SIFMA
Securities Industry and
Financial Markets Association

June 27, 2007

Robert E. Plaze
Associate Director, Division of Investment Management

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

United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Request for Rulemaking and/or Guidance Related to Fee-Based Brokerage Accounts

Dear Mr. Plaze and Ms. McGuire:

The Securities Industry and Financial Markets Association[1] respectfully submits this request for rulemaking and/or guidance in light of the U.S. Court of Appeals for the D.C. Circuit's recent decision in *Financial Planning Association v. Securities and Exchange Commission*.[2] That decision in effect invalidated Rule 202(a)(11)-1 – the so-called "fee-based brokerage rule." In its motion to stay the mandate, which was granted by the court, the

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[1] The Securities Industry and Financial Markets Association ("SIFMA"), established in 2006 through the merger of the Securities Industry Association and The Bond Market Association, brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. More information about SIFMA is available on its home page: www.sifma.org.

[2] 482 F.3d 481 (D.C. Cir. Mar. 30, 2007).

Commission stated that it "would use the period of a stay to consider whether further rulemaking or interpretations are necessary regarding the application of the [Investment Advisers Act of 1940, as amended ("Advisers Act")] to the accounts involved." We appreciate your willingness to discuss whether further rulemaking is possible and what form it might take. We submit the attached document for your consideration and to facilitate that effort. We believe that the Commission needs to act expeditiously to protect investors who have chosen fee-based brokerage services, and in many cases have relied upon them for a considerable number of years. The Commission also needs to provide guidance to the firms who have been providing these services, and who now must deal with the consequences of the court's decision under extremely tight deadlines.[3]

The alternative that would cause the least disruption to clients is to preserve fee-based brokerage as a brokerage service, rather than treat it as an investment advisory service. Fee-based brokerage services first became widely available almost a decade ago, in 1999, following the Commission's actions to smooth the regulatory path for such services. Since then, investors have been attracted in large numbers to this type of account for a variety of reasons, including the greater predictability of costs and the closer alignment of interests of the client with those of the firm and its representatives. Cerulli Associates estimates that, as of the end of 2006, approximately *$277.4 billion* in client assets were held in more than *996,000 fee-based brokerage accounts*.[4] The forced closure of this brokerage pricing avenue would be a major loss of client choice and a significant diminution in both pricing and account management flexibility that clients have come to expect and enjoy.

Notwithstanding the court's decision, we believe the Commission has the authority under Section 206A to promulgate a permanent rule treating fee-based brokerage accounts as entirely exempt from the Advisers Act. The court specifically noted that "the SEC disavows any reliance on Section 206A in promulgating the final rule … and thus the court has no occasion to express an opinion on the SEC's authority under [Section 206A]. But the broader language found in § 206A supports the conclusion that subsection (F) must be read more narrowly."[5] The court's statement that the Commission's authority under Section 206A is broader than the provision relied upon in promulgating Rule 202(a)(11)-1 further supports the conclusion that Section 206A could be used to promulgate the rule we propose.

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3 We appreciate the Commission's decision to seek a stay of the mandate until October 1, 2007. Nonetheless, depending on the result of the Commission's consideration of the issues contained herein, firms may need to prepare, print, and distribute written client communications and give advance notice of any change in status of the fee-based brokerage accounts prior to October 1, 2007.

4 If anything, these numbers increased through the time of the court's decision.

5 *FPA v. SEC,* 482 F.3d at 492 (internal citations omitted).

We continue to believe that a rulemaking preserving fee-based brokerage would be the best result for the investing public. If, however, the Commission decides not to treat fee-based accounts as entirely exempt from the Advisers Act, a more limited form of relief is necessary and appropriate, and very much in the public interest. This relief would modify the Advisers Act principal trading restrictions applicable to non-discretionary investment advisory accounts. Such relief would ensure that clients may continue to receive a wide variety of services, and in particular would preserve the client's ability to access certain securities that are best – or only – available through trades with the adviser or an affiliate of the adviser.

We believe that principal trading relief should take the form of a rule exempting certain financial services firms from trade-by-trade disclosure and consent requirements under Section 206(3) of the Advisers Act with respect to principal trades in non-discretionary investment advisory accounts. To ensure investor protection, we suggest that the Commission impose various conditions with respect to the proposed exemption. For instance, the exemption would be available only to financial services firms that are registered with the Commission as broker-dealers and as investment advisers or where the adviser's affiliate that would be effecting the principal trades is registered as a broker-dealer. Furthermore, the exemption would apply only to non-discretionary investment advisory accounts. Finally, we propose that the adviser taking advantage of the exemption be required to: (i) disclose that the account is not subject to separate written trade-by-trade disclosure and consent and that the adviser will have a conflict of interest when effecting principal transactions; (ii) obtain the client's prospective, blanket consent; and (iii) provide a written confirmation at or before completion of the transaction disclosing that the adviser traded as principal.

Firms also need interpretive guidance regarding other issues pertaining to now-vacated Rule 202(a)(11)-1. For example, there is still uncertainty in the industry regarding, among other things, the method by which existing fee-based brokerage agreements may be modified to conform with Advisers Act requirements if fee-based brokerage accounts are deemed to be investment advisory accounts, when Form ADV Part II brochures may be delivered if fee-based brokerage accounts are deemed to be investment advisory accounts, and the impact of multiple commission pricing levels within a single firm.

As noted, time is short, and the Commission needs to act soon to resolve the issues that pertain to fee-based brokerage accounts and arise from the court's decision. To the extent firms need to provide clients with information regarding regulatory developments, service options going forward, and the impact of any changes, they need time to, among other things, develop and disseminate such disclosures, conduct staff training, and revise marketing materials and policies and procedures.

* * *

We very much appreciate your timely consideration of the above request, and would be happy to answer any questions that you may have. If you have any such questions, please contact the undersigned at 202.434.8440.

Sincerely,

Ira D. Hammerman
Senior Managing Director & General Counsel

Enclosure

cc: Christopher Cox, Chairman
Paul S. Atkins, Commissioner
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Outline of Proposed Rulemaking and Guidance to Address Issues Related to Fee-Based Brokerage Accounts

EXECUTIVE SUMMARY

I. The Securities Industry and Financial Markets Association ("SIFMA")[1] respectfully submits this request for rulemaking and guidance in order to address issues related to fee-based brokerage accounts and the U.S. Court of Appeals for the D.C. Circuit's decision in *Financial Planning Association v. Securities and Exchange Commission*, 482 F.3d 481 (D.C. Cir. 2007) ("*FPA v. SEC*").

II. This document lays out various forms of rulemaking and guidance that the Securities and Exchange Commission (the "Commission") should promulgate to address issues raised by the court's decision.

A. *OPTION 1: An exemption from the Investment Advisers Act of 1940 ("Advisers Act")[2] for fee-based brokerage services.* The proposed rule would rely on a different source of authority than was relied upon in promulgating Rule 202(a)(11)-1 to exclude certain classes of financial services firms from the definition of investment adviser under Section 202(a)(11)[3] of the Advisers Act with respect to the provision of fee-based brokerage services.

B. *OPTION 2: Principal trading relief for non-discretionary investment advisory accounts.* The proposed rule would exempt non-discretionary investment advisory accounts, including accounts that were formerly fee-based brokerage accounts, from the principal trading restrictions of the Advisers Act.

C. *Additional guidance is necessary regardless of which option the Commission selects.* Firms also need interpretive guidance regarding other issues related to Rule 202(a)(11)-1 being vacated, including amending existing client agreements, delivery of the Form ADV Part II disclosure brochure, and discount and full-service brokerage accounts.

III. **OPTION 1: An exemption from the Advisers Act for fee-based brokerage services.** The alternative that would cause the least disruption to clients is to preserve fee-based brokerage as a brokerage service, rather than treat it as an advisory service under the Advisers Act. The Commission could promulgate a rule that would rely on a different source of authority than was relied upon in promulgating Rule 202(a)(11)-1.

A. Under this option, the proposed rule would apply to fee-based brokerage services

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[1] SIFMA, established in 2006 through the merger of the Securities Industry Association and The Bond Market Association, brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. More information about SIFMA is available on its home page: www.sifma.org.

