THE FINANCIAL PLANNING ASSOCIATION

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BY ELECTRONIC MAIL

September 22, 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:

The Financial Planning Association ("FPA®")[1] appreciates the decision by the Securities and Exchange Commission ("SEC" or "Commission") to reopen for public comment a proposed regulation entitled "Certain Broker-Dealers Deemed Not To Be Investment Advisers" (the "Rule"), and to proceed expeditiously by taking action on the long-pending rule. FPA takes this opportunity to furnish additional comments with respect to the instant proposal.

We would like to incorporate by reference for the agency record our comment letters dated January 14, 2000, December 7, 2002, June 21, 2004, and a joint letter submitted with other interested parties on May 6, 2003.[2] The issues raised therein, by the FPA and by more than a thousand other commenters opposing the Rule continue to reflect our concerns with respect to a level playing field for the

[1] The Financial Planning Association is the largest organization in the United States representing financial planners and affiliated firms, with approximately 28,500 individual members. Most are affiliated with registered investment adviser firms registered with the Securities and Exchange Commission ("SEC" or "Commission"), state securities administrators, or both. Approximately two-thirds are registered representatives affiliated with NASD member firms. FPA is incorporated in Washington, D.C., with its primary administrative office in Denver.

[2] *See* May 6, 2003, letter from Certified Financial Planning Board of Standards, Inc., Consumer Federation of America, FPA, Fund Democracy, Investment Counsel Association of America, and National Association of Personal Financial Advisors to SEC Chairman William Donaldson.

financial planning profession and consumers. We believe that among the countless number of comments made over the last five years concerning this issue, the paramount concern that needs to be addressed by the Commission is to preserve the consumer's right to know about their financial planner, irrespective of the form of compensation.

In addition to placing our earlier comment letters on the record, we wish to correct any misconceptions proffered by supporters of the Rule who contend that NASD sales standards are an adequate substitute for the comprehensive disclosure requirements and blanket fiduciary protections of the Investment Advisers Act of 1940 (the "Advisers Act"). Finally, with respect to the securities industry's contention that comprehensive financial planning is "solely incidental" to brokerage services as a rationale for adopting the Rule intact, we offer a brief description of practice standards as required for CFP® practitioners who are in a comprehensive financial planning engagement. We believe that these standards are appropriate for all financial planners.

Background

FPA has opposed the Rule since it was proposed in 1999. Since then we have met with 10 of the 11 Commissioners who have had the authority to act on the proposal. More than 1,200 comment letters have been generated over this period with the overwhelming majority strongly opposed to the Rule. FPA has consistently urged the Commission to withdraw the Rule based on our longstanding concern with the establishment of two different standards of market conduct for investment advisers and broker-dealers with respect to the delivery of financial planning services.

The SEC's primary mission is to protect investors and maintain the integrity of the securities markets. This mission is even more important today than it was five years ago in light of enforcement actions taken by the states and the SEC that have exposed widespread, systemic abuse in the marketplace in virtually every area of its jurisdiction except financial planning and non-institutional asset management. We believe that the SEC's mission to protect the public has been compromised by a defective Rule and we are troubled by the Commission's recent questions posed in the latest Release expressing greater concern about the Rule's effect on brokers rather than on the public.

The Rule, in fact, muddies the distinction between brokers and advisers under separate laws; fails to recognize the clear advantages of transparency afforded by the Advisers Act to the SEC's primary constituency (the investor); ignores the massive migration of the brokerage industry to the advisory business by declaiming these activities as "traditional" brokerage programs deserving a new pricing structure; and abandons its support for functional regulation of the securities industry.

