

Fund Democracy  
Consumer Federation of America

November 2, 2007

BY EMAIL AND U.S. MAIL

Nancy M. Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, N. E.  
Washington, D.C. 20549-1090

RE: File No. S7-22-07

Dear Secretary Morris:

We are writing on behalf of the Consumer Federation of America<sup>1</sup> and Fund Democracy<sup>2</sup> to comment on the Commission's proposed interpretive rule addressing various issues related to broker-dealer regulation under the Investment Advisers Act. We are in general agreement with the agency's decision to reinstate its interpretations with regard to treatment of fee-based compensation and separate contracts for advisory services, discretionary authority, and differential compensation for discount brokerage services. We do have concerns and questions about various aspects of the Commission's proposal, however, which we discuss in greater detail below.

**Solely Incidental**

We are extremely disappointed to see the Commission reassert in this context its unfounded, anti-consumer definition of "solely incidental to." Contrary to the assertions in the proposed rule, the Commission staff's interpretation of solely incidental to as meaning "in connection with and reasonably related to" is consistent neither with the plain meaning of the statutory language, nor with its legislative history. In fact, it is this faulty interpretation of solely incidental to which is the source of much of the confusion that exists in the current marketplace. Rather than re-argue that issue here, however, we incorporate by reference our previous letters

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<sup>1</sup> Consumer Federation of America (CFA) is a non-profit association of approximately 300 national, state, and local pro-consumer organizations founded in 1968 to advance the consumer interest through research, advocacy and education.

<sup>2</sup> Fund Democracy is a non-profit membership organization that was formed in 2000 to act as an information source and advocate for mutual fund investors.

on this topic.<sup>3</sup> Furthermore, we urge the Commission to make clear that it does not consider this settled Commission policy. Rather, this is an issue that should, in fact must, be addressed in light of the findings of the upcoming RAND Corporation study and subject to appropriate public comment.<sup>4</sup> Only then will it be possible to arrive at a comprehensive, rational, pro-investor policy for regulating investment professionals.

### **A Separate Contract for Advisory Services**

CFA agrees with the Commission's interpretation that, when a broker contracts separately for advisory services or charges a separate fee for advisory services, those services should be regulated under the Investment Advisers Act. Clearly, charging a separate fee for advice triggers the special compensation prong limiting the broker-dealers' Investment Advisers Act exclusion. Just as clearly, a broker that contracts separately to provide advisory services cannot be viewed as providing advice that is *solely* incidental to brokerage services, regardless of whether the advisory services in question are offered in connection with and reasonably related to the brokerage services. A reasonable investor should be able to safely assume that advisory services which are contracted for separately are subject to Advisers Act regulation and the fiduciary duty that goes with it.

### **Discretionary Authority**

We agree with the Commission's interpretation that accounts over which a broker exercises discretionary authority should be regulated under the Investment Advisers Act and that this is one of the types of advisory services Congress intended to regulate under the Act. Because of its faulty definition of solely incidental to, however, the Commission in its proposed rule ties itself into knots trying to justify this position. The simple fact is that discretionary accounts should be treated as advisory accounts because they include the provision of extensive personalized investment advice that goes far beyond any reasonable interpretation of advice that is solely incidental to brokerage services.<sup>5</sup>

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<sup>3</sup> See, in particular, the letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Jonathan Katz, dated February 7, 2005, and the letter of the same date from CFA, Fund Democracy, Consumers Union, Consumer Action, also to Secretary Jonathan Katz.

<sup>4</sup> The Commission has referred to publicizing and seeking comment on the RAND Study as "one option." See Interpretive Rule under the Advisers Act Affecting Broker-Dealers, Investment Advisers Act Rel. No. 2652 at note 19 (Sep. 24, 2007) ("Proposing Release"). We firmly believe that the RAND Study must be made public and subject to comment to permit a fair and full opportunity to comment on the Commission's rule proposal.

<sup>5</sup> This is, in fact, a perfect illustration of the flaws in the Commission's interpretation of solely incidental to. Investment discretion is clearly offered in connection with and reasonably related to brokerage services and therefore falls outside of the Commission's definition of solely incidental to. But no one could reasonably consider discretionary advice to be solely incidental to brokerage services.

