Fund Democracy
Consumer Federation of America
Consumers Union
Consumer Action

February 7, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

File No. S7-25-99

Dear Mr. Katz,

Fund Democracy,[1] the Consumer Federation of America,[2] Consumers Union[3] and Consumer Action[4] appreciate the opportunity to comment on the SEC's proposal[5] to exempt certain fee-based brokerage accounts from regulation under the Investment Advisers Act.[6] We congratulate the Commission for taking action on this matter, which has been left unresolved for too long.

---

1 Fund Democracy is a nonprofit membership organization that acts as an advocate and information resource for mutual fund shareholders.

2 The Consumer Federation of America (CFA) is a non-profit association of more than 260 pro-consumer organizations which in turn represent more than 50 million individual consumers. CFA was founded in 1968 to advance the consumer interest through advocacy and education.

3 Consumers Union, publisher of *Consumer Reports* magazine, is an independent nonprofit testing, educational and information organization serving only the consumer.

4 Founded in 1971, Consumer Action works on a wide range of consumer issues through its national network of 6,500 community based organizations.

5 *See* Certain Broker-Dealers Deemed Not to be Investment Advisers, Advisers Act Release No. 2340 (Jan. 6, 2005) ("Broker Exclusion Proposal").

6 We incorporate by reference the following letters submitted in connection with the proposal: Letter from CFA to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Nov. 4, 2004); Letter from CFA to

Because we agree with the Commission's analysis that fee compensation should not automatically be viewed as special compensation for advice, we do not object to that part of the Release that proposes to provide a limited exemption from Advisers Act regulation for certain fee-based accounts that meet specific criteria. Furthermore, we appreciate the steps the Commission has taken to strengthen the rule, both by defining all discretionary accounts as advisory accounts and by improving somewhat the disclosures to investors. These two steps address important weaknesses in the original rule proposal.

From the outset, our objection to the proposed rule has had relatively little to do with the rule language itself.[7] Our primary complaint has been with the Commission's continued reliance on a "solely incidental to" standard it has neither defined nor enforced. An appropriate definition of "solely incidental" is key to providing the kind of functional distinction between brokers and advisers that Congress sought to create and that the Commission professes to support. We were therefore greatly encouraged when the Commission announced in December that it would be issuing a concept release clarifying this standard.

Unfortunately, far from clarifying the issues, this release provides an interpretation of "solely incidental to" that flatly contradicts the statutory language, is not supported by the legislative history, and would inappropriately strip advisory accounts offered through brokers of the Investment Advisers Act's protections. While we acknowledge that reasonable views may differ as to the scope of advisory services that would be considered to be solely incidental, we do not believe that the Commission can reasonably argue that advisory services are not "solely incidental" as long as they are rendered "in connection with and reasonably related to brokerage services provided to [an] account."[8] If the Commission were to endorse this interpretation, it

---

Jonathan G. Katz, Secretary, Securities and Exchange Commission (Oct. 5, 2004); Letter from CFA to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Sep. 20, 2004); Letter from CFA, Fund Democracy, Investment Counsel Association of America, Financial Planning Association, Certified Financial Planner Board of Standards, Inc., and National Association of Personal Financial Advisors to William H. Donaldson, Chairman, Securities and Exchange Commission (May 6, 2003); Letter from the CFA to Harvey L. Pitt, Chairman, Securities and Exchange Commission (Dec. 13, 2001); Letter from CFA, Investment Counsel Association of America, Certified Financial Planner Board of Standards, and National Association of Personal Financial Advisors to Jonathan G. Katz, Secretary, Securities and Exchange Commission (May 31, 2000); Letter from CFA to Arthur Levitt, Chairman, Securities and Exchange Commission (Feb. 28, 2000); Letter from CFA to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Jan. 13, 2000). We also incorporate by reference the press release issued by CFA, Fund Democracy, Consumers Union and Consumer Action on July 20, 2004, which is attached to this letter.

[7] We do not agree, however, that this exemption must take the form of a rule. We believe that the problem is essentially an interpretive one created by the SEC's traditional view that fee-based accounts are charging "special compensation." There is no reason why the Commission could not simply clarify that fee-based accounts are not necessarily charging "special compensation" to the extent that the compensation does not reflect a materially different level of advisory services from those that would be considered solely incidental.

