Government of the District of Columbia

Department of Insurance, Securities and Banking

Lawrence H. Mirel
Commissioner

February 23, 2005

VIA FIRST CLASS MAIL

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, District of Columbia 20549-0609

Re: Proposed Rule For Certain Broker-Dealers Deemed Not To Be Investment Advisers
S.E.C. File Number S7-25-99

Dear Mr. Katz:

The Securities Bureau of the District of Columbia's Department of Insurance, Securities and Banking (hereinafter the "Department") appreciates the opportunity to comment on investment adviser Release No. 2340, the Proposed Rule for Certain Broker-Dealers Deemed Not To Be Investment Advisers (hereinafter, the "Reproposal") issued by the Staff of the United States Securities and Exchange Commission (hereinafter, the "Commission's Staff") on January 6, 2005 and hereby withdraws its February 7, 2005 request for an extension to comment on the Reproposal. While these comments were prepared by the Securities Bureau, they are being submitted on behalf of the Department. The Department administers the District of Columbia Securities Act of 2000, D.C. Official Code, Title 31, Chapter 56, Insurance and Securities, Section 31-5601.01 *et seq.* (2001 Edition & 2004 Pocket Part) (hereinafter, the "DC Securities Act"). Under the DC Securities Act, the Department has a mandate to protect the District's investors and regulate, inter alia, broker-dealers and investment advisers.

For over sixty years, consumers and the advisory industry looked to the Commission and its staff to define how advisers should treat their customers and to build investor protection expectations. During the time the Investment Advisers Act of 1940 (cite omitted) (hereinafter, the "Advisers Act") has been in effect, brokerage firms have been guided by the two-prong test in that legislation: broker-dealers who provide advisory services to their customers that are "solely incidental" to their brokerage services and who do not receive "special compensation" for those advisory services are not required to register with the Commission as investment advisers.

For the sake of uniformity among State and federal securities laws, some jurisdictions, including the District, have adopted the definition of investment adviser found in the Advisers Act, and have generally followed the Commission's policies and interpretation relating to the registration of investment advisers. The Department agrees with the premise of the Reproposal, i.e. that the old brokerage business model is changing. The Department submits the following comments in response to the Commission's Staff's Reproposal in the hope the comments will assist the

Commission to adopt a final rule that will maintain and support our common goal of investor protection. Investor protection is of paramount concern; therefore any changes should be clear and designed to advance investor protection.

The Department commends the Commission's Staff's for seeking to treat like business situations alike in the regulatory sphere by elevating substance over form. In the securities industry the old paradigm – advice by broker-dealers is transactional; advice by investment advisers is strategic -- is being transformed: broker-dealers are holding themselves out as providing financial planning services, so the old distinctions are blurring. The Reproposal seeks to craft a regulatory response to the paradigm shift that is based on disclosure and nomenclature.

The Reproposal addresses two fundamental concerns: that investors should be protected from unethical practices on the part of the securities professionals that advise them; and that the capital markets should be transparent for investors. Regardless of registration status, broker-dealers are primary gatekeepers of information about the markets. As gatekeepers, broker-dealers owe a duty to the investors they serve to provide complete and accurate information about their role as broker-dealers, the capacity of individual brokers, the administration of the investor's funds in the broker-dealers' custody and the differences among broker-dealers and other gatekeepers, such as lawyers, accountants and investment advisers. The Commission's Staff's is headed in the right direction by elevating the substance of the broker-dealers' activities over the formalities surrounding the regulatory categories.

Historically, the securities industry's paradigm of the delivery of brokerage services has been transactional. In the accompanying business model, the investor pays a price – the commission or markup – for trade execution services, and all the services the broker provides, including advisory services, are compensated for in that charge. In the past sixty years, the trade execution services model has grown to include, among others, such services as selection of portfolio managers and portfolio review. On the other hand, the business model of an investment adviser's services is strategic, i.e. the adviser recommends or chooses investments based on the client's needs and best interests. Both models often intersect, because investors request it and capital market efficiencies drive it. The Department, however, is concerned that the Reproposal may shift the regulatory paradigm too drastically, leaving investors confused about the differences between the services provided by broker-dealers and those provided by investment advisers.

What follows are the Department's responses to questions posed in the Reproposal and suggestions that the Commission may consider in adopting the final rule.

