SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release Nos. 34–50980; IA–2340; File No. S7–25–99]

RIN 3235–AH78

Certain Broker-Dealers Deemed Not To Be Investment Advisers

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is reproposing a rule addressing the application of the Investment Advisers Act of 1940 to broker-dealers offering certain types of brokerage programs. Under the reproposed rule, a broker-dealer providing nondiscretionary advice that is solely incidental to its brokerage services is excepted from the Investment Advisers Act regardless of whether it charges an asset-based or fixed fee (rather than commissions, mark-ups, or mark-downs) for its services. The rule would also state that exercising investment discretion is not solely incidental to brokerage business, and thus, a broker-dealer providing discretionary advice would be deemed to be an investment adviser under the Investment Advisers Act. In addition, under the rule, broker-dealers would not be subject to the Investment Advisers Act solely because they offer full-service brokerage and discount brokerage services, including electronic brokerage, for reduced commission rates. Finally, the Commission is proposing to issue a statement of interpretive position that would clarify when certain broker-dealer advisory services, including financial planning, are solely incidental to brokerage business.

DATES: Comments should be received on or before February 7, 2005.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number S7–25–99 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609.

All submissions should refer to File Number S7–25–99. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Robert L. Tuleya, Senior Counsel, or Nancy M. Morris, Attorney-Fellow, at 202–942–0719, or Iarules@sec.gov, Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth St., NW., Washington, D.C. 20549–0506.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission (''Commission'' or ''SEC'') is proposing rule 202(a)(11)-1 under the Investment Advisers Act of 1940 (''Advisers Act'' or ''Act'').[1] We are also requesting comment on interpretive positions under section 202(a)(11)(C) of the Act.

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I. Background

The Advisers Act regulates the activities of certain ''investment advisers,'' which are defined in section 202(a)(11) as persons who receive compensation for providing advice about securities as part of a regular business.[2] Section 202(a)(11)(C) of the Advisers Act excepts, from the definition, 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 therefor.'' The broker-dealer exception ''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.'' [3]

Many securities firms currently are registered with us under both the Securities Exchange Act of 1934 [4] (as broker-dealers) and the Advisers Act (as advisers), but treat only certain of their accounts as subject to the Advisers Act. We have viewed the Advisers Act, and the protections afforded by the Act, as applying only to those accounts to which the broker-dealer provides investment advice that is not solely incidental to brokerage services or from which the firm receives special compensation (or both).[5]

On November 4, 1999, the Commission issued a release proposing for comment a new rule under the Advisers Act in response to the introduction of two new types of brokerage programs offered by full-service broker-dealers ''fee-based brokerage programs'' and ''discount brokerage programs.'' [6] The rulemaking addressed whether, as a result of introducing these programs, broker-

[1] 15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Act, we are referring to 15 U.S.C. 80b of the United States Code in which the Act is published.

[2] For a discussion of the scope of the Advisers Act, see *Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services,* Ivnestment Advisers Act Release No. 1092 (Oct. 8, 1987) [52 FR 38400 (Oct. 16, 1987)] (''Advisers Act Release No. 1092'').

[3] *See Opinion of the General Counsel relating to Section 202(a)(11)(C) of the Ivnestment Advisers Act of 1940,* Investment Advisers Act Release No. 2 (Oct. 28, 1940) [11 FR 10996 (Sept. 27, 1946)] (''Advisers Act Release No. 2'').

[4] 15 U.S.C. 78a (''Exchange Act'').

[5] *Final Extension of Temporary Rules,* Investment Advisers Act Release No. 626 (Apr. 27, 1978) [43 FR 19224 (May 4, 1978)] (''Advisers Act Release No. 626'') (''A broker or dealer who is registered as an investment adviser is not by reason of that fact an ivnestment adviser to those of his brokerage clients to whom he provides advisory services on a solely incidental basis and without special compensation.'').

[6] In the Proposing Release, we referred to what we not term ''discount brokerage'' programs as ''execution-only'' programs. Proposing Release, *supra* note 5. ''Discount brokerage'' more fully describes the programs referenced in this Release.

dealers would be unable to rely on the broker-dealer exception of the Advisers Act. If so, some broker-dealers would be required to register under the Act, while those already registered would be required to treat customers with such accounts as advisory clients and also as brokerage customers.

Fee-based brokerage programs provide customers a package of brokerage services ''including execution, investment advice, custodial and recordkeeping services ''for a fee based on the amount of assets on account with the broker-dealer (*i.e.,* an asset-based fee) or a fixed fee. Asset-based fees generally range from 1.10 percent to 1.50 percent of assets.[7] A broker-dealer receiving fee-based compensation may be unable to rely on the broker-dealer exception because the fee constitutes ''special compensation'' under the Act—that is, it involves the receipt by a broker-dealer of compensation other than brokerage commissions or dealer compensation (*i.e.,* mark-up, mark-down, or similar fee).[8]

Discount brokerage programs, including electronic trading programs, give customers who do not want or need advice from brokerage firms the ability to trade securities at a lower commission rate. Electronic trading programs provide customers the ability to trade on-line, typically without the assistance of a registered representative, from any personal computer connected to the Internet. Customers trading electronically may devise their own investment or trading strategies, or may seek advice separately from investment advisers. The introduction of electronic trading and other discount services at a lower commission rate may trigger application of the Advisers Act to any full-service accounts for which the broker-dealer provides some investment advice. This is because the difference in the commission rates represents a clearly definable portion of the brokerage commission that may be primarily attributable to investment advice. Our staff has viewed such a two-tiered fee structure as involving ''special compensation'' under the Advisers Act.[9]

After reviewing these new programs, we concluded that they were not fundamentally different from traditional brokerage programs. As a general matter, fee-based brokerage programs offer the same general package of services as commission-based brokerage programs. Electronic and other discount brokerage programs, for their part, do not offer any advisory service, but merely make visible that which has always been understood: A portion of the commissions charged by full-service broker-dealers compensate the broker-dealers for advisory services. Thus, we viewed broker-dealers offering these new programs as having re-priced traditional brokerage programs rather than as having created advisory programs.[10]

We were concerned that application of the Advisers Act to broker-dealers offering these new programs would inhibit the development of these programs, which we viewed as potentially providing important benefits to brokerage customers. Most importantly, we believed Congress could not have intended to subject full-service broker-dealers offering these programs to the Advisers Act when, in conducting these programs, broker-dealers offer advice as part of traditional brokerage services.

Under the 1999 proposed rule, a broker-dealer providing investment advice to customers would be excluded from the definition of investment adviser regardless of the form that its compensation takes as long as: (i) The advice is provided on a nondiscretionary basis; (ii) the advice is solely incidental to the brokerage services; and (iii) the broker-dealer prominently discloses to its customers that their accounts are brokerage accounts. These provisions of the proposed rule were designed to make application of the Advisers Act turn more on the nature of the services provided by the broker than on the form of the broker's compensation.

In addition, we proposed that a broker or dealer would not be deemed to have received special compensation solely because the broker or dealer charges a commission, mark-up, mark-down, or similar fee for brokerage services that is greater than or less than one it charges another customer. This provision was designed to permit full-service broker-dealers to offer discounted brokerage, including electronic trading, without having to treat full-price, full-service brokerage customers as advisory clients.[11]

These new brokerage programs responded to changes in the market place for retail brokerage.[12] They also 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. These concerns led to the formation, in 1994, of a broad-based committee (''Tully Committee'') whose mandate was to identify conflicts of interest in brokerage industry compensation practices and ''best'' practices in compensating registered representatives.[13] The Tully Committee found that fee-based compensation would better align the interests of broker-dealers and their clients and would allow registered representatives to focus on their most important role—providing investment advice to individual clients, not generating transaction revenues.[14]

Over the years, many of our enforcement cases and many investor losses can be traced to individual representatives responding to the need to generate commissions rather than service customers.[15] These new fee-

[7] The Cerulli Edge, Managemed Accounts Edition (1st Quarter 2004) at 2 (''Cerulli Edge 1st Quarter''.)

[8] *See* S. Rep. No. 76–1775, 76th Cong., 3d Sess. 22 (1940) (''S. Rep. No. 76–1775'') (section 202(a)(11)(C) of the Advisers Act applies to broker-dealers ''insofar as their advice is merely incidental to brokerage transactions for which they recieve *only* brokerage commission.'') (emphasis added). *See also Disclosure by Investment Advisers Regarding Wrap Fee Programs,* Investment Advisers Act Release No. 1401 (Jan. 13, 1994) at n.2. Our references in this release to ''commission-based brokerage'' include transactions effected on a prinipal basis for which the broker-delaer is compensated by a mark-up or mark-down.

[9] Advisers Act Release No. 626, *supra* note 5; Advisers Act Release No. 2, *supra* note 3; Robert S. Strevell, SEC Staff No-Action Letter (Apr. 29, 1985) (''Strevell No-Action Letter'') (''If two general fee schedules are in effect, either formally or informally, the lower without investment advice and the higher with investment advice, and the difference is primarily attributable to this factor there is special compensation.'').

[10] For a discussion of ''traditional brokerage services'' and ''traditional brokerage programs'' *see infra* note 42 and accompanying text.

[11] We also proposed an amendment to the instructions for Advisers Act Form ADV [17 CFR part 279] regarding calculation of assets under management for investment advisers dually registered as broker-dealers. Proposing Release, *supra* note 5, at II.B. This proposal was effectively incorporated into the instructions of the new Form ADV adopted by the Commission in September 2000, and is, therefore, not further addressed in this release. *See Electronic Filing by Investment Advisers;Amendments to Form ADV,* Investment Advisers Act Release No. 1897 (Sept. 12, 2000) [65 FR 57438 (Sept. 22, 2000)].