[8] Broker Exclusion Proposal at 43.

would effectively repeal the "solely incidental" test, leaving no meaningful basis for regulating advisory services offered by brokers under the Investment Advisers Act.

To the extent that the elimination of the special compensation test for fee-based accounts is based on this understanding of "solely incidental," the proposed rule is contrary to the public interest and inconsistent with Congress's intent, and therefore is an illegal exercise of the SEC's exemptive authority. The elimination of the "special compensation" test for these accounts can only be appropriate if the Commission reasonably and explicitly defines the scope of "solely incidental" advisory services in a way that is consistent with the plain meaning of that term.

Once the Commission has arrived at a reasonable definition of "solely incidental" – a standard the current release does not satisfy – it should be included in the text of the rule, which should also include a non-exhaustive list of examples of situations in which advisory services would not be solely incidental. This list should include, at a minimum: discretionary accounts, wrap accounts, financial planning services, ongoing account review and advice, and services that are held out as predominantly or substantially advisory in nature. In devising this list, the Commission should assess which services are most appropriately regulated under a standard that includes a fiduciary duty to the client and an obligation to disclose conflicts of interest and which can safely be regulated under a less stringent sales standard of conduct.

The Meaning of Solely Incidental

The aspect of the SEC's proposal that we find most disturbing is its discussion of the meaning of "solely incidental." Reasonable people can disagree about how significant advisory services must be before they no longer qualify as solely incidental to the brokerage services provided. No reasonable interpretation could lead, however, to the conclusion that advisory services are solely incidental when they are rendered "in connection with and reasonably related to the brokerage services provided to the account," as stated by the Commission.[9] This interpretation directly undermines other more pro-investor parts of its release, which suggest that certain advisory services (such as all discretionary accounts and financial planning services) would in fact fail the solely incidental test, despite the fact that they would be rendered "in connection with" and would be "reasonably related to" the brokerage services provided.

The in connection with/reasonably related to test proposed by the Commission bears no rational relationship to the plain meaning of the term "incidental." Webster's Dictionary defines "incidental," when used as an adjective, as "(1) being likely to ensue as a chance or minor consequence . . . , (2) occurring merely by chance or without intention or calculation," and when used as a plural noun as "minor items (as of expense) that are not particularized.[10] However,

---

9 Broker Exclusion Proposal at 43.

10 Webster's Ninth New Collegiate Dictionary (1983); *see also* Black's Law Dictionary at 686 (5th ed. 1979)

even if you accept the Commission's selection of the one definition of "incidental to" that doesn't include any reference to the minor or secondary aspect of the term, it still doesn't support the Commission's definition of "solely incidental to" as "in connection with and reasonably related to." Rather, if you paraphrase the "solely incidental to" requirement using the Commission's chosen definition, it would except broker-dealers from the Advisers Act only insofar as they limit themselves to giving nothing more than (solely) the investment advice that follows as a direct consequence of (incidental to) their primary business of effecting transactions in securities on behalf of customers. While it may not always be easy to draw the line between brokerage services and advisory services using that definition, one thing is clear. Solely incidental advisory services must arise as a consequence of specific transactions. The transactions must drive the advice, not the other way around.[11]

In contrast, the terms "in connection with" and "reasonably related to" do not limit the scope of the advisory services provided to those that arise only as a consequence of the brokerage business. Indeed, the meaning of these terms is essentially in opposition to the meaning of "solely incidental" in the context of the broker exclusion. Advisory services that are offered "in connection with" or are "reasonably related to" a brokerage business would include a substantially broader category of services than are included in the category of advisory services than are provided solely as a consequence of the brokerage business.

