less frequently than annually.	No comparable requirement.
PROTECTION OF CUSTOMER FUNDS AND SECURITIES	The Securities Investor Protection Corporation ("SIPC") offers protection for customer funds and securities in the event that a registered broker-dealer goes bankrupt.	Rule 206(4)-4 under the Advisers Act requires every SEC-registered investment adviser that has custody or discretionary authority over

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	Rule 15c3-3 governs a broker-dealer's acceptance, custody and use of a customer's securities. Rule 15c3-3 is intended to ensure that a broker-dealer in possession of customers' funds either deployed those funds "in safe areas of the broker-dealer's business related to servicing its customers" or, if not deployed in such areas, deposited the funds in a reserve bank account to prevent commingling of customer and firm funds. Rule 15c3-3 seeks to inhibit a broker-dealer's use of customer assets in its business by prohibiting the use of those assets except for designated purposes. The Rule also aims to protect customers involved in a broker-dealer liquidation. If a broker-dealer holding customer property fails, Rule 15c3-3 seeks to ensure that the firm has sufficient reserves and possesses sufficient securities so that customers promptly receive their property and there is no need to use the SIPC fund. NASD Conduct Rule 3020 requires members to maintain fidelity bonds to insure against certain losses and the potential effect of such losses on firm capital. The Rule applies to all members with employees who are required to join SIPC and who are not covered by the fidelity bond requirements of a national securities exchange. New York Stock Exchange Rule 319 imposes similar requirements upon members of the New York Stock Exchange.	client funds or securities, or that requires prepayment six months or more in advance of more than $500 of advisory fees, to disclose promptly to clients and prospective clients (collectively, "clients") any financial conditions of the adviser that are reasonably likely to impair the ability of the adviser to meet contractual commitments to clients. The rule also requires advisers (regardless of whether the adviser has custody or requires prepayment of fees) to disclose promptly to clients legal or disciplinary events that are material to an evaluation of the adviser's integrity or ability to meet its commitments to clients. There is no organization similar to the SIPC protecting customers of registered investment advisers and there is no net capital requirement or bonding requirement under the Advisers Act. Section 412 of ERISA requires that an investment adviser fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan to be covered by a fidelity bond that meets the requirements of section 412 of ERISA and the Department of Labor's implementing regulations, unless the fiduciary is a corporation that is permitted to exercise trust powers or to conduct an insurance business.

CATEGORY	BROKER-DEALERS: PROTECTION OFFERED	INVESTMENT ADVISERS: PROTECTION OFFERED
STATUTORY DISQUALIFICATION	a. Under § 3(a)(39) of the Securities Exchange Act of 1934 ("Exchange Act"), broker-dealers and employees who have committed serious misconduct, such as securities or commodities-related misconduct, crimes described in Section 15(b)(4) of the Exchange Act, which involve fraud, or misappropriation of funds, or any felony conviction, are statutorily barred from the securities business. b. Under Article III, Section 3(b) of NASD's By-Laws, a "statutorily disqualified" employee cannot become or remain associated with an NASD member unless the disqualified person's member firm applies for relief from the statutory disqualification under Article III, Section 3(d) of the By-Laws. c. NASD Conduct Rule 3010 requires each member to establish, maintain, and enforce written procedures to supervise the activities of its registered representatives and associated persons. A member who seeks to employ a statutorily disqualified person must implement a special supervisory plan.	Under § 203(c)(2) and 203(e) of the Investment Advisers Act of 1940, the Commission cannot register an investment adviser if the investment adviser or an associated person has been convicted of a felony or had a disciplinary record subjecting them to disqualification. The SEC may suspend or terminate the registration of any investment adviser if the investment adviser or an associated person has been convicted of a felony or had a disciplinary record subjecting them to disqualification.
PUBLIC AVAILABILITY OF DISCIPLINARY INFORMATION ABOUT REPRESENTATIVES	NASD collects, compiles, organizes, indexes, digitally converts and maintains regulatory information from registered persons, member firms, government agencies and other sources and maintains information in the proprietary Central Registration Depository ("CRD®") database. NASD publicly releases information regarding registered securities representatives, including disciplinary information on the NASD's website through the BrokerCheck system, allowing customers to easily access up-to-date information. Information collected by the NASD is compiled and monitored by the NASD, which adds an extra level of protection for customers against fraudulent disclosures.	The Advisers Act requires investment advisers to disclose their disciplinary history and investment experience in a Form ADV. The SEC makes the completed Form ADV publicly available through its website.
OVERSIGHT OF BROKER-DEALERS AND REGISTERED REPRESENTATIVES	Broker-dealers are subject to the oversight of the NASD (and/or the New York Stock Exchange) in addition to the SEC (principally under the Exchange Act), which offers several benefits, including: a. The opportunity for the NASD to marshal resources unavailable to the SEC, including greater access to industry expertise; b. The NASD is subject to fewer personnel, contracting and procedural requirements than the SEC; c. Standards of ethical behavior established by the NASD that are higher than those set by the SEC	For SEC-registered investment advisers, there is currently only SEC oversight (principally under the Investment Advisers Act).

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	(*e.g.*, NASD and other SRO members are required to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business). d. The opportunity for industry leaders to participate in the regulatory process through the NASD and thus acquire a greater sense of their stake in the process; and e. A staff of 2200 at the NASD dedicated to monitoring brokerage firms only.	
COMPLIANCE POLICIES AND PROCEDURES	NASD Conduct Rule 3010(b) requires broker-dealers to establish and maintain written procedures that are reasonably designed to achieve compliance with applicable securities laws and regulations, and the applicable rules of the NASD.	New Rule 206(4)-7, with which investment advisers must comply by October 5, 2004, mandates that investment advisers (1) adopt and implement policies and procedures reasonably designed to prevent violation of the Advisers Act, (2) annually review those policies and procedures, and (3) appoint a chief compliance officer to oversee the policies and procedures. However, the Rule does not require the policies and procedures to be reasonably designed to prevent violations of other federal securities laws.
EXAMINATION OVERSIGHT	Both the NASD and SEC inspect broker-dealers on an annual basis. In addition, other SROs will inspect their member broker-dealers.	Only the SEC staff will inspect investment advisers. The inspection cycle averages five years.