RESPONSES TO THE REPROPOSAL

I. Question Applicable to all Brokerage Service Programs

A) *Would failure to adopt the reproposed rule eventually result in the extension of the Advisers Act to most brokerage relationships?*

While the question came under the heading of fee-based brokerage programs, it has implications for many of the programs and services provided by broker-dealers. Failure to adopt the Reproposal would maintain the current status of accepted brokerages practices that are solely incidental to brokerage services. The Commission's Staff's estimates that of the 3,850 remaining broker-dealers that engage in any type of advisory activities, approximately 900 are registered as broker-dealers and investment advisers (hereinafter, "dually registered") and 1,000 other broker-dealers are affiliated with investment advisers (hereinafter, "advisory affiliates"). The remaining 1900, are thus exclusively registered as broker-dealers. Some of these have no retail customers, but a significant number do. Also according to the Commission's Staff's, a significant number of broker-dealers are extremely unlikely to involve discretionary customer accounts or any financial planning.

Failure to adopt the Reproposed rule would not necessarily result in extension of the Advisers Act to most brokerage relationships. The Reproposal would require some broker-dealers that are not now registered as investment advisers to do so, and would permit some that are presently dually registered to discontinue their investment adviser registration. Additionally, some broker-dealers might engage in activities they have not engaged in previously because they did not want to register as investment advisers, and under the Reproposal they would be able to engage in the activities without having to register. Brokers that structure their relationships with clients in accordance with the statutory exemption and the regulations and interpretations presently in effect are not required to register as investment advisers. To the extent that their business models are adjusted to reflect changes in revenue streams and customer preferences, if those changes require them to register as investment advisers, they will do so, as numerous brokers already have. The existence of a substantial number of brokers that are not dually registered suggests that in the absence of a major change in the regulatory regime, extension of the Act to most brokerage relationships will take place in the indeterminate future, if at all.

While, as a policy matter, the Department supports the position taken in the Reproposal, that wrap fees and discretionary authority over a brokerage account are advisory in nature and should be subject to the Advisers Act, the Department questions the apparent premise, i.e. that the principal effect of the Reproposed rule, if adopted, would be to allow firms to engage in certain activities without having to register as investment advisers. The Reproposal may have the opposite effect -- extending the Advisers Act to a significant portion of broker-dealers that are presently not registered as investment advisers, i.e those that offer discretionary accounts, while it removes the Act's potential coverage from some, such as those broker-dealers who provide discounted fees or the option of execution-only services. The Bureau notes that adoption of the Reproposed rule could very likely result in an increase in the registration of affiliated entities as investment advisers. An increase in this form of dual registration could lead to further confusion among investors about the nature of their relationship with the securities professionals that service their accounts and the firms that employ those professionals (which we will discuss further below).

B) *Would such a result be inconsistent with the intent of the Advisers Act, which was designed to fill a regulatory gap that permitted firms and individuals to engage in advisory activities without being regulated at the same time as it excepted broker-dealers from duplicative regulation?*

The primary objective of the Advisers Act was to fill a gap in investor protection by regulating firms and individuals that played an important role in investment decisions, but were unregulated, because they did not engage in activities that would require them to register as broker-dealers. The broker-dealer exemption to the Advisers Act, like all others, is to be construed narrowly. Broker-dealers are exempt from registration under specific, limited circumstances, and over the years they have understood that if their activities were outside the scope of the exception they would be subject to dual, not duplicative, regulations.

The Advisers Act is neutral on the question of registration. Broker-dealers are exempt from registration to the extent that their activities are within the terms of the exception. If the Advisers Act were intended to regulate only non-broker-dealers that provided advisory services, then the two conditions of the broker-dealer exemption from the definition would be superfluous – the drafters would have needed only to exempt broker-dealers unconditionally. The Department notes, for example, that in examinations of dually registered broker-dealers (where the broker-dealers are also registered as a state-covered investment advisers), we do not conduct two examinations, but one. Record requirements often overlap and retention is often kept by the firm. In our experience, the only difference is that more broker-dealer records are kept than advisory records. In order to achieve compliance, and depending on the nature of their business, broker-dealers learn to maintain records that they needs in order to meet their advisory requirements. Even if the broker-dealers were not to register as investment adviser, they are still subject to the anti-fraud provision of the Advisers Act if those activities fall within the Advisers Act.