The Commission is correct that, for the services to be considered solely incidental they must refer to services involving "advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities," but the SEC's in connection with/reasonably related to test would cover all such securities-related services. Brokers could easily structure their advisory programs such that all services that involve "advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities" were reasonably related to or provided in connection with their brokerage business. In fact, it is difficult to imagine a financial advisory service that could not be offered in connection with a brokerage service and that could not be construed as being reasonably related to that service. It is unclear, under this approach, why even any investment adviser or financial planner would necessarily be subject to adviser regulation as long as they also happened to provide brokerage

---

(defining incidental as "[d]epending upon or appertaining to something else as primary; something necessary, appertaining to, or depending upon another which is termed the principal; something incidental to the main purpose."); Roget's International Thesaurus at 928 ((3d ed. 1962) (listing as synonyms for "incidental" the words "extrinsic," "circumstantial," "parenthetical," "occasional," and "spare.").

[11] *See* Committee on Banking and Currency, U.S. Senate, Investment Company Act of 1940 and Investment Advisers Act of 1940, Report No. 1775, 76th Cong., 3d Sess. (June 6, 1940) at 22 (exclusion available to brokers only "insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions"); Opinion of General Counsel Relating to Section 202(a)(11)(c) of the Investment Advisers Act of 1940, Advisers Act Release No. 2 (Oct. 28, 1940) ("The essential distinction to be borne in mind . . . is the distinction between compensation for advice itself and compensation for services of another character to which advice is merely incidental.").

services to their advisory clients.

For the solely incidental test to make sense, there must be some securities-related services that a broker could not provide without being subject to adviser regulation. The in connection with/reasonably related to test concludes that there are none. In short, the SEC's interpretation of the "solely incidental" test simply writes that test out of the statute.

In presenting its interpretation, the Commission has ignored not just the plain meaning of the statutory language, but also the vast majority of the legislative record. Contrary to the SEC's assertions, the legislative history and early Commission interpretations of the legislation both clearly demonstrate Congress's expectation that the solely incidental test would result in brokers' sometimes being subject to adviser regulation, even when they did not offer that advice through a separate advisory department or charge a special fee for it. Further, the legislative history demonstrates that a significant concern was to ensure that the provision of advisory services would be subject to the higher fiduciary standard to which professionals were held.

Congress addressed this concern by establishing the solely incidental test. This requirement of the exception recognized that traditional brokerage necessarily included some degree of incidental advisory services, such as recommending securities for purchase or sale and expressing a view on the value of particular investment opportunities. At the same time, Congress sought to ensure that, if the advisory services offered went beyond these sorts of traditional brokerage activities, the broker's customers would be protected by the higher legal standards of the Advisers Act. CFA has written separately to address in greater detail the SEC's interpretation of the legislative history of the broker exclusion, and we hereby incorporate that letter by reference.[12]

The Commission also relies for its interpretation on more recent history that has been created by its own lax enforcement of the law. For decades, the Commission has turned a blind eye to advisory services provided by brokers under commission-based programs that were not solely incidental to their brokerage services under any reasonable interpretation of that standard. In permitting these commission-based programs to provided unlimited advisory services, the Commission substantially exacerbated the breakdown of the functional distinction between brokers and advisers that Congress intended the solely incidental test to maintain. The SEC's proposal would codify its longstanding disregard for the statute by expressly repealing the special compensation test for fee-based accounts and extend its position by eviscerating the solely incidental test as well.

The Commission justifies its approach in part because failure to do so might result in the extension of the Advisers Act to most brokerage relationships – something it says Congress

---

[12] Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Feb. 7, 2005).

could never have intended. But Congress did not intend in 1940 that commissions would be deregulated. And it did not intend that full-service brokers would come to face competition on two sides – from discount brokers offering cheaper execution and from financial planners offering comprehensive financial advice. Congress did not intend that brokers would respond by adopting a more advice-driven business model. Congress did not intend these things, but it did provide for them – by limiting the broker-dealer exception to brokers engaged exclusively in traditional brokerage activities. It is not the Commission's job to preserve the broker's regulatory status when the broker's business model has changed so dramatically. It is the Commission's job to ensure that investors are adequately protected. By that standard, both the Commission's past policy and its current interpretation with regard to the solely incidental standard are an abysmal failure.