[2] 15 U.S.C. §§ 80b-1-18a.

[3] 15 U.S.C. § 80b-2(a)(11).

that are non-discretionary in nature and meet certain other conditions, including that the financial services firm providing such services is registered with the Commission as a broker-dealer and is a member of the National Association of Securities Dealers ("NASD").

1. SIFMA believes that the Commission has the authority under Section 206A and/or Section 211 to promulgate a permanent rule treating fee-based brokerage accounts as entirely exempt from the Advisers Act.

2. The court did not reach the nature and merits of fee-based brokerage or the Commission's authority under other sections of the Advisers Act.

B. The preservation of fee-based brokerage services would benefit many investors.

1. In 1999 fee-based brokerage services first became widely available following the Commission's actions that year to smooth the regulatory path for such services. Since then, investors have been attracted in large numbers to this type of service for a variety of reasons, including the greater predictability of costs and the closer alignment of interests of the client with those of the firm and its representatives. Cerulli Associates estimates that, as of the end of 2006, approximately *$277.4 billion* in client assets were held in more than *996,000 fee-based brokerage accounts*.

2. The forced closure of this brokerage pricing avenue would be a major loss of client choice and a significant diminution in both pricing and account management flexibility that clients have come to expect and enjoy.

3. We continue to believe that a rulemaking that preserves fee-based brokerage would be the best result for the investing public.

IV. **OPTION 2: Principal Trading Relief.** If, however, the Commission decides not to treat fee-based accounts as entirely exempt from the Advisers Act, a more limited form of relief is necessary and appropriate, and very much in the public interest.

A. Under this option, the proposed rule would exempt certain financial services firms from the trade-by-trade disclosure and consent requirements under Section 206(3)[4] of the Advisers Act with respect to principal trades in non-discretionary investment advisory accounts.

1. The rule would provide a safe harbor from the requirements of Section 206(3) to permit an investment adviser to trade as principal with a non-discretionary investment advisory client, provided that the adviser:

a) Itself is dually registered as a broker-dealer, or its affiliate that will be effecting principal transactions is registered as a broker-dealer;

b) Acts as an investment adviser in relation to the transaction, and the adviser, or any person controlling, controlled by or under common

[4] 15 U.S.C. § 80b-6(3). The limitations of Section 206(3) do not apply to a transaction with a broker-dealer's client if the broker-dealer is not acting as an investment adviser in relation to the transaction. Thus, principal trading was not an issue when fee-based accounts were classified as brokerage.

control with the adviser, acts in its capacity as a registered broker-dealer when it trades as principal with the client;

c) Provides written disclosure that the account is not subject to trade-by-trade written disclosure (other than trade confirmations) and consent, and that the adviser may have a conflict of interest with respect to principal transactions;

d) Obtains the client's prospective general consent once, either in the account agreement or through separate documentation, before engaging in any such transactions and explains how the client may revoke consent; and

e) Provides the client with a written confirmation at or before the completion of such transaction that complies with the requirements of Rule 10b-10 under the Securities Exchange Act of 1934, as amended ("Exchange Act"),[5] including disclosure of the capacity in which the firm acted with respect to the transaction.

B. This relief would ensure that firms may continue to offer a wide variety of services to clients, and in particular would preserve the client's ability to access certain securities that are best – or only – available through trades with the adviser or an affiliate of the adviser.

C. Principal trading relief is necessary for all non-discretionary investment advisory accounts that receive both advisory and related brokerage services from a dual registrant (or an affiliate of the adviser).

1. Limiting principal trading relief to only those accounts that were in fee-based brokerage programs would make the requested relief impractical, unusable, and would not serve either the best interest of clients or assist the firms affected by the court's ruling in the transition and ongoing servicing of these accounts.

2. If clients want to continue to have a fee-based account, many firms may transition them into existing non-discretionary investment advisory account programs. Allowing principal trading only for clients that previously were in fee-based brokerage programs would be operationally impossible, because the relief would apply only to some accounts and not all accounts in the program.

3. Having firms and their representatives keep track of the genealogy of accounts that were formerly fee-based brokerage versus other non-discretionary investment advisory accounts would be technologically difficult, if not impossible, given the October 1, 2007 compliance date. Trade execution routing for investment advisory programs often is derived through specific program or account type codes (*e.g.*, "advisory accounts program ABC" or "ERISA accounts") rather than the date an account was opened.

5 15 U.S.C. §§ 78a-mm.

4. The interests of investors with fee-based brokerage accounts would not be served by forcing them to choose between receiving the benefits of a non-discretionary investment advisory platform or the benefits of being able to trade freely with the adviser or its affiliate on a principal basis (through a commission-based account). By contrast, we believe that treating all clients in non-discretionary investment advisory programs in the same manner is consistent with the fiduciary obligations imposed by the Advisers Act.

V. We believe that the Commission's statutory authority under Sections 206A[6] and Section 211[7] of the Advisers Act is broad enough to promulgate such rules and guidance. SIFMA believes that either proposed option would be necessary or appropriate in the public interest, consistent with the protection of investors, and fairly intended by the policy and provisions of the Advisers Act.

VI. Time is of the essence in providing the requested relief and guidance.

A. In its motion to stay the mandate in *FPA v. SEC*, which was granted by the court, the Commission indicated that it "would use the period of a stay to consider whether further rulemaking or interpretations are necessary regarding the application of the [Advisers Act] to the accounts involved."

B. The court's stay of its mandate until October 1, 2007 provides the Commission a limited amount of time to promulgate a new rule and provide guidance under Sections 206A and/or 211 that would provide relief for customers that wish to continue to receive services previously received in their fee-based brokerage accounts.

1. To the extent firms need to provide clients with information regarding regulatory developments, service options going forward, and the impact of any changes, they need time to, among other things, develop and disseminate such disclosures, conduct staff training, and revise marketing materials and policies and procedures.

2. Client communications need to be sent in late July or early August to provide adequate time for affected clients to consider their options.

C. Thus, it is imperative that the Commission issue a proposed rulemaking and guidance as soon as possible.

VII. This document is divided into sections.

A. Part I describes Option 1. We:

1. describe the historical context for fee-based brokerage;

2. outline the statutory authority under which the Commission could promulgate the proposed fee-based brokerage rule;

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6 15 U.S.C. § 80b-6a.

7 15 U.S.C. § 80b-11.

3. illustrate why the proposed fee-based brokerage rule is: (1) necessary or appropriate in the public interest, (2) consistent with the protection of investors, and (3) fairly intended by the policy and provisions of the Advisers Act; and

4. provide text of the proposed rule.

B. Part II describes Option 2. We:

1. describe the historical context for principal trading restrictions under the Advisers Act;

2. outline the statutory authority under which the Commission could promulgate the proposed principal trading rule;

3. illustrate why the proposed principal trading rule is: (1) necessary or appropriate in the public interest, (2) consistent with the protection of investors, and (3) fairly intended by the policy and provisions of the Advisers Act; and

4. provide text of the proposed rule.

C. Part III discusses certain issues related to Rule 202(a)(11)-1 being vacated that could be addressed through interpretive guidance, including amending existing client agreements, delivery of the Form ADV Part II disclosure brochure, and discount and full-service brokerage accounts.

PART I – OPTION 1: EXEMPTION FROM THE ADVISERS ACT FOR FEE-BASED BROKERAGE SERVICES

I. Historical context for fee-based brokerage

A. The Commission's actions for more than a decade have evidenced its support for fee-based brokerage.

B. The Tully Report, which was commissioned by then-Commission Chairman Levitt, urged broker-dealers to adopt fee-based compensation arrangements as a best practice.[8]

C. In 1999 the Commission proposed, and in 2005 adopted, Rule 202(a)(11)-1, which, among other things, exempted certain broker-dealers from being deemed investment advisers with respect to fee-based pricing for brokerage accounts.[9] The 1999 proposal included an embedded no-action position for fee-based brokerage accounts, upon which many firms relied to begin offering such accounts.