C) *Would application of the Advisers Act to a potentially large number of brokerage accounts interfere with the market-making role of broker-dealers and the efficiency of the capital markets? For example, section 206(3) of the Advisers Act restricts the ability of advisers to engage in principal transactions with clients.*

Under the Advisers Act, Section 206(3) applies when a dually registered broker-dealer effects for client an advisory transaction in securities as a principal or as a broker for another client.[1] The Reproposal questions whether this provision limits the market-making abilities of the dually registered broker-dealers, but it presents no information that would indicate that Section 206(3) has had that effect. Currently, dually registered broker-dealers have two forms of relief from the prohibition found in Section 206(3): timing of performance; and substantive applicability. The timing relief is the interpretation that allows the dually registered firm to give notice and receive consent before settlement date, instead of before execution of the trade.[2] That puts dually registered broker-dealers on a comparable footing with solely brokerage firms, which are subject to Exchange Act Rule 10b-10 (cite omitted). Substantively, if the dually registered firm is not acting as a client's investment adviser in the particular transaction, that transaction is not subject to the Section 206(3) prohibition.[3]

In light of the many years that Section 206(3) has been in effect without apparently hindering market-making activity, the Department suggests that this issue be handled in the post-adoption period, by interpretations, etc., in the event that situations are presented in which some relief from the statutory provision is required to maintain the efficiency of the capital markets. The Department strongly encourages the Commission to adopt a rule in the first instance that protects investors, rather than defer action out of concern for unlikely and undocumented effects the rule might have on capital markets.

D) *What investor protections would be lost or gained under the rule? Is our proposed disclosure appropriate? Will it effectively serve its intended purposes? Should we require additional information to be disclosed? If so, what should that information be? Is the proposed disclosure too long to be practicable in an advertisement? If so, what should we omit? Will investors understand the terms we have used and their significance? If not, what terms should we use? Should materials specify who the appropriate person at their firm is who can discuss the differences between an advisory and a brokerage account? Should we designate the level of seniority the person should have? Given the complexity of the concepts involved, should we consider alternatives to disclosure? If so, what alternatives should we consider?*

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[1] See the Commission's Staff No-Action Letter of April 16, 1997, Morgan, Lewis & Bockius, 1997 SEC No-Act. LEXIS 529.
[2] See the Commission's Staff No-Action Letter of August 6, 1975, Dillion, Read & Co., Fed. Sec. L. Rep (CCH) ¶ 80,352.
[3] See the Commission's Staff No-Action Letter of April 16, 1997, Morgan, Lewis & Bockius, 1997 SEC No-Act. LEXIS 529, where the Commission stated that the prohibition found in Section 206(3) of the '40 Act was not applicable to a dually registered broker-dealer who recommends wrap fee programs, but a non-affiliated portfolio manager, involved in a wrap fee program, directs trades to the broker-dealer so long as the broker-dealer does not recommend, select or play any role, directly or indirectly, in the portfolio manager's selection of particular securities to be purchased for, or sold on behalf of, the clients of the wrap fee program. In that circumstance, the Commission contends that the broker-dealer is not acting as an investment adviser and is excluded from Section 206(3).

The Tully Report[4] suggests that fee-based compensation results in a better alignment of the customer's interests with those of the broker-dealer agents than does "pure" commission-based compensation. On the other hand, the Tully Report suggests by implication that fee-based brokerage programs may be inappropriate for certain customers, as recognized by the Commission's Staff in the Reproposal.[5] In an industry that constantly markets its brokerage and advisory services as a single integrated product, the Department is concerned that the disclosure currently available and proposed in the Reproposal may not be clear or adequate to describe the differences between the advisory services offered by a solely registered broker-dealer and those offered by an investment adviser, including the regulatory protections available to customers of the two types of securities professionals. While pointing out that in addition to their rights, investors have important responsibilities to be informed, and to be responsible for their decisions, in the transactional model of brokerage services, the Tully Report also makes it clear that:

> As a general rule, [brokers] and their clients are separated by a wide gap of knowledge--knowledge of the technical and financial management aspects of investing. The pace of product innovation in the securities industry has only widened this gap. It is a rare client who truly understands the risks and market behaviors of his or her investments, and the language of prospectuses intended to communicate those understandings is impenetrable to many. This knowledge gap represents a potential source of client abuse, since uninformed investors have no basis for evaluating the merits of the advice they are given.[6]

Accordingly, the Department supports the requirement, under proposed rule 202(a)(11)-1(a)(1)(iii), of the conspicuous "NOT AN ADVISORY ACCOUNT" notice. However, the Department urges the Commission's Staff to rethink that part of the rule that would require broker-dealers to identify an appropriate person with whom the customer can discuss the difference between a brokerage account and an advisory account. The most obvious problem is that the identified person may be deemed to be providing investment advice to customers. On what basis will that identified person "discuss" the differences between a brokers fiduciary duty over that of an adviser? What standards, other than the antifraud provisions, will apply to the identified person? Will the identified person be a supervisor, who is compensated in part by the volume of business in the office? Or will the identified person be a compliance officer, in which case who will review the discussions to determine if they are in compliance? Will the identified person take into account the customer's investment objective, risks, financial savvy, etc. when imparting its advice to a customer? It boils down to this: if the differences are important (and they are), they should be clearly explained in writing so that there can be an audit trail and accountability. Although written disclosure can be lengthy and is often encased in legalese, it is preferable to disclose in writing a customer's rights and obligations under a non-advisory fee-

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[4] Report of the Committee on Compensation Practices (April 10, 1995) (hereinafter, the "Tully Report").
[5] Id. at 10.
[6] Id. at 15.

based program and a description of the services provided, which can be comparable to the Form ADV, Part II.

