



## Securities Industry Association

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January 13, 2000

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

**Re: Proposed Rule 202(a)(11) – 1  
(Release Nos. 34-42099, IA-1845; File No. S7-25-99)**

Dear Mr. Katz:

The Securities Industry Association (“SIA”)<sup>1</sup> appreciates the opportunity to comment on proposed rule 202(a)(11)-1 which would exclude a broker-dealer providing investment advice to customers in a fee-based account from the definition of investment adviser as long as the advice is provided on a non-discretionary basis, is solely incidental to brokerage services, and the broker-dealer discloses to customers that their accounts are brokerage accounts. The proposed rule would also keep a broker-dealer providing incidental advice to customers from being subject to the Investment Advisers Act of 1940 (“Advisers Act”), solely because it also offers execution-only or web-based services at reduced commission rates. An alternative way of viewing the proposed rule, is that it will not deem arrangements that are essentially traditional brokerage relationships to be investment advisory activities solely because they utilize a non-commission based compensation methodology. The same would be true where the components of a traditional brokerage relationship are merely unbundled.

### A. OVERVIEW AND BACKGROUND

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<sup>1</sup> The Securities Industry Association brings together the shared interest of more than 740 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. The industry generated more than \$300 billion of revenues yearly in the U.S. economy and employs more than 700,000 individuals.

During the past year there has been a rapid growth in fee-based customer account compensation programs, as well as of programs that provide customers with the option of receiving execution-only or web-based services, rather than a traditional full service brokerage arrangement. These programs are viewed as a very positive industry development in that they offer customers a variety of options geared to the level of services desired and transactional activity in their accounts. Also, as pointed out in the SEC release, these programs should benefit customers by aligning their interests more closely with those of brokerage firms and their registered representatives.<sup>2</sup> However, because these programs involve compensation in the form of fees other than traditional brokerage commissions, or a higher commission for full brokerage services than for execution-only or web-based services, such services may give rise to an inference that “special compensation” is being paid, and the programs thus may be subject to the Advisers Act. Early on, both the industry and the SEC recognized that this result would not be desirable, because the additional regulation entailed, might discourage further growth of these programs. Thus, the SEC set out to formulate a proposal which enables such programs to flourish without impairing the integrity of the Advisers Act. This was no easy task, but we believe that the SEC is to be congratulated for developing a proposal that in large measure achieves this dual objective. We also believe that the SEC is to be applauded for the way in which it went about developing a proposal under which the nature of the services rendered, rather than the form of compensation, would determine the applicable regulation. In particular, we note the fine coordination between the Divisions of Investment Management and Market Regulation and the fact that the SEC had extensive dialogue with SIA and other industry participants, through which the staff obtained a more comprehensive understanding of the various elements of these programs. Clearly, this approach represents the administrative process at its best, and substantially contributed to the positive end result.

While SIA is in substantial agreement with the content of the proposed rule, we do have a few recommendations that we believe will improve the proposed rule by providing additional clarity. These are set forth below, together with a discussion of some issues on which the SEC has requested comment.

B. SPECIAL COMPENSATION

We note that there is some inconsistency between the language in the release and the actual text of the rule regarding “special compensation.” While the release states that fee-based compensation may constitute special compensation because it involves the receipt of compensation “other than traditional brokerage commissions,” subsection (a) of the proposed rule appears to unequivocally conclude that compensation other than traditional brokerage commissions does constitute special compensation. In fact, there is no reason to conclude that a

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<sup>2</sup> These programs are also consistent with the recommendations in the “Report of the Committee on Compensation Practices,” April 10, 1995, (the Tully Report).

fee-based account necessarily constitutes special compensation. This underscores the difficulty one often encounters in trying to define special compensation. Therefore, consistent with the language in the release we suggest that subsection (a) and certain other sections of the rule proposal be modified to refer to “compensation other than brokerage commissions” rather than to special compensation. In the attached Appendix we have made suggested text changes to conform to this recommendation. We also suggest that when the SEC adopts a final rule, its release clarify that the rule is intended to operate as a non-exclusive safe harbor.

C. DISCLOSURE

We agree with the SEC’s proposed approach of requiring broker-dealers to clearly disclose the nature of the account relationship to their clients, so as to assure that when entering into a fee-based compensation arrangement they do not erroneously believe they are receiving investment advisory services or participating in an investment advisory program. However, we do not believe that proposed subsection (a)(3) in its current form will adequately accomplish this, since the disclosure that the accounts are brokerage accounts does not provide sufficient information to customers. Many customers may conclude that it is a brokerage account simply because it is maintained at a broker-dealer, and will not understand that the disclosure is intended to distinguish the account from an investment advisory account. Therefore, we propose that the language of subsection (a)(3) be expanded to clarify that the account is a brokerage account, rather than an investment advisory account. We have included suggested alternative language in the Appendix to this letter. We believe our suggested disclosure requirement will more effectively explain the nature of these programs and prevent any customer inference that these programs provide investment advisory services. The modified language also reflects our belief that the term “prominent statement” regarding disclosure, should be replaced with a requirement that broker-dealers clearly disclose the nature of the account relationship. The term “prominent statement” suggests that a “stand alone” sentence or paragraph is required, which may unduly limit the flexibility of broker-dealers to make the disclosures in the manner they deem most effective in the context of the particular medium which is being utilized to describe the account relationship.