[12] *See* Patrick McGeehan, *The Media Business: Advertising, Schwab Takes Another Kind of Swipe at the Big Wall Street Firms in a New Campaign,* N.Y. TIMES, Aug. 28, 2000, at C11; Jack White and Doug Ramsey, *A Belle Epoque for Wall Street,* BARRON'S, Oct. 18, 1999, at 54; John Steele Gordon, *Manager's Journal: Merrill Lynch Once Led Wall Street. Now It's Catching Up,* WALL ST. J., June 14, 1999, at A20.

[13] *Report of the Committee on Compensation Practices* (Apr. 10, 1995) (''Tully Report''). The committee was formed in 1994 at the suggestion of Commission Chairman Arthur Levitt.

[14] *Id.*

[15] *See, e.g., In the Matter of the Application of Michael T. Studer,* Securities Exchange Act Release No. 50543 (Oct. 14, 2004) (churning customer account); *In the Matter of Robert H. Wolfson,* Securities Exchange Act Release No. 41831 (Sept.

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based programs offered at least a partial solution to an age-old problem facing investors, the Commission, and the securities firms themselves. We included in the Proposing Release a statement that our staff would not recommend, based on the form of compensation received, that the Commission take any action against a broker-dealer for failure to treat any account over which the broker-dealer does not exercise investment discretion as subject to the Advisers Act.[16]

Twenty-five letters were submitted during the comment period. Following the close of the comment period, however, we received hundreds more letters, most of which opposed the rule, and many of which appeared to be form letters. Some commenters wrote multiple letters. In view of ongoing and significant public interest in the proposal, and in order to provide all persons who were interested in this matter a current opportunity to comment, we reopened the period for public comment on the proposed rule in August 2004.[17] In all, we have received over 1,700 comment letters on the proposal.[18]

Most commenters discussed only the provisions of the rule that addressed fee-based brokerage programs. Broker-dealers commenting on the rule strongly supported it.[19] They asserted that fee-based brokerage programs benefited customers by aligning the interests of representatives with those of their customers.[20] According to some of these broker-dealers, the application of the Advisers Act would discourage the introduction of fee-based programs by imposing what these brokerage firms viewed to be a duplicative and unnecessary regulatory regime.[21] Other commenters argued that investors do not lose relevant protections when they deal with a brokerage firm instead of an advisory firm.[22]

A large number of investment advisers—in particular, financial planners—and a few consumer groups submitted letters strongly opposed to the proposed rule.[23] Some of these commenters took issue with our conclusions that the new programs do not differ fundamentally from traditional brokerage programs.[24] These and other commenters argued that the broker-dealers that would be affected by the rule are providing advisory services similar to, or the same as, those that investment advisers provide and thus should be subject to the Advisers Act.[25] Many of these commenters asserted that the adoption of the rule would deny investors important protections provided by the Act, in particular, the fiduciary duties and disclosure obligations to which advisers are held.[26] Another theme among many opponents of the rule was the perceived competitive implications for financial planners, which would generally be subject to the Act, while broker-dealers would not.[27]

Some opponents of the rule urged that the form of compensation remained a good indicator of whether an account should be treated as an advisory account.[28] Others, however, agreed with the Proposing Release that compensation was no longer a valid distinction.[29] Many commenters focused on whether and when advisory services can be considered ''solely incidental to'' brokerage and urged us to provide guidance on the meaning of the ''solely incidental to'' requirement.[30] In this regard, these and other commenters urged us to focus on how broker-dealers held themselves out to investors.[31]

2, 1999) (consent) (churning customer account and making unsuitable recommendations); *In the Matter of J.B. Hanauer & Co.,* Securities Exchange Act Release No. 41832 (Sept. 2, 1999) (consent) (churning customer accounts and making unsuitable recommendations); *In the Matter of John M. Reynolds,* Securities Exchange Act Release No. 30036 (Dec. 4, 1991) (engaging in excessive trading and purchasing unsuitable securities); *In the Matter of Victor G. Matl,* Securities Exchange Act Release No. 22395 (Sept. 10, 1985) (consent) (churning customer accounts and making unsuitable recommendations). Individual investors may also bring private claims. *See, e.g., Saxe* v. *E.F. Hutton & Company, Inc.,* 789 F.2d 105 (2d Cir. 1986).

[16] Proposing Release, *supra* note 5. In a companion release we are today adopting a temporary rule under which a broker-dealer providing non-discretionary advice to customers would be excluded from the definition of investment adviser under the Advisers Act regardless of the form its compensation takes, as long as the advice is solely incidental to the brokerage services. As a result of the adoption of this temporary rule, the staff no-action position announced in the Proposing Release has terminated.

[17] Investment Advisers Act Release No. 2278 (Aug. 18, 2004) [69 FR 51620 (Aug. 20, 2004)]. The reopened comment period closed on September 22, 2004. In our release reopening the comment period, we also noted that The Financial Planning Association had filed a petition for judicial review of the proposal. *Financial Planning Ass'n* v. *SEC,* No. 04–1242 (D.C. Cir.) (case docketed on July 20, 2004).

[18] These comment letters are generally available for viewing and downloading on the Internet at http://www.sec.gov/rules/proposed/s72599.shtml. Letters are otherwise available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549 (File No. S7–25–99).

[19] *See, e.g.,* Comment Letter of Merrill, Lynch, Pierce, Fenner & Smith Incorporated (Sept. 22, 2004) (''Merrill Lynch Sept. 22, 2004 Letter''); Comment Letter of Raymond James Financial, Inc. (Sept. 21, 2004); Comment Letter of Northwestern Mutual Investment Services, LLC (Sept. 22, 2004); Comment Letter of Smith Barney Citigroup (Jan. 14, 2000) (''Smith Barney Letter''). *See also* Comment letter of Securities Industry Association (Sept. 22, 2004) (''SIA Sept. 22, 2004 Letter'') (representing broker-dealers).

[20] Comment Letter of Citigroup Global Markets Inc. (Sept. 22, 2004) (''CGMI Letter''); Comment Letter of Charles Schwab & Co. (Sept. 22, 2004) (''Charles Schwab Sept. 22, 2004 Letter''); Comment Letter of Securities Industry Association (Sept. 13, 2000); (''SIA Sept. 13, 2000 Letter''); Comment Letter of Securities Industry Association (Aug. 5, 2004).

[21] CGMI Letter, *supra* note 20, Merrill Lynch Sept. 22, 2004 Letter, *supra* note 19; Comment Letter of Securities Industry Association (Jan. 13, 2000).

[22] *E.g.,* Comment Letter of Hardy Callcott (Aug. 23, 2004); SIA Sept. 22, 2004 Letter, *supra* note 19.

[23] *E.g.,* Comment Letter of Carl Kunhardt (Dec. 28, 1999); Comment Letter of Pamela A. Jones (Jan. 4, 2000) (''Jones Letter''); Comment Letter of Investment Counsel Association of America (Jan. 12, 2000) (''ICAA Jan. 12, 2000 Letter'') (representing SEC-registered investment advisers); Comment Letter of Consumer Federation of America (Jan. 13, 2000) (''CFA Jan. 13, 2000 Letter''); Comment Letter of The Financial Planning Association (Jan. 14, 2000) (''FPA Jan. 14, 2000 Letter'') (representing financial planners); Comment Letter of AARP (Nov. 17, 2003) (''AARP Letter''); Comment Letter of PFPG Fee-Only Advisors (June 21, 2004); Comment Letter of Timothy M. Montague (Sept. 10, 2004); Comment Letter of William S. Hrank (Sept. 20, 2004); Comment Letter of Marilyn C. Dimitroff (Sept. 21, 2004) (''Dimitroff Letter'').

[24] *E.g.,* FPA Jan. 14, 2000 Letter, *supra* note 23.

[25] *See, e.g.,* Comment Letter of Arthur V. von der Linden (May 10, 2000); CFA Jan. 13, 2000 Letter, *supra* note 23; FPA Jan. 14, 2000 Letter, *supra* note 23; ICAA Jan. 12, 2000 Letter, *supra* note 23.

[26] *See, e.g.,* Comment Letter of American Institute of Certified Public Accountants (Sept. 22, 2004) (''AICPA Sept. 22, 2004 Letter''); CFA Jan. 13, 2000 Letter, *supra* note 23; FPA Jan. 14, 2000 Letter, *supra* note 23.

[27] *See, e.g.,* Comment Letter of Dan Jamieson (June 1, 2000); Comment Letter of Joel P. Bruckenstein (May 31, 2000); Comment Letter of Margaret Lofaro (May 8, 2000); Comment Letter of Shawnee Barbour (Sept. 13, 2004); Comment Letter of Roselyn Wilkinson (Sept. 13, 2004); Comment Letter of Robert J. Lindner (Sept. 14, 2004); Comment Letter of Robert Lawson (Sept. 16, 2004); Comment Letter of Linda Patchett (Sept. 20, 2004) (''Patchett Letter''); Comment Letter of John Ellison (Sept. 20, 2004); Comment Letter of Connie Brezik (Sept. 18, 2004); Comment Letter of Keven M. Doll (Sept. 20, 2004); Comment Letter of Phoebe M. White (Sept. 20, 2004); Comment Letter of Eric G. Shisler (Sept. 20, 2004); Comment Letter of Jami M. Thornton (Sept. 20, 2004); *see also* Comment Letter of Consumer Federation of America (Feb. 28, 2000) (''CFA Feb. 28, 2000 Letter'').

