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September 9, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549-0609

Re: Release Nos. 34-42099; IA-1845; File No. S7-25-99

Dear Mr. Katz:

I am submitting my request to have the Securities and Exchange Commission ("SEC" or "Commission") withdraw the above-referenced proposed rule entitled "Certain Broker-Dealers Deemed Not to Be Investment Advisers" (the "Rule") as proposed on November 4, 1999.

Background

The SEC has taken no formal action on the Rule since it was proposed four and one-half years ago. The Rule eliminates "special compensation" as a factor that would require broker-dealers to register as investment advisers, while permitting a broker-dealer to provide investment advice to customers, regardless of the form of its compensation, provided: (i) the advice is provided on a non-discretionary basis; (ii) the advice is "solely incidental" to the brokerage services; and (iii) the broker-dealer discloses to its customers that their accounts are brokerage accounts.

The proposed Rule is unique among the numerous Commission rulemakings in that until final action is taken, the Division of Investment Management has stated that it would not recommend enforcement action for failure to comply with the proposed Rule.

I have actively opposed the Rule since its inception. I believe the Rule is detrimental to consumer protection by allowing broker-dealers to avoid the blanket fiduciary protections of the Investment Advisers Act of 1940 ("Advisers Act"). By eliminating "special compensation" as a critical element in the contractual relationship, the Rule permits stockbrokers to misrepresent their fundamental sales role as one of a fiduciary adviser receiving a fee for advice. Further, it places financial planners at a competitive disadvantage by allowing brokers to market similar programs under less rigorous regulatory standards for disclosure and advertising.

I respectfully request the SEC act to immediately withdraw the Rule for the following reasons:

- **Non-Compliance with Administrative Procedures Act ("APA").** By providing "no-action" relief to broker-dealers with no clear deadline for taking action after proposing the Rule four years ago, the SEC has failed to act in a timely fashion.

- **Failure to Provide Clear Regulatory Guidance.** During the lengthy intervening period since the Rule was proposed, the Commission has received numerous comment letters requesting clarification on what it meant by "solely incidental" advice under the Rule. The Commission has failed to provide clear guidance to affected parties on other key terms in the Rule, including the distinction between "full service brokerage" and "financial planning" services.

- **Misinterpretation and Misapplication of Discretionary Exemption Authority.** In creating a "new" class of exempted broker-dealer under the Rule, the Commission has misinterpreted congressional intent by eliminating a statutory "special compensation" element that required broker-dealer registration under the Advisers Act for nearly 60 years. Further, by not adopting a final Rule, the Commission also failed to apply its exemptive authority consistent with the requirements of the Advisers Act.

- **Absence of Rule Enforcement.** The Commission has not provided any evidence of enforcement activity or oversight with respect to the *de facto* exemption of broker-dealers under the Advisers Act, which has been in effect for the past four years, notwithstanding the marketing emphasis by brokerage firms on investment advice and financial planning. In addition, the Rule has created problems with "reverse churning" of the fee-based brokerage accounts, a disturbing development under the Rule that is being investigated by the NASD.

- **Inconsistent Application of Disclosure Standards to Brokerage Transactions.** The Commission has applied inconsistent disclosure standards for broker-dealers under federal securities laws by recently adopting new rules related to disclosure of broker-dealer conflicts of interest with respect to mutual fund transactions and initial public offerings, among other investment products, but not in connection with principal trades and other individual securities transactions under the Rule.

Discussion

1. Non-Compliance with Administrative Procedures Act

Public comments on the Rule were initially due on or before January 14, 2000. The SEC has not formally responded to the comments or taken any action with respect to the Rule. More than 250 comment letters have been received by the SEC since the proposal was made in 1999, with the overwhelming majority – including those from major consumer groups – opposed to the Rule. In its executive summary of the Rule, the SEC stated that

> 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.

