



February 11, 2005

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

Re: Certain Broker-Dealers Deemed Not to Be Investment Advisers, Securities Exchange Act  
Release No. 40980; File No. S7-25-99 ("Proposing Release")

Dear Mr. Katz:

NASD staff appreciates the opportunity to express its view on the Securities and Exchange Commission's ("SEC" or the "Commission") proposed rule amendments under the Investment Advisers Act of 1940 ("Advisers Act") to clarify that certain broker-dealers are deemed not to be investment advisers ("Proposed Amendments"), as well as on the SEC's proposed interpretive position concerning when broker-dealer advisory services are solely incidental to brokerage business.<sup>1</sup>

### **1. NASD Supports the Proposed Amendments**

Under the Proposed Amendments, a broker-dealer would not have to register as an investment adviser under the Advisers Act provided that the broker-dealer's investment advice is non-discretionary and solely incidental to its brokerage services, and the broker-dealer makes certain disclosure to its customers.<sup>2</sup>

NASD generally supports the Proposed Amendments.<sup>3</sup> Many NASD-regulated securities firms increasingly rely upon asset-based fees for brokerage services because of the

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<sup>1</sup> SEC Rel. No. 34-50980 (Jan. 6, 2005), 70 Fed. Reg. 2716 (Jan. 14, 2005) ("Proposing Release"). The comments provided in this letter are solely those of the staff of NASD; they have not been reviewed or endorsed by the Board of Governors of NASD. For ease of reference, this letter may use "we," "NASD" and "NASD staff" interchangeably, but these terms refer only to NASD staff.

<sup>2</sup> The Proposed Amendments also would clarify that a broker-dealer that offers execution-only brokerage services at reduced commission rates, in addition to full service brokerage at higher rates, would not have to register under the Advisers Act.

<sup>3</sup> In 1999, the Commission proposed a similar rule. See SEC Rel. No. 34-42099 (Nov. 4, 1999), 64 Fed. Reg. 61226 (Nov. 10, 1999). We submitted a comment letter in support of that earlier proposal. See Letter from T. Grant Callery to Jonathan G. Katz (February 24, 2000).

advantages that these arrangements can provide to their customers.<sup>4</sup> By eliminating certain non-discretionary advisory activities from Advisers Act coverage, the Proposed Amendments would foster the types of brokerage services encouraged by the Report of the Committee on Compensation Practices (known as the “Tully Report”). NASD commends the Commission for proposing these important measures. As to the interpretation of the meaning of “solely incidental” for purposes of the Proposed Amendments, NASD recommends that the Commission interpretation be broad enough to effect the purposes of the rule without unnecessarily interfering with the traditional functions of a broker-dealer, such as recommending transactions, market making and investment banking.<sup>5</sup>

The Proposing Release does present a more fundamental question, which is whether the form of compensation should have independent relevance to the determination of whether one is subject to the Advisers Act or the Securities Exchange Act of 1934 (“Exchange Act”). From a retail client’s perspective, the differences between investment advisory services and traditional brokerage services are almost imperceptible. For example, an investment adviser may recommend securities, including mutual funds, to clients. The adviser might execute those transactions with a broker-dealer it chooses and from which it receives research, newsletters, back-office support, referral programs, marketing conferences and other forms of sales assistance. The investment adviser also might receive a service fee from the mutual fund underwriter, based upon the size of the customer’s investment. In short, it is not unusual for an investment adviser to offer advisory services and arrange for brokerage services for its retail customers. In fact, the adviser might receive a fee from a product sponsor that gives the adviser a “salesman’s stake” in the outcome of its recommendation.