[28] Comment Letter of Investment Counsel Association of America (Sept. 22, 2004) (''ICAA Sept. 22, 2004 Letter''); CFA Feb. 28, 2000 Letter, *supra* note 27; Comment Letter of Federated Investors, Inc. (Jan. 14, 2000) (''Federated Letter'').

[29] *See, e.g.,* Comment Letter of Gilmond & Gilmond Financial Consulting Associates, Ltd. (Dec. 31, 1999).

[30] AICPA Sept. 22, 2004 Letter, *supra* note 26; Comment Letter of The Financial Planning Association (June 21, 2004) (''FPA June 21, 2004 Letter''); Comment Letter of Consumer Federation of America (Nov. 4, 2004); ICAA Jan. 12, 2000 Letter, *supra* note 23.

[31] Comment Letter of National Association of Personal Financial Advisors (Sept. 21, 2004) (NAPFA Letter''); Comment Letter of Charles O'Connor (Sept. 14, 2004); Comment Letter of Abbas A. Heydri (Sept. 16, 2004) (''Heydri Letter''); Patchett Letter, *supra* note 27; Comment Letter of Henry L. Woodward (Sept. 21, 2004); Dimitroff Letter, *supra* note 23; Comment Letter of North American Securities Administrators Association, Inc. (Oct. 6, 2004) (''NASAA Letter''); AICPA Sept. 22, 2004 Letter, *supra* note 26; ICAA Sept. 22, 2004

Some commenters suggested that broker-dealers relying on the rule should be prohibited from advertising their advisory services entirely.[32] In a related vein, many commenters urged us to strengthen the disclosure required of broker-dealers availing themselves of the exception.[33]

II. Discussion of Reproposal

The many comments we received have caused us to re-consider our proposed rule. We share commenters' concern that investors are confused about the differences between brokerage and advisory accounts and, as discussed below, we are proposing stronger disclosure. We are requesting comment on whether broker-dealers have contributed to this confusion when they refer to their representatives as ''financial advisors,'' ''financial consultants'' or similar titles, and we are requesting comment on this issue. We agree with the many commenters who urged us to develop better and clearer guidance on when a broker's advisory activities are ''solely incidental to'' its brokerage business, and are seeking additional comment on guidance we might provide.

We continue, however, to believe that fee-based brokerage has the potential to provide significant benefits to brokerage customers. Our reproposal therefore reflects our belief that when broker-dealers offer advisory services as part of the traditional package of brokerage services, broker-dealers ought not to be subject to the Advisers Act merely because they re-price those services. The reproposal also reflects our belief that broker-dealers should be permitted to offer both full-service brokerage and discount brokerage services without triggering application of the Advisers Act. The reproposal also reflects our belief that a broker-dealer providing discretionary advice would be deemed to be an investment adviser under the Advisers Act. We look forward to learning commenters' views on these matters.

A. Fee-Based Brokerage Programs

Commenters on our original proposal generally fell into two groups—one representing broker-dealers and the other representing investment advisers, including financial planners. These two groups viewed the development of fee-based brokerage accounts through different lenses, and came to entirely different conclusions. Advisers saw the introduction of fee-based brokerage programs as the culmination of a migration from a relationship primarily characterized by customers paying for brokerage transactions to one in which advisory services predominate—a shift they viewed as dramatic.[34] They held up broker-dealers'' marketing of these accounts based on the quality of advisory services as evidence that these were, in essence, primarily advisory accounts and urged that we, therefore, treat them as advisory accounts.[35] Broker-dealers viewed the new fee-based programs as providing the same services, including investment advice, they have traditionally provided to customers.[36] While they acknowledged that these programs have generally been marketed based on the advice involved, some of these commenters pointed out that broker-dealers have long sold retail brokerage by promoting ancillary services such as advice.[37] They were concerned that a view of the broker-dealer exception that turned on whether full-service brokerage accounts were marketed to any extent based on the provision of advice would require that we treat all full-service accounts as advisory accounts. Broker-dealers did not view the change in the pricing of brokerage accounts as significant except insofar as it better aligns the interests of registered representatives with those of their customers.[38] We request further comment on these differing views of the practices of broker-dealers and the implications for our rulemaking. As discussed below, we believe that commenters have raised important issues that concern us and should concern all market participants. We are therefore reproposing the rule. Before we discuss the elements of the reproposed rule, however, we draw attention to five areas that we consider to be important to our decision whether to adopt a final rule.

1. History of the Broker-Dealer Exception

Broker-dealers have traditionally provided investment advice that is substantial in amount, variety, and importance to their customers.[39] This was well understood in 1940 when Congress passed the Advisers Act. The broker-dealer exception in the Act was designed not to except broker-dealers whose advice to customers is minor or insignificant, but rather to avoid additional and duplicative regulation of broker-dealers,[40] which were regulated under provisions of the Exchange Act that had been enacted six years earlier.[41] The exception also differentiated between advice provided by broker-dealers to customers as part of a package of traditional brokerage services[42] for

Letter, *supra* note 28; CFA Jan. 13, 2000 Letter, *supra* note 23; Jones Letter, *supra* note 23.

[32] *E.g.,* AARP Letter, *supra* note 23.

[33] *E.g.,* Comment Letter of the CFP Board (Jan. 13, 2000); FPA Jan. 14, 2004 Letter, *supra* note 23; FPA Letter June 21, 2004, *supra* note 30; ICAA Jan. 12, 2000 Letter, *supra* note 23. *See also* NAPFA Letter, *supra* note 31. Some commenters also took issue with the policy judgment underlying the rule, arguing that it departs from the design of the securities laws to protect investors. FPA Jan. 14, 2000 Letter, *supra* note 23; Comment Letter of the Financial Planning Association (June 24, 2004); Comment Letter of T. Rowe Price Associates, Inc. (Jan. 14, 2000) (''T. Rowe Price Jan. 14, 2000 Letter''). Other commenters challenged our authority to adopt the rule, arguing that it is inconsistent with the Congressional intent embodied in section 202(a)(11) of the Advisers Act. Comment Letter of The Financial Planning Association (Dec. 7, 2001) (''FPA Dec. 7, 2001 Letter''); CFA Jan. 13, 2000 Letter, *supra* note 23; Comment Letter of Joseph Capital Management, LLC (Aug. 30, 2004).

[34] *See, e.g.,* Federated Letter, *supra* note 28; ICAA Jan. 12, 2000 Letter, *supra* note 23; CFA Feb. 28, 2000 Letter, *supra* note 27; FPA Jan. 14, 2000 Letter, *supra* note 23; Comment Letter of Jared W. Jameson (Sept. 16, 2004); Comment Letter of Geoffrey F. Fosie (Sept. 22, 2004). *See also* CFA Jan. 13, 2000 Letter, *supra* note 23; Comment Letter of the Foundation for Fiduciary Studies (Sept. 12, 2004).

[35] *See, e.g.,* Comment Letter of Roy T. Diliberto (Aug. 24, 2004); Comment Letter of Don B. Akridge (Sept. 7, 2004); Comment Letter of William K. Dix, Jr. (Sept. 21, 2004) (''Dix Letter''). *See also* CFA Jan. 13, 2000 Letter, *supra* note 23.

[36] *See, e.g.,* Comment Letter of Paine Webber Incorporated (Jan. 14, 2000) (''Paine Webber Letter''); Comment Letter of U.S. Bancorp Piper Jaffray Inc. (Jan. 19, 2000) (''U.S. Bancorp Letter''); Comment Letter of Prudential Securities Incorporated (Jan. 31, 2000) (''Prudential Letter''); Merrill Lynch Sept. 22, 2004 Letter, *supra* note 19.

[37] *See, e.g.,* U.S. Bancorp Letter, *supra* note 36; Prudential Letter, *supra* note 36. One commenter opposed to the rule pointed to specific advertising campaigns as evidence that ''over at least the last decade'' broker-dealers have, in their view, inappropriately been permitted to market themselves as though their primary service offered was advice. CFA Jan. 13, 2000 Letter, *supra* note 23.

[38] *See, e.g.,* U.S. Bancorp Letter, *supra* note 36; Prudential Letter, *supra* note 36; CGMI Letter, *supra* note 20; Merrill Lynch Sept. 22, 2004 Letter, *supra* note 19; SIA Sept. 22, 2004 Letter, *supra* note 19.

[39] Charles F. Hodges, WALL STREET (1930) (''WALL STREET'') at 253–85; Twentieth Century Fund, The SECURITY MARKETS (''SECURITY MARKET'') (1935) 633–43.

[40] Research Department of the Illinois Legislative Council, *Statutory Regulation of Investment Advisers* (prepared by the Research Department of the Illinois Legislative Council) reprinted in *Investment Company Act: Hearings Before a Subcomm. of the Senate Committee on Banking and Currency,* at 1007 (1940), 76th Cong. 3d Sess.; *The Advisers Act: Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce,* 76th Cong., at 88 (1940) (''Hearings on H.R. 10065'').

[41] 48 Stat. 881, Pub. L. 73–291 (June 6, 1934). Four years later in the Maloney Act, Congress amended the Exchange Act to authorize the Commission to register national securities associations. Pub. L. 75–719, 52 Stat. 1070 (June 25, 1938).

[42] Then, as now, brokerage services included services provided throughout the execution of a securities transaction, including providing research and advice prior to a decision to buy or sell, implementing that decision on the most advantageous terms and executing the transaction, arranging for delivery of securities by the seller and

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which customers paid fixed commissions ''which was not covered by the Advisers Act,[43] and advice provided through broker-dealer's special advisory departments for which customers separately contracted and paid a fee ''which was covered by the Act.[44] Although, as discussed above, the Advisers Act was written in such a way to cover fee-based programs because the fee would constitute ''special compensation,'' it does not appear to have been Congress'' intent to apply the Act to cover broker-dealers providing advice as part of the package of brokerage services they provide under fee-based brokerage programs.