Since the major Wall Street brokerage houses initially approached the SEC about exemptive relief in the summer of 1999, many other brokerage firms have adopted similar fee-based brokerage programs and have relied upon the SEC's embedded "no action" enforcement policy in the proposed Rule to avoid the disclosure requirements and increased liability under the Advisers Act. In light of the SEC's statement that it will not enforce the Adviser Act's registration requirements against broker-dealers offering fee-based programs, its *de facto* adoption of the Rule proposal constitutes a violation of the letter and intent of the APA.

2. Failure to Provide Clear Regulatory Guidance

The Rule allows broker-dealers to provide advice that is "solely incidental" to "brokerage services", but neither term is defined, nor are the distinctions between the incidental advice provided under "brokerage services" and the series of recommendations commonly associated with a comprehensive financial plan.

Moreover, the Rule requires "prominent disclosure" that the fee-based program is a "brokerage account". I have seen numerous ads and marketing materials prominently featuring the advice offered in these programs but with the brokerage account disclaimer buried in hard-to-read fine print. The SEC provides no guidance of what is prominent disclosure under the Rule.

I do not believe the public appreciates the nuances of the Rule or understands that a brokerage account means the registered representative – unlike a registered investment adviser – has no blanket fiduciary duty to place the client's interests first or an affirmative obligation to disclose all material conflicts of interest. Such conflicts may include special financial awards for selling stocks from inventory (known as "principal trades") or from sales contests. Unlike registered representatives, advisers also must affirmatively disclose any material disciplinary history, as well as their experience and qualifications.

3. Misinterpretation and Misapplication of Discretionary Exemptive Authority

Section 202(11) of the Advisers Act defines an "investment adviser" as including "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing or selling securities . . . but does not include . . .

> (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore[.] . . . or
>
> (F) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order."

In issuing its Notice of Proposed Rulemaking, the SEC concedes that the Rule does not fall within Congress' language in subsection (C). Subsection (C) requires that to be excluded from the definition of "investment adviser", a broker's or dealer's investment advice must not only be incidental to its business, it must not be provided in exchange for "special compensation". The Commission would eliminate the "special compensation" requirement provided certain conditions are met.

In its reasoning, the Commission relies mainly on subsection (F), the provision that allows it to create other exemptions for persons who are "not within the intent of this paragraph" [referring to Section 202(11), the paragraph defining "Investment Adviser"]. However, the exemption for broker-dealers is clearly prescribed within subsection (C), and broker-dealers as a class are clearly identified by Congress as warranting a limited statutory exemption contingent on meeting special compensation and solely incidental advice tests.

Finally, I do not believe that the Commission has the authority to exempt a class of persons without first issuing a rule under subsection (F). Section 211 of the Advisers Act states that "[f] or the purposes ot its rules or regulations the Commission may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters." Even if one were to agree that brokerage firms with fee-based programs could be re-classified, subsection (F) requires a rule to be in place. No final rule, however, has ever been adopted to provide for that exemption.

In contrast to its reliance on subsection (F) to broaden the Advisers Act exemption for broker-dealers, the SEC several years ago proposed and later adopted an exemption under the same provision for a new class of investment advisers whose core clients were advised over the Internet, and who had no more than 15 "face" clients. [*See* Release No. IA-2091.] I supported the exemption from state adviser registration because the rule proposal was consistent with the intent of subsection (F) in creating a clearly demarcated and new class of investment adviser. Unlike the Rule under discussion, the SEC did not permit compliance by Internet advisers with the proposal until after it was adopted.

4. Absence of Rule Enforcement

More than four years after the SEC implemented a "no-action" position under the Rule, it is unclear if the Rule has been effective in benefiting brokerage customers "by aligning their interests more closely with those of the brokerage firm", in accordance with the Proposing Release.

Consumer complaints made in connection with the Rule would be concealed in mandatory and confidential arbitration requirements, making it difficult for anyone other than the NASD or the Commission to identify systemic problems of securities laws caused by misleading marketing practices. Conversely, I am not aware of any studies by the SEC or the NASD concerning the success of the Rule in reducing broker violations.

