April 4, 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. 50980; File No. S7-25-99

Dear Mr. Katz:

Please include the enclosed letter and its attachments with the public comments on the above referenced Commission rule proposal. This letter supplements our original comment letter on this proposal dated February 11, 2005. Thank you for your consideration of this request.

Sincerely,

Elisse B. Walter
Executive Vice President
Regulatory Policy and Oversight

April 4, 2005

Annette L. Nazareth,
Director, Division of Market Regulation
Meyer Eisenberg,
Acting Director, Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Disparate Regulation of Investment Advisers and Broker-Dealers

Dear Ms. Nazareth and Mr. Eisenberg:

By letter dated March 8, 2005, the Financial Planning Association, a trade association for the investment adviser industry, disputed the accuracy of information we submitted to the Commission, by letter dated February 11, 2005, commenting on a Commission rule proposal, concerning the disparate regulation of investment advisers and broker-dealers.[1] We attach a brief memorandum that responds to the FPA letter. Several aspects of the FPA letter deserve special attention, however.

Our prior letter expressed our continuing concern with the gap that exists between the regulation of broker-dealers under the Securities Exchange Act of 1934 and NASD rules, and the system of investment adviser regulation under the Investment Advisers Act of 1940 ("Advisers Act") and state law. We believe that, from a retail investor's perspective, investment advisers and broker-dealers engage in activities that are virtually indistinguishable; yet, there is an uneven regulatory playing field with disparate standards.

The FPA accuses NASD of attempting to "make a case for NASD oversight of investment advisers." In fact, our February letter simply argued for functional regulation of *broker-dealers*, not for an extension of broker-dealer regulation to investment advisers. It is true that since 1997 we have expressed our concern about the regulatory gap that exists between broker-dealers and investment advisers. But we have raised this issue solely as a matter of investor protection.

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[1] Certain Broker-Dealers Deemed Not to Be Investment Advisers, SEC Rel. No. 34-50980 (Jan. 6, 2005), 70 Fed. Reg. 2716 (Jan. 14, 2005) ("Proposing Release"). The comments provided in that letter and the attached regulatory matrices, as well as 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, the letters may use "we," "NASD" and "NASD staff" interchangeably, but these terms refer only to NASD staff.

The FPA also asks why NASD does not support "comprehensive disclosure and fiduciary standards for broker-advisers." In fact, we do more than support such standards. We promulgate them, examine for them, and enforce them, as NASD Conduct Rules. But, this statement by the FPA presents a more fundamental issue. The FPA often proclaims that investment advisers are subject to a "fiduciary duty," while broker-dealers are not. Thus, they assert, the customers of an investment adviser are better protected than brokerage customers. We strongly disagree.

The FPA's assertion is unpersuasive. First, in many situations broker-dealers also have been found to be subject to a fiduciary duty. Courts have held that broker-dealers who exercise discretion or control over client assets owe clients a broad fiduciary duty similar to that imposed on advisers. *See, e.g.*, Lieb v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff'd* 647 F.2d 165 (6th Cir. 1981). Even broker-dealers with only a principal/agent relationship with clients, a relationship that does not involve discretion or control of client assets, have been found to owe their clients some limited fiduciary obligations.

Second, for both discretionary and non-discretionary broker-dealers, the SEC and NASD have imposed an extensive scheme of mandated supervision and prophylactic regulation to protect investors that goes far beyond traditional fiduciary obligations. Among these are requirements that, consistent with general fiduciary principles, are designed to protect clients' interests, even absent a specific fiduciary obligation under law. For example, NASD Rule 2110, requiring that broker-dealers comply with just and equitable principles of trade, resembles the general fiduciary duty touted by the FPA.

Third, the contours of an adviser's "fiduciary duty" are imprecise and indeterminate. Indeed, these contours have been developed unevenly over time, and much of what the FPA describes as an adviser's fiduciary duty is more implied than expressed. This general, implied duty simply cannot afford retail investors with the same level of protection as the explicit regulatory standards governing the conduct of business as a broker-dealer, which are developed after extensive public comment and Commission approval. In clearly articulating the obligations of a broker-dealer, SEC and NASD rules provide much better assurance that brokerage customers will be protected.