The Advisers Act was enacted in an era when broker-dealers were paid fixed commission rates for the traditional package of services (including investment advice), and Congress understood ''special compensation'' to mean non-commission compensation.[45] There is no evidence that the ''special compensation'' requirement was included in section 202(a)(11)(C) for any purpose beyond providing an easy way of accomplishing the underlying goal of excepting only advice that was provided as part of the package of traditional brokerage services.[46] In particular, neither the legislative history of section 202(a)(11)(C) nor the broader history of the Advisers Act as a whole, considered in light of contemporaneous industry practice, suggests that, in 1940, Congress viewed the form of compensation for the services at issue—commission versus fee-based compensation—as having any independent relevance in terms of the advisory services the Act was intended to reach.

Thus, our reading of the legislative history in the context of brokerage industry practice at the time the Act was passed suggests that in drawing the line to determine when broker-dealers should be subject to the Advisers Act, we should focus our attention on the package of services offered by broker-dealers, including advisory services, rather than on the significance or importance of those advisory services within the context of that package. Because fee-based brokerage programs offer substantially the same package of services offered as part of traditional full service brokerage programs as they were understood in 1940, we believe that it would be appropriate for us to propose a rule allowing brokers to offer these programs without being subject to the Advisers Act.

In the Proposing Release, we expressed concern that, should these fee-based brokerage programs gain widespread acceptance, most full-service brokerage arrangements might eventually be subject to regulation under both the Exchange Act and Advisers Act if we were not to except from the Advisers Act broker-dealers offering these programs. The intervening years have substantiated that concern. Today fee-based brokerage accounts are offered by most larger broker-dealers, and hold over $254 billion of customer assets.[47] Industry observers expect that fee-based programs will continue to grow as broker-dealers move away from transaction-based brokerage relationships that provide unsteady sources of revenue.[48]

Would our failure to adopt this reproposed rule eventually result in the extension of the Advisers Act to most brokerage relationships? Would such a result be inconsistent with the intent of the Advisers Act, which was designed to fill a regulatory gap that permitted firms and individuals to engage in advisory activities without being regulated at the same time as it excepted broker-dealers from duplicative regulation?[49] We request comment on our reading of the legislative history of the broker-dealer exception. Do commenters agree that our reproposed rule is necessary to preserve the scope of the Advisers Act as Congress had intended it?

Would application of the Advisers Act to a potentially large number of brokerage accounts interfere with the market-making role of broker-dealers and the efficiency of the capital markets? For example, section 206(3) of the Advisers Act restricts the ability of advisers to engage in principal transactions with clients. How would such a restriction affect broker-dealers' market making and other principal activities? What would be the consequences to the liquidity of the securities markets?

2. Investor Protections

Many commenters opposing the proposed rule focused their arguments on additional investor protections that regulation under the Advisers Act provides and argued that the rule would harm investors.[50] Most of these comments assumed that clients of advisers received substantially more protections from the federal securities laws than do customers of broker-dealers.

To some extent, these comments amount to criticisms of the broker-dealer exception in section 202(a)(11)(C), which permits broker-dealers to provide advice without

payment by the buyer, and maintaining custody of customer funds and securities. Exchange Act Release No. 27018 [54 FR 30087–88] (July 18, 1989). *See* Exchange Act section 28(e)(3), 15 U.S.C. 78bb(e)(3). *See also* generally WALL STREET, *supra* note 39. When we refer to ''traditional brokerage programs'' we mean those programs that offer traditional brokerage services for commissions. As a general matter, when we refer to ''new fee-based programs'' we mean those programs that offer traditional brokerage services for fees other than commissions. See supra notes 7—8 and accompanying text.

[43] *See* S. REP. NO. 76–1775, *supra* note 8, at 22; H.R. REP. NO. 76–2639, at 28, 76th Cong. 3d Sess. (''H.R. REP. NO. 76–2639''). *See also* Thomas P. Lemke & Gerald T. Lins, REGULATION OF INVESTMENT ADVISERS § 1:19 (''The exception in section 202(a)(11)(C) was included in the Advisers Act because broker-dealers routinely give investment advice as part of their brokerage activities, yet are already subject to extensive regulation under the 1934 Act and possibly state law''); Thomas P. Lemke, *Investment Advisers Act Issues for Broker-Dealers,* SECURITIES & COMMODITIES REGULATION at 214 (Dec. 9, 1987) (''While most broker-dealers initially will come within the definition of an investment adviser, it is clear that Congress did not intend brokerage activities to be regulated under the 1940 Act [citing S. REP. NO. 76–1775]. Rather, such activities were intended to be regulated under the 1934 Act without the additional and often duplicative requirements under the 1940 Act.'').

[44] *See* Hearings on S. 3580, *supra* note 40, at 711 (testimony of Douglas T. Johnston, vice-president of Investment Counsel Association of America) (''The definition of 'investment adviser' as given in the bill * * * would include * * * certain investment banking and brokerage houses which maintain investment advisory departments and make charges for services rendered * * *''). The earliest Commission staff interpretations of the Advisers Act also reflect the same understanding, *i.e.,* that the Act was intended to cover broker-dealers only to the extent that they were offering investment advice as a distinct service for which they were specifically compensated. *See* Advisers Act Release No. 2, *supra* note 3 (''[T]hat portion of clause (C) which refers to 'special compensation' amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities. It is well known that many brokers and dealers have investment advisory departments which furnish investment advice for compensation in the same manner as does an investment adviser who operates solely in an advisory capacity.'').

[45] At the time the Advisers Act was enacted, Congress understood ''special compensation'' to mean compensation *other than* commissions. S. REP. NO. 76–1775, *supra* note 8, at 22.

[46] Of course, the absence of ''special compensation'' was necessary but not sufficient for the section 202(a)(11)(C) exception. But the other requirement—that the advice be provided ''solely incidental to'' the conduct of the brokerage business—has always required a judgment based on the facts and circumstances and was not the sort of ''bright-line'' test that non-commission ''special compensation'' was.

[47] The Cerulli Edge, Managed Accounts Edition (3rd Quarter 2004) (''Cerulli Edge 3rd Quarter'').

[48] Cerulli Edge 1st Quarter, *supra* note 7.

[49] *See* Hearings on S. 3580, *supra* note 40, at 716–18, 736–753 (Advisers Act filled a regulatory gap in which firms and individuals engaged in advisory activities without being regulated.).

[50] *See e.g.,* CFA Jan. 13, 2000 Letter, *supra* note 23; FPA Jan. 14, 2000 Letter, *supra* note 23; *see also* ICAA Jan. 12, 2000 Letter, *supra* note 23.

subjecting them to the Advisers Act. We acknowledge that there are differences between the regulatory frameworks provided by the Exchange Act and the Advisers Act, but Congress was well aware of these sorts of differences when it passed the Advisers Act and excepted broker-dealers from the definition of investment adviser.[51]

Moreover, the differences on which many commenters focused may not be as great as they asserted. Broker-dealers are subject to extensive oversight by the Commission and one or more self-regulatory organizations under the Exchange Act. The Exchange Act, Commission rules, and SRO rules provide substantial protections for broker-dealer customers that in many cases are more extensive than those provided by the Advisers Act and the rules thereunder.[52]

Many commenters asserted that the Commission, by providing the proposed exception, would relieve broker-dealers of the fiduciary responsibility to clients that is imposed by the Advisers Act.[53] In some cases, such as when broker-dealers assume positions of trust and confidence with their customers similar to those of advisers, broker-dealers have been held to similar standards.[54] However, broker-dealers often play roles substantially different from investment advisers and in such roles they should not be held to standards to which advisers are held. For example, an investor who engages a broker-dealer to sell certain stocks should not be heard to complain a week later that the broker-dealer should have advised him to hold on to those stocks in order to take advantage of a tax benefit. Thus we believe that broker-dealers and advisers should be held to similar standards depending not upon the statute under which they are registered, but upon the role they are playing.

We request comment generally on the investor protection implications of a rule excepting fee-based brokerage accounts from the Advisers Act. What investor protections would be lost or gained under the rule? Commenters should address how fee-based brokerage offers brokerage customers the potential for additional protections over commission-based brokerage. Are broker-dealers' and their representatives' interests better aligned with those of their customers in such arrangements? Would the realignment of economic incentives accomplish substantially more for these customers than application of an additional investment advisory regulatory regime with its attendant costs?

While fee-based brokerage accounts eliminate certain conflicts of interest that broker-dealer representatives have with their customers, we recognized

[51] Many of the commenters focused on the conflicts under which brokers function. Congress, however, was well aware of these conflicts. *See, e.g.,* Hearings on S. 3580, *supra* note 40 at 736 (''Some of these organizations using the descriptive title of investment counsel were in reality dealers or brokers offering to give advice free in anticipation of sales and brokerage commissions on transactions executed upon such free advice''); REPORT ON INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES (1939) (H.R. DOC. NO. 477) 23–25 (quoting testimony of investment advisers regarding ''vital conflicts'' in broker-dealers providing investment advice when they were at the same time intending to sell particular securities they owned); *Statutory Regulation of Investment Advisers, reprinted in* Hearings on S. 3580, *supra* note 40 at 1010 (''This might give rise to questions as to whether a counselor who is also a dealer or broker can be relied upon always to give unbiased advice.''); SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER, AT XV (June 20, 1936) (submitted to Congress pursuant to section 11(e) of the Securities Exchange Act of 1934) (''A broker who trades for his own account or is financially interested in the distribution or accumulation of securities, may furnish his customers with investment advice inspired less by any consideration of their needs than by the exigencies of his own position.''). Despite such conflicts, Congress nonetheless determined to except brokers providing investment advice from the Advisers Act as set out in section 202(a)(11)(C).