At least one news report indicates that the Rule has created problems through a practice called "reverse churning", where the fee-based program is neglected by the registered representative while continuing to accept fees for monitoring account performance. In November 2003, the NASD published Notice to Members 03-68 reminding brokerage firms that fee-based programs must be appropriate to the customer. The NASD noted that brokers might benefit by simply placing a customer in a "buy-and-hold" fee-based account that ultimately is more costly to the investor than a similar one in which the customer was charged a commission only when placing trades. The news article indicated that the NASD had recently launched an industry-wide probe into abusive practices involving the fee-based brokerage accounts.[1]

5. Inconsistent Application of Disclosure Standards for Brokerage Transactions

The Rule requires disclosure to new customers that the fee-based programs are "brokerage accounts", but not of any conflicts of interest in the broker-customer relationship. However, the Commission recently has taken aggressive action to disclose conflicts of brokerage firms in securities transactions involving mutual fund shares. Among the most significant disclosure requirements affecting retail brokerage sales are those contained in Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities [Release No. 33-8358]. This rule proposal requires broker-dealers to disclose sales incentives for registered representatives in selling certain mutual fund shares as well as disclosure of financial remuneration from fund companies to broker-dealers in connection with "shelf space" for mutual fund products.

Because the Commission proposed the Rule several years before the recent emphasis by Congress and the SEC on disclosure of conflicts in the brokerage industry, there is an inconsistent application of a similar standard to equities transactions. I fail to see any difference in the compelling need for disclosure of conflicts of interest in the sale of mutual fund shares and individual shares of stock by the same registered representative, particularly with respect to principal trades. Incentive compensation may vary depending upon the nature of the security transaction, but the inherent conflict of interest remains. I hope the Commission shares the same investor protection concern that disclosure requirements should be applied fairly to all investment products.[2]

Amendments to the Rule

I believe the Rule creates far greater problems than it resolves. I also believe that the public would be better served by requiring broker-dealers offering fee-based programs to comply with current registration requirements of the Advisers Act, and thereby, restoring a level playing field for disclosure of conflicts and fiduciary conduct by anyone meeting the definition of "investment adviser". An advisory representative who is in a financial planning engagement is required to disclose, among other things, his or her conflicts

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[1] *See* "NASD Investigating Fee-Based Accounts at Brokerages," Dow Jones Newswires, April 9, 2004, by Kaja Whitehouse and Lynn Cowan.

[2] Arthur Levitt, chairman of the SEC at the time the Rule was approved for public comment, has reservations about the Rule, telling an audience recently that "the [the SEC] shouldn't grant them [broker-dealers] that exception. I think it's wrong". Remarks made at the TD Waterhouse Partnership 2004 conference in Orlando, Florida, following Mr. Levitt's presentation entitled, "The SEC and the Independent Advisor".

of interest and sources of compensation and a written statement describing material agency relationships that the planner has with third parties.[3] I believe similar standards should apply to anyone holding out publicly as a financial planner.

I continue to believe that the Rule is so substantively flawed that it should simply be withdrawn.

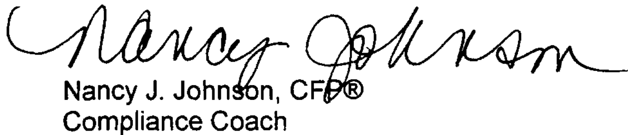
Summary

I believe that full disclosure of conflicts of interest in the fee-based programs is the key to an effective Rule. Regulatory reforms since the Rule was first proposed now routinely require disclosure of conflicts material to the point-of-sale transaction and customer relationship.

I believe that it is time for the Commission to restore functional regulation of investment advice under federal securities laws. Investors will benefit through consistent and comprehensive disclosure of conflicts and the related fiduciary protections of the Advisers Act by withdrawing the Rule.

Thank you for considering my request.

Sincerely,



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[3] *See* Rule 402, CFP Board of Standards, Inc., *Code of Ethics and Professional Responsibility*.