Fourth, the FPA's arguments reflect a widespread belief that an adviser's fiduciary duty provides a much greater level of protection to investors than broker-dealer rules. However, a careful analysis of the relative regulatory standards shows that the substantive protections afforded broker-dealer customers are equivalent to, and in many cases exceed, those afforded to adviser customers.

Indeed, the enactment of the Advisers Act and adoption of Advisers Act rules by the Commission demonstrate that a general fiduciary duty cannot provide complete protection to customers. As the Commission explains in the Proposing Release, Congress enacted the Advisers Act in order to "fill a regulatory gap" that previously existed.

The enclosed memorandum, as well as the matrices we previously submitted, describes the regulatory disparity between broker-dealer and investment adviser regulation in more detail. Thank you again for the opportunity to present our views on this important issue. Please feel free to contact Tom Selman or me at 240/386-4500 if you have any questions concerning our comments.

Sincerely,

Mary L. Schapiro
Vice Chairman and President
Regulatory Policy and Oversight

Elisse B. Walter
Executive Vice President
Regulatory Policy and Oversight

Attachments

cc: The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos

Robert E. Plaze, Associate Director,
Division of Investment Management

Catherine McGuire, Associate Director/Chief Counsel,
Division of Market Regulation

Duane R. Thompson, The Financial Planning Association

Response to Issues Raised by Financial Planning Association

This memorandum briefly responds to some of the issues raised by the Financial Planning Association ("FPA") in its March 8, 2005 letter to Elisse Walter of NASD, which was copied to the SEC Commissioners and the Directors of the Divisions of Investment Management and Market Regulation. The FPA's letter responds to a letter dated February 11, 2005, that NASD staff filed with the Commission on its proposal not to deem certain broker-dealers to be investment advisers.[1] The FPA's letter also comments on two charts that accompanied our letter that compared the regulation of investment advisers and their individual representatives to the regulation of broker-dealers and their registered representatives.

The primary purpose of this memorandum is to correct inaccuracies contained in the FPA's letter and further explain positions taken in our February 11th letter. This memorandum supplements comments contained in the main body of the letter to which this memorandum is attached. We have purposely limited our responses to the many issues raised in the FPA letter. However, we would be happy to meet with the Commission staff to discuss these issues in more detail, or to discuss any other matters not addressed in this memorandum.

Main Text of FPA Letter

Fund Fees Paid to Investment Advisers

The FPA argues in the main text of its March 8th letter that fees that an investment adviser receives from mutual funds and their affiliates in connection with advisory clients' purchases of fund shares do not give the adviser a salesman's stake in the recommendation of fund shares. The FPA further represents that such fees do not pay for advisory services, and that investment advisers may not receive such fees from funds and their sponsors.

It is true that advisers may not receive distribution-related fees from mutual funds and their distributors unless they are registered as broker-dealers. However, we understand that mutual funds do pay investment advisers a 25 basis-point service fee and other forms of compensation (including so-called "revenue sharing" payments).[2] Indeed, many mutual funds offer a so-called "adviser class" of shares that pays a 25 basis-point service fee to investment advisers. We are not aware of any SEC rule or interpretive position that prohibits advisers from receiving these

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[1] *See* SEC Rel. No. 34-50980 (Jan. 6, 2005), 70 Fed. Reg. 2716 (Jan. 14, 2005). The comments provided in the memorandum 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.