It is fortunate, we suppose, that the Commission contradicts its own position in this release, by describing certain advisory services as not being solely incidental, despite the fact that they are "reasonably related to" and provided "in connection with" brokerage services. For example, the proposed rule would treat discretionary accounts as triggering adviser regulation "because they bear a strong resemblance to traditional advisory accounts, and it is highly likely that investors will perceive such accounts to be advisory accounts."[13] This position is correct, but it is flatly contradicted by the SEC's in connection with/reasonably related to test, which discretionary accounts, especially commission-based accounts, would satisfy. While we strongly support the Commission's decision to define all discretionary accounts as advisory accounts, we are concerned that it may not be able to maintain this position in light of its faulty interpretation of solely incidental.

The same concern applies to the other positive provisions in the release, in particular those that consider restricting brokers' ability to hold themselves out to the public as advisers without being regulated as advisers and that propose to recognize financial planning as an advisory service. The Commission has long held that the ability of lawyers and other professional to rely on their solely incidental exception turned "on whether the lawyer or accountant has held himself out as providing financial planning, pension consulting, or other financial advisory services." The release asks whether the Commission should apply a similar standard to brokers. We have long advocated restricting the ability of brokers to hold themselves out to the public as advisers without regulating them as advisers. We believe it is clear Congress never intended that they be allowed to do so. Failure to restrict such holding out promotes not just investor confusion, but outright investor deception. However, this approach, while the right one for investors, does not appear to be supported by the Commission's approach to solely incidental.

Similarly, we strongly concur with the Commission's suggestion that financial planning services do not satisfy the solely incidental test. The issue is not just that the advice involves matters unrelated to securities. The issue is that advice is what is being sold. Under no reasonable

---

[13] Broker Exclusion Proposal at 29.

standard, therefore, could financial planning services be considered as solely incidental to brokerage activities. On the other hand, we cannot conceive of a financial planning service that could not be considered to be connected with or reasonably related to a broker's business in this context. Once again, reasonable, pro-investor policy is undercut by the Commission's anti-investor interpretation of solely incidental. Even wrap programs, which the Commission has long viewed as subject to adviser regulation, also may be provided in connection with and reasonably related to brokerage services. Their status under adviser regulation could therefore be threatened by the Commission's current interpretation of solely incidental.

What the foregoing analysis illustrates is not only the SEC's impermissible interpretation of the solely incidental test, but also its continuing confusion regarding the meaning of solely incidental. It proposes the in connection with/reasonably related to test in one breath, and contradicts it in another. If it wants to develop reasonable, pro-investor policy, the Commission must reject the in connection with/reasonably related to interpretation of solely incidental outright. It must then decide what degree and type of advisory services a broker may provide under the broker exclusion, and incorporate a clear statement of that standard into the rule. In doing so, it should keep in mind the need to provide a clear and rational functional distinction between brokers and investment advisers.

The "Repricing of Brokerage Services" Argument

In developing this rule proposal and attendant policy discussion, the Commission appears to have unquestioningly adopted the brokerage industry's sophistry that a mere change in the structure of the compensation they charge should not affect their status under the Advisers Act if the services they provide remain the same. This argument fails for a number of reasons.

First and foremost, the industry's argument fails because the services provided under commission-based programs often are not, in fact, solely incidental; the programs should have been subject to adviser regulation for many years. The Commission has implicitly conceded this point by its belated realization that the broker exclusion should not be available to ***commission-based*** discretionary accounts or financial planning.

Second, the industry's argument fails because the services provided by brokers have changed dramatically over time.[14] Brokers' advertisements for their fee-based accounts often seek to attract business by boasting about the new level of financial planning and advisory services being provided. Unlike the incidental services provided by full-service brokers in the past, the advisory services provided by full-service brokers today are critical and even predominant. Congress anticipated this situation by specifically requiring that brokers providing such advisory services be subject to adviser regulation.

---

[14] *Id*. n. 113 ("On the other hand, the brokerage business has evolved significantly since 1940, and it may be appropriate to consider financial planning to be part of the traditional package of services broadly understood.").

