Consumer Federation of America

September 20, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File No. S7-25-99

Dear Mr. Katz:

The Consumer Federation of America[1] is gratified that the Commission has finally committed to taking action on the proposed rule expanding the broker-dealer exclusion from the Investment Advisers Act and appreciates this opportunity to submit additional comments. Since submitting a formal comment letter in opposition to the proposed rule in January 2000, CFA has written to the Commission and its chairmen on four separate occasions, both individually and with other organizations, to reiterate our concerns and to urge the Commission to adopt a more pro-investor approach.[2] Those letters, as well as our original comment letter, are included here.

This letter is not intended to restate the detailed arguments against the rule that we provided in our original comment letter. Instead, it is designed to highlight what we see as continued serious short-comings in the Commission's approach to this issue, as described in both the news release and formal rule release reopening the comment period. Specifically, we are concerned that the Commission:

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[1] The Consumer Federation of America (CFA) is a nonprofit association of 300 consumer groups, representing more than 50 million Americans. It was established in 1968 to advance the consumer interest through research, education, and advocacy.

[2] February 28, 2000 letter from CFA Director of Investor Protection Barbara Roper to then Chairman Arthur Levitt; May 31, 2000 letter from CFA, the Certified Financial Planner Board of Standards, the Investment Counsel Association of America, and the National Association of Personal Financial Advisors to Secretary Jonathan G. Katz; December 13, 2001 letter from Roper to then SEC Chairman Harvey Pitt; May 6, 2003 letter from CFA, Fund Democracy, the Investment Counsel Association of America, the Financial Planning Association, Certified Financial Planner Board of Standards, Inc., and the National Association of Personal Financial Advisors to Chairman William Donaldson.

- continues to maintain that the rule would make the "nature of services offered" the key factor determining the applicability of the Investment Advisers Act when this is clearly not the case;

- does not appear to be taking the steps necessary to create an effective functional distinction between brokerage services and advisory services; and

- continues to show a greater concern for the effect that failure to adopt the proposed rule would have on brokerage firms than it shows for the effect on investors of having financial professionals who are otherwise indistinguishable subject to two very different standards of conduct.

I. The Commission has mischaracterized the effects of the proposed rule.

The news release announcing the decision to re-open the comment period states that "[t]he proposed rule makes the nature of the services provided, rather than the form of compensation, the primary factor in determining whether the Advisers Act applies." This is simply not the case. If that statement were true, CFA would almost certainly be writing in strong support, since we firmly believe that function should determine the nature of regulation. By mischaracterizing the effects of the rule, the Commission circumvents an open and honest discussion of what steps are needed to achieve this goal of creating a clear, well understood functional distinction between advisory services and brokerage services.

In reality, the proposed rule simply gives lip service to the notion of making "the nature of services provided" the primary means of distinguishing between brokers and advisers. The rule reiterates a "solely incidental" standard the Commission has neither defined nor enforced. Its one advance on this front is its provision specifying that discretionary accounts for which an asset-based fee is charged would be subject to the Advisers Act, because these accounts "bear a strong resemblance to traditional advisory accounts." Even here, however, the Commission has made method of compensation the key factor determining applicability of the Advisers Act, since commission-based discretionary accounts would continue to be regulated as brokerage accounts under the proposed rule. If the nature of services provided were in fact the determining factor, then those two types of accounts would have to be treated the same. Furthermore, other services, such as financial planning, that are offered by both advisers and brokers would continue to be given different regulatory treatment under the proposed rule, depending not on the nature of services provided, but rather on the nature of the firm providing those services.

Clearly, then, the effect of the proposed rule is not to make nature of services provided the primary factor in determining whether the Advisers Act applies. Rather, it simply erodes the one factor on which the Commission has previously relied – method of compensation – while erecting no new functional distinctions to take its place. The result has been a further blurring of the already fuzzy lines between brokers and advisers and an erosion of the protections investors have a right to expect when they sign up for what they believe to be advisory services.

II. The Commission does not appear to be taking the necessary steps to create a clear functional distinction between advisory services and brokerage services.

The fact that method of compensation, rather than nature of services provided, has been the primary factor used to determine regulation under the Investment Advisers Act has nothing to do with any shortcomings of the act itself and everything to do with shortcomings in the SEC's implementation of the act. The statutory language makes clear that the primary distinction between a broker and an investment adviser is intended to rest on the extent of any advice being provided. But the SEC has failed to enforce that standard. Nor has it provided clear guidance on what services are brokerage services, appropriately regulated under a sales standard, and what services are advisory services, requiring the added protections contained in the Investment Advisers Act.

The full service brokerage firms have taken full advantage of the Commission's passive approach. More and more of these firms have over the years adopted titles for their salespeople, such as financial consultant or financial adviser, designed to portray them as advisers first and salespeople second. And they aggressively market their accounts as if advice were the primary service being offered. The predictable result is that financial professionals who are subject to two very different standards of conduct – one with an obligation to disclose conflicts of interest and one without, one with an obligation to place their clients' interests ahead of their own and one with a weaker obligation simply to make generally suitable recommendations – are nonetheless indistinguishable to the investors who must choose among them. The recent mutual fund sales scandals – from inappropriate sale of B shares to recommendations based on revenue sharing payments and directed brokerage agreements – make clear the serious harm that can befall investors when a sales pitch masquerades as advice and when advice is offered without the appropriate regulatory protections.