II. Fee-Based Brokerage Programs

A) *If commission-based brokerage accounts receive differing levels of service depending upon the extent to which customers trade securities, it would seem to follow that fee-based brokerage accounts would receive varying levels of service depending upon the amount of assets held in the accounts. We request comment on this observation. Should differences in the nature of services provided be relevant to our consideration in deciding whether to adopt the rule?*

Fee-based programs may provide varying levels of services depending on the size of the account, but that is not the relevant inquiry. The question is, are the advisory services provided by brokers in fee-based programs different in kind from the advisory services provided by investment advisers? The Department applauds the Commission's Staff for taking the position that the manner of compensation, i.e. "special" or non-"special," does not necessarily affect the kind of service that is being provided. To the extent that the services are fundamentally the same, should they not be under the same regulatory regime? If there are important differences, the differences should not be eliminated, but investors should be enabled to make informed choices based on clear and accurate descriptions.

Fee-based programs may take various forms. If the fee-based program is based on the transactional model, the customer wants certain transactions to be effected and the broker obliges. Advice is purely "transactional": it consists of the broker's recommendations. In that model, "special compensation" – if it is present under current interpretations -- has no relevance to the kind of advisory services being provided. In the transactional model, the annual or asset-based fee of the fee-based program is just another form to compensate a broker-dealer for traditional broker-dealer services, including the advice implicit or explicit in solicited transactions or recommendations.

The Reproposal seeks to come to grips with the "mission creep" in the advisory services the broker may provide, often in the context of some type of fee-based compensation. Brokers may employ a "strategic model" that involves a more comprehensive kind of advisory service than the transactional advice that functionally is "solely incidental" to the conduct of the brokerage business. It puts them in direct competition with investment advisers, who are retained by investors to provide the strategic model of advisory services. Some hallmarks of the strategic model of services would be:

1. Providing advisory documents that are tailor-made to the specific investment objectives of a customer;
2. Setting up a financial or asset allocation plan based on information more extensive than that provided by a customer other than the open account form used by broker-dealers;

3. Providing a periodic review of the portfolio for consistency with the customer's long-term investment objectives;
4. Giving advice about a broad range of financial products; or
5. Assisting customers with money management services.

While this list is not exhaustive, it indicates the type of advisory services that a broker-dealer in a fee-based program may offer to customers that go beyond the traditional brokerage function. It is here that the benefits of following the recommendations of the Tully Report may conflict with the need to avoid investor confusion as between the advisory services provided by brokers and those provided by investment advisers. But the Reproposal does not directly address this potential confusion. It removes the "bright line," but provides no guidance for distinguishing between various types of advisory services that may be provided by brokers in fee-based programs. Perhaps the transactional/strategic dichotomy would be helpful in this regard.

B) *We seek comment on the competitive implications of the rule for investment advisers as well as broker-dealers. To what extent should we be guided by those competitive considerations? To what extent should broker-dealers be permitted to compete for business based on the advisory services they provide that are incidental to their brokerage business?*

As stated above, that investor protection is the paramount concern, and competitive factors should be viewed through that filter. Competition is best served when consumers (i.e., investors) have choices that reflect economic and legal considerations and the differences between the choices are fully and clearly explained. If the Commission's Staff concludes that there are real differences between advisory services that are "solely incidental to" the brokerage business and "strategic" advisory services, the Commission's Staff may decide that brokers should continue to be able to offer the former without being required to register as investment advisers, so long as the differences in the services being offered are fully and accurately explained to the customers. Some customers may want the ability to choose between the two types of firms and advisory services (only broker-dealers have the authority to execute the transactions that implement an investment strategy), just as there are some investors who only want trade execution services from brokers.