[2] NASD Rule 2830(d) distinguishes between asset-based sales charges, which pay a broker-dealer for distributing a mutual fund, and service fees, which funds pay to financial intermediaries for personal service and/or the maintenance of shareholder accounts. Rule 2830(d) prohibits brokers from receiving asset-based sales charges in excess of 0.75% per annum of the fund's average net assets, and prohibits brokers from receiving service fees in excess of 0.25% of the fund's average net assets. NASD Rules 2830(d)(2)(E)(i) and 2830(d)(5).

fees, even if the adviser is not registered as a broker-dealer, nor does the FPA cite any such rule or interpretation. Indeed, one expert has indicated that these arrangements are common:

> Under [third-party payment plans], the fund, its adviser, or its distributor makes payments to other financial institutions of a percentage of the fund's assets attributable to their customer accounts. These payments are typically made to entities such as banks, broker-dealers, or investment advisers for distribution and/or servicing customer accounts and may be referred to as "trailer fees."

Lemke, Lins and Smith, *Regulation of Investment Companies*, vol. 1, § 7.05[3][a] (LEXIS Publishing 2001).

These trailer fees do give an investment adviser a salesman's stake in the mutual funds that it recommends.

Central Registration Depository System

The FPA complains that NASD's letter to the Commission touts the benefits to investors of NASD's Central Registration Depository ("CRD") system without acknowledging that investors may also receive information about investment advisers through the IARD system. Investors may receive some information about advisory firms through the Investment Adviser Public Disclosure ("IAPD") system. However, unlike the CRD system, the IAPD system generally does not allow investors to search for information about an advisory representative's disciplinary history using the representative's name (unless the individual is a sole proprietor and uses his or her name as the firm name). We understand there are over 190,000 individuals registered with the states as advisory representatives, many of whom are not sole proprietors, and thus cannot be searched using the individual's name.[3]

The FPA also states on page 5 of its letter that there is no NASD requirement for broker-dealers to disclose information about the broker or the existence of the CRD system. This statement is incorrect. NASD Rule 2280 requires all NASD members that carry customer accounts or hold customer funds and securities to provide in writing at least once per year the NASD Regulation Public Disclosure Program toll-free hotline number (BrokerCheck), the NASD Regulation web site address, and a statement as to the availability to the customer of an investor brochure that includes information describing the Public Disclosure Program.

<u>FPA Comments on NASD Chart Comparing the Regulation of Investment Advisers vs. Broker-Dealers</u>

Application Process

The FPA complains that our chart fails to acknowledge the disclosure benefits of the Form ADV. While, in the interest of brevity, the chart does not provide a detailed discussion of the disclosure requirements of Form ADV, it also does not discuss in detail the disclosure requirements for

[3] The Commission has stated that the IAPD system will allow investors to search by individual advisory representatives' names in the future.

broker-dealers' Form BD or U-4. If the Commission is interested in receiving such a detailed chart for both investment advisers and broker-dealers, we would be happy to provide one.

The FPA also complains that we failed to mention state registration and qualification requirements for individual advisory representatives. Unfortunately, this comment is incorrect. Our first chart focuses on differences in regulation between investment advisers and broker-dealers as entities. Our second chart focuses on differences in regulation of individual brokerage and advisory representatives, and does in fact mention state advisory representative testing and registration requirements.[4]

An investment adviser's application process is not comparable to the application process for broker-dealers. NASD Rule 1010 establishes the substantive standards and procedural guidelines for the membership application and registration process. The application process necessitates (among other requirements):

- Presentation of:
  - a detailed business plan that adequately and comprehensively describes all material aspects of the business;
  - any future business expansion plans;
  - financial and operational statements, including a balance sheet, net capital computation, projection of income and expenses, and description of business facilities;
  - a description of methods and media to be employed to develop a customer base;
  - a list of all associated persons;
  - copies of contracts with banks, clearing agencies or service bureaus;
  - a description of the nature and source of the applicant's capital;
  - a copy of the applicant's supervisory procedures;
  - a description of the experience and qualifications of supervisors and principals;
  - a written training plan to comply with the continuing education requirements; and
  - strict adherence by the applicant to specific deadlines;
- A membership interview with NASD staff;
- A separate determination by NASD whether the applicant meets specific standards and whether the applicant and its associated persons are capable of complying with the securities laws;
- The placement of restrictions on the applicant's business that NASD deems necessary;
- The possibility that membership will be denied if all applicable standards are not met;
- NASD approval of any modification or removal of a previously-imposed membership agreement restriction; and

[4] See page 1 of the chart entitled "Regulation of Individuals Who Are Investment Advisers vs. Registered Representatives" accompanying our letter of February 11, 2005.