Contrary to the perception of many commenters, broker-dealers are under obligations to disclose conflicts of interest. Those obligations derive from many sources, including agency law, the shingle theory, antifraud provisions of the securities laws and the rules and regulations of the Commission and the SROs.

[52] Beginning in 1937, the Commission adopted rules to regulate broker-dealers' activities in the over-the-counter market. *See* Exchange Act Rule 15c1–1 [17 CFR 240.15c1–1], *et seq.* These rules, adopted under antifraud authority, complement other antifraud rules governing broker-dealers' activities. *See* Exchange Act Rule 10b–1 [17 CFR 240.10b–1], *et seq.* The Commission also has set out detailed requirements for information that broker-dealers must provide their customers at or before the completion of securities transactions. *See id.* And the Commission has adopted heightened sales practice and disclosure requirements for sales of penny stocks. *See* Exchange Act Rule 15g9–1 [17 CFR 240.15g9–1], *et seq.* In addition to the general rules governing the over-the-counter market, which were adopted in 1937, other rules have been adopted to prevent fraud and manipulation, as well as establish qualification standards for broker-dealers. *See* Exchange Act Rule 15c2–1 [17 CFR 240.15c2–1], *et seq.*, Rule 10b–5 [17 CFR 240.10b–5], Rules 15b7–1 [17 CFR 240.15b7–1], and Rule 19h–1 [17 CFR 240.19h–1]. The self-regulatory organizations (''SROs'') have also adopted rules increasing their supervision of broker-dealers since 1940. For example, NASD established a clear suitability obligation for broker-dealers that recommend securities to investors, as well as extensive rules governing communications with the public, advertising standards for broker-dealers, and requirements for fair pricing in the over-the-counter market. *See* NASD Rule 2310, Rule 2210, and Rule 2440. As broker-dealers' business models continue to evolve, SROs continue to respond by adopting targeted new rules and providing other forms of guidance. Through these efforts, SROs can ensure that the sales practice requirements keep pace with their members' activities and address any resulting investor protection concerns. For example, recently NASD published a Notice to Members concerning fee-based compensation programs, reminding members that they must have reasonable grounds for believing that a fee-based programs, reminding members that they must have reasonable grounds for believing that a fee-based program is appropriate for a particular customer, taking into account the services provided, the cost, and customer preferences. *See* NASD Notice to Members 03–68 (Nov. 2003). Also, in February 2004, the NYSE filed with the Commission a rule proposal governing non-managed fee-based accounts. *See* SR–NYSE–2004–13.

The Exchange Act also provides significant investor protections, and, since 1940, the Exchange Act has been amended numerous times to, among other things, subject broker-dealers to increasingly detailed regulatory oversight. For example, in 1964, the Exchange Act was amended to provide for improved qualification and disciplinary procedures for registered broker-dealers and to expand substantially the responsibilities of the NASD under more intensive Commission oversight. Pub. L. No. 88–467, 78 Stat. 580, (Aug. 20, 1964). Later, the Securities Acts Amendments of 1975, considered the most significant securities legislation since the Exchange Act, end fixed commission rates, initiated action toward development of a national market system, and granted the Commission final authority in the adoption and amendment of SRO rules. Pub. L. No. 94–29, 89 Stat. 97 (June 4, 1975). In addition, the Penny Stock Reform Act of 1990 enhanced regulation of broker-dealers that sell penny stocks to investors. Pub. L. No. 101–429, 104 Stat. 931 (Oct. 15, 1990). More recently, the Gramm-Leach-Bliley Act of 1999 limited the extent to which commerical banks may act as brokers or dealers without broker-dealer registration. Pub. L. No. 106–102, 113 Stat. 1138 (Nov. 1, 1999).

[53] AICPA Sept. 22, 2004 Letter, *supra* note 26; CFA Jan. 13, 2000 Letter, *supra* note 23; FPA Jan. 14, 2000 Letter, *supra* note 23.

[54] *See, e.g., Arleen W. Hughes,* 27 S.E.C. 629 (1948) (noting that fiduciary requirements generally are not imposed upon broker-dealers who render investment advice as an incident to their brokerage unless they have placed themselves in a position of trust and confidence), *aff'd sub nom. Hughes* v. *SEC,* 174 F.2d 969 (D.C. Cir. 1949); *Leib* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* 461 F. Supp. 951 (E.D. Mich. 1978), *aff'd,* 647 F. 2d. 165 (6th Cir. 1981) (recognizing that broker who has de facto control over non-discretionary account generally owes customer duties of a fiduciary nature; looking to customer's sophistication, and the degree of trust and confidence in the relationship, among other things, to determine duties owed); *Paine Webber, Jackson & Curtis, Inc.* v. *Adams,* 718 P.2d. 508 (Colo. 1986) (evidence ''that a customer has placed trust and confidence in the broker'' by giving practical control of account can be ''indicative of the existence of a fiduciary relationship''); *MidAmerica Federal Savings & Loan* v. *Shearson/American Express,* 886 F.2d. 1249 (10th Cir. 1989) (fiduciary relationship existed where broker was in position of strength because it held its agent out as an expert); *SEC* v. *Ridenour,* 913 F.2d. 515 (8th Cir. 1990) (bond dealer owed fiduciary duty to customers with whom he had established a relationship of trust and confidence); C. Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty,* 23 Iowa J. Corp. Law 65 (1997). *Cf. De Kwiatkowski* v. *Bear, Stearns & Co.,* 306 F.3d 1293, 1302–03, 1308–09 (2d Cir. 2002) (noting that brokers normally have no ongoing duty to monitor nondiscretionary accounts but that ''special circumstances,'' such as a broker's de facto control over an unsophisticated client's account, a client's impaired faculties, or a closer-than-arms-length relationship between broker and client, might create extra-contractual duties).

that they create certain other conflicts. Fee-based brokerage accounts are not suitable for all broker-dealer customers, particularly those customers who rarely purchase or sell securities. Moreover, investors with large cash positions or investments in mutual funds (for which a customer may pay multiple fees) may wish to avoid them. In November 2003, the NASD issued a notice to members identifying these conflicts and indicating that NASD members should have supervisory procedures in place to determine whether a fee-based brokerage account is appropriate for a customer and to periodically review the customer's account to determine whether a fee-based account continues to be appropriate.[55] Would broker-dealers' lack of compliance with the NASD notice suggest that we ought not adopt this rule? On the other hand, does the NASD's action suggest that appropriate actions are being taken?

3. Package of Services

In our Proposing Release, we suggested that broker-dealers offering fee-based brokerage were merely re-pricing their existing brokerage accounts. Information provided to us by our staff indicates, however, that some broker-dealers today offer a different mix of services within the traditional package of services (including, for example, a different level of investment advice) to fee-based accounts than they offer to commission-based accounts. When brokers re-price traditional commission-based brokerage accounts, they create a different set of incentives for their registered representatives. Thus, it is not surprising to us, nor is it inconsistent with the design of the rule we are today reproposing, that customers with fee-based brokerage accounts may obtain a different level or quality of services, within the traditional package of services (including a different level or quality of advisory services), than do customers with commission-based brokerage accounts. Indeed, one of the aims of the Tully Committee, as articulated in its report, was to create incentives for brokers to improve the quality of the advisory services provided their customers.[56]

If commission-based brokerage accounts receive differing levels of service depending upon the extent to which customers trade securities, it would seem to follow that fee-based brokerage accounts would receive varying levels of service depending upon the amount of assets held in the accounts. We request comment on this observation. Should differences in the nature of services provided be relevant to our consideration in deciding whether to adopt the rule?

4. Competitive Implications

As we noted above, many financial planners expressed concern for the competitive implications of the rule because they would generally be subject to the Advisers Act, while broker-dealers would not.[57] Broker-dealers and investment advisers have historically provided similar advisory services and competed for similar clients seeking similar advice. The steps many commenters urged us to take—such as prohibiting broker-dealers from advertising advisory services entirely—would restrict the ability of broker-dealers to compete for customers based on advisory services the customers may be seeking.

Broker-dealers are subject to our oversight under the Exchange Act, as well as oversight by one or more self-regulatory organizations, to which they must pay membership dues. The SRO rules require broker-dealers to comply with numerous detailed regulatory requirements, as well as general requirements that brokers treat their customers fairly.[58] Although, as commenters pointed out, the Advisers Act contains some restrictions, and thus imposes some costs on investment advisers that are not a part of broker-dealer regulation, broker-dealer regulation is much more detailed and involves significantly more regulatory costs than investment adviser regulation.

We seek comment on the competitive implications of the rule for investment advisers as well as broker-dealers. To what extent should we be guided by those competitive considerations? To what extent should broker-dealers be permitted to compete for business based on the advisory services they provide that are incidental to their brokerage business?