As the Commission states in the Proposing Release, when Congress enacted the Advisers Act, it intended to “fill a regulatory gap” that previously existed.<sup>6</sup> Before 1940, firms and individuals could provide advisory services without being regulated. According to the Proposing Release, Congress was concerned that investment advisers were not subject to

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<sup>4</sup> Although we recognize the benefits that fee-based programs offer for many customers, in Notice to Members 03-68, NASD reminded regulated firms that these programs are not appropriate in all circumstances. Broker-dealers must have reasonable grounds for believing that a fee-based program is appropriate for a particular customer, taking into account the services provided, cost, and customer preferences. *See* Notice to Members 03-68 (November 2003).

<sup>5</sup> As discussed below, we request clarification that any nondiscretionary brokerage account that the Commission deems to be not solely incidental to brokerage, would continue to be subject to the Exchange Act and NASD rules.

<sup>6</sup> Proposing Release at 19, 70 Fed. Reg. at 2720.

the same level of regulation as broker-dealers. The Advisers Act was designed to fill this regulatory gap.<sup>7</sup>

Unfortunately, a similar regulatory gap exists today. From the retail investor's perspective, investment advisers engage in activities that are virtually indistinguishable from the brokerage business, but advisers are not subject to the same type of detailed, prophylactic regulation as broker-dealers.

As the Proposing Release states:

Broker-dealers are subject to extensive oversight by the Commission and one or more self regulatory organizations under the Exchange Act. The Exchange Act, Commission rules, and SRO rules provide substantial protections for broker-dealer customers that in many cases are more extensive than those provided by the Advisers Act and the rules thereunder<sup>8</sup> . . . . The SRO Rules require broker-dealers to comply with numerous detailed regulatory requirements, as well as general requirements that brokers treat their customers fairly. Although . . . the Advisers Act contains some restrictions, and thus imposes some costs on investment advisers that are not a part of broker-dealer regulation, broker-dealer regulation is much more detailed and involves significantly more regulatory costs than investment adviser regulation.<sup>9</sup>

We have attached two matrices that illustrate this regulatory disparity. The first matrix compares the regulation of investment advisers and broker-dealers, and the second compares the regulation of individuals who are investment advisers and those who are registered representatives. The matrices illustrate, for example, that broker-dealers (but not investment advisers) must comply with:

- explicit, detailed suitability standards;

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<sup>7</sup> Nevertheless, the Advisers Act “was of considerably less consequence [than the Investment Company Act of 1940], originally providing little more than a pro forma registration requirement for personal investment advisers with fifteen or more clients, and antifraud provisions.” See Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* 222 (1982).

<sup>8</sup> Proposing Release at 21, 70 Fed. Reg. at 2721 (footnote omitted).

<sup>9</sup> *Id.* at 26, 70 Fed. Reg. at 2722 (footnote omitted).

- explicit, detailed standards concerning the disclosure of risks and investment objectives of recommended investments and disclosure of investment performance;
- a requirement for prior registered principal approval of their sale material and a requirement to file many types of sales material with NASD's Advertising Regulation Department;
- required public disclosure on the Central Registration Depository (CRD®) system of detailed information concerning the firm and its associated persons, including their disciplinary history;
- qualifying standards of training, experience and competence in all cases, including continuing education requirements and qualifying examinations that test knowledge of securities products that are offered, the markets in which such products are sold, and the laws and regulations that govern sales activities;
- requirements for independently audited financial statements; and
- a requirement that firms and their representatives be subject to adequate bonding.

We agree with the purpose of the Proposed Amendments, to hold “broker-dealers and advisers . . . to similar standards depending not upon the statute under which they are registered, but upon the role they are playing.”<sup>10</sup> Of course, not every Exchange Act rule or NASD rule is necessarily appropriate for all investment advisers. Similarly, some rules applicable to investment advisers may not be appropriate for all aspects of the brokerage business. Nevertheless, as a general matter, the retail customers of both investment advisers and broker-dealers should receive a similar level of protection.

## **2. Comments to the Disclosure Requirement**

Proposed Rule 202(a)(11)-1(a)(1)(iii) would require that advertisements, contracts and certain other documents for accounts for which a broker-dealer receives special compensation prominently:

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<sup>10</sup> *Id.* at 21, 70 Fed. Reg. at 2721.