Finally, the brokerage industry has argued, and the Commission apparently concurs, that fee-based accounts will not be offered if they are subject to adviser regulation. Yet the Securities Industry Association concedes that "more than three-quarters of all fee-based accounts maintained at broker-dealers are already treated as advisory accounts."[15] Thus, many brokers are, in fact, quite able to offer fee-based accounts subject to adviser regulation. In any case, even if some brokers decided not to offer fee-based accounts in order to avoid adviser regulation, this is precisely the outcome that Congress intended when it determined that brokers should not provide non-incidental advisory services without complying with the Advisers Act. Congress certainly did not intend that investment advisers should be able to avoid adviser regulation simply by offering minimal brokerage services in connection with or that are related to their advisory services.

Disclosure Requirements

The Commission has proposed that, in connection with fee-based brokerage accounts, a legend appear on advertisements and account documents: (1) stating that the account is a brokerage account and not an advisory account and that there are differences between these accounts, including with respect to the scope of the firm's fiduciary obligations, and (2) identifying a person at the firm with whom the customer can discuss these differences. We generally support these proposed disclosure requirements, but believe that they must be reoriented and expanded to be effective.

We agree with the SEC's conclusion that simply informing brokerage customers that what appear to be advisory accounts are in actuality brokerage accounts is inadequate, but we do not see how the additional disclosure proposed by the Commission will more than minimally improve brokerage customers' understanding of their rights. The legend will still leave the customer guessing as to scope of differences between the legal duties owed by brokers and investment advisers. Investors will naturally assume that if these differences were important, and they are, they would be fully explained, rather than being implicitly relegated to the category of information that is not necessary to understand.

The high degree of investor confusion about the nature and regulation of advisory services provided by brokers is illustrated by recent surveys. One survey commissioned by the CFA and the Zero Alpha Group[16] showed that many investors are confused about the types of services offered by brokers.[17] Nearly three-quarters (73 percent) of the investors surveyed did not

---

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

[16] The Zero Alpha Group is a national network of eight independent investment adviser firms.

[17] The study was conducted by Opinion Research Corporation International. Results are based on telephone interviews October 2004 with 1,044 investors. The margin of error at a 95 percent confidence level is plus or minus

understand the very basic point that the primary service brokers offer is the execution of transactions, and among those investors, 28 percent thought financial advice was the primary service offered by brokers, 25 percent thought advice and transaction assistance were equally important services offered by brokers, and 20 percent couldn't even venture a guess.

The CFA/ZAG survey also showed that investors believe that brokers who provide financial planning services should be subject to the same investor protection rules that apply to financial planners and that brokers should have to disclose any financial incentives they receive to promote the sale of particular investment products. Thus, investors believe that brokers are advisers, and they accordingly believe that brokers should have to provide the same disclosure and be subject to the same general regulations as advisers.

Similarly, a recent study commissioned by TD Waterhouse found substantial confusion among investors about the rules applicable to brokers and advisers.[18] The study found that:

> [f]ifty eight percent incorrectly believe that both stockbrokers and investment advisors have a fiduciary responsibility to act in the investor's best interest in all aspects of the financial relationship, and 63% incorrectly believe that both stockbrokers and investment advisors are required to disclose all conflicts of interest prior to providing financial advice. Nonetheless, nearly 85% of investors expect all financial professionals offering fee-based financial advice to provide these protections. . . . Eighty three percent were either very concerned or somewhat concerned that all financial professionals offering fee-based financial advice are not subject to the same industry regulation."[19]

The CFA/ZAG and TD Waterhouse survey demonstrate that investors' expectations are defined by the functional services they receive, and they expect that advisory services will be accompanied by the higher standard to which a fiduciary is held.

To adequately address such investor confusion and expectations, disclosure must be prominent, substantive and pointed. The legend should include a statement to the effect that, among other things, a broker, (1) unlike an investment adviser, may not be required to act solely in the best interests of the customer; (2) may not be required to disclose material information, such as conflicts of interest between the broker and the customer, that advisers are required to disclose; and (3) may engage in principal transactions with the customer without obtaining the customer's

---

three percentage points. Complete results of the survey, including the actual questionnaire, are available at www.zeroalphagroup.com.

[18] *See* TD Waterhouse 2004 U.S. Investor Perception Study.

