FOUNDATION FOR FIDUCIARY STUDIES
DEFINING PRACTICES THAT DETAIL A PRUDENT INVESTMENT PROCESS

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September 12, 2004

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Comment Letter on "Certain Broker-Dealers Deemed Not To Be Investment Advisers" File Number S7-25-99
Proposed rule 202(a)(11)-1 [17 CFR 275.202(a)(11)-1], and amendment to the instructions for Schedule I of Form ADV [17 CFR 279.1], of the Investment Advisers Act of 1940.

Dear Mr. Katz:

The Foundation for Fiduciary Studies ("Foundation")[1] is opposed to the proposed rule that would extend exemptions to broker-dealers from being subject to the Investment Adviser's Act of 1940 ("Act"). The Foundation believes it would be in the public's best interests if there was a clearer demarcation between "brokers-dealers" and "advisers." An exemption, such as the one proposed by the Commission, would further obfuscate the distinction.

There are a number of presuppositions to the Commission's proposed exemption that are fundamentally flawed: (1) Discretion is a valid means of distinguishing between advisory and brokered activities; (2) The broker-dealers' form of compensation has changed, but their function has not; and (3) Disclosure is an effective means of protecting the interests of the investing public.

- **Discretion is a valid means of distinguishing between advisory and brokered activities.** The Foundation does not believe that "discretion" is a reliable factor in determining appropriate regulatory registration. There are a number of registered investment advisers, such as investment consultants, that provide nondiscretionary investment advisory services, yet register under the Act because

[1] The Foundation for Fiduciary Studies is a not-for-profit organization founded in 2000 to define and promulgate the investment practices that detail a prudent process for investment fiduciaries.

the advice they provide to clients is comprehensive and continuous. Conversely, there are a number of broker-dealers that execute nondiscretionary services agreements, yet retain de facto discretion over client accounts because clients lack the education, sophistication, initiative, time, and/or experience to make independent informed decisions. The most frequent conversation between a client and a broker after the client has been shown an array of investment options is the client saying: "Hey, you make the selection, that's what I'm paying you for!"

- **The broker-dealers' form of compensation has changed, but their function has not.** *"The new programs essentially re-price traditional full-service brokerage programs, but do not fundamentally change their nature."* [Commentary to 1999 SEC proposed exemption.] There has been a fundamental change in the way broker-dealers work with the investing public, however, the proposed exemption would leave the regulatory oversight of the broker-dealer unchanged. In the last ten-to-fifteen years, the function of the typical broker-dealer has evolved from the selling of financial products to the provision of investment advice — this, in itself, is a positive transformation for the typical investor. However, the primary catalyst behind broker-dealers offering asset-based fees has been to facilitate putting assets under management. The primary motivation has not been, as suggested, to provide investors an alternative form of compensation.

- **Disclosure is an effective means of protecting the interests of the investing public.** *"Under the proposed rule, a broker-dealer providing investment advice to customers, regardless of the form of its compensation, would be excluded from the definition of investment adviser as long as: ... (iii) the broker-dealer discloses to its customers that their accounts are brokerage accounts."* [Commentary to 1999 SEC proposed exemption.]

  Disclosure has proven to be an inadequate means of informing investors of the differences and/or the distinction between the roles of a broker-dealer and an adviser. Take, for example, the following chart which depicts the investment consulting firms that have the largest number of public pension plans as clients.[2]

[2] Nelson Information, *Pension Fund Consultant Survey*, 2001. More than 500 public pension plans have assets of more than $100 million. Of these, approximately 78 percent utilize investment consultants.

| Firm | Number of plans | Percentage | Assets |
|---|---|---|---|
| Callan Associates | 56 | 16% | $800 billion |
| Mercer | 48 | 13% | $434 billion |
| Wilshire Associates | 26 | 7% | $516 billion |
| **Merrill Lynch Consulting** | 22 | 6% | $8 billion |
| **Smith Barney Consulting** | 18 | 5% | $12.9 billion |
| Strategic Investment Solutions | 13 | 3.5% | $327 billion |
| Watson Wyatt | 13 | 3.5% | $200 billion |
| Summit Strategies Group | 13 | 3.5% | $19 billion |
| Ennis, Knupp & Associates | 12 | 3.2% | $213 billion |
| Capital Resource Associates | 11 | 3% | $188 billion |

Ranked fourth and fifth on the list are two broker-dealers. This strongly suggests that even the trustees of the nation's largest public pension plans cannot distinguish between a broker-dealer and an investment adviser.