- disclose that the accounts are brokerage accounts and not advisory accounts;
- state that, as a consequence, the customer's rights and firm's duties and obligations to the customer, including the scope of the firm's fiduciary obligations, may differ; and
- identify an appropriate person at the firm with whom the customer can discuss the differences.

This disclosure implies that customer's rights, the firm's duties and obligations, and the applicable fiduciary obligations are greater with respect to an investment adviser account than they are with respect to a brokerage account. As we have previously discussed, this is simply not the case.

Moreover, it is unclear why a customer would be interested in this disclosure. If there is some aspect of broker-dealer regulation that leaves an investor unprotected, then the Commission should address that issue. If brokerage investors are fully protected -- which they are -- then the disclosure is unnecessary and misleading.

If the Commission decides to mandate this disclosure, then at a minimum the Commission should require similar disclosure with respect to investment adviser accounts. For example, the Commission could require that investment advisers:

- disclose that their accounts are advisory accounts and not brokerage accounts;
- state that, as a consequence, the customer's rights and firm's duties and obligations to the customer, including the scope of the firm's obligations under federal law, may differ; and
- identify an appropriate person at the firm with whom the customer can discuss the differences, including a clear explanation of the meaning and scope of the investment adviser's general, implied duty to the customer.

### **3. Request for Clarification of the Commission's Position on Discretionary Brokerage**

The Commission proposes to clarify that discretionary brokerage accounts must be subject to regulation under the Advisers Act. Consistent with our position concerning functional regulation of investment advisers, we support this proposed interpretation.

However, we respectfully request that the Commission clarify three aspects of this proposed interpretation.

First, the Commission should clarify that discretionary brokerage accounts would continue to be subject to the Exchange Act and NASD rules.<sup>11</sup> It would be unfortunate if the proposed interpretation were used as the basis for an argument to deprive brokerage customers of the higher level of protection to which they are accustomed. Based on our reading of the Proposing Release, we assume that this is not the effect that the Commission intended.

Second, the Commission should clarify that the de minimis exception from registration in Section 203(b)(3) of the Advisers Act, for certain advisers with fewer than 15 clients, would continue to apply. Broker-dealers with a very small number of discretionary accounts should not have to bear the costs of dually registering when they only serve a few discretionary brokerage accounts. While they should be subject to the substantive provisions that an unregistered adviser is subject to, such as the antifraud provisions of Section 206, they should not be subject to registration if they meet the requirements of Section 203(b)(3) with respect to their advisory clients. For that reason, we recommend that the Commission clarify that broker-dealers with fewer than 15 clients with discretionary accounts and who otherwise meet the requirements of Section 203(b)(3), would not have to register under the Advisers Act.

Third, the Commission should clarify that the definition of “discretion” would recognize the difference between discretionary authority that is fundamental to a particular account, and temporary or conditional discretion that is designed to accommodate the client. For example, some clients authorize their registered representatives to engage in certain types of transactions on their behalf when the client is unavailable (e.g., on vacation) or pursuant to time and price discretion. We request that the Commission clarify that conditions such as these do not render an account into a “discretionary account” for purposes of Advisers Act applicability.

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<sup>11</sup> We also request Commission clarification that any nondiscretionary brokerage accounts that the Commission subsequently deems to be not solely incidental to brokerage, also would continue to be subject to the Exchange Act and NASD rules.

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Thank you for the opportunity to present our views on this important proposal. Please feel free to contact Tom Selman or me at 240/386-4500 if you have any questions concerning the comments raised in this letter.

Sincerely,

A handwritten signature in cursive script that reads "Elisse B. Walter".