D. DISCRETIONARY ACCOUNTS

In recent years there has been a trend toward the use of discretion by dually registered broker-dealers in the context of wrap account programs. These programs are clearly structured and marketed as investment advisory programs, and are readily distinguishable from traditional brokerage accounts where a registered representative exercises discretion in accordance with SRO rules.<sup>3</sup> These latter accounts have always been treated as brokerage accounts and lack most of the characteristics and services associated with investment advisory programs. Moreover, we

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<sup>3</sup> While individual registered representative discretion appears to be declining, it is still significant.

do not believe they are held out or viewed as other than brokerage accounts. Therefore, the proposed rule appropriately continues to treat commission-based discretionary accounts as brokerage accounts. Conceptually, fee-based discretionary accounts should be treated the same way since the accounts function identically, except for the method of compensation. However, we understand, though do not share, the SEC's view, that the combination of discretion and fee-based compensation may cause customers to believe they are receiving investment advisory services. Moreover, we can appreciate that a failure to treat accounts that involve both discretion and fee-based compensation as advisory, could call into question the applicability of the Advisers Act to other programs which otherwise are generally considered to be advisory in nature. Therefore, we support the SEC's proposal regarding discretionary accounts even though it creates a regulatory distinction based solely on how the service is priced. We would, however, note that this distinction may create a disincentive to extend fee-based compensation alternatives to discretionary brokerage accounts because it would subject such accounts to the provisions of the Advisers Act, and, in particular, the principal trading prior consent requirements of Section 206(3) of the Act. We believe such disincentives would be largely ameliorated by the SEC's expeditious adoption of regulatory relief from certain of the restrictions of 206(3), which it is currently considering.

E. STATE INVESTMENT ADVISER DEFINITION

We understand that the SEC is participating in discussions involving the National Conference of Commissioners on Uniform State Laws ("NCCUSL"), whose major objective is to modernize the 1956 Uniform Securities Act. This potentially could include developing a uniform definition of the term investment adviser. We urge the SEC to continue to participate in such discussions, to help assure that any such definition is consistent with proposed rule 202(a)(11)-1.

F. SUMMARY

The SEC has done an outstanding job of drafting a proposed rule that will accommodate new forms of broker-dealer compensation arrangements which are beneficial to customers, without compromising the integrity of the Advisers Act. SIA is pleased to support the SEC in its effort, and applauds the SEC for seeking industry input during its consideration of the proposed rule.

We believe our recommendations, most of which are reflected in the suggested rule text amendments in the Appendix, will further improve an already excellent proposal, and we urge that serious consideration be given to their implementation.

If you have any questions regarding this letter or related issues please contact Michael D. Udoff of SIA at (212) 618-0509.

Very truly yours,

Jonathan G. Katz  
January 13, 2000  
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Jean Margo Reid, Chair  
SIA Investment Adviser Committee

cc: Paul F. Roye, Esq.  
Annette Nazareth, Esq.  
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## APPENDIX

### **§275.202(a)(11)-1 Certain broker-dealers deemed not to be investment advisers.**

A broker or dealer registered with the Commission under Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) (the “Exchange Act”):

(a) Will not be deemed to be an investment adviser based solely on its receipt of ~~special~~ compensation, *other than brokerage commissions*, provided that:

(1) The broker or dealer does not exercise investment discretion, as that term is defined in Section 3(a)(35) of the Exchange Act (15 U.S.C. 78c(a)(35), over the accounts from which it receives ~~special compensation~~; *other than brokerage commissions*;

(2) Any investment advice provided by the broker or dealer with respect to accounts from which it receives ~~special~~ compensation *other than brokerage commissions*, is solely incidental to brokerage services provided to those accounts; and

(3) Advertisements for, and contracts or agreements governing, accounts for which the broker or dealer receives ~~special~~ compensation *other than brokerage commissions*, ~~include a prominent statement~~ *must clearly disclose* that the accounts are brokerage accounts, *not investment advisory accounts*.

(b) Will not be deemed to have received special compensation solely because the broker or dealer charges a commission, mark-up, mark-down or similar fee for brokerage services that is greater than or less than one it charges another customer; and

(c) Is an investment adviser solely with respect to those accounts, *assets or transactions* for which it provides services or receives compensation that subject the broker or dealer to the Act.