[19] *Id.*

permission, as an adviser would be required to do. The legend should make clear that investment advisers are subject to these heightened legal duties because of the greater potential for conflicts of interest and harm to customers that are present in an advisory relationship. When brokers choose not to be subject to these heightened standards, they should at least be required to disclose the effect of this choice to their customers.[20]

We recognize the Commission's desire not to provide lengthy disclosures that will not end up being read, but leaving a candid explanation of the lower legal standards that apply to brokers in the hands of an employee of the brokerage, where effective monitoring will not be possible and the conflict of interest will be crippling, is impractical as a means of effectively communicating the difference in standards. It is an invitation for brokers to engender even greater misunderstanding among their customers. If clear and concise disclosures cannot be devised to convey the above information, then that makes the case for prohibiting brokers from holding out all the more compelling.

We also believe that disclosure requirements should be expanded beyond fee-based accounts. The problem that the disclosure is intended to address is the misleading impression that brokers who provide investment advice – including solely incidental advice – are subject to heightened legal standards that consumers tend to associate with such advisory relationships, as evidenced by the CFA/ZAG and TD Waterhouse studies. They are accustomed to expecting doctors, lawyers, investment advisers and other professionals who provide them with individualized counsel to do so based solely on their own best interests. This impression is false as to brokers, however, and brokers who provide investment advice should be required to remind their customers of this fact wherever and whenever practicable.

We strongly disagree with the Commission that a legend, regardless of its content, will alone be sufficient to neutralize misleading disclosure by brokers. In its original proposal, the Commission conceded that "that some broker-dealers offering these new accounts have heavily marketed them based on the advisory services provided rather than the execution services, which raises troubling questions as to whether the advisory services are not (or will be perceived by investors not to be) incidental to the brokerage services."[21] Advertisements and sales materials for fee-based and other brokerage accounts routinely emphasize terms and use descriptive phrases that create a strong impression that advisory services are an important, even central element of the services provided. These communications often refer to brokers as "financial consultants" or similar titles that imply their primary role is advisory. No amount of disclosure can correct the misleading impression created these communications.

---

[20] *Id*. ("86% of investors indicated that their choice of financial professional would be impacted if they understood the different levels of investor protection from stockbrokers and investment advisors offering the same fee-based advisory services.")

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

We therefore believe that the Commission should preclude brokers from holding out to the public as advisers unless they also accept regulation as advisers. In addition, the Commission should expressly prohibit any communication that implies that advisory services are anything more than solely incidental to the brokerage services provided. This should be interpreted to require that, in any communication that refers to advisory services, such references are substantially less prominent than references to brokerage services. Only when combined with such an approach, will the enhanced disclosures provide meaningful protections to investors.

Perspective of the Commission

We also are concerned that the Commission, in a number of respects, has shown a striking insensitivity to the interests of the investing public and the public policy underlying the Investment Advisers Act. For example, the release reopening the comment period on the SEC's original proposal asked, "If the Commission determines not to adopt this rule as proposed, what would be the practical impact on broker-dealers?" The release asks no such question about the adverse impact on investors if the rules were adopted.

This perspective carried forward to the proposing release, in which the Commission characterizes the debate surrounding its proposal as little more than a turf war between competing, self-interested service providers. The comments on the proposal do not, as the Commission states, reflect solely the view of "two groups – one representing broker-dealers and the other representing advisers . . . [that] view the development of fee-based brokerage accounts through different lenses."[22] The Commission further states that it believes "that [the two groups] have raised important issues that concern us and should concern all market participants,"[23] while ignoring both the CFA/ZAG and TD Waterhouse investor surveys discussed above and the extensive comments submitted by investors and investor advocates to the agency on this issue over many years.

We believe that there is only one "lens" that should apply in this context and that is the lens of investor protection through which Congress viewed advisory services in 1940. We believe that the group about which the Commission should be most concerned is investors, not brokers or financial planners. Congress designed the securities laws not primarily to serve or balance the interests of different industry participants, but to protect investors and promote efficient capital markets. We disagree strongly with the SEC's implied view that only private interests are at stake and urge it to give greater consideration to the public interest in drafting a final rule. In particular, the Commission should consider the effect on the investing public of having two classes of financial professionals that investors cannot tell apart subject to different legal

---

22 *See* Broker Exclusion Proposal at 14.