- An opportunity for the applicant to seek a review of NASD's decision by NASD's National Adjudicatory Council and the Commission.

Net Capital Requirements

In response to our chart's comparison of the net capital requirements applicable to investment advisers and broker-dealers, the FPA observes that some states have bonding and net capital requirements applicable to advisers. Bonding requirements simply do not afford the same level of protection as net capital requirements. In addition, all broker-dealers are subject to SEC-mandated net capital requirements, regardless of the state in which they are located. Advisers' net capital and bonding requirements are not mandated by the SEC and vary by state.

Financial Monitoring by Regulators

In response to our chart's representation that there are no financial monitoring requirements for advisers that do not have custody of client assets, the FPA points out that an adviser is required to update its Form ADV if the firm experiences any material change that may affect clients. The FPA's comment misses the point. In this regard, the duty to update either a Form BD or a Form ADV due to a material change is largely the same.

What is different is that all brokers – whether or not they have custody of client assets – must make monthly or quarterly financial filings with NASD and conduct an annual independent audit that must be filed with the SEC and NASD. Advisers that do not have custody of client assets are not subject to these periodic filing and audit requirements. Moreover, NASD uses an automated financial surveillance system to assess exceptions that may be generated from the financial reports filed by broker-dealers.

Supervision

In response to our chart's comparison of supervision requirements, the FPA suggests that there is no need for supervision of individuals who are investment advisers due to the existence of "an embedded fiduciary culture" that "allows for independent and objective advice without the need for constant, transactional supervision."

Frankly this comment baffles us. The mere existence of a "fiduciary culture" does not make any legal duty self-executing. Clearly, brokers are professionals who owe a duty of trust to their customers yet supervision requirements rightly apply to their conduct. The bottom line is that, as long as there is potential for customer abuse, which exists in both the brokerage and advisory worlds, there is a need for supervision to ensure that customers are protected.

Advertising

In response to our chart's comparison of the standards applicable to broker and adviser advertising, the FPA makes much ado about the difference in regulation of the use of testimonials in broker and adviser sales material. The FPA also attempts to equate the NASD

broker-dealer advertising filing requirements with SEC requirements to maintain records of past sales material and correspondence.

These modest requirements reflect the fact that adviser advertising is subject to far fewer specific standards and requirements than broker-dealer advertising. Investment advisers are subject to few specific content requirements, unlike broker-dealers who must comply with a battery of SEC and NASD standards in this area. Investment advisers do not have to obtain principal pre-approval of all sales material and they do not have to file any sales material. A requirement to maintain records (which broker-dealers also have to meet) does not provide investors with the same level of protection as the NASD's extensive content standards and filing requirements.

When a broker-dealer files sales material, NASD's Advertising Regulation Department reviews each piece and demands that the broker-dealer make any changes required by the SEC and NASD advertising rules. Moreover, the Department conducts periodic sweeps of broker-dealer sales material that is not required to be filed, and regularly reviews sales material forwarded to the Department by the district offices, in order to determine whether this sales material complies with SEC and NASD advertising rules. In addition to the comprehensive regime implemented through the Advertising Regulation Department, NASD's Member Regulation Department conducts more than 2,300 on site examinations of its member firms each year. Our examiners routinely review member firm advertising and sales materials not filed with the Advertising Regulation Department during the course of its inspections.

As to the FPA's specific point concerning testimonial advertising, we understand the SEC staff has stated publicly on several occasions that it intends to review the prohibition on advisers using testimonials in advertising, since it views this prohibition as overly restrictive and unnecessary. In addition, brokers' use of testimonials is also severely restricted. In this regard, NASD Rule 2210 prohibits broker sales material from including a testimonial about the investment advice or performance of a member or its products unless the sales material prominently discloses:

(i) the fact that the testimonial may not be representative of the experience of other clients;

(ii) the fact that the testimonial is no guarantee of future performance or success; and

(iii) if more than a nominal sum is paid, the fact that it is a paid testimonial.