/TMS

Elisse B. Walter  
Executive Vice President

Attachments

## Regulation of Investment Advisers vs. Broker-Dealers

Subject	Registered Investment Advisers	Broker-Dealers
Application Process	<ul style="list-style-type: none"> <li>• File and keep current Form ADV.</li> <li>• State registration required for small advisers and “investment adviser representatives” of SEC registered advisers.</li> <li>• Form ADV covers employees under adviser’s control.</li> </ul>	<ul style="list-style-type: none"> <li>• File Form BD, financial statements and business plan.</li> <li>• NASD membership process:               <ul style="list-style-type: none"> <li>○ membership interview</li> <li>○ applicable state licensing</li> <li>○ establish supervisory system</li> <li>○ membership agreement.</li> </ul> </li> <li>• Written notice to, and approval by NASD to remove or modify business restrictions.</li> <li>• Employees required to file Form U4.</li> </ul>
Net Capital Requirements	None	<ul style="list-style-type: none"> <li>• Minimum net capital required at all times.</li> <li>• Level of capital depends on type of business that the firm conducts.</li> </ul>
Customer Protection: Custody of Client Assets <sup>1</sup>	<ul style="list-style-type: none"> <li>• Must segregate client’s securities and identify which client has beneficial interest in securities.</li> <li>• Quarterly itemized statements must be sent to client.</li> <li>• Annual surprise examinations by independent public accountant.</li> <li>• File Form ADV-E stating examination was completed and providing balance sheet.</li> </ul>	<ul style="list-style-type: none"> <li>• Internal periodic customer funds reserve formula computation and deposit requirement.</li> <li>• Daily review for determination of custody requirements, possession and control.</li> <li>• Annual audited financial statements sent to customers.</li> <li>• Semi-annual unaudited financial statements sent to customers</li> <li>• Calendar quarter accounting of all securities held or subject to firm control or direction</li> </ul>
Customer Protection: No Custody of Client Assets	No requirements	Subject to exemptive requirements, i.e., prompt forwarding of customer funds and securities to clearing firm.

<sup>1</sup> Investment advisers may have “custody” by directly possessing client funds or securities or by holding those funds and securities on behalf of the client in an omnibus account with a broker-dealer or financial institution. In the latter situation, the investment adviser has control of the funds and securities and may move them if it transfers the omnibus account to a different firm.



<b>Subject</b>	<b>Registered Investment Advisers</b>	<b>Broker-Dealers</b>
Recordkeeping	Specific books and records creation, currency and maintenance requirements.	Specific books and records creation, currency and maintenance requirements.
Financial Monitoring by Regulators	None, unless adviser has custody of assets.	Monthly and quarterly financial filings to NASD, annual independent audit for all firms.
Compliance Inspections and Examinations	Periodic examinations by SEC or the states.	Periodic examination by SEC, states, NASD and other SRO's.
Fidelity Bond	No Advisers Act requirements; ERISA and state requirements may apply.	Coverage requirements based on net capital requirement.
Supervision	Supervision of activities of persons who act on adviser's behalf. <sup>2</sup>	Supervisory systems must be established and maintained including comprehensive written procedures, internal inspections, annual compliance meetings, written principal approval, and branch designations.
Continuing Education	No formal standards; states may impose requirements.	Current and continuing education programs for covered persons must be established and maintained.
Public Disclosure	Certain written disclosures to prospective and existing clients required at specified times in a "brochure."	NASD public disclosure of CRD information required for members and their associated persons.
Advertising	<ul style="list-style-type: none"> <li>• Certain advertising practices prohibited by Advisers Act.</li> <li>• No filing requirements.</li> <li>• Few specific standards concerning advertising of adviser performance.<sup>3</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Principal pre-approval required for all sales material.</li> <li>• Filing requirement for certain sales material and certain members.</li> <li>• Specific and general content requirements, including specific performance advertising standards.</li> <li>• NASD conducts periodic spot checks of sales material.</li> </ul>

<sup>2</sup> As a practical matter, many investment advisers are operated as small entities, often consisting only of one person who provides financial advice and "supervises" the firm. In these cases, the financial adviser is essentially "supervising" himself.