C) *We request comment whether we should take an alternate approach under which we would use our authority in section 206A to exempt broker-dealers from provisions of the Act, such as the registration requirements, with respect to these accounts.*

We do not view this approach as necessary. To the degree that the Commission's Staff concludes that the particular services that brokers are offering are in direct competition with those that investment advisers are offering, and the services questioned are not "solely incidental to" the brokerage business, the brokers that are offering those services should be required to register as investment advisers. However, if the Commission's Staff wishes to level the playing field generally between brokers and advisers, placing all securities professionals in the same regulatory category is not the only way to achieve that. The Commission has extensive authority over both categories – unlike situations in which exemptions are more absolute. To the degree that firms in both categories offer services that are directly comparable, even if they are within the traditional brokerage model, the Commission's Staff has the power to impose comparable regulatory requirements on both, to achieve investor protection and level the playing field, without obliterating distinctions in operations and business models between the two that may increase customer choice and foster competition.

III. Discretionary Asset Management

Does the legislative history of section 202(a)(11)(C) support our proposed rule?

As a policy matter, we support the Commission's Staff's new bright line that discretionary brokerage accounts involve advisory services that are in direct competition with investment advisers and that firms with that comprehensive authority over customers' assets should be subject to the same investor protections regardless of the firms' regulatory category. This is not an area where disclosure of differences – no matter how presented – is sufficient. Managing discretionary accounts combines both the transaction and strategic model which we attribute to broker-dealers and investment advisers, respectively. Support for the Commission's Staff's authority to draw this line may be found in the evolving business practices of the brokerage industry and the manner in which discretionary accounts are managed today, as opposed to 65 years ago. The legislative history of the Advisers Act does not include an in-depth study of the contemporary management of discretionary accounts by the brokerage firm's advisory of the time. While the legislative history is silent on the issue of discretionary authority of broker-dealers, a study of investment advisers conducted by the Commission's Staff recommended that persons who have discretionary authority over an investor's funds be subject to new legislative requirements not available under the Securities Exchange Act of 1934.[7]

IV. Discount Brokerage Programs

The reproposed rule makes a broker-dealer's eligibility for the broker-dealer exception with respect to an account turn on the characteristics of that particular account and not of other accounts the broker-dealer may also service. Commenters discussing this aspect of the proposed rule generally supported it, and we are reproposing it without change. Do commenters continue to support this provision?

While logic supports the Commission's Staff's position, the Department questions whether it is appropriate to reverse an interpretation that has been followed since it was issued shortly after

[7] Investment Trusts and Investment Companies, Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services, (report prepared by the Securities and Exchange Commission, August 17, 1939) reprinted in Thomas P. Lemke, & Gerald T. Lins, Regulation of Investment Advisers, Appendix D-3 (2003 ed.)

passage of the Advisers Act. Discounted brokerage fee programs have been around since before federal securities laws were created. The practice was well established at the time of adoption of the Advisers Act.[8] The Commission's Staff wants to eliminate the per se rule that prohibits a full-service broker-dealer from offering discount brokerage services as well as a discount broker-dealer from offering full-service brokerage services, unless they register as investment advisers. The interpretative release, however, has guided broker-dealers for decades. The release makes clear that special compensation alone will not require a broker-dealer to register as an investment adviser even when the broker-dealer charges a fee for giving clients consultation about a trade execution.

The release commented on four factual situations. The Commission's Staff deemed a broker-dealer as an investment adviser in two of those situations, because the broker-dealer charged the client an additional commission for providing advice and only charged those clients who the broker-dealer gave advice. In another situation, where all the clients were charged an additional commission regardless of advice, the Commission's Staff did not deem the broker-dealer to be acting as an investment adviser. This situation is similar to discount brokerage firms offering full-service if the amount charged is the same for all clients. The last situation where the broker-dealer does not charge clients "who do a substantial amount" of business with the broker-dealer, the Commission's Staff could not conclude based on those facts that a broker-dealer is acting as an investment adviser as is the case with some full-service brokers who want to offer execution-only services. In this case the Commission's Staff can close the loop with an appropriate interpretation or rule.

The key is that the release when properly interpreted means that compensation is part of an analysis to exclude the broker-dealer from having to register under the Advisers Act. For that reason, while the Department agrees with the Commission's Staff's reproposed provision, we do not think that the elimination of the cited interpretative release is necessary.

If you have any questions regarding this request, please feel free to call me at 202/442.7800 or J. Barron Knight, Assistant Director, at 202/442.4794. Thank you in advance.

Yours truly,

Theodore A. Miles

Theodore A. Miles
Director, Securities Bureau

cc: Rex Staples, Esquire (VIA ELECTRONIC MAIL rs@nasaa.org)

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[8] Opinion of the General Counsel Relating to Section 202(a)(11)(C) of the Investment Advisers Act of 1940, Investment Advisers Act Release No. 2 (October 28, 1940), 11 FR 10996.

Jennifer L. Sawin, Esquire (VIA ELECTRONIC MAIL SawinJ@SEC.GOV)