If the Commission wants the "nature of services provided" to be "the primary factor in determining whether the Advisers Act applies," it must bite the bullet and define what it means for a broker to offer advice that is "solely incidental" to its primary business of effecting transactions in securities. In doing so, it must define "solely incidental" in a way that hews closely to Congress's clear intent to provide only a very narrow exclusion. It is not enough that the advice be loosely related to the broker's primary business of buying and selling securities from and to customers. Financial planning, for example, cannot reasonably be considered solely incidental advice. It is not even enough that the advice be related directly to a specific securities transaction, although that is a start. Rather, the advice must be directly related to a specific transaction, and the transaction must drive the advice, rather than the other way around. In short, solely incidental advice in our view would sound something like this: "I've looked over your portfolio, and I think you're a little heavily concentrated in your company stock. I advise you to sell off half your shares of company stock and invest the proceeds in the following diversified portfolio of mutual funds ..."

Once it defines what is meant by solely incidental advice, the Commission should conduct a thorough review of the services being provided by brokers and should determine which are correctly classified as brokerage services and which cross the line into advisory services. As a further step, it should prohibit brokers from promoting brokerage services based

on the advice offered. Brokers would then be faced with a choice. They could continue to offer advisory services, but, in doing so, they would have to comply with the requirements of the Advisers Act. If they are not willing to accept regulation under the Advisers Act, then they would have the option of refraining from offering advisory services. If this approach were adopted, investors would be assured that, regardless of the nature of the firm offering advisory services, they would be entitled to the same level of investor protections.

III. The Commission continues to express greater concern for the rule's effects on brokers than for its effects on investors.

The current situation didn't arise by chance. On the contrary, it has evolved specifically because the Commission has been all too accommodating to the full service brokerage firms over the last few decades. Back in the late 1980s, for example, when the brokers first decided they needed to offer financial planning services to compete for retail clients, the Commission could and should have made clear that such services obviously exceeded the solely incidental advice that was excluded from the Advisers Act. In the early 1990s, when Shearson Lehman ads told investors to "[t]hink of your Shearson Lehman Financial Consultant more as an advisor than a stockbroker," the Commission could and should have put an end to misleading advertisements that portray salespeople as advisers. And as brokers began advertising their fee accounts based on the advice being offered, the Commission could have concluded that the advice must then be more than solely incidental. Instead, every time the full service firms tested the line, the Commission gave ground. The proposed rule currently under consideration is simply the latest example.

We are gratified that the Commission has finally committed to take formal action on this proposed rule. We are concerned, however, that the Commission continues to hint in its statements that changing course now would deal an unacceptably heavy blow to the brokerage firms that have been allowed to rely on the proposed rule for nearly five years. Specifically, the release reopening the comment period asks, "If the Commission determines not to adopt this rule as proposed, what would be the practical impact on broker-dealers?" This seemingly innocuous question invites the argument, which we have no doubt the Securities Industry Association and individual brokerage firms will make, that any change in the rules now would impose costly and disruptive changes on the firms' method of operations and must therefore be avoided. We categorically reject that argument, which rests on the notion that investor protection should play second fiddle to industry protection. This argument also underscores the Commission's imprudence in permitting brokers to rely on the rule, even before receiving public comments, and then delaying final action for almost five years.

Furthering the impression that it favors retaining the rule is the Commission's failure to ask any comparable questions about the practical effects of the proposed rule on investors. One such question that needs to be answered is what has been the practical effect on investors of having financial professionals who are indistinguishable based on the titles they use and the services they claim to offer subject to two different standards of conduct. Another such question is what has been the practical effect on investors of having advisory services offered by brokers under a sales standard. Has it led investors to be misled about the nature of services offered or the basis for recommendations made by the broker? While the Commission does ask about the

adequacy of relying on disclosures that the accounts are brokerage accounts, there is no evidence that it has made any effort to determine whether investors, particularly the most vulnerable, unsophisticated investors, understand the difference between brokerage accounts and advisory accounts and the regulations that apply. Evidence from the recent mutual fund sales abuse scandals suggest that the answers to these questions would argue strongly against adoption of the proposed rule and for adoption of a meaningful functional distinction between advisory services and brokerage services.

IV. Conclusion

Through its inaction over a course of more than two decades, the Commission has all but erased the lines between brokerage services and advisory services. In order to rectify that situation, and ensure that application of appropriate investor protections is determined by the nature of the services provided and not by the nature of the firm providing the services, the Commission must as a first step scrap this ill-conceived rule. It must then quickly set about the more difficult task of defining an appropriate functional distinction between advisory services and brokerage services, analyze services currently being offered by brokers to determine where they fall along this continuum, and enforce the new standard. As a final step, the Commission must put an end to misleading brokerage firm ads and other practices that incorrectly portray salespeople as advisers and brokerage services as advisory services. Only then can it claim to have made the "nature of services provided" the key factor determining application of the Advisers Act.

Respectfully submitted,

Barbara Roper
Director of Investor Protection