Sept. 22, 2004

Jonathan Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth St. NW
Washington D.C. 20549
By email to rule-comments@sec.gov

File No. S7-25-99: Certain Broker-Dealers Deemed Not To Be Investment Advisors

To the Commissioners:

On behalf of TD Waterhouse Investor Services, Inc., I submit this comment letter on the Commission's rule proposal to permit brokerage firms to offer their retail customers investment advice for a fee without having to follow the rules that apply to registered investment advisors. TD Waterhouse, a member of the New York Stock Exchange, is a leading national brokerage firm that provides investors and financial advisors with a broad range of brokerage, mutual fund and other consumer financial products. Through its Institutional Services Division, TD Waterhouse is also one the nation's leading providers of brokerage and custody services to registered independent investment advisors and their clients. Because of our role providing brokerage services to individual investors and to investment advisors, we believe we offer a unique perspective on this proposal: the investor's perspective.

1. THE DEBATE OVER THE REGULATION OF RETAIL ADVISORY SERVICES SHOULD BE RESOLVED IN FAVOR OF INVESTOR PROTECTION

Congress' basic purpose in passing the Investment Advisors Act was to protect investors from the potential conflicts of interest affecting any financial professional who manages assets for clients. Quoting the SEC's Report which led to the Act's passage, the Supreme Court stated that the primary function of an investment advisor is "to render to clients, on a personal basis, competent, unbiased and continuous advice regarding the sound management of their investments[.]" *Lowe v. SEC*, 472 U.S. 181, 192 (1985). While the SEC's regulation of brokerage firms also seeks to protect investors, it does not have the same core purpose of protecting the integrity of investment advice as the Advisor's Act.

In 1999, the SEC proposed to expand the exemption from Investment Advisors Act registration which permits brokers to give incidental investment advice without meeting any of the legal requirements that apply to registered investment advisors. Since that time, a fierce debate has raged. Brokerage firms and their trade associations have argued that they should be allowed to provide unlimited investment advice without following any of the provisions of the Investment Advisors Act. Financial planners, other investment advisors and their trade associations have argued that only registered investment advisors should be permitted to offer any investment advice to customers.

Much of this debate appears to be about gaining a potential competitive advantage. Sadly lacking from the debate has been a focus on what is actually best for the individual investor. We believe the Commission, as the primary advocate for the interests of the individual investor, should seek a middle-ground position that combines the best aspects of both investment advisor and brokerage firm regulation to create a uniform regulatory standard applicable to anyone who is compensated for providing investment advice to a retail customer.[1]

2. THE PROPOSED REGULATORY DISTINCTION BETWEEN BROKERS AND ADVISORS DOES NOT PROVIDE INDIVIDUAL INVESTORS WITH UNIFORM PROTECTION

We agree with the statement in the Commission's 1999 proposing release for this rule that "the nature of the services provided, rather than the form the broker-dealer's compensation takes, [sh]ould be the primary feature distinguishing an advisory account from a brokerage account." Congress endorsed this functional approach to regulation in the Gramm-Leach-Bliley Act, when it required banking institutions to move their investment advisory, mutual fund and brokerage businesses into SEC-regulated subsidiaries. Similarly, the Commission recently proposed allowing savings and loan associations to engaged in trust activities (a traditional banking function) without registering as investment advisors, but would continue to require investment advisory registration to manage agency accounts or provide retail financial planning services. *Investment Advisors Rel. No.* 2232 (May 7, 2004). We suggest that the Commission follow the same functional approach to the regulation of investment advice - it should be regulated consistently based on the activity, not the type of entity that engages in that activity.

The regulatory distinction between brokers and advisors made sense in 1940 when the Investment Advisors Act was passed, because at that time the businesses of brokerage firms and investment advisors were very different. Brokerage firms executed securities orders for their customers, who paid high commissions at rates fixed by the New York Stock Exchange. Investment advisors generally offered fully discretionary asset management or ongoing investment advice and supervision for a fee which could be flat or could be a percentage of the customer's assets. Congress recognized this distinction by enacting Section 202(a)(11)(C) of the Advisors Act, which created an exemption for a broker or dealer "whose performance of [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore".