1. The Commission acknowledged in the Rule 202(a)(11)-1 adopting release that "fee-based brokerage programs responded to concerns we have long held about the incentives that commission-based compensation provides to churn accounts, recommend unsuitable securities, and engage in aggressive marketing of brokerage services."[10]

2. The Commission also cited the "substantial protections" provided to broker-dealer customers under the Exchange Act and self-regulatory organization ("SRO") rules in stating that it believed duplicative regulation of fee-based brokerage accounts was not necessary.[11]

D. Although the Commission promulgated Rule 202(a)(11)-1 under different authority, the Commission noted in the adopting release, "We also have authority under section 206A, which is available as an alternative ground, because the rule we are adopting is in the public interest and consistent with the protection of investors and the purposes intended in the Act.[12]

E. On March 30, 2007, the U.S. Court of Appeals for the D.C. Circuit vacated Rule 202(a)(11)-1 in its entirety, holding that the Commission exceeded its authority when it promulgated the rule.[13]

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8 *Report of the Committee on Compensation Practices*, Apr. 10, 1995, *available at* http://www.sec.gov/news/studies/brkcomp.txt.

9 Certain Broker-Dealers Deemed Not To Be Investment Advisers, Exchange Act Release No. 51523, Advisers Act Release No. 2376, 70 Fed. Reg. 20424 (Apr. 19, 2005); Certain Broker-Dealers Deemed Not To Be Investment Advisers, Exchange Act Release No. 42099, Advisers Act Release No. 1845, 64 Fed. Reg. 61226 (Nov. 10, 1999).

10 Certain Broker-Dealers Deemed Not To Be Investment Advisers, Exchange Act Release No. 51523, Advisers Act Release No. 2376, 70 Fed. Reg. 20424 (Apr. 19, 2005).

11 *Id*.

12 *Id.*

13 *FPA v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

II. The Commission has statutory authority to adopt a new fee-based brokerage rule.

A. The court noted explicitly that its decision in *FPA v. SEC* was based on an analysis of the Commission's exemptive authority under Section 202(a)(11)(F) of the Advisers Act. The court did not reach the nature and merits of fee-based brokerage accounts or the Commission's authority under other sections of the Advisers Act.[14]

1. The court specifically noted that "the SEC disavows any reliance on Section 206A in promulgating the final rule … and thus the court has no occasion to express an opinion on the SEC's authority under [Section 206A]. But the broader language found in § 206A supports the conclusion that subsection (F) must be read more narrowly." [15]

2. In addition, the court noted that "Because the court's duty is to give meaning to each word of a statute, the court cannot properly treat one authorization, under subsection (F), as duplicative of another authorization, under Section 206A."[16]

3. The court's statements further support that the Commission's authority under Section 206A is broader than under Section 202(a)(11)(F).

B. SIFMA believes that the Commission has the authority under Sections 206A and/or 211 to promulgate a permanent rule treating fee-based brokerage accounts as entirely exempt from the Advisers Act.

1. Section 211 of the Advisers Act grants the Commission authority to make and issue rules, regulations and orders, to "classify persons and matters within its jurisdiction," and to "prescribe different requirements for different classes of persons or matters."[17]

2. Section 206A of the Advisers Act grants the Commission the authority, among other things, to exempt by rule any person, transaction, or class of persons or transactions from any provision of the Advisers Act or rule promulgated thereunder, if the exemption "is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."[18]

D. We acknowledge that Section 206A has been used in limited circumstances, most often in connection with exemptions or rules regarding performance fees.[19]

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14 *See id.*

15 *Id.* at 492 (internal citations omitted).

16 *Id.* at 492.

17 15 U.S.C. § 80b-11(a).

18 15 U.S.C. § 80b-6a.

19 *See, e.g.,* Exemption To Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Advisers Act Release No. 996, 50 Fed. Reg. 48556 (Nov. 26, 1985) (adopting Rule 205-3, which permits registered investment advisers to charge certain clients performance or incentive fees).

However, an analogous section of the Investment Company Act of 1940, as amended (the "Investment Company Act")[20] has been used much more frequently, in some instances to provide broad relief to an industry or class of entities.

1. Section 206A is modeled after and contains virtually the same language as Investment Company Act Section 6(c). Section 6(c) provides the Commission the authority, among other things, to exempt by rule any person, transaction, or class of persons or transactions from any provision of the Investment Company Act or rule promulgated thereunder, if the exemption "is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."[21]

2. The Commission has used its Section 6(c) authority to promulgate several rules that provide exemptions, exceptions, and safe harbors from the definition of an "investment company" and the requirements of the Investment Company Act.

    a. Rule 3a-7 excludes issuers that pool income-producing assets and issue securities backed by those assets (*i.e.*, structured financings) from the definition of "investment company".[22]

    b. Rule 3a-4 provides a nonexclusive safe harbor from the definition of "investment company" for certain investment advisory programs, including "wrap fee programs" or "separately managed account programs," if the programs are organized and operated in the manner described in the rule.[23]

    c. Rule 3a-6 excludes foreign banks and foreign insurance companies from the definition of "investment company".[24]

    d. Rule 3a-5 exempts companies organized primarily to finance the business operations of their parent companies or companies their parent companies control from being considered "investment

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[20] 15 U.S.C. §§ 80a-1-65.

[21] 15 U.S.C. § 80a-6(c).

[22] *See* Exclusion from the Definition of Investment Company for Structured Financings, Investment Company Act Release No. 19105, 57 Fed. Reg. 56248 (Nov. 27, 1992) ("Rule 3a-7 Release").

[23] *See* Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release No. 22579, Advisers Act Release No. 1623, 62 Fed. Reg. 15098 (Mar. 31, 1997) ("Rule 3a-4 Release").

[24] *See* Exception from the Definition of Investment Company for Foreign Banks and Foreign Insurance Companies, Securities Act Release No. 6921, Investment Company Act Release No. 18381, 56 Fed. Reg. 56294 (Nov. 4, 1991) ("Rule 3a-6 Release").

companies".[25]

e. Rule 3a-8 provides a nonexclusive safe harbor from the definition of "investment company" for certain bona fide research and development companies. [26]

3. Several of the factors that the Commission considered in granting these exemptions under Section 6(c) also are present with respect to fee-based brokerage.

a. The classes exempted or excluded from the definition of "investment company" and from the requirements of the Investment Company Act were not engaged in the activities of and did not have the purpose of being an investment company.[27] Similarly, fee-based brokerage accounts generally have the same characteristics and are handled the same way as commission-based brokerage accounts.

b. Despite the exemption from the requirements of the Investment Company Act, other restrictions protected investors, including safeguards in the adopted rule and registration with a regulatory body (such as a manager's registration as an investment adviser with the Commission or an entity's registration with foreign bank regulators).[28] Here, extensive Commission and SRO rules and regulations are applicable to registered broker-dealers and the safeguards included in the proposed rule will protect investors using fee-based brokerage services.

c. Prior to adopting the rules under Section 6(c), the Commission historically exempted the groups that were the subject of the rulemaking from the definition of an "investment company" and from the requirements of the Investment Company Act (often in no-action letters or individual exemptive orders).[29] As discussed above, the Commission has exempted fee-based brokerage accounts from the definition of "investment adviser" and from the requirements of the Advisers Act since 1999.

d. Before the rulemaking, subgroups within the class were treated

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[25] *See* Exemption from the Definition of Investment Company for Certain Finance Subsidiaries of United States and Foreign Private Issuers, Investment Company Act Release No. 14275, 49 Fed. Reg. 49441 (Dec. 20, 1984) ("Rule 3a-5 Release").

[26] *See* Certain Research and Development Companies, Investment Company Act Release No. 26077, 68 Fed. Reg. 37046 (June 20, 2003) ("Rule 3a-8 Release").

[27] *See* Rule 3a-4 Release; Rule 3a-5 Release; Rule 3a-6 Release; Rule 3a-7 Release; Rule 3a-8 Release.

[28] *See* Rule 3a-4 Release; Rule 3a-6 Release; Rule 3a-7 Release; Rule 3a-8 Release.