We understand and appreciate the Commission's original intent to "more closely align the interests of investors with those of brokerage firms and their registered representatives than do traditional commission-based services"[3] consistent with the goal of the 1995 Report of the Committee on Compensation Practices ("Tully Report") to effect changes in the brokerage industry. We believe that the Tully Commission had it backwards, though. It should have looked at ways to more closely align the interests of brokers with their clients. The Tully Report's statement also highlights a regulatory paradox. While broker-dealer firms are restructuring their compensation method under the Rule, they are also using the asset-based fee accounts as a marketing platform to push commission-based revenue in new product areas such as insurance and mortgages. We question whether former Chairman Arthur Levitt, who appointed the Tully Commission, or Chairman Tully, would find these practices consistent with the report bearing his name. The sale of insurance products presents an even greater conflict since the commissions and trails are far less transparent than in a typical securities transaction.

Moreover, we believe that the Tully Commission and the SEC fell short by focusing primarily on compensation and glossing over industry disclosure practices. In its haste to propose an exemption for the securities industry, the SEC overlooked the consequences of removing the stronger fiduciary and disclosure protections of the Advisers Act. We believe that the negative consequences of the exemption far outweigh any improvements to investor protection.

We believe that the Commission would have been well-advised to invite representatives from the advisory community to participate, as it has done in other rulemakings,[4] by providing recommendations on changes to their primary area of regulation. Only when the Rule was published for comment did these organizations, including FPA, become fully apprised of the scope of the exemption and only then, once the no-action position was in effect, did the Commission solicit comments from the public.

<u>Discussion</u>

During the five years that the instant proposal has been pending, the Commission has seen an energetic debate over the scope of protections offered under the rules and regulations provided by the Securities Exchange Act of 1934 ("Exchange Act") and the Advisers Act. Comparing sales industry rules and regulations to professional standards is like comparing apples to oranges. One set of rules has developed over decades and is applicable to sales agents of a broker-dealer whose business is to execute securities trades and providing advice directly related to

[3] *See* discussion in SEC Release 34-50213 reopening comment period, August 18, 2004.

[4] *See* discussion in proposing release titled "Certain Thrift Institutions Deemed Not To Be Investment Advisers," SEC Release 34-49639, May 3, 2004 with respect to solicitation of industry comments.

those transactions. The other set of rules is applicable to an ongoing advisory relationship where fees are paid for advice, not for transactions.

Seventy years later, there is still a clear difference between the sales and advisory cultures and the rules of conduct that have evolved under these separate laws. The many comments submitted to the Commission by financial planners reflect these deep-rooted differences in business practices and client relationships.

The only real change over the last 10 to 15 years has been the brokerage industry gradually moving into the advisory business, a trend that accelerated in the mid-1990s after commissions for trades rapidly declined following intense competition from on-line trading firms. As a result of this trend, intensified by the embedded no-action position of the Rule, industry data suggests a significant increase in fee-based products for stockbrokers over an eight-year period, from 10 percent to 31 percent ending in 2003.[5]

General Comparison of Broker/Adviser Regulation. The securities industry is subject to extensive regulation with respect to broker suitability requirements in the sale of stocks and bonds, in holding custody over customer assets, and in protecting the firm's customers due to bankruptcy of the broker-dealer. Securities industry commenters note that "independent investment advisers and financial planners are not subject to a comparable self-regulatory regime."[6] We agree. The statutory frameworks are substantially different. The Advisers Act and SEC oversight, while not as extensive as the regulation of securities sales (which necessarily must be more detailed to encompass net capital, clearance and settlement issues), covers a different industry sector and we would suggest that it imposes a greater burden on financial planners in dispensing investment advice.[7]

Instead of more frequent examination cycles, investor protection is enhanced through disclosure and fiduciary requirements that, combined with fee services, closely align the adviser with the client's best interests. This alignment of interest through a different method of compensation is, of course, what the Tully

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[5] We would ask the Commission to request clarification of this data from the Securities Industry Association ("SIA"), which cites the data as income from "fee-based products" in assessing the impact of withdrawing the Rule. Specifically, we believe it should be clarified whether these fees include compensation from wrap-fee programs that combine fee and commissions for one client, thereby requiring dual registration as brokers and investment advisers. *See* SIA letter to Commissioner Cynthia Glassman concerning Proposed Rule 202(a)(11)-1, August 5, 2004.