23 *Id*. at 15 – 16.

standards.

We also object strongly to the SEC's characterization of the Investment Advisers Act as not providing significant protections beyond those provided under the Exchange Act.[24] We believe, as have previous Commissions, that the Advisers Act provides important investor protections that Congress decided some brokers should be subject to when they provide advisory services, notwithstanding their regulation under the Exchange Act. If the SEC staff had chosen to describe in the proposing release the specific additional protections afforded by the Advisers Act, perhaps the Commission might not have been so quick to dismiss them. For example, the Advisers Act requires extensive disclosure and information delivery requirements to which brokers are not subject. Advisers are not permitted to act as principal in trades with their clients without their clients' permission. Advisers are fiduciaries, and, as the Commission points out, they have been treated as such when acting in an advisory capacity.

The proposing release suggests that the proposed rule would not affect brokers' status as fiduciaries.[25] If the Commission deems brokers who provide extensive advice not to be advisers for purposes of the Advisers Act, however, brokers will inevitably cite this position before other adjudicative bodies in support the argument that such brokers are not fiduciaries. The basis for subjecting investment advisers to heightened regulation under the Advisers Act relies on the same relationship of trust and confidence on which courts have based a finding that an investment professional is a fiduciary.[26] Surely the Commission does not believe that its excluding such brokers from federal adviser regulation will have no affect on their status as fiduciaries in our courts.

We agree that some areas of adviser and broker regulation may be duplicative, such as custodial requirements, but this is not a sufficient basis to exempt brokers from an entire regulatory regime. The Commission has broad exemptive authority under the Advisers Act to relieve brokers from duplicative requirements, and it could easily exercise that authority with respect to those requirements that are particularly burdensome. Instead, it has chosen to ignore Congress's intent that certain brokers be subject to adviser regulation by summarily striking them from the Act's purview.

Conclusion

The SEC's analysis of solely incidental overthrows Congress's express statutory mandate. The Commission argues that "Congress was well aware of these sorts of differences when it passed

---

[24] *See id.* at 20 – 24.

[25] *See id.* at 22.

[26] *See id.* at n.54.

the Advisers Act and excepted broker-dealers from the definition of investment adviser."[27] In fact, Congress did not except all broker-dealers from the Act. Rather, it expressly provided that brokers whose advisory services were not solely incidental or who received special compensation ***would be subject to adviser regulation***. Congress "was well aware" of the extensive regulation of brokers under the Exchange Act that it had enacted only six years earlier and could have excepted all brokers from the Advisers Act. Contrary to the SEC's assertion, it expressly chose not to do so because it believed, as do we, that the Advisers Act provides important investor protections that should not be so lightly dismissed.

The SEC has over many years steadily undermined the distinction between brokerage and advisory services that Congress recognized and codified, to the point where the distinction no longer bears any relation to the nature of the services provided. The Commission now has an opportunity to rescue its failed policy, and several good suggestions in the release for doing so. However, it would be a grave error and a great disservice to investors to let stand the unfounded, illogical, anti-investor interpretation of "solely incidental to" presented in this release. Instead, we urge the Commission to adopt an interpretation that supports a meaningful functional distinction between brokers and advisers. We believe the alternative interpretation we have provided in this comment letter meets that criterion. It has the added benefits of being consistent – as the Commission interpretation is not – with the statutory language, with the legislative history, and with simple common sense.

Respectfully,

Mercer Bullard
Founder and President
Fund Democracy
Assistant Professor of Law
University of Mississippi
(662-915-6835)

Barbara Roper
Director of Investor Protection
Consumer Federation of America
(719-543-9468)

Sally Greenberg
Senior Counsel
Consumers Union
(202-462-6262)

---

[27] *Id*. at 21.

Ken McEldnowney
Executive Director
Consumer Action
(415- 777-9648)

cc: Chairman William H. Donaldson
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Mr. Paul F. Roye, Director, Division of Investment Management
Mr. Robert E. Plaze, Associate Director, Division of Investment Management