[29] *See* Rule 3a-4 Release; Rule 3a-5 Release; Rule 3a-8 Release.

differently under the Investment Company Act.[30] Without the exemption, fee-based brokerage accounts will be treated differently than functionally identical commission-based brokerage accounts.

III. Based on the benefits of fee-based brokerage and the large number of clients enrolled in fee-based brokerage programs, the Commission's use of its exemptive authority to permit fee-based brokerage is necessary or appropriate in the public interest.

A. Clients want a choice in how to compensate their financial services provider for brokerage services, and large numbers of clients have chosen fee-based brokerage accounts.

B. Fee-based brokerage services align the interests of the brokerage firm and client. As assets grow, each benefits.

C. Fee-based pricing offers clients a better basis to determine brokerage transaction costs in advance than do commissions, which vary based on the size and number of transactions.

D. Fee-based brokerage offers clients access to the full range of brokerage services and the ability to consolidate client holdings in one account as a convenience and cost-saving measure. Some services or transactions, such as those involving check writing, margin, options, principal trades with the sponsoring firm, and access to public offerings, are not as readily available to investment advisory clients.

1. In some instances, by trading as principal a firm can offer its clients access to a security for which there are few other sources, or for which an external trade would occur at a higher cost. *See infra* Part II, Section III.A.

E. Many clients save considerably with fee-based brokerage, as commission-based brokerage and investment advisory services may be more expensive than fee-based brokerage services.

F. The forced closure of fee-based brokerage would be a major loss of client choice and a significant diminution in both pricing and account management flexibility that clients have come to expect and enjoy.

IV. Preserving fee-based brokerage services would be consistent with the protection of investors.

A. To ensure investor protection, we suggest that the Commission impose various conditions with respect to the proposed exemption.

1. The exemption would be available only for entities that are registered with

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30 *See* Rule 3a-7 Release (due to applicable exemptions under the Investment Company Act, structured financings involving certain instruments were exempt from the requirements of the Investment Company Act, but structured financings involving other instruments were not).

the Commission as a broker-dealer and are a member of the NASD.

2. In addition, the exemption would apply only to non-discretionary accounts that are being provided to clients:

   a. As a fee-based alternative (*i.e.*, fee in-lieu-of commissions);

   b. Where any advice provided to the account is solely incidental to brokerage (including, in particular, that the firm does not charge a separate fee or separately contract for the advice and the advice is not provided in connection with a wrap fee program); and

   c. With disclosures regarding the status of the account as a brokerage account and the compensation that the firm and its representatives receive.

B. Such limitations regarding account type and class of entity will ensure that the exemption is consistent with the protection of investors.

1. The activities of broker-dealers are comprehensively regulated under the Exchange Act and by SROs such as the NASD. Broker-dealers are subject to periodic examinations and audits.

2. The Uniform Application for Broker-Dealer Registration, Form BD, requires broker-dealers to disclose detailed information about their business, including their disciplinary history, if any. Similar information about registered personnel of broker-dealers must be disclosed on Form U4, the Uniform Application for Securities Industry Registration. This information is maintained in the Central Registration Depository ("CRD"), which is operated by the NASD. Much of this information, including disciplinary history, is made publicly available by the NASD through BrokerCheck.

3. All registered personnel of broker-dealers must pass qualification examinations administered by the NASD in order to work for a broker-dealer and complete continuing education requirements. Registered securities representatives must be supervised by a principal of the broker-dealer who also is registered with the NASD.[31]

4. The Exchange Act includes antifraud provisions that are substantially similar in content and scope to the antifraud provisions of the Advisers Act (*i.e.*, Sections 206(1) and 206(2)).

   a) Rule 10b-5 prohibits any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security. This rule requires intentional action.[32]

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31 *See* NASD Rule 3010(a)(5).

32 17 C.F.R. § 240.10b-5.

b) Section 15(c)(1),[33] as clarified by the rules thereunder,[34] prohibits a broker-dealer from using a manipulative, deceptive, or other fraudulent device or contrivance (including, but not limited to, knowingly making untrue statements of material fact or omitting to state a material fact necessary to make a statement not misleading) in connection with effecting a transaction in, or inducing or attempting to induce the purchase or sale of any security otherwise than on a national securities exchange of which it is a member.

c) We acknowledge that the Commission and the Commission's staff ("Staff") may believe that fee-based brokerage should at minimum be afforded the antifraud protections of the Advisers Act as described in Sections 206(1) and 206(2). However, to the extent the Commission has relied upon its authority under Section 6(c) of the Investment Company Act to exclude entities from the definition of investment company, it has done so for all purposes under the act, even absent comprehensive oversight by another regulatory structure (such as that applicable to broker-dealers).[35] In promulgating rules under Sections 6(c), the Commission has not subjected the excluded entity to the Investment Company Act's antifraud provisions.

5. Section 17(a)[36] of the Securities Act of 1933, as amended, prohibits fraud or deceit in connection with the offer or sale of securities. Proof of scienter is not required to prove a violation of Section 17(a)(3), which states that it is unlawful "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."[37] This language is very similar to Section 206(2) under the Advisers Act, which states that it is unlawful for an investment adviser "to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon any client or prospective client."[38]

6. Broker-dealers are required to give transaction-specific disclosures at or before the completion of a transaction, pursuant to Exchange Act Rule 10b-10[39] and various SRO rules.

7. The Exchange Act also establishes, among other things, customer protection, net capital and recordkeeping requirements for broker-dealers.

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33 15 U.S.C. § 78*o*(c)(1).

34 17 C.F.R. §§ 240.15c1-1-9.

35 *See* Release 3a-5; Release 3a-7; Release 3a-8.

36 15 U.S.C. § 77q(a).

37 15 U.S.C. §77q(a)(3). *See Aaron v. SEC,* 446 U.S. 680, 695-700 (1980).

38 15 U.S.C. § 80b-6(2).

39 17 C.F.R. 240.10b-10

8. NASD Rules provide additional investor protections.

   a) NASD Rule 2440 requires broker-dealers to buy or sell at a price that is fair, meaning that the price must be reasonably related to the current market price for the security.

   b) The NASD's markup policy, IM-2440, states that markups generally should not exceed 5% of the prevailing market price, and in debt transactions should be much less.

   c) NASD Rule 2320(a) requires broker-dealers to give "best execution" to their customers; in any transaction for or with a customer, the broker-dealer must use reasonable diligence to ascertain the best market for the security and buy or sell in such market so the resultant price to the customer is as favorable as possible under prevailing market conditions. Both debt and equity transactions are subject to the rule.

   d) Rule 2110 establishes an expectation that member firms conform to just and equitable principles of trade.

   e) Rule 2310 requires a member firm to have reasonable grounds for believing a recommendation to a customer is suitable for that customer.

   f) Rule 2210(d) governs the content of public communications by NASD member firms. Communications with the public must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service.

   g) Rules 3010, 3012, and 3013 require NASD member firms to establish and maintain supervisory systems, supervisory control systems, and a process to maintain, review, modify, and test policies and procedures.

C. An NASD Notice to Members[40] discusses specific requirements regarding fee-based brokerage accounts. Members must have "reasonable grounds" for believing that a fee-based brokerage account is appropriate for a particular customer, after considering certain factors and information, and must periodically review each account to determine whether it continues to be appropriate for the customer.[41]

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[40] NASD Notice to Members 03-68 (Nov. 2003). *See also* Fee-Based Account Questions & Answers (Nov. 2003).

[41] The New York Stock Exchange's Rule 405A has similar requirements for its members that offer fee-based brokerage services, and also requires that customers receive a disclosure document containing certain information about fee-based programs before opening a fee-based brokerage account.

V. The proposed rulemaking is fairly intended by the policy and provisions of the Advisers Act.

A. With respect to Section 206A's requirement that a rule or order thereunder be "consistent with the purposes fairly intended by the policy and provisions of the Advisers Act,"[42] the court's consideration of or comments regarding congressional intent associated with the scope of Section 202(a)(11)(F) did not address Section 206A. Section 206A is by its terms broader than the authority under Section 202(a)(11)(F) and allows the Commission to look to the policy considerations underlying the entirety of the Advisers Act, whereas the narrow question in *FPA v. SEC* was limited to congressional intent regarding 202(a)(11)(F). Additionally, the court did not have the opportunity to consider the impact of its decision on clients.