5. Regulatory Approach

Our reproposed rule would deem broker-dealers offering fee-based brokerage accounts not to be investment advisers because they are not intended to be covered by the Advisers Act.[59] As a result, broker-dealers, at least with respect to accounts covered by the rule, would not be subject to any of the provisions of the Act. We request comment whether we should take an alternate approach under which we would use our authority in section 206A to exempt broker-dealers from provisions of the Act, such as the registration requirements, with respect to these accounts.[60] What advantages do commenters view this alternative approach as providing? Are there costs? If we were to adopt a rule based on this approach, from which provisions of the Act or rules thereunder, such as the registration requirements of section 203 of the Act, should broker-dealers offering fee-based brokerage accounts be exempt with respect to those accounts? For example, should broker-dealers offering fee-based accounts be exempted from the principal trading prohibitions in the Act?

B. Exception for Fee-Based Brokerage Accounts

Under reproposed rule 202(a)(11)–1(a), a broker-dealer providing

[55] NASD Notice to Members (Nov. 23, 2004). Our staff examinations of broker-dealers offering fee-based programs suggest that not all NASD members may be complying with the advice provided by this notice and may be in violation of NASD rules identified in the notice. The NASD is addressing these matters.

[56] *See* Tully Report, *supra* note 13, at 11.

[57] *See, e.g.,* Comment Letter of Dan Jamieson (June 1, 2000); Comment Letter of Joel P. Bruckenstein (May 31, 2000); Comment Letter of Margaret Lofaro (May 8, 2000); Comment Letter of Shawnee Barbour (Sept. 13, 2004); Comment Letter of Roselyn Wilkinson (Sept. 13, 2004); Comment Letter of Robert J. Lindner (Sept. 14, 2004); Comment Letter of Robert Lawson (Sept. 16, 2004); Patchett Letter, *supra* note 27; Comment Letter of John Ellison (Sept. 20, 2004); Comment Letter of Connie Brezik (Sept. 18, 2004); Comment Letter of Keven M. Doll (Sept. 20, 2004); Comment Letter of Phoebe M. White (Sept. 20, 2004); Comment Letter of Eric G. Shisler (Sept. 20, 2004); Comment Letter of Jami M. Thornton (Sept. 20, 2004); *see also* Comment Letter of Consumer Federation of America (Feb. 28, 2000) (''CFA Feb. 28, 2000 Letter'').

[58] *See supra* note 52.

[59] We are reproposing rule 202(a)(11)–1 pursuant to our authority under section 202(a)(11)(F) to except ''such other persons not within the intent of'' the definition of ''investment adviser'' in section 202(a)(11). We are also relying on our authority under section 211(a) of the Act ''to classify persons and matters within [our] jurisdiction and prescribe different requirements for different classes or persons or matters.'' A new classification we are making here is broker-dealers who provide investment advice solely incidental to traditional brokerage services for a fee—a group which, as discussed above, could not have existed at the time Congress enacted the Advisers Act because, in 1940, broker-dealers were paid *only* fixed commissions for traditional brokerage services. Such broker-dealers are therefore ''other persons'' within the meaning of section 202(a)(11)(F) or ''different * * * persons'' within the meaning of section 211(a). In addition, section 206A of the Act permits us to exempt persons, conditionally or unconditionally from any provision of the Act or our rules to the extent such 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.''

[60] Under this approach, broker-dealers offering fee-based brokerage programs would be investment advisers within the meaning of section 202(a)(11) of the Act, although exempt from certain provisions of the Act, such as the registration provisions.

investment advice to its brokerage customers would not be required to treat those customers as advisory clients solely because of the form of the broker-dealer's compensation. The rule would be available to any broker-dealer registered under the Exchange Act that satisfies three conditions: (i) The broker-dealer must not exercise investment discretion over the account from which it receives special compensation; (ii) any investment advice must be solely incidental to the brokerage services provided to the account; and (iii) advertisements for and contracts, agreements, applications and other forms governing the account must contain certain prominent disclosures, including a statement that the account is a brokerage account and not an advisory account. These are similar requirements to those included in the proposed rule, except that we would expand the required customer disclosure.

1. Investment Discretion

Under the reproposed rule, a broker or dealer relying on the exception may not ''exercise investment discretion,'' as that term is defined in section 3(a)(35) of the Exchange Act,[61] over the accounts from which it receives special compensation.[62] Discretionary accounts that are charged an asset-based fee or a flat fee would be considered advisory accounts because they bear a strong resemblance to traditional advisory accounts, and it is highly likely that investors will perceive such accounts to be advisory accounts. Fee-based discretionary accounts were clearly the type of accounts that Congress understood would be covered by the Advisers Act when it passed the Act in 1940.

Most broker-dealer commenters thought that the rule drew the appropriate line, although one commenter expressed concern that the rule's exclusion of fee-based discretionary accounts would provide a disincentive for brokers to offer a fee-based alternative to commission-based discretionary accounts that could be offered without subjecting the broker-dealer to the Advisers Act.[63] Many commenters opposed to the proposed rule were concerned that the Commission would, in effect, abandon the ''bright-line'' test that ''special compensation'' provided for when an account should be treated as an advisory account.[64]

As we discuss above, we do not believe that ''special compensation'' was included in section 202(a)(11)(C) for any purpose beyond readily identifying advice that was clearly not provided as part of the package of traditional brokerage services, *i.e.*, advice that was clearly not incidental to the brokerage services.[65] In 1940, broker-dealers were paid *only* fixed commissions for the traditional package of services (including investment advice) that Congress intended to except from coverage of the Act.[66] Because Congress understood ''special compensation'' to mean non-commission compensation,[67] the ''special compensation'' limitation in section 202(a)(11)(C) reliably identified advisory services that Congress intended the Advisers Act to cover. That is no longer true. Unlike in 1940, broker-dealers are no longer prohibited by SRO rules from charging a fee for the same package of brokerage services (including investment advice) that formerly could be paid for only by commissions and only recently have broker-dealers started charging these new sorts of fees. These developments could not have been foreseen in 1940, and the ''bright line'' that Congress identified 60 years ago has ceased to accomplish its original purpose. Permitting broker-dealers to provide nondiscretionary advice may provide a workable ''bright line,'' and it will not operate to extend the exception beyond the intent of Congress because in all circumstances this advice must be solely incidental to the brokerage services provided.

We request comment on this condition of the rule. Is ''discretionary authority'' a workable ''bright line'' test? Are there alternate tests that would be more appropriate? What are they?

2. Solely Incidental To

Reproposed rule 202(a)(11)–1 would require that the advisory services provided in reliance on the exception must be solely incidental to the brokerage services provided.[68] The provision, which was included in our original proposal from 1999, was designed to preserve the ''solely incidental to'' requirement in section 202(a)(11)(C), although it is somewhat narrower in that it would require that advice the broker-dealer provides must be solely incidental to brokerage services provided by the broker-dealer to *each account* rather than the overall operations of the broker-dealer. Commenters did not disagree with this element, but urged that we provide more guidance on when advice is solely incidental to brokerage services. Section III of this Release includes a discussion of when advice is ''solely incidental to'' brokerage and requests comment on the application of this analysis to particular broker-dealer practices.

3. Customer Disclosure

We propose to require that all advertisements for an account excepted under rule 202(a)(11)–1(a) and all agreements, contracts, applications and other forms governing the operation of a fee-based brokerage account contain a prominent statement that the account is a brokerage account and not an advisory account. In addition, the disclosure must explain that, as a consequence, the customer's rights and the firm's duties and obligations to the customer, including the scope of the firm's fiduciary obligations, may differ. Finally, broker-dealers must identify an appropriate person at the firm with whom the customer can discuss the differences.

Our original proposal would have required broker-dealers to disclose only that the fee-based accounts are brokerage accounts. We received a great deal of comment that this disclosure was inadequate to permit customers and prospective customers to understand the differences between advisory and brokerage accounts, including the differences in fiduciary duties owed to investors by advisers and brokers.[69] In

[61] 15 U.S.C. 78c(a)(35). Under section 3(a)(35) of the Exchange Act, a person exercises ''investment discretion'' with respect to an account if, ''directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even through some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.''

[62] Rule 202(a)(11)–1(a)(1).

[63] Paine Webber Letter, *supra* note 36.

[64] T. Rowe Price Jan. 14, 2000 Letter, *supra* note 33; Federated Letter, *supra* note 28; FPA Jan. 14, 2000 Letter, *supra* note 23. *See also* FPA Dec. 7, 2001 Letter, *supra* note 33.

[65] *See supra* note 46.

[66] Until 1975, the New York Stock Exchange and the other stock exchanges required their members to charge a fixed commission on every transaction. *See generally* Securities Exchange Act Release No. 11203 (Jan. 23, 1975) [40 FR 7394 (Jan. 23, 1975)] (adopting Exchange Act rule 19b–3 [17 CFR 19b–3] which eliminated the fixed commission rate structure on national securities exchanges).

[67] S. REP. NO. 76–1775, *supra* note 8, at 22; H.R. REP. NO. 76–2639, *supra* note 43, at 28.

[68] Rule 202(a)(11)–1(a)(1)(ii).

[69] *E.g.*, ICAA Sept. 22, 2004 Letter, *supra* note 28; AICPA Sept. 22, 2004 Letter, *supra* note 26; FPA Jan. 14, 2000 Letter, *supra* note 23; ICAA Jan. 12,

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response, we have reproposed significantly expanded disclosure in order to focus investors on the differences between the two types of accounts.

We recognize that there may be a tension between the amount of information required in a legend and the likelihood of investors reading and understanding the information. Shorter disclosure may be more effective. Because it is impracticable to include all of the many possible differences between advisory and brokerage accounts in a brief disclosure, we have proposed an approach to encourage investors to discuss the differences with appropriate brokerage personnel. Is our proposed disclosure appropriate? Will it effectively serve its intended purposes? Should we require additional information to be disclosed? If so, what should that information be? Is the proposed disclosure too long to be practicable in an advertisement? If so, what should we omit? Will investors understand the terms we have used and their significance? If not, what terms should we use? Should materials specify who the appropriate person at their firm is who can discuss the differences between an advisory and a brokerage account? Should we designate the level of seniority the person should have? Given the complexity of the concepts involved, should we consider alternatives to disclosure? If so, what alternatives should we consider?