[6] SIA letter concerning Proposed Rule 202(a)(11)-1, February 14, 2002.

[7] For example, the Commission does not require investment advisers to maintain electronic records in a WORM (non-writeable or erasable) format, unlike broker-dealers. The Commission simply noted that "use of WORM would require most advisers and funds to invest in new electronic recordkeeping technologies. Such costs may not be justified in light of the limited problems we have experienced with funds and advisers altering stored records." See Release No. IC-24890; IA-1932; File No. S7-06-01] "Electronic Recordkeeping by Investment Companies and Investment Advisers, " March 13, 2001.

Commission was trying to accomplish with its recommendations, but without addressing disclosure and fiduciary requirements, and the impact on other federal securities laws.

Fiduciary vs. Suitability Requirement. In the landmark 1963 Supreme Court case, *SEC v. Capital Gains Research Bureau, Inc.,* the Court held that the antifraud provisions and legislative history of the Advisers Act reflected congressional recognition "of the delicate fiduciary nature of an investment advisory relationship."[8] As such, investment advisers owe their clients a duty of loyalty and a duty of care.

The Commission has always, as part of those twin duties, imposed an implied suitability requirement on investment advisers. On an operational level, its investment adviser examination manuals going back to at least 1980 have noted that an investment adviser's fiduciary obligations include the duty to render disinterested and impartial advice; to make suitable recommendations to clients in light of their needs, financial circumstances and investment objectives; to exercise a high degree of care to ensure that adequate and accurate representations and other information about securities are represented to clients; and to have an adequate basis in fact for its recommendations.[9] More formally, the SEC has stated that "investment advisers under the Advisers Act owe their clients the duty to provide only suitable investment advice… To fulfill this suitability obligation, an investment adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives."[10]

In summary, suitability is inherent to an adviser's fiduciary obligations, which were formally recognized in case law 41 years ago. The suitability duty for investment advisers cited in an SEC release by one commenter[11] as drawing precedent from broker regulation was simply clarification of an adviser's underlying duties, not a new one. <u>In contrast, there is no evidence in the legislative history of the Adviser Act that a previously existing suitability standard existed for brokers as a basis for the original exemption, or why the broker-dealers' limited exemption was tied to special compensation and "solely incidental" investment advice.</u> We believe the answer is obvious: that the distinctions between stock brokers and investment counselors were clear enough to Congress in 1940 that it believed determining

[8] 375 U.S. 180 (1963).

[9] SEC, *Investment Adviser Examination Manual* (1980) (*quoted* in LEMKE & LINS, *supra* note 42, app. F-6, at F6-23 to F6-24).

[10] *See* Status of Investment Advisory Programs Under the Investment Company Act of 1940, Rel. Nos. IC-22579, IA-1623, S&-24-95, 1997 SEC LEXIS 673, at 26 (Mar. 24, 1997).

[11] Comment letter of W. Hardy Callcott on the Rule, August 23, 2004, at 2.

registration status based on compensation and amount of investment advice was sufficient to differentiate the two industries.[12]

Some attorneys in the securities bar will argue that the suitability duty is very similar to a fiduciary obligation, or that all brokers are fiduciaries, but this is not correct.[13] Suitability is a lower standard. Compliance firms have made a good living from seminars describing the fiduciary requirements of financial planners vs. broker standards.[14] You will not likely see the same lawyers who energetically defend their broker clients as fiduciaries making the same pitch in an arbitration proceeding involving unsuitable trades, where a common defense tactic is to cast the broker simply as an order taker.[15]

In reviewing industry practices and problems, the Tully Report indirectly acknowledged the myriad conflicting duties facing a registered representative (RR) in the brokerage environment:

> *The RR, however, is not just a representative of the customer, but is also an employee of the firm. This means that the RR and the firm each have three interests to balance: the broker has the customer, the employer, and his or her own well-being; and the firm has the customer, the broker, and the firm's own interest (including its shareholders, if it is publicly held).*[16]

Disclosure Requirements. One of the critical distinctions between broker and adviser regulation is the comprehensive disclosure requirement for investment advisers mandated by rule since 1985. There is no similar disclosure requirement for broker-dealers. Currently, Part II of Form ADV contains the disclosure statement that advisers must deliver to prospective clients and offer to them annually. The disclosure statement contains information about their methods of compensation, business practices, qualifications and conflicts of interest. Further, advisers have an affirmative duty to disclose material changes in a timely manner, not just annually. They also must proactively disclose to clients past disciplinary

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[12] Interestingly, Congress was apparently more interested in the proposed exemption for attorneys, not brokers, according to testimony during committee hearing records in spring 1940.

[13] Depending upon facts and circumstances, a broker may also have a fiduciary duty to his or her customer, but there is no blanket duty or counterpart to *Capital Gains. S*ome states have adopted a statutory fiduciary duty for brokers and advisers but it is not predominant.

[14] For example, *see* "Dual Registrant Fiduciary Obligations Under the Advisers Act," a session held at a July 2001 National Regulatory Services seminar in New York City for dually registered broker-dealers and investment advisers. The background outline simply noted that "the client should understand the capacity in which a firm or its reps are acting in order to determine whether the firm and reps are acting according to a commercial standard of conduct (as a broker-dealer), or the higher fiduciary standard (as an investment adviser)."

[15] Comment letter of NASD arbitrator Mitchell B. Goldberg, Esq., on the Rule, August 25, 2004.

[16] *See* "Report of the Committee on Compensation Practices," *Executive Summary,* April 10, 1995.

problems with regulators, unlike brokers whose clients must visit the Central Registration Depository to review those records.

FPA's position on disclosure requirements and professional conduct in a financial planning engagement are guided by the CFP Board *Code of Ethics and Professional Responsibility.* When in such an engagement,[17] the planner must comply with a far more comprehensive disclosure regimen than is required in Form ADV. They must also follow a specific, six-step process that complies with practice standards promulgated several years ago by the CFP Board of Standards, Inc.

Notwithstanding the comprehensive nature of the disclosure requirements of the Advisers Act, we would note that there is *pro forma* disclosure and there is meaningful disclosure. FPA strongly supports the proposed changes to Part II of Form ADV by the Commission which would transform a quasi-data collection and disclosure document into a more meaningful, plain-English narrative form that would make it easier for the client to understand the advisory business and individuals offering investment advice.

Supporters of the Rule list disclosure requirements on the brokerage side, including Rule 10b-10 and Rule 2230, which are piecemeal and not contained in a core disclosure document. These disclosures are not part of a core disclosure document, and not remotely comparable to Form ADV. Broker disclosure is opaque and scattered across sales receipts and various account forms. For example, disclosure on the sales confirms may note that orders could be directed to certain broker-dealers, but a discussion of how the firm handles conflicts in directing orders and receiving payment for order from other firms is absent.

Moreover, the SEC recently adopted a rule that prohibits investment advisers from directing order flow to reward sales activities,[18] but broker-dealers remain free to direct order flow to those broker-dealers that will pay the first broker-dealer for that order flow – a practice that could fairly be called a kickback in any other industry. Similarly, principal transactions may be disclosed on the sales confirm, but customers are usually required to sign a blanket consent when the account is opened. Investment advisers, by contrast, are obligated as fiduciaries to only enter into principal transactions after receiving client consent on a trade-by-trade basis,

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[17] Rule 201 requires a CFP practitioner to "exercise reasonable and prudent professional judgment in providing professional services." Rule 202 requires a practitioner to act in the interest of the client. In rendering professional services, Rule 401 requires a CFP practitioner to disclose information relevant to the professional relationship, including conflicts of interest, credentials, qualifications, licenses, compensation structure, and any agency relationships. Rules 402 and 403 require additional disclosure statements, among others, about qualifications, the philosophy, theory and/or principles of financial planning utilized by the practitioner, third-party compensation, and compensation information expressed in an approximate dollar amount or percentage, or range thereto. Such disclosure would include insurance and brokerage commission amounts or estimates, including trails, not just advisory fees.