B. As early as 1940, the Commission explained that the broker-dealer exception from the Advisers Act "amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business and that it would be inappropriate to bring them within the scope of the [Advisers Act] merely because of this aspect of their business."[43]

C. Fee-based brokerage is a pricing alternative for basically the same transactions, advice, guidance, and other services that are available with a traditional commission-based brokerage account.[44] There should not be a distinction in the treatment of the accounts simply based on pricing.

VI. Text of Proposed Rule

A. An entity registered with the Commission under Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) will not be considered an investment adviser as defined in Section 202 of the Act (15 U.S.C. 80b-2) in connection with accounts to which it provides brokerage services for a fee in-lieu-of commissions, provided that:

(i) Any investment advice provided by the entity is solely incidental to the brokerage services provided to the account (including, in particular, that the firm does not charge a separate fee or separately contract for the advice and the advice is not provided in connection with a wrap fee program);

(ii) The entity does not exercise investment discretion over the account within the meaning given in Section 3(a)(35) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(35)), other than investment discretion granted on a

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42 15 U.S.C. § 80b-6a.

43 *See* Status of Over-the-Counter Brokers Who Charge Certain Commissions, Advisers Act Release No. 2, 11 Fed. Reg. 10996 (Oct. 28, 1940).

44 *See* Certain Broker-Dealers Deemed Not To Be Investment Advisers, Exchange Act Release No. 51523, Advisers Act Release No. 2376, 70 Fed. Reg. 20424 (Apr. 19, 2005) (stating that "these new fee-based brokerage programs … were not fundamentally different from traditional brokerage programs" and that broker-dealers had simply "repriced traditional brokerage programs rather than ... created advisory programs").

temporary or limited basis; and

(iii) The account owner is provided with a disclosure regarding:

(a) The status of the account as a brokerage account and the nature of brokerage services in comparison to investment advisory services. In particular, the entity should disclose the following: “Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest”; and

(b) The ways that the entity and its representatives are compensated. If applicable, the entity should disclose the fact that it receives compensation in addition to that paid by the customer.

PART II -- OPTION 2: PRINCIPAL TRADING RELIEF

I. Historical context for principal trading restrictions

A. Section 206(3) of the Advisers Act prohibits an investment adviser from effecting transactions for clients while acting as principal for its own account without disclosing its role in the transaction to the client in writing and getting the client's consent before completion of the transaction.[45]

1. The Commission and the Staff have stated that investment advisers must provide written notice and obtain consent before the completion of each principal transaction; blanket disclosure and consent is not enough.[46]

2. In particular, the Staff and the Commission indicated that the investment adviser must disclose in writing the capacity in which it proposes to act, the cost of the security to the adviser (where it proposes to sell), and the best price at which the transaction could be effected by or for the client elsewhere if such price is more advantageous to the client than the actual purchase or sale price.[47]

3. Frequently, the Section 206(3) restrictions on principal trading result in reduced product availability to investment advisory accounts, impede the customer from obtaining the most favorable prices for securities that are primarily traded in principal markets, and/or require that the customer maintain multiple account relationships to achieve the customer's investment objective.

B. The legislative history shows that Section 206(3) was adopted to prevent investment advisers from executing transactions for clients as principal under circumstances favorable to the adviser but not necessarily to the client.

1. The limited legislative history concerning Section 206(3) indicates that lawmakers were concerned in particular about unscrupulous advisers dumping unwanted securities, potentially at unfavorable prices.

2. During the Senate hearings prior to enactment of the Advisers Act, David Schenker[48] intimated that Section 206(3) was meant to address self-dealing and anti-dumping concerns.

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45 15 U.S.C. §80b-6(3).

46 *See, e.g.,* Illegality of Investment Adviser Effecting Transaction Without Client's Consent, Advisers Act Release No. 40, Exchange Act Release No. 3653, Securities Act Release No. 3043, 11 Fed. Reg. 10997 (Feb. 5, 1945) (written notice and consent before the completion of each principal transaction required; blanket disclosure not enough); *In re* Stephens Inc., Advisers Act Release. No. 1666, 48 SEC Docket 1026 (Sept. 16, 1997) (violation for dually-registered broker-dealer and investment adviser to effect principal transactions through its own broker-dealer operations and only obtain written blanket consent from each client).

47 *See In re Arleen W. Hughes*, 27 SEC 629 (1948), *aff'd by Hughes v. Securities and Exchange Commission*, 174 F.2d 969 (D.C. Cir. 1949) (adviser must disclose cost of security and best price at which transaction could be effected elsewhere if such price is more advantageous than actual purchase or sale price); Illegality of Investment Adviser Effecting Transaction Without Client's Consent, Advisers Act Release No. 40, Exchange Act Release No. 3653, Securities Act Release No. 3043, 11 Fed. Reg. 10997 (Feb. 5, 1945) (adviser must disclose capacity in which it is acting, cost of security and best price).

48 David Schenker was Chief Counsel of the SEC Investment Trust Study.

3. The Commission later noted that, "in adopting Section 206(3), Congress recognized the potential for these abuses, but did not prohibit advisers entirely from engaging in all principal and agency transactions with clients. Rather, Congress chose to address these particular conflicts of interest by imposing a disclosure and client consent requirement in Section 206(3) of the Advisers Act."[49]

4. The lack of depth, liquidity and transparency in the securities markets in 1940 no doubt made it more likely that these abuses could occur and remain undetected. Keeping investment advisers at arms-length from transactions with their customers was the best protection against self-serving conduct.

C. The Commission and Staff have discussed the need for principal trading relief for some time.

1. The Commission has recognized that Section 206(3) is unduly burdensome in some circumstances, such as in connection with agency cross transactions.[50]

a) In promulgating Rule 206(3)-2[51] regarding agency-cross transactions over thirty years ago, the Commission noted that "since the publication of Release No. 40, both the investment advisory business and the securities business have undergone many changes. The SEC recognizes that in light of those changes, and particularly the unbundling of advisory services offered by certain broker-dealers, some modification of the earlier staff interpretation of Section 206(3), as set forth in Release No. 40, is appropriate."[52]

i) At that time, the Commission noted that with principal trading, "the pressures of self-interest" may still "require the prophylaxis of the disclosures specified in Investment Advisers Act Release No. 40."[53]

2. In a 1978 release, the Commission said it would give "serious and prompt consideration to providing relief from any other undue burdens that might be imposed by Section 206(3) or any other provision of the Advisers Act or the rules thereunder on brokers and dealers who are registered as

49 Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Advisers Act Release No. 1732, 63 Fed. Reg. 39505 (July 23, 1998).

50 Method for Compliance with Section 206(3) of the Investment Advisers Act of 1940 with Respect to Certain Transactions, Advisers Act Release No. 557, Exchange Act Release No. 13029, 11 SEC Docket 1108 (Dec. 2, 1976) ("Rule 206(3)-2 Proposing Release"); Agency Cross Transactions for Advisory Clients, Advisers Act Release No. 589, Exchange Act Release No. 13583, 12 SEC Docket 740 (June 1, 1977) ("Rule 206(3)-2 Adopting Release") (Commission "recognizes that some modification is appropriate of an earlier staff position, published as Advisers Act Release No. 40 (Feb. 5, 1945), which now appears inappropriate in light of the investment advisory business as it has evolved to the present time").

51 17 C.F.R. § 275.206(3)-2.