The legend would be required only on documents offering fee-based brokerage programs because only broker-dealers offering those programs would be relying on the rule. But many commenters suggested to us that the confusion between brokerage and advisory accounts is not limited to fee-based brokerage. If that is the case, what is the appropriate vehicle to address this confusion? For example, should we request the broker-dealer self regulatory organizations to consider disclosure requirements that have broader application, including requiring disclosure on broker-dealer documents that do not offer or govern fee-based brokerage accounts?

C. Discretionary Asset Management

As discussed above, the exception for broker-dealers offering fee-based brokerage accounts would be available only if the broker-dealer does not exercise discretionary authority over the account. We recognized in the Proposing Release the existence of a regulatory anomaly that the proposed rule would create. Broker-dealers that manage discretionary accounts for which they receive commissions or dealer-based compensation may not receive any ''special compensation.'' If managing a discretionary account can be viewed as solely incidental to the brokerage business, then a broker-dealer paid through commissions or dealer-based compensation could rely on the statutory exception and need not treat the account as an advisory account. Under this view, a regulatory distinction would continue to be drawn based solely on the form the broker-dealer's compensation takes. This result seemed inconsistent with our intent in designing the proposed rule. In the Proposing Release, we requested comment on whether we should require broker-dealers to treat all discretionary accounts as advisory accounts, without regard to the form of the broker-dealer's compensation.[70]

Many broker-dealers who responded to this request for comment urged that we continue to permit broker-dealers offering discretionary brokerage accounts for commissions or dealer-based compensation to avail themselves of the statutory broker-dealer exception.[71] Some argued that these accounts were made available as an accommodation to customers who understood the nature of the accounts, and that any additional regulatory protections provided by the Advisers Act would be redundant to those already provided by broker-dealer regulation.[72] Many other commenters, however, including those representing investment advisers, argued that discretionary brokerage accounts are indistinguishable from advisory accounts and urged us to apply the Advisers Act and the rules thereunder to both.[73] Some, including one large broker-dealer, asserted that discretion was a key distinguishing feature of an advisory account and therefore all discretionary accounts should be regulated as advisory accounts.[74] Others argued that broker-dealers exercising discretionary authority would actually be providing advice that is not solely incidental to brokerage, and thus should not have available the broker-dealer exception in section 202(a)(11)(C).[75]

We have not previously interpreted the scope of section 202(a)(11)(C) to preclude a broker-dealer from exercising discretionary authority over the accounts of a limited number of its customers as long as the customers did not pay special compensation for these services. In 1978, however, we expressed concern that brokerage relationships ''which include discretionary authority to act on a client's behalf have many of the characteristics of the relationships to which the protections of the Advisers Act are important,'' and we requested comment on whether we should take action to require that these accounts be treated as advisory accounts.[76] After considering the issue, we determined not to take action at that time on whether discretionary accounts should be treated as advisory accounts but explained that our staff would continue to examine the applicability of the federal securities laws to discretionary accounts.[77] We further stated that ''the staff would continue to take the position that brokers or dealers who exercise discretion over a limited number of their customers' accounts, but do not receive special compensation for such services, can rely on the exception in section 202(a)(11)(C).'' [78]

After reviewing the many comment letters we received on this matter, and exploring this issue anew in the context of this rulemaking, we are proposing a rule stating that discretionary investment advice, as that term is defined in section 3(a)(35) of the Exchange Act, is not ''solely incidental

2000 Letter, *supra* note 23; Comment Letter of Walter R. Greenfield (Jan. 4, 2000).

[70] Proposing Release, *supra* note 5. The Commission received over 50 comment letters in response to this request for comments.

[71] *E.g.,* Comment Letter of Paine Webber Incorporated (Jan. 14, 2000) (''Paine Webber Letter''); Comment Letter of Smith Barney Citigroup (Jan. 14, 2000) (''Smith Barney Letter''); Comment Letter of First Dallas Securities'' (Jan. 13, 2000) (''First Dallas Letter''); Comment Letter of Stephens, Inc. (Jan. 12, 2000) (''Stephens Letter''). *See also* Comment Letter of Securities Industry Association (Jan. 13, 2000); Comment Letter of National Association of Securities Dealers (Feb. 24, 2000). *But see* Comment Letter of Charles Schwab & Co. (Sept. 22, 2004); Comment Letter of TD Waterhouse Investor Services, Inc. (Sept. 22, 2004).

[72] *See* Stephens Letter, *supra* note 71; First Dallas Letter, *supra* note 71; Smith Barney Letter, *supra* note 71.

[73] *E.g.,* Comment Letter of T. Rowe Price Associates, Inc. (Jan. 14, 2000) (''T. Rowe Price Jan. 14, 2000 Letter''); FPA Jan. 14, 2000 Letter, *supra* note 23; Comment Letter of North American Securities Administrators Association, Inc. (Jan. 14, 2000) (''NASAA Jan. 14, 2000 Letter''); ICAA Jan. 12, 2000 Letter, *supra* note 23. *See also* AICPA Sept. 22, 2004 Letter, *supra* note 26.

[74] Charles Schwab Sept. 22, 2004 Letter, *supra* note 71. *See also* T. Rowe Price Jan. 14, 2000 Letter, *supra* note 73; NASAA Jan. 14, 2000 Letter, *supra* note 73; ICAA Jan. 12, 2000 Letter, *supra* note 30.

[75] *See, e.g.,* Comment Letter of AARP (Nov. 17, 2003) (''AARP Letter''); FPA Jan. 14, 2000 Letter, *supra* note 23; T. Rowe Price Jan. 14, 2000 Letter, *supra* note 73. *See also* ICAA Jan. 12, 2000 Letter, *supra* note 23; NASAA Jan. 14, 2000 Letter, *supra* note 73.

[76] Investment Advisers Act Release No. 626, *supra* note 5.

[77] *Applicability of the Investment Advisers Act to Certain Brokers and Dealers,* Investment Advisers Act Release No. 640 (Oct. 5, 1978) [43 FR 47176 (Oct. 13, 1978)] (''Advisers Act Release No. 640'').

[78] *Id.*

to'' brokerage services within the meaning of section 202(a)(11)(C). The exercise of investment discretion seems to us to be qualitatively distinct from simply providing advice as part of a package of brokerage services, because a broker-dealer with such discretion is not just a source of advice, but has authority to make investment decisions relating to the purchase or sale of securities on behalf of clients. In this way, discretionary accounts have a quintessentially supervisory or managerial character that we previously have recognized as a critical indicator of services that warrant the protection of the Advisers Act because of the ''special trust and confidence inherent'' in such relationships.[79]

Although we did not require that *all* discretionary accounts be treated as advisory accounts when the issue was presented in 1978, we and our staff have long acknowledged that a broker-dealer's exercise of investment discretion over customer accounts raises serious questions about whether such accounts must be treated as subject to the Advisers Act—even where no special compensation is received.[80] Since at least 1978, the staff has viewed the exercise of investment discretion in commission-based accounts as a critical factor in determining whether a broker-dealer could rely on the exception provided by section 202(a)(11)(C).[81] Indeed, broker-dealers have known for decades that ''if the business of a broker or dealer consists almost exclusively of managing accounts on a discretionary basis, the [Division of Investment Management] would not regard such broker or dealer as providing investment advice solely incidental to his business as a broker or dealer and therefore the broker or dealer would not be eligible for the [exception] in section 202(a)(11)(C).'' [82]

The rule we propose today would supersede this existing staff approach, under which a discretionary account is subject to the Advisers Act only if the broker-dealer has enough *other* discretionary accounts to trigger the Act. Under proposed rule 202(a)(11)–1(b), the exception provided by section 202(a)(11)(C) would be unavailable for any account over which a broker-dealer exercises investment discretion, without regard to how the broker-dealer handles other accounts. We believe that such an approach may be preferable for several reasons. First, it better ensures that the Advisers Act is applied where investors have the sort of relationship with a broker-dealer that we have long recognized the Act was intended to reach.[83] Second, it is consistent with the longstanding view, which would be codified in reproposed rule 202(a)(11)–1(c), that a broker-dealer is an investment adviser solely with respect to those accounts for which the broker-dealer provides services or receives compensation that subject the broker-dealer to the Advisers Act. Third, unlike the existing staff approach, the proposed rule provides a bright-line test for the availability of the section 202(a)(11)(C) exception. It thereby clarifies that provision at a time when the line between advisory and brokerage services is blurring and the original ''bright line'' of special compensation has ceased to function as a reliable indicator of the services the Act was designed to reach. Finally, the proposed interpretation would result in all discretionary accounts being treated as advisory accounts without regard to the form of broker compensation and would therefore be consistent with the design of reproposed rule 202(a)(11)–1 as a whole.

We understand that, on occasion, a broker-dealer may exercise limited discretion over a customer account for a brief period of time (*e.g.,* when a customer is on vacation). Should such an isolated or occasional exercise of discretion cause a broker-dealer to lose its ability to rely on the exception? Should we consider other exceptions? [84] Should we include any or all exceptions in the rule text?

We request comment on this interpretation, and the use of ''discretionary advice'' as a bright line test to identify those brokerage accounts that must be treated as advisory accounts. We propose to use the definition of investment discretion in section 3(a)(35) of the Exchange Act and we request comment on using this definition. Is some other definition more appropriate? If so, what definition should we use?