[18] *See* Investment Company Act Release no. 26591.

and more importantly, may only engage in principal transactions that benefit the client.

If the Commission remains uncertain as to which form of disclosure provides a more meaningful format to assist investors in making an informed selection of their adviser or broker, we suggest that the Commission use consumer focus groups in helping to make that determination.

Brokerage Suitability Standards vs. CFP Board Practice Standards. The primary market conduct standard for the brokerage industry are suitability standards in connection with brokerage transactions. There are best practices for the industry and there are numerous seminars, compliance manuals and articles on confirming suitability with respect to investment objectives. FPA in the past has initiated support for NASD suitability standards as a means of satisfying model rules for the sale of fixed annuities[19] as proposed by the National Association of Insurance Commissioners several years ago. FPA believes such rules generally, when followed in an ethical and diligent manner, are appropriate to sales practices for the financial services industry.

We are troubled, however, by the Rule's proponents who suggest suitability standards are sufficient to cover financial planning or other advisory services in the fee-based programs. In order to hold the CFP® credential, an individual must pass six courses on related areas of the financial planning process, including investments, insurance, estate, retirement and tax planning. They must also have three years' experience in financial planning. Candidates who sit for the two-day, 10-hour CFP exam are advised to study 200 to 300 hours prior to taking the exam as well as go through a two- to three-day refresher course. We are not aware of any NASD-sponsored exam which provides the same comprehensive coverage. We believe that anyone holding out as a financial planner should meet these same basic competency requirements.

The financial planning process and related practice standards for CFP® certificants require compliance with the following standards (in order):

1. Defining the scope of the engagement (establishing and defining the client relationship);
2. Determining a client's personal financial goals and obtaining client data;
3. Analyzing and evaluating the client's information;
4. Identifying and evaluating alternatives, developing the recommendations, and presenting them to the client;
5. Implementing the plan recommendations; and

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[19] *See* FPA comment letters dated August 10, 2001, April 11, 2003, and July 3, 2003, to NAIC concerning Senior Protection in Annuity Transactions Model Regulation, at http://www.fpanet.org/member/govt_relation/state/insurance/index.cfm.

6. Defining monitoring responsibilities.[20]

We are also concerned with the securities industry's characterization of financial planning that explicitly rejects financial planning as an advisory service and instead describes it as a tool for meeting suitability requirements for brokerage and advisory accounts.[21] This flawed dialectic approach to explain away financial planning as "solely incidental" to brokerage services is diametrically in conflict with the CFP Board practice standards as a comprehensive approach for helping a client meet his or her personal financial objectives and life goals. In fact, we would suggest the inverse is true, that the brokerage industry is attempting to transmogrify into financial planners without regard to ethics, experience or education requirements that would far better align the adviser/broker with the client's best interests than simple compensation arrangements. If this convoluted logic is indeed to be believed by the Commission, then the SEC staff's interpretation 17 years ago in IA Release No. 1092 applying Advisers Act registration to financial planners who provide investment advice must be reconsidered.

Summary

FPA reiterates its belief 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. The Commission should withdraw the Rule and require full compliance by brokers offering fee-based programs and marketing financial planning services to the public.

We would be pleased to respond to any questions in connection with these comments. Please do not hesitate to contact the undersigned at 202.626.8770.

Sincerely,

Duane R. Thompson
Group Director, Advocacy

[20] *See* CFP Board's Standards of Professional Conduct at http://www.cfp.net/certificants/conduct.asp.

[21] *See* memorandum by Michael Udoff of the Securities Industry Association to SEC staff concerning the instant proposal, March 27, 2003.