52 Rule 206(3)-2 Proposing Release.

53 *Id.*

investment advisers."[54]

3. In 1998, the Commission published an interpretive position under Section 206(3) of the Advisers Act that stated an adviser may obtain its client's consent prior to a principal or agency transaction, or after execution but prior to settlement of the transaction.[55]

    a) The Commission promulgated the interpretation in part out of concern that, unless it clarified the issue, "advisers will unnecessarily avoid engaging in principal and agency transactions that may serve their clients' best interests."[56]

    b) The Commission emphasized that for consent to a principal trade to be effective, the disclosure would need to include facts necessary to alert the client to the adviser's potential conflict of interest. Depending on the timing of the disclosure, the adviser should transmit to the client such information as the current quoted price for a proposed transaction and best price available.[57] Importantly, in footnote 15 the Commission stated that, "[c]onsistent with its obligations under Section 206(3), an adviser, in lieu of disclosing best price information, could undertake to its client to match or better the best price in the market at the time that the adviser receives the client's consent."[58] In the past few years, many broker-dealers have built bond sourcing systems to access dealer markets that assure their clients the best price reasonably available, whether from the firm's own inventory or from another dealer.

4. More recently, industry participants and the Staff have recognized the need for additional principal trading relief in light of the changes in the markets.

    a) During his tenure as Director of the Division of Investment Management, Paul Roye acknowledged market developments that minimize the need for principal trading restrictions in some instances. For example, Roye stated on multiple occasions that "Greater liquidity in certain types of securities and transparency in certain types of transactions minimize the dangers that principal transactions presented when the Advisers Act was written. In addition, the rapid pace of today's market transactions often renders the written consent provisions a *de facto* prohibition on

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54 Final Extension of Temporary Exemption from the Investment Advisers Act for Certain Brokers and Dealers, Advisers Act Release No. 626, Exchange Act Release No. 14714, 14 SEC Docket 946 (Apr. 27, 1978).

55 Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Advisers Act Release No. 1732, 63 Fed. Reg. 39505 (July 17, 1998).

56 *Id.*

57 *Id.*

58 *Id.*

such transactions."[59]

b) As noted above, in 1940 principal trading restrictions were intended to protect investors due to a lack of transparency in the market, difficulties in determining execution quality, and the lack of robust auditing and surveillance standards. Today's markets are vastly different on all fronts.

5. The Staff granted no-action relief to Credit Suisse First Boston ("CSFB") to use certain prior global consent forms, rather than transaction-by-transaction consents, to provide written disclosures to and obtain written consents from its investment advisory clients for the purchase of certain derivatives by CSFB's affiliated derivatives dealer.[60]

a) Establishing an account with each third-party dealer could take several weeks and would involve voluminous paperwork and negotiations. By allowing the pass-through in the affiliated derivative dealer's account, time was saved.

b) CSFB and the affiliated derivatives dealer would have no incentive to engage in price manipulation because they could not benefit from these transactions. The calls would offset the affiliate's transaction with clients and prohibit the affiliate from any benefit.

c) Finally, the clients received disclosures about the transactions. The global consents would explain the capacities in which CSFB and its affiliate would be acting, the fee rate the affiliate would receive, and any potential conflicts raised by the transactions. The confirmations and account statements also would help clients "to monitor the number and appropriateness of the OTC Calls [*sic*] that CSFB caused the client to enter into."[61] Finally, the client's financial sophistication enabled them to assess the information.

II. The Commission has statutory authority to adopt a new rule providing limited relief from the principal trading restrictions of Section 206(3).

A. SIFMA believes that the Commission has authority under Sections 206A and/or 211 of the Advisers Act to promulgate this proposed rule if fee-based brokerage accounts are deemed to be investment advisory accounts.

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59 *See, e.g.,* Paul F. Roye, *Regulatory Initiatives for the Investment Management Industry*, Speech Before the Glasser Legal Works, Fourth Annual Institute on Investment Management Regulation (Nov. 9, 2000), *available at* http://www.sec.gov/news/speech/spch422.htm; Paul F. Roye, *Keynote Address*, Speech Before the Glasser Legal Works, Fifth Annual Institute on Investment Management Regulation (2001), *available at* http://www.sec.gov/news/speech/spch488.htm.

60 Credit Suisse First Boston LLC, SEC No-Action Letter, 2005 WL 2291617 (Aug. 31, 2005). CSFB proposed to seek bids from third parties to buy covered call options from CSFB's affiliate, on terms identical to those of the OTC call that the affiliate would purchase as principal from CSFB's client. If a bid would meet a client's needs, CSFB would sell an OTC call for the client's account to its affiliate on the same terms in the best bid received from the third-party dealer. The affiliate simultaneously would sell an offsetting OTC call to the third-party dealer on terms mirroring those of the contract purchased from the client.

61 *Id.*

B. The Commission cited its authority in the adopting release for Rule 206(3)-2, which granted a safe harbor from the trade-by-trade consent requirements for certain agency cross transactions.[62]

C. The following sections discuss how the proposed rule meets each of the three requirements under Section 206A: (1) necessary or appropriate in the public interest, (2) consistent with the protection of investors, and (3) fairly intended by the policy and provisions of the Advisers Act.

III. The Commission's use of its authority to provide a safe harbor from the requirements of Section 206(3) if fee-based brokerage accounts are deemed to be investment advisory accounts is necessary or appropriate in the public interest, would be consistent with the protection of investors, and is fairly intended by the policy and provisions of the Advisers Act.

A. In modern financial markets, with respect to non-discretionary investment advisory accounts, the trade-by-trade disclosure and consent requirements of Section 206(3) are not necessary in the public interest. In fact, Section 206(3) could result in investors paying higher prices, since the best execution venue for a particular trade may be the investment adviser acting as a broker-dealer, or the investment adviser's affiliate.

1. We are concerned that given the Commission and Staff's current interpretation of Section 206(3) to require trade-by-trade disclosure and consent, absent principal trading relief, investment advisory clients who previously held fee-based brokerage accounts may be denied worthwhile investment opportunities and/or may pay higher prices if these accounts are deemed to be investment advisory in nature.

a) Many of the products traded in fee-based brokerage accounts are not available on an exchange and are traded primarily on a principal basis (*e.g.*, municipal bonds, structured products and initial public offerings).

b) Significant issues arise with respect to fixed income offerings and other offerings where an affiliate of the adviser is a sole or principal underwriter of an issue, or otherwise has in inventory a block of such securities that are available at an attractive price.

c) Usually securities held by an affiliated broker-dealer are sold to "ready" purchasers rather than the advised accounts, because the process of providing trade-by-trade disclosure and obtaining prior trade-by-trade consent is too cumbersome and time consuming and cannot be accomplished before market conditions change.

2. In some instances, by trading as principal a firm can offer its clients access to a security that could be acquired in an external trade only at a higher cost.

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[62] Rule 206(3)-2 Adopting Release.

a) For example, where an adviser or its affiliate is a market maker, or otherwise maintains an inventory in a given security, it may be more advantageous to the client for transactions to occur with the investment adviser or its affiliate to the extent that the broker-dealer's quote is better than that of unaffiliated broker-dealers. A transaction done on an agency basis might well result in a higher total price depending on the price of the security and the associated commission that would be paid by the client. Even in instances in which the affiliated broker-dealer's quote was significantly better, the difference might be more than offset by the addition of an agency commission.

b) Many fixed income securities, including municipal securities, that have limited availability are quoted, purchased and sold quickly through electronic communications networks utilized by bond dealers. It is no longer true that principal transactions "do not require immediate action in a competitive market."[63] In today's principal markets, investment advisers do not necessarily have "sufficient opportunity to secure the client's specific prior consent" and provide trade-by-trade disclosure, and opportunities to achieve best execution may be lost if the adviser does not act immediately on current market prices.[64]

3. Trade-by-trade written disclosure (other than trade confirmations) and consent is not practicable, even in non-discretionary investment advisory accounts where the customer directs the trades. For example, discussions between investment advisers and non-discretionary clients about a trade or strategy may occur before a particular transaction is effected, but at the time that discussion occurs the representative may not know whether the transaction will be effected on an agency or a principal basis.

4. The Commission recognized the importance of these kinds of concerns in adopting other rules and amendments. For example:

a) In connection with amendments to Rule 10f-3 under the Investment Company Act of 1940, the Commission noted that in the context of mutual funds purchasing securities in offerings in which an affiliate acts as underwriter, unduly restrictive limitations on transactions between the funds and their affiliates may: "…cause these funds to pay a significantly higher price for the securities and incur significant additional transaction costs, and the funds…might not be able to purchase desirable securities at prices that would benefit their portfolios…"[65]

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63 Rule 206(3)-2 Proposing Release.