We understand that many broker-dealers today treat discretionary accounts as advisory accounts. Is this understanding correct? Do many broker-dealers also treat discretionary accounts as brokerage accounts? Do broker-dealers maintain both types of accounts, and if so, what are the determinative factors for classifying an account as an advisory or brokerage account? What impact on broker-dealers would our interpretation have? We are particularly interested in learning whether most broker-dealers that do not treat discretionary accounts as advisory accounts are already registered under the Advisers Act for other reasons.

We are also interested in understanding the impact on investors of these distinctions. As we acknowledged in the Proposing Release, investors are often confused by the differences between advisory and brokerage accounts. Would the distinction we propose to draw between discretionary and non-discretionary accounts resolve at least some of that that confusion?

Does the legislative history of section 202(a)(11)(C) support our proposed rule? Although in 1940 many broker-dealers exercised discretion over the accounts they serviced for a fee through separate advisory departments in their firms, broker-dealers were generally disinclined to accept such discretionary advisory accounts,[85] and the extent to which broker-dealers were exercising discretion over commission-based customer accounts outside of separate advisory departments is unclear. As a result, we are unable to conclude that in 1940 Congress would have understood investment discretion to be part of the traditional package of services broker-dealers offered for commissions. We are aware of nothing in the legislative history of section 202(a)(11)(C) (or of the Act as a whole) or in the brokerage practices in 1940 that would preclude our interpretation of that section as being unavailable for all accounts over which broker-dealers exercise investment discretion.[86] There is no

[79] *Adoption of Amendments to Rule 206A–1(T) under the Investment Advisers Act of 1940 Extending the Duration and Limiting the Scope of the Temporary Exemption from the Advisers Act for Certain Brokers and Dealers,* Investment Advisers Act Release No. 471 (Aug. 20, 1975) (''Advisers Act Release No. 471'').

[80] *See supra* note 76 and accompanying text.

[81] Advisers Act Release No. 640, *supra* note 76.

[82] *Id.*

[83] Advisers Act Release No. 471, *supra* note 79.

[84] We note, for example, that NASD Rule 2510(d) sets forth certain exceptions to the NASD rule governing discretionary accounts (*e.g.,* discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite amount of a specified security shall be executed not subject to rules governing discretionary accounts).

[85] SECURITY MARKETS, *supra* note 39, at 649–650.

[86] In the decade preceding the enactment of the Advisers Act, both the New York Stock Exchange and the Commission promulgated measures designed to regulate and, in the case of the NYSE rules, to significantly limit the exercise of investment discretion by broker-dealers. The NYSE prohibited customers' men from handling discretionary accounts; with few exceptions, only partners were authorized to handle such accounts. SECURITY MARKETS, *supra* note 39, at 638–40. *See also Wall St. Problem in Customers' Men,* N.Y. Times, Jan. 14, 1934, at N7 (''[T]he Stock Exchange has approved rules prohibiting customers' men from handling discretionary accounts, which powers are now delegated with few exceptions, only to partners in Stock Exchange firms.''). In

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evidence that Congress directly considered this question, and, given the inherently managerial nature of investment discretion, we see no reason why Congress would have intended to exclude such services from the reach of the Advisers Act.

Commenters asserting that discretionary authority is not an appropriate means of drawing a line in the case of commission-based accounts should address whether it draws an appropriate line for fee-based accounts. Is reproposed rule 202(a)(11)–1 as a whole appropriate in light of our reliance in the rule on the distinction between discretionary and non-discretionary authority?

D. Discount Brokerage Programs

We are also reproposing, as part of rule 202(a)(11)–1, a provision that a broker-dealer will not be considered to have received special compensation solely because the broker-dealer charges a commission, mark-up, mark-down or similar fee for brokerage services that is greater than or less than one it charges another customer.[87] This provision is intended to keep a full-service broker-dealer from being subject to the Advisers Act solely because it also offers electronic trading or other forms of discount brokerage. Conversely, a discount broker-dealer would not be subject to the Act solely because it introduces a full-service brokerage program.

The rule, if adopted, would supersede staff interpretations under which a full-service broker-dealer is subject to the Advisers Act with respect to accounts for which it provided advice incidental to its brokerage business merely because it offers electronic trading or other form of discount brokerage.[88] These staff interpretations led to the odd result that a full-service broker-dealer cannot offer discount brokerage without treating its full-service brokerage accounts as advisory accounts even though the services offered to those accounts remained unchanged. Moreover, these staff interpretations may create disincentives for full-service broker-dealers to offer electronic or other types of discount brokerage, and thus may limit customers' choices of types of brokerage service, and may reduce competition in discount brokerage. The reproposed rule makes a broker-dealer's eligibility for the broker-dealer exception with respect to an account turn on the characteristics of that particular account and not of other accounts the broker-dealer may also service. Commenters discussing this aspect of the proposed rule generally supported it,[89] and we are reproposing it without change. Do commenters continue to support this provision? Should we consider any modifications to this provision?

E. Scope of Exception

Reproposed rule 202(a)(11)–1 would also provide that a broker-dealer that is registered under both the Exchange Act and the Advisers Act is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subject the broker or dealer to the Advisers Act.[90] This provision would codify our earlier interpretation of the Act that permits a broker-dealer registered under the Advisers Act to distinguish its brokerage customers from its advisory clients.[91] We received few comments regarding the scope of the proposed exception, which we are reproposing without change.

Finally, the Commission would interpret the broker-dealer exception as being available not only to a broker-dealer, but also to any of its registered representatives, *i.e.,* those employees and other persons whose investment advisory activities are subject to the control and supervision of the broker-dealer.[92] A registered representative who provides investment advice independent of his broker-dealer employer (*e.g.,* by establishing an independent financial planning practice or providing advisory services outside his capacity as a registered representative, without the control, knowledge and approval of his broker-dealer employer) could not rely on the exception because his investment advisory activities would not be solely incidental to the broker-dealer's business.[93]

III. Proposed Statement of Interpretive Position

Many commenters urged us to provide greater guidance on when advice is solely incidental to brokerage services, observing that, in the past, most questions arising under section 202(a)(11)(C) have involved the meaning of ''special compensation.''[94] A number of commenters offered suggestions of how we might further develop the interpretation of ''solely incidental to.'' Some supported very narrow views of what ''solely incidental to'' means, suggesting that it should include only advice that is a minor or insignificant part of a broker-dealer's business,[95] or advice that is not marketed by the broker.[96] Because reliance on both the rule and statute turn on whether advice provided by a broker-dealer is solely incidental to the brokerage business (or, in the case of the rule, to the brokerage services provided to the account), it is a question of substantial significance to broker-dealers.

In general, we understand investment advice to be ''solely incidental to'' the conduct of a broker-dealer's business within the meaning of section 202(a)(11)(C) when the advisory services rendered to an account are in connection with and reasonably related to the brokerage services provided to that account. This understanding is consistent with the legislative history of the Advisers Act, which indicates Congress' intent to exclude broker-dealers providing advice as part of traditional brokerage services.[97] It is also consistent with the Commission's contemporaneous construction of the Advisers Act as excepting broker-dealers whose investment advice is given ''solely as an incident of their regular business.''[98]

1937, the Commission adopted Exchange Act Rule 15cl–7 [17 CFR 240.15cl–7], which deals with discretionary accounts maintained by broker-dealers, but does not distinguish between commission-based brokerage accounts and the advisory accounts broker-dealers serviced for a fee through their separate advisory departments.

[87] Rule 202(a)(11)– 1(a)(2).

[88] *See* Advisers Act Release No. 2, *supra* note 3.

[89] Federated Letter, *supra* note 28; Comment Letter of Charles Schwab & Co. (Jan. 14, 2000); Comment Letter of NASD (Feb. 24, 2000).

[90] Rule 202(a)(11)– 1(c).

[91] Advisers Act Release No. 626, *supra* note 5.

[92] The staff's views on this matter were set forth in Advisers Act Release No. 1092, *supra* note 2. *See also* Strevell No-Action Letter, *supra* note 9; Brent A. Neiser, SEC Staff No-Action Letter (pub. avail. Jan. 21, 1986) (''Neiser No-Action Letter'').

[93] The staff's views on this matter were set forth in the Strevell No-Action Letter, *supra* note 9 and the Neiser No-Action Letter, *supra* note 92.

[94] *E.g.,* Comment Letter of Consumer Federation of America (Jan. 14, 2000); ICAA Jan. 12, 2000 Letter, *supra* note 23; T. Rowe Price Jan. 14, 2000 Letter, *supra* note 32; Comment Letter of Investment Company Institute (Jan. 14, 2000); U.S. Bancorp Letter, *supra* note 36; Letter of Connecticut Department of Banking (Jan. 20, 2000)(''Connecticut Department of Banking''); Letter of Certified Financial Planner Board of Standards (Sept. 22, 2004); Charles Schwab Sept. 22, 2004 Letter, *supra* note 20; NASAA Letter, *supra* note 31.

[95] ICAA Jan 12, 2000 Letter, *supra* note 23, Comment Letter of T. Rowe Price Associates, Inc. (Sept. 22, 2004).

[96] CFA Jan. 13, 2000 Letter, *supra* note 23, Connecticut Department of Banking, *supra* note 94, ICAA Sept. 22, 2004 Letter, *supra* note 28.

[97] *See supra* notes 40–46 and accompanying text.

[98] *See* Investment Advisers Act Release No. 1 [11 FR 10996 (Sept. 23, 1940)] (''