<sup>3</sup> Investment advisers may issue sales material and customer account statements that tout the investment performance of the investment adviser. This performance information is not subject to the rigorous standards to which broker-dealers are subject.

<b>Subject</b>	<b>Registered Investment Advisers</b>	<b>Broker-Dealers</b>
Suitability	Suitability requirements implied, but no express suitability provisions in the Advisers Act.	Specific NASD and other SRO suitability rules.
Disclosure of Fees and Commissions	<ul style="list-style-type: none"> <li>• Part I of the Form ADV.</li> <li>• State requirements may apply.</li> </ul>	<ul style="list-style-type: none"> <li>• Disclosure of commissions on confirmations.</li> <li>• Explicit standards concerning the disclosure of risks when recommending investments.</li> <li>• Substantive regulation of fees charged in connection with certain transactions.</li> <li>• Broker-dealers required to give adequate notice to customers prior to changing fees and charges.</li> </ul>
529 College Savings Plan	Not subject to MSRB rules.	Subject to MSRB rules, including membership and qualifications requirements.
Anti-Money Laundering	Not subject to Patriot Act.	Must establish comprehensive anti-money laundering compliance programs.
Research Analyst Rules	No requirements	Supervision and disclosure requirements and restrictions on personal trading when providing research reports.

**Regulation of Individuals Who Are Investment Advisers  
vs. Registered Representatives**

<b>Subject</b>	<b>Individual Registered Investment Adviser</b>	<b>Registered Representative</b>
Application Process	<ul style="list-style-type: none"> <li>• File Form ADV.</li> <li>• State registration and testing requirements may apply.</li> </ul>	<ul style="list-style-type: none"> <li>• File Form U4.</li> <li>• Fingerprinting for identification and appropriate processing.</li> <li>• State testing requirements.</li> <li>• NASD qualification tests.</li> <li>• NASD continuing education requirements, including regulatory and firm elements.</li> </ul>
Supervision	Supervision of activities of persons who act on adviser's behalf. <sup>1</sup>	<ul style="list-style-type: none"> <li>• Written supervisory procedures and assignment to a registered principal required.</li> <li>• Internal investigation of qualifications.</li> <li>• Participation in annual compliance meeting.</li> <li>• Written approval by registered principal of customer activity for suitability analysis.</li> <li>• Periodic internal inspections of activities.</li> <li>• Sales material approved by a registered principal.</li> <li>• Reporting to CRD of customer complaints and disciplinary actions.</li> </ul>

<sup>1</sup> As a practical matter, many investment advisers are operated as small entities, often consisting only of one person who provides financial advice and “supervises” the firm. In these cases, the investment adviser is essentially “supervising” himself.

<b>Subject</b>	<b>Individual Registered Investment Adviser</b>	<b>Registered Representative</b>
Supervision		<ul style="list-style-type: none"> <li>• Approval and supervision required from employing member for any private securities transactions.</li> </ul>
Books and Records	Books and records must be maintained and available for periodic SEC or state inspections.	<ul style="list-style-type: none"> <li>• Books and records must be maintained and available for periodic SEC, NASD and state inspections.</li> <li>• Written notification to employing member of outside business activities.</li> </ul>
Disclosure of Fees and Commissions	<ul style="list-style-type: none"> <li>• Part II of the Form ADV</li> <li>• State requirements may apply.</li> </ul>	<ul style="list-style-type: none"> <li>• Disclosure of commissions on confirmations.</li> <li>• Explicit standards concerning the disclosure of risks when recommending investments. See Notices to Members 91-74, 93-87, 94-16 and 95-80.</li> <li>• Substantive regulation of fees charged in connection with certain transactions.</li> <li>• Brokers must give adequate notice to customers prior to changing fees and charges.</li> </ul>