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[1] We believe the investor protection concerns set forth in this letter need not apply to institutional accounts at brokerage firms, which, as defined by NASD Rule 3110 would include "(A) a bank, savings and loan association, insurance company, or registered investment company; (B) an investment advisor registered either with the Securities and Exchange Commission under Section 203 of the Investment Advisors Act of 1940 or with a state securities commission (or agency or office performing like functions); or (C) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million."

However, since 1940, the businesses of brokerage firms and investment advisors have converged with respect to providing investment advice to individual investors. In 1975, the SEC de-regulated brokerage commissions. As a result, competition has lowered brokerage commissions, and brokerage firms have sought new sources of revenue. Today, many brokerage firms offer proprietary mutual funds managed by their own, registered investment advisor, or offer other products, such as wrap fee programs, that require them to be registered (for those purposes) as investment advisors. Moreover, the advice and guidance offered by most traditional brokerage firms is no longer an "incidental" aspect of the brokerage relationship; in fact, investment advice has become the principal focus of their marketing efforts and is, presumably, the justification for charging as much as ten times more for execution services than do discount brokerage firms.

In short, the retail businesses of full service brokerage firms and retail investment advisors have become almost indistinguishable, but the SEC's regulatory scheme does not reflect this convergence. In our view, most individual investors are not aware of the fact that there is a difference between the regulation of investment advisors and brokerage firms. And in our view, investors expect a consistent and high level of investor protection from whomever they receive their investment advice. We suggest that the Commission's regulation provide a consistent set of rules, based on the activity being performed - investment advice - rather than being based on the type of entity (investment advisor versus brokerage firm) that is engaging in that activity or the form of compensation received for providing the advice.

3. THE SEC SHOULD ADOPT A CLEAR, UNIFORM REGULATORY SCHEME FOR ALL BROKERS AND ADVISORS WHO PROVIDE FINANCIAL ADVICE TO INDIVIDUAL INVESTORS

In one of the leading cases interpreting the Investment Advisor's Act, the Supreme Court stated that "A fundamental purpose, common to [the federal securities laws], was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *SEC v. Capital Gains Research Bureau, Inc., et al.* 375 U.S. 180, 186 (1963). Because of its focus on protecting the integrity of investment advice, there are certain features of investment advisor regulation that provide greater investor protection than does brokerage firm regulation. Investment advisors are charged with operating in the best interests of all their clients at all times. By contrast, brokerage firms generally have a fiduciary relationship with a customer only for limited purposes (for example, a duty of best execution when executing the customer's order). Investment advisors must provide their clients with a Form ADV before establishing a customer relationship, in which the advisor must describe its process for providing advice and disclose all of its potential conflicts of interest and its policies for managing those conflicts of interest. Advisors are required to offer this same disclosure again at least on an annual basis. Brokerage firms, while subject to a general duty to disclose material facts, have no similar duty to disclose their method for providing advice or to avoid or disclose all conflicts of interest.

However, there are features of brokerage firm regulation which provide greater investor protection than does investment advisor regulation. Brokerage firms are subject to concurrent state regulation and examination in each state in which they do business. By contrast, investment advisors are inspected only by the SEC, or only by their home state. SEC-registered investment advisors are inspected on average no more often than every six or seven years; state-registered investment advisors are often inspected even less frequently. While voluntary groups like the Financial Planning Association have rigorous examination and continuing education requirements for employees of investment advisors, these requirements are mandatory for brokerage firm employees.

We believe the SEC should borrow from best investor protection practices of both the investment advisor and the brokerage firm worlds, and subject all brokers and advisors who provide financial advice to individual investors, to a new kind of regulation. This new regulation would require anyone who provides investment advice to individual investors for a fee or other form of compensation to give their customers a detailed description of the process they use for providing advice, and full disclosure of all potential conflicts of interest.[2] These disclosures would have to be provided before opening a new account for a customer and offered at least annually thereafter - just as an investment advisor is currently required to provide a Form ADV to customers and potential customers. These disclosures would be made available on the firm's website and the SEC should make these disclosures centrally available, so that investors can compare the analytical methods and potential conflicts of interest of many different firms before choosing a provider of financial services. In this way, investors can be assured that the individual they select to provide investment advice is operating with their interests at heart. And investors would benefit from improved disclosure of industry practices such as payment-for-order-flow, order internalization, revenue-sharing, and securities lending.