64 *Id.*

65 Exemption for the Acquisition of Securities During the Existence of An Underwriting or Selling Syndicate, Investment Company Act Release No. 22775, 62 Fed. Reg. 42401 (July 31, 1997) (exempting certain series or portfolios of investment companies from Section 10(f) prohibitions).

b) In connection with the adoption of Rule 206(3)-2, the Commission also noted that obtaining consent before each agency cross transaction could result in an adviser's inability to "take advantage of current market prices" and "to effect possible 'best executions' for advisory clients," which "appears to be contrary to the purposes for which the client may have established such account."[66]

c) We believe that undue restrictions on principal transactions present similar risks to an investment adviser's non-discretionary clients.

B. Given the extensive protections provided by regulations applicable to registered broker-dealers, changes in the financial markets that provide additional protections, and the characteristics of non-discretionary accounts, providing limited principal trading relief would be consistent with the protection of investors and "with the purposes fairly intended by the policy and provisions of the Advisers Act."[67]

1. To ensure investor protection, we suggest that the Commission impose various conditions with respect to the proposed exemption.

a) The exemption would be available only for financial services firms that are registered with the Commission as broker-dealers and as investment advisers or where the adviser's affiliate that will be effecting the principal trades is registered as a broker-dealer. Clients would receive investment advice in accordance with the provisions of the Advisers Act, but would also be brokerage customers of the firm for purposes of trade execution services.

b) The exemption would apply only to non-discretionary investment advisory accounts.[68]

c) The adviser must:

i) Disclose that the account is not subject to trade-by-trade written disclosure (other than trade confirmations) and consent under Section 206(3) of the Advisers Act and that the investment adviser may have a conflict of interest when effecting these transactions;

ii) Obtain the client's prospective general consent once, either in the account agreement or through separate documentation, before engaging in any such transactions and explain how the client may revoke consent; and

iii) Provide the client with a written confirmation pursuant to

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66 Rule 206(3)-2 Proposing Release (providing relief from the principal trading restrictions for certain agency cross transactions).

67 15 U.S.C. § 80b-6a.

68 Of course, arrangements between advisers and their clients in which an independent attorney-in-fact may be designated by the client to consent to principal transactions, would be one of several acceptable ways of meeting the consent requirements in both discretionary and non-discretionary accounts.

Exchange Act Rule 10b-10 at or before completion of the trade disclosing that the adviser traded as principal.

d) This information provides the client a basis to determine whether to continue or revoke the consent for principal transactions.[69]

e) The adviser will continue to act in the best interests of the client, including a duty to provide best execution, and will be required to meet all disclosure obligations imposed by Sections 206(1)[70] and (2)[71] of the Advisers Act and by other applicable provisions of the federal securities laws and rules of SROs.

f) Such limitations will ensure that the exemption is consistent with the protection of investors.

2. The activities of broker-dealers are comprehensively regulated under the Exchange Act and by SROs such as the NASD, which would provide investor protection even if the Commission grants limited principal trading relief. *See supra* Part I, Section IV.A.3.

3. The nature of non-discretionary investment advisory accounts reduces the likelihood of the abuses Section 206(3) was designed to address.

a) An investment adviser to a non-discretionary account may not unilaterally effect trades for the account. The adviser provides advice to the client, and the client directs the adviser whether to execute particular trades or engage in a particular strategy.

b) The client has control over the investment decisions that are made for his or her account. As a consequence, many of the protections provided by the Commission through the current interpretation of Section 206(3) are already present.

c) Moreover, clients with non-discretionary accounts have indicated by virtue of that relationship a willingness and desire to be more actively engaged in the management of their accounts.

d) As a result, an investment adviser may not cause the client to purchase an unprofitable security from or sell a particular security to the adviser without the client's prior knowledge.

4. The markets and technology have evolved significantly since 1940 when the principal trading restrictions were adopted. The markets for most securities are more transparent and deeper and more liquid than ever before, causing the reasons for restricting principal transactions in non-discretionary investment advisory accounts to become largely obsolete.

a) For example, technology has contributed greatly to market

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69 *See* Rule 206(3)-2 Proposing Release.

70 15 U.S.C. § 80b-6(1).

71 15 U.S.C. § 80b-6(2).

transparency by providing instant access to current quote information and storage of more detailed price histories to enable customers to review the quality of their executions. Therefore, it has become easier to ensure that the proposed prices approximate the best prices available in the open market, "an independently determinable gauge of performance."[72]

i) National Market System equity securities trade in very active, liquid, and transparent markets. Once the Order Protection Rule of Regulation NMS is fully effective next month, such securities will be subject to market-wide and uniform trade through-protection.

ii) The transparency of the fixed income markets also has made great strides with the development of multiple electronic trading markets for fixed income securities, TRACE reporting and other enhancements to the fixed income markets.

b) Investment advisers and broker-dealers can fulfill their best execution obligations almost instantaneously by accessing electronic quotations from multiple venues.

i) With respect to equity securities, firms review the quality of execution offered by various market centers by comparing execution information that is available on the website of every market center.[73]

ii) SROs and the Commission regularly examine order routing practices to ensure that regulated advisers and broker-dealers are routing and executing orders properly.

c) These technological developments reduce the likelihood of abuse, and facilitate detection if it occurs.

5. In sum, the issues that concerned Congress when it incorporated Section 206(3) into the Advisers Act are no longer present with respect to non-discretionary investment advisory accounts. Consequently, the benefits of requiring non-discretionary investment advisory clients to provide trade-by-trade disclosure and consent under Section 206(3) does not justify the burdens, particularly in light of these other considerations that also protect clients.[74]

C. If fee-based brokerage accounts are deemed to be investment advisory accounts,

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72 *See* Rule 206(3)-2 Proposing Release.

73 *See* 17 C.F.R. 240.605 and 606.

74 *See* Proposed Amendments to Investment Adviser Requirements Concerning Agency Cross Transactions for Advisory Clients, Advisers Act Release No. 860, 48 Fed. Reg. 22328 (May 12, 1983).

the Commission should facilitate the client's ability to transition such accounts into firms' existing non-discretionary investment advisory programs.

1. Many firms currently offer non-discretionary investment advisory programs, and intend to transfer fee-based brokerage accounts into those programs if clients choose to maintain fee-based pricing. Those programs are designed specifically to ensure that firms satisfy the fiduciary duties that attach to investment advisory accounts.

2. Principal trading relief that is limited only to investment advisory accounts that formerly were fee-based brokerage accounts would force clients to choose between existing advisory programs and the ability to effect trades with the firm as principal (through a commission-based account).

    a) Compliance and regulatory oversight for non-discretionary investment advisory accounts often is accomplished, in part, through systems that prohibit principal trading and monitor for compliance with diversification and other account parameters and restrictions.

    b) Keeping track of the genealogy of accounts that were formerly fee-based brokerage versus other non-discretionary investment advisory accounts would be technologically difficult, if not impossible, given the October 1, 2007 compliance date. Trade execution routing for investment advisory programs often is derived through specific program or account type codes (*e.g.*, "advisory accounts program ABC" or "ERISA accounts") rather than the date an account was opened.

    c) Limiting relief to accounts that were in fee-based brokerage programs would make the requested relief impractical, unusable, and would not serve either the best interest of clients or assist the firms affected by the court's ruling in the transition and ongoing servicing of these accounts.