This observation, however, should not be construed as a criticism of the individual brokers involved in providing investment consulting services. An entity related to the Foundation, the Center for Fiduciary Studies, has trained more than two-thousand investment professionals. Based on our observations, we have not seen a correlation between quality of work, expertise, professionalism, and/or integrity; and form of registration.

**Additional Comments**

The SEC requested comments on these additional topics:

*Instead of the proposed disclosure, should the SEC preclude brokers from relying on the rule if they market these accounts in such a way as to suggest they are advisory accounts?*

If it walks like a duck … No entity, not just broker-dealers, should be permitted to market misleading investment services. A related topic is the SEC's current sweep of registered investment consulting firms that are involved in "pay-to-play" schemes. The investment consulting firms subject to the sweep state that they are providing objective third-party advice while, at the same time, receiving substantial revenues from the very money managers the consultant is being paid to monitor and evaluate.

*Do current fee-based programs more closely align the interests of investors with those of brokerage firms and their registered representatives than do traditional commission-based services?*

Yes, they do, but this is a tangential issue. The proposed exemption is attempting to position fees and form of compensation as being the central issue, which it is not.

*If the Commission determines not to adopt this rule as proposed, what would be the practical impact on broker-dealers?*

This answer gets to the heart of the argument: Broker-dealers should be required to bifurcate their sales force into brokers and advisers, the later being registered under the Act. The requirement for broker-dealers to demonstrate a clear demarcation between their brokers and advisers would be a "win-win-win."

It would be a "win" for clients, because they would be able to distinguish between brokers selling financial products and advisers providing objective investment advice.

It would be a "win" for producers within the broker-dealer that want to be at the top of their game — advisers who want to provide clients comprehensive and continuous investment advice. Today, these producers are hamstrung from providing such services because of compliance rules that are intended for the execution of transactions and/or the selling of financial products.

It would be a "win" for broker-dealers because the leading cause of arbitration and litigation against broker-dealers has been "breach of fiduciary responsibility" — clients believing they are receiving objective advice, but later discovering otherwise. The best way for broker-dealers to deal with this risk is to have policies and procedures that define the roles and responsibilities of producers providing comprehensive and continuous investment advice.

*Should we require broker-dealers who would seek to rely on the rule nevertheless to register if they market fee-based accounts based on the quality of investment advice provided? For example, should brokers be precluded from using certain terms like "investment advice" and "financial planning" in advertising these services, or is prominent disclosure that an account is a brokerage account sufficient to alert an investor to the nature of the account?*

If it walks like a duck, it should be registered as a duck! The best interests of the public are not being served by requiring the duck to hang a sign around its neck that states it actually is a goose.

**Summary**

The Foundation believes that framing the proposed broker-dealer exemption around the broker-dealer's form of compensation is misleading. The real issue is whether the function of the typical broker-dealer has fundamentally changed — which it has; and whether the public can distinguish between brokers and advisors — and the public can't.

At stake is the standard of care an investor should be entitled to when receiving comprehensive and continuous investment advice. The nation's wealth is a finite resource, and the management of the nation's wealth should only be entrusted to professionals that are held to the highest standards of care defined by law. If this proposed exemption is adopted, the Commission will, in essence, permit the existence of two different classes of advisers, each with a different standard of care. The investing public deserves better.

Respectfully submitted,

Donald B. Trone, AIFA®
President