In addition, under our proposal, the SEC would adopt a single set of sales practice rules, including uniform requirements for customer communications, advertisements and sales literature. Similarly, we envision uniform regulations for advice on asset allocation, and financial planning. The regulation of trade executions would continue to be subject to a rigorous requirement of best execution in handling customer orders, which we believe is a more effective way to ensure the quality execution of investor orders than the restrictions in the Investment Advisors Act on principal trading.

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[2] The Commission's proposed Point-of-Sale disclosures for mutual fund transactions represent an effort to improve brokerage firms' disclosure of potential conflicts of interest. However, we believe it would be more effective to require these disclosures for all types of transactions, not just for mutual fund sales, and at the beginning of a customer's relationship with the brokerage firm and annually thereafter, rather than in connection with each specific transaction.

Under our proposal fully discretionary asset management would require registration as an investment advisor regardless of whether the compensation is paid for a fee or through brokerage commissions. And, to ensure that customers of investment advisors have the same protections as brokerage firm customers, we suggest that the Commission consider making mandatory for employees of investment advisors the examination and continuing education requirements currently suggested by the Financial Planning Association. We also suggest that the Commission consider basic financial solvency and fidelity bonding regulation for investment advisors similar to that already imposed on brokerage firms.

4. THE SEC PROPOSED RULE SHOULD NOT BE ADOPTED BECAUSE IT WOULD EXPAND, RATHER THAN ELIMINATE, THE REGULATORY DISTINCTION BETWEEN BROKERS AND ADVISORS

Proposed Rule 202(a)(11)-1 would, if adopted, expand and codify the regulatory distinctions between investment advisors and brokerage firms. Under the proposed rule, brokerage firms could offer investment advice for a fee to brokerage customers if they satisfy three conditions: (i) the broker-dealer must not exercise investment discretion over the account from which it receives special compensation; (ii) any investment advice is incidental to the brokerage services provided to each account; and (iii) advertisements for and contracts or agreements governing the account must contain a prominent statement that it is a brokerage account. In our view, this proposal does not go far enough to adequately protect investors. These three conditions effectively redefine the term "special compensation" out of the Advisors Act altogether, yet they provide no guidance about when advice is "solely incidental" to brokerage. We believe these three conditions do not achieve the goal of eliminating conflicts of interest intended by the drafters of the Advisors Act.

We recognize that some portions of our proposal might require action by Congress. However, the Commission's current proposal also raises substantial issues about Congress' intent when it drafted the Advisors Act, and the ability of the Commission to define away key terms of that Act. We believe that the convergence of brokerage firms and investment advisors is an issue that should be considered by Congress as part of a broad rethinking of the best way to regulate investment advice in the interest of investor protection.

CONCLUSION

We believe the debate over the regulation of retail advisory services should be resolved in favor of investor protection and we believe that the proposed regulation, which would increase the regulatory distinction between brokers and advisors does not provide individual investors with uniform protection. We suggest that Congress and the Commission should instead adopt a clear, uniform regulatory scheme for all brokers and advisors who provide financial advice to individual investors as the best way to ensure that all individual investors receive the same disclosures and benefit from the same regulatory protections.

In conclusion, TD Waterhouse Investor Services, Inc. appreciates the opportunity to comment on this important issue. We believe it the right time for the SEC to move toward a regulatory structure that offers individual investors one standard of transparency and protection. We would be pleased to discuss these comments further or provide the Commission or its staff with any other assistance on this matter. Please to do hesitate to contact me or Richard H. Neiman, Executive Vice President & General Counsel in this regard.

Sincerely,

Timothy P. Pinnington
Vice Chair & Chief Operating Officer
TD Waterhouse USA