In addition, if any testimonial concerns a technical aspect of investing, the person making the testimonial must have the knowledge and experience to form a valid opinion.

Disclosure of Fees and Commissions

The FPA rebukes our chart's discussion of the respective requirements to disclose fees and commissions by asserting that our efforts in this area were made only in reaction to industry investigations by New York Attorney General Elliot Spitzer. The FPA is simply incorrect. NASD has a long history of requiring full disclosure of mutual fund and broker fees, expenses

and conflicts of interest. These efforts extend well before Mr. Spitzer's recent enforcement actions against certain mutual fund firms.[5]

Research Analyst Rules

In response to our chart's observation that there are no research analyst rules applicable to investment advisers, the FPA argues that none are needed since the rules were created to address investment banking conflicts. While it is true that the rules address these conflicts in part, they also address other conflicts that apply equally to investment advisers. For example, the NASD research analyst rules impose personal trading restrictions and disclosure requirements on research analysts who invest in stocks that they cover. Investment adviser analysts face these same personal trading conflicts when they invest in stocks that they cover, and yet are not subject to comparable rules. Moreover, an analyst who works for an adviser affiliate of an investment bank faces similar conflicts of interest as analysts who work directly for the investment bank.

FPA Comments on NASD Chart Comparing Regulation of Individuals Who Are Investment Advisers vs. Registered Representatives

Supervision

Responding to our chart's comparison of the supervision requirements applicable to broker-dealer representatives versus adviser representatives, the FPA argues that adviser representatives do not require detailed supervisory standards because they are subject to a fiduciary duty. We observe that the Commission recently changed its rules to require advisers to adopt policies and procedures necessary to prevent violations of the federal securities laws and to designate a chief compliance officer responsible for implementing those policies and procedures. We applaud the Commission for adopting these rules; however, these new rules dispel the notion that advisory customers are fully protected simply through the existence of a fiduciary duty.

Solicitors

The FPA notes that our chart omits any reference to solicitation agreements, and that the disclosure requirements for adviser solicitors are greater than those for broker-dealer solicitors. We believe that this argument is a red herring. While it is true advisers are permitted to employ solicitors to attract business, the Commission staff has generally declined to grant no-action relief for proposed broker-dealer solicitation arrangements involving unregistered persons.[6]

Standards of Conduct

The FPA complains that our chart omitted any reference to differences in "standards of conduct," particularly the requirement that advisers act as fiduciaries. As the FPA states, "Brokers must

[5] *See, e.g.*, Notice to Members 94-16 (March 1994); Notice to Members 95-80 (Sept. 26, 1995).

[6] *See, e.g.*, 1st Global, Inc., SEC No-Action Letter (May 7, 2001).

act in accordance with suitability rules in transactions, a much lower standard of conduct." The FPA omits the panoply of other conduct rules that apply to broker-dealers.

Moreover, the FPA never answers a fundamental question: What, precisely, are the contours of this much-vaunted fiduciary duty? The standards of conduct applicable to broker-dealers are developed after extensive opportunity for public comment and Commission approval. They are published. They are well defined and they may be amended only through rulemaking. And, as discussed above, they provide at least the same level of investor protection as adviser regulatory standards. The advisory industry's fiduciary standard is imprecise and indeterminate, and has been developed unevenly over time. This general, implied duty simply cannot afford retail investors with the same level of protection as the NASD Conduct Rules.

Ethics Requirements

The FPA also notes that our chart omits any reference to a recent Commission requirement for advisers to develop a code of ethics, and that brokers face no ethics requirement. The latter point is, once again, incorrect. NASD Rule 2110 requires all broker-dealers to observe high standards of commercial honor and just and equitable principles of trade. Those in the brokerage industry have long regarded Rule 2110 as imposing ethical standards on broker-dealers. Moreover, mandated continuing education of registered persons of broker-dealers includes an ethics component that will be deployed this month.