IV. Text of Proposed Rule

A. An investment adviser registered under Section 203 of the Act (15 U.S.C. 80b-3) and also registered as a broker-dealer under Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o), or an affiliated broker-dealer shall be deemed in compliance with the provisions of Section 206(3) of the Act (15 U.S.C. 80b-6(3)) in trading as principal with a non-discretionary advisory client, if:

1. The investment adviser obtains the prospective consent of the non-discretionary advisory client authorizing the investment adviser to trade as principal with the non-discretionary advisory client, provided that such consent is obtained after full written disclosure that: (i) the account is not subject to written trade-by-trade consent or disclosure requirements for principal transactions under Section 206(3) of the Act, (ii) with respect to trading as principal, the investment adviser may have a conflict of interest with the non-discretionary advisory client, and (iii) the consent may be

revoked at any time by written notice to the investment adviser or affiliated broker-dealer from the non-discretionary advisory client; and

2. The investment adviser or affiliated broker-dealer provides each such non-discretionary advisory client a written confirmation at or before the completion of such transaction that complies with the requirements of Rule 10b-10 under the Securities Exchange Act of 1934 (15 U.S.C. 78o), including disclosure of the capacity in which the firm acted with respect to the transaction.

B. For purposes of this rule the term "non-discretionary advisory client" shall mean a client for which the investment adviser does not exercise investment discretion within the meaning given in Section 3(a)(35) of the Securities Exchange Act of 1934 (15 U.S.C. 78c), other than investment discretion granted on a temporary or limited basis.

C. For purposes of this rule the term "trading as principal with a non-discretionary advisory client" shall mean a transaction in which a person acts as an investment adviser in relation to the transaction and such investment adviser, or any person controlling, controlled by or under common control with such investment adviser, acting in its capacity as a registered broker-dealer, trades as principal with the non-discretionary advisory client.

D. For purposes of this rule the term "affiliated broker-dealer" shall mean a broker-dealer registered under Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) that is controlling, controlled by, or under common control with an investment adviser.

E. This rule shall not be construed as relieving an investment adviser or affiliated broker-dealer from acting in the best interests of the advisory client, including fulfilling the duty with respect to providing best execution for the particular transaction for the advisory client.

PART III -- ADDITIONAL GUIDANCE REGARDLESS OF WHICH OPTION THE COMMISSION IMPLEMENTS

I. SIFMA also requests that the Commission or its Staff issue interpretive guidance regarding certain issues related to Rule 202(a)(11)-1 being vacated. Alternatively, the Commission could promulgate a rule that addresses these issues. The scope of such guidance depends upon the particular rulemaking implemented by the Commission.

II. *Amending Existing Client Agreements.* If fee-based brokerage accounts are deemed to be investment advisory accounts, the time to transfer the accounts is extremely limited; the court's stay of its mandate will expire on October 1, 2007.

A. Many firms have tens or hundreds of thousands of clients with fee-based brokerage accounts.

1. Firms must prepare, print, and distribute written client communications and give advance notice of any change in status of the accounts prior to October 1, 2007.

2. However, as a practical matter, it may be impossible to also repaper the accounts and obtain signatures from all clients before October 1, 2007.

B. To prevent unnecessary disruption of service to clients, firms may need to rely on providing notice of amendment to their existing agreements without seeking affirmative consent or obtaining a signature from each client to transition fee-based brokerage accounts to an investment advisory relationship. SIFMA is seeking guidance from the Commission regarding the following if fee-based brokerage accounts are deemed to be advisory:

1. Under the Commission's rules and regulations (including those related to an investment adviser's fiduciary duty), firms may amend an existing agreement by advance notice without obtaining a client signature or executing a new agreement for accounts that were fee-based brokerage accounts, provided that there would be no material changes to the services offered to the customer or the firm's responsibilities toward the customer that would negatively impact the client.

2. Firms would not violate the disclosure delivery requirements under Advisers Act Rule 204-3(b)[75] by providing disclosure statements with the notice sent to fee-based brokerage clients no more than 90 days and no fewer than 30 days before the date the amendments would go into effect, rather than 48 hours before or at the time of entering into a new investment advisory contract.

3. Amending existing client agreements by notice (and allowing customers to call or write to indicate that they do not want to continue the relationship) to reflect regulation under the Advisers Act would be consistent with Advisers Act Sections 205 and 215 regarding contract provisions,

[75] 17 C.F.R. 275.204-3(b).

provided that firms include the required non-assignment and non-waiver clauses, respectively.

III. *Discount and Full Service Brokerage Accounts.* SIFMA agrees with other market participants that the Commission should provide guidance about this topic.[76]

A. Because the court vacated the entirety of Rule 202(a)(11)-1, guidance on which firms previously relied has been lost.

B. Many broker-dealers offer both a full-service brokerage and a discount brokerage option to clients. The mere existence of multiple commission pricing levels within a single firm should not impact the nature of accounts.

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[76] *See* Letter from Barbara Roper, *et al.* to Chairman Christopher Cox (Apr. 24, 2007), *available at* http://www.fpanet.org/member/govt_relation/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=53333 (urging the Commission to provide guidance about financial planning and discretionary accounts, consistent with the vacated rule).

PART IV -- CONCLUSIONS AND TIMING

I. *OPTION 1: An exemption from the Advisers Act for fee-based brokerage services.* The proposed rule, which would exclude certain classes of financial services firms from the definition of investment adviser under Section 202(a)(11) of the Advisers Act with respect to the provision of fee-based brokerage services, would be consistent with the Commission's authority under Sections 206A and/or 211 of the Advisers Act.

A. A section of the Investment Company Act analogous to Section 206A of the Advisers Act has been used to provide broad relief to an industry or class of entities.

B. The proposed rule would meet the requirements of Section 206A because it is: (1) necessary or appropriate in the public interest, (2) consistent with the protection of investors, and (3) fairly intended by the policy and provisions of the Advisers Act.

II. *OPTION 2: Principal trading relief for non-discretionary investment advisory accounts.* If fee-based brokerage accounts are deemed to be subject to the Advisers Act, the proposed rule that would exempt certain financial services firms from the trade-by-trade disclosure and consent requirements under Section 206(3) of the Advisers Act with respect to principal trades in non-discretionary investment advisory accounts would be consistent with the Commission's authority under Sections 211 and/or 206A of the Advisers Act.

A. With respect to Section 211, the Commission already has provided similar relief from Section 206(3) for agency cross transactions.

B. The proposed rule would meet the requirements of Section 206A because it is: (1) necessary or appropriate in the public interest, (2) consistent with the protection of investors, and (3) fairly intended by the policy and provisions of the Advisers Act.

C. To the extent that principal trading relief is granted as we propose, we also would ask the Commission to waive the disclosure and consent requirements of the proposed rule for accounts that initially were opened as fee-based brokerage accounts and transitioned to investment advisory accounts subsequent to the vacating of Rule 202(a)(11)-1. We believe that this would be consistent with client expectations that they will continue to have access to the same services they previously contracted for.

III. SIFMA requests that the Commission propose for notice and comment a rule pursuant to one of the options outlined above as quickly as possible.

A. The court has stayed its mandate until October 1, 2007.

B. If the Commission publishes a proposed rule it could provide 30 (or fewer) days for the public to provide comments.[77] Once the comment period expires, the Commission would have a limited amount of time to review the comments and approve a final rule before the court's mandate issues.

C. The immediacy of the need for a proposed rule reflects not only the significance of these issues generally, but also the practical realities of ensuring that customers receive uninterrupted access to services that they have previously requested, contracted for, and upon which they have relied.

1. To the extent firms need to provide clients with information regarding regulatory developments, service options going forward, and the impact of any changes, they need time to, among other things, develop and disseminate such disclosures, conduct staff training, and revise marketing materials and policies and procedures.

2. Client communications need to be sent in late July or early August to provide adequate time for affected clients to consider their options.

IV. SIFMA also requests that the Commission address other issues that arise from the court's decision through interpretive guidance. These issues may include: amending existing client agreements, delivery of the Form ADV Part II disclosure brochure, and discount and full-service brokerage accounts.

V. We appreciate the Commission's consideration of our request and welcome any opportunity to answer your questions.

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[77] The typical time period for comment is between 30 and 60 days. *See* http://sec.gov/answers/rulemaking.htm. The Administrative Procedures Act and the Commission's Rules of Practice would allow for a notice period of less than thirty days if the Commission determines that the notice and public procedure are impracticable, unnecessary, or contrary to the public interest. *See* 5 U.S.C. § 553(d); SEC Rule of Practice 192.