We support the definition of discretionary services included in the interpretive rule. We are concerned, however, that the commission's exception for situations in which the broker has discretion over an account for limited period of time may provide too broad a loophole. Discretionary authority over an account for "a few months" indicates a degree of reliance by the investor on the broker's advice that seems indicative of an account in which there is a relationship of trust, and the advice is more than solely incidental to brokerage services. In such circumstances, the investor should be entitled to the protections that go along with the Investment Advisers Act's fiduciary duty.

### **Full Service and Discount Brokerage Services**

We agree with the Commission's interpretation that merely offering discount brokerage and full service brokerage services within the same firm should not automatically trigger regulation under the Investment Advisers Act. As we noted in a previous comment letter to the Commission, other factors, such as overhead costs and the privilege of dealing directly with a registered representative, contribute to the higher costs in full service accounts.<sup>6</sup> In such circumstances, the higher costs cannot be attributed exclusively to special compensation for advice, but may rather reflect compensation for a package of services, of which advice may merely be an incidental component. On the other hand, where a brokerage firm advertises that the provision of advice is primarily responsible for this difference in transaction costs or otherwise implies that the advice offered through the full service account is more than solely incidental to the brokerage services, Advisers Act regulation should apply.

### **Financial Planning**

We strongly supported the Commission's original interpretation defining financial planning as an investment advisory service. The Commission has not included the financial planning rule in this release, on the grounds that "many financial services firms found [it] difficult to apply." While we believe the commission's original interpretation was clearly the correct one, and that the reason offered for failing to re-adopt it is inadequate, we are not arguing for the financial planning rule to be reinstated at this time.<sup>7</sup> Until the SEC adopts an appropriate definition of solely incidental to, it will be impossible for the agency to develop an appropriate approach to regulating financial planning. While we believe these are issues of highest priority,

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<sup>6</sup> Letter from Barbara L. N. Roper, Director of Investor Protection, Consumer Federation of America to Jonathan G. Katz, Secretary, Securities and Exchange Commission, January 13, 2000, regarding File No. S7-25-99.

<sup>7</sup> As the staff interpretation of that rule had effectively eviscerated the rule's position on financial planning, see Securities Industry Association, SEC staff letter (December 16, 2005), available at <http://www.SEC.gov/divisions/investment/guidance.shtml> and February 15, 2006 letter from CFA and Fund Democracy to SEC Chairman Christopher Cox responding to the staff interpretation, we agree that the Commission had no choice but to terminate that interpretation. See Proposing Release at note 18.

we believe they are best deferred until after completion of the RAND study.

### **Investor Protection and Investor Education**

As we have noted previously, the transition occasioned by the court decision overturning the Commission's fee-based brokerage account rule poses significant challenges and potential risks to investors. We hereby reiterate our previous request that the Commission pay careful attention to how brokers handle that transition, providing investors with appropriate information and helping them to choose accounts that are in the investor's best interests. We were disappointed to find recently that the Commission had removed from its website the brochure, "Cutting through the Confusion," which CFA developed with state securities regulators and industry groups to educate investors on how to determine which types of accounts are best for them. The Commission has not to our knowledge replaced the brochure with any more up-to-date educational materials on this topic, although such materials are badly needed. We urge the Commission to play a much more active role than it has to date in educating investors about how to select the investment professionals, accounts, and services that are best for them. We would be happy to assist the Commission in any way that we can.

### **Conclusion**

Investors face a daunting task when they choose an investment services professional. As we have noted before, this is arguably the most important investment decision most retail investors will ever make, as they are likely to rely heavily if not exclusively on the investment recommendations they receive from that professional. The interpretive rule regarding investment discretion represents a step in the right direction, but much remains to be done to develop a rational, pro-investor policy for regulating investment professionals. We look forward to working with the Commission as it interprets the findings of the RAND study and seeks to develop new policy in this area.

Respectfully submitted,

Barbara Roper  
Director of Investor Protection  
Consumer Federation of America

Mercer Bullard  
Founder and President  
Fund Democracy

cc: (U.S. Mail only)

The Honorable Christopher Cox  
The Honorable Paul S. Atkins  
The Honorable Kathleen L. Casey  
The Honorable Annette L. Nazareth  
Andrew Donohue, Esq.