Consumer Federation of America

Fund Democracy
The Mutual Fund Shareholder's Advocate

February 15, 2006

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Dear Chairman Cox:

We are writing to follow up on our September 30 letter, in which we urged you to make improved regulation of financial professionals a key issue during your tenure as SEC chairman. In that letter we noted that effective implementation of the new rule defining financial planning as an investment advisory service was a key first step toward accomplishing that goal, and we expressed concern that a "narrow, legalistic approach to the rule's implementation" would ensure that it did "virtually nothing either to enhance investor protections or to rationalize regulation of financial professionals." Since then, we have had a chance to review the December 16 letter from the Division of Investment Management to the Securities Industry Association (SIA) answering a number of questions from SIA about how the staff is interpreting the rule.[1] Unfortunately, that letter confirms our worst fears that the new rule defining financial planning as an advisory service would be eviscerated in its implementation. If the staff interpretation is allowed to stand, brokers will remain free to mislead the investing public about the nature of services they offer and to provide what are clearly investment advisory services outside the protections of the Investment Advisers Act.

In our earlier letter, we outlined two principles that are fundamental to a rational, pro-investor policy for the regulation of financial professionals. The first is that all those who will be perceived by investors as offering the same services should be subject to the same standards of conduct. The second is that all those offering personalized investment advice should be subject to appropriate investor protections – for example, the fiduciary duty and disclosure obligations of the Investment Advisers Act. The financial planning provision of the new rule appeared to offer progress on both fronts, by recognizing that financial planning is clearly an investment advisory service that should be regulated as such and by requiring brokers who offer financial planning services or who hold themselves out as offering financial planning services to be regulated as investment advisers. Unfortunately for investors, the letter outlining the staff's interpretation of

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[1] Letter from Robert E. Plaze, Associate Director, Division of Investment Management, Securities and Exchange Commission to Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association, December 16, 2005.

issues related to implementation of the new financial planning rule flouts both these principles and interprets the new rule's investor protections out of existence in the process.

As we read the staff's interpretation, a broker would be free to advertise that it offers financial planning services and escape regulation as an investment adviser as long as that broker didn't actually provide investment advice to a customer as part of a financial plan or in connection with financial planning services. Moreover, the only thing that the staff interprets as constituting "financial planning services" is something that "bears the characteristics" of a comprehensive financial plan. Under the interpretation of the staff letter, the provision of extensive personalized investment advice would only be considered an advisory service if it were provided in the context of a comprehensive financial plan.[2] This would seem to confirm the disturbing reports cited in our previous letter that, in the division staff's view, it is not the extensive personalized investment advice involved that makes financial planning an investment advisory service. Rather, it is the inclusion of a number of elements that clearly do not constitute investment advice, such as advice about insurance, tax planning, and estate planning.

Through this interpretation, the staff has effectively nullified the rule's provision requiring investment advice provided as part of a financial plan or in connection with financial planning services to be regulated under the Investment Advisers Act. The staff states that a "financial plan seeks to address a wide spectrum of a client's long-term needs, and can include recommendations about insurance, savings, tax and estate planning, and investments." While this may be a fairly accurate description of a typical comprehensive financial plan, it does not follow, as the staff further states, that investment planning would not constitute financial planning services unless "applied in the context of the more comprehensive plan described above." This absurdly narrow definition of financial planning services makes a mockery of the Commission's position on financial plans and financial planning services. Under this interpretation, a broker need only ensure that any financial plan provided to a client lacks some arguably important component of a "comprehensive" financial plan in order to avoid regulation.

It is easy to predict what will result if this misguided staff interpretation is allowed to stand. Brokers will list in the financial planning section of the Yellow Pages. They will make prominent reference to various types of planning services in their advertisements and on their websites. They will provide customers with various investment planning "tools" that the customer will view as financial planning. Because those tools will lack some of the components of a comprehensive plan, however, they will not constitute financial planning in the eyes of the Commission staff and they will therefore not be subject to regulation under the Advisers Act.[3] Brokers will as a result continue to be free to offer advice under a sales standard of conduct – with the same results we have recently seen in the widespread abuses associated with the sale of

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[2] The staff states in its letter that a "financial plan seeks to address a wide spectrum of a client's long-term needs, and can include recommendations about insurance, savings, tax and estate planning, and investments." While this would seem to leave open the possibility that a plan including some, but not all, of these characteristics would satisfy the definition of a financial plan, the staff further states that a "financial tool that is used ... to provide guidance ... based upon the long-term needs of the client" would not constitute financial planning services unless "applied in the context of the more comprehensive plan described above."

[3] See, e.g., Dan Jamieson, "BD Rule Sparks Software Restrictions on Reps," *Investment News*, (Feb. 13, 2006) citing brokers at Wachovia Securities stating that the firm's "Envision analysis tool clearly states that it isn't a financial plan and doesn't include estate or insurance planning."

mutual funds, variable annuities, and 529 plans or, if you look back further, in the sale of limited partnerships. In short, if this interpretation is allowed to stand, investors will continue to be misled about the nature of services they receive from brokers; they will continue to place undue trust in what they believe is an advisory relationship; and they will be denied the protections that accompany regulation under the Advisers Act.[4] Surely that is not the Commission's intended outcome for this rule.

The staff interpretation does little or nothing, however, to prevent such an outcome. Nowhere in its interpretation does the staff suggest even the minimal step that brokers who advertise the availability of financial planning services have any obligation to warn customers who are not recipients of financial planning services that theirs is not an advisory account. The letter includes one statement designed to provide an air of balance to its interpretation. It states, "How a reasonable investor would perceive the services would also be an important consideration." We already know, however, from both SEC and independent research, that "reasonable" investors do not understand the differences between brokers and advisers, do assume that someone who calls himself or herself an adviser and advertises various types of investment planning services is an adviser, and do expect that professionals offering the same types of services will be subject to comparable regulation. If the staff policy really reflected an approach that was based on what a "reasonable investor" would expect, it would not remotely resemble the contorted arguments presented in this letter.

The staff letter includes another disturbing interpretation that could actually deprive investors of protections they currently enjoy when dealing with those financial planners who both give advice and sell products to implement their recommendations. The staff has previously interpreted that, once a financial professional is subject to regulation as an investment adviser, the fiduciary duty that accompanies that role applies to all that professional's dealings with his or her clients. This interpretation was used to challenge those financial planners who argued that their fiduciary duty as an adviser ended when they switched roles from proffering advice to selling products to implement their recommendations. In this letter, however, the staff does an about-face and states, "The parties may agree that the advisory relationship terminates with the delivery of a financial plan."

The combination of advice and product sales creates a more urgent need for strong regulatory protections than does the provision of either service separately. The inclusion of a significant advisory component with the product sales makes it more likely that the client will perceive the relationship as one of trust and, as a result, makes it less likely that the client will have their guard up against conflicts of interest. The inclusion of product sales with advice creates a greater opportunity for financial harm, since it is in the implementation of advice through product sales that the most serious abuses can occur. An awareness of these risks

[4] When it first released its rule proposal on fee-based accounts in 1999, the Commission acknowledged these same concerns with regard to fee-based accounts marketed on the basis of the advisory services offered. The rule release stated: "We have observed 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 not be perceived by investors to be) incidental to the brokerage services." It is difficult to comprehend how a Commission staff that is fully aware of the potential for investors to be misled in this way could turn around and implement a policy on financial planning that creates an even greater potential for investors to be misled.

informed the staff's previous interpretations that the adviser's fiduciary duty could not be abandoned mid-relationship. It is at best naive, at worst cynical, to suggest as this letter does that disclosure alone would ever be adequate to ensure that clients of brokers (or the less ethical financial planners who seize on this interpretation) would understand the implications of the changed relationship.

A series of misguided staff interpretations over the past 20 years or more has created a marketplace in which financial professionals who are indistinguishable to the average investor – based on the titles they adopt and the services they profess to offer – are subject to two different regulatory standards. These decisions include the initial one to allow brokers to offer financial planning services under their "solely incidental to" exemption from the Advisers Act as well as subsequent decisions to allow brokers to adopt titles like financial consultant and financial adviser and to market their services based on the investment advice offered without subjecting them to the professional standards that are appropriate to an advisory relationship. The financial planning rule was supposed to be a first step toward rationalizing the regulation of financial professionals. If allowed to stand, this staff interpretation would kill that hope in its infancy.

We sincerely hope this staff interpretation does not reflect the views of the Commission and that it will be quickly overturned once a permanent division director is finally in place. We further hope that its misguided approach confirms for the Commission what we have previously argued, that only an independent outsider can be entrusted with responsibility for the study of further regulatory and legislative initiatives if the goal is fresh thinking on this important topic. Nothing is more crucial to the well-being of average investors than ensuring that the financial professionals they rely on for advice and assistance must meet appropriate standards of conduct and are subject to rigorous regulatory oversight.

We appreciate your attention to our concerns.

Respectfully submitted,

Barbara Roper
Director of Investor Protection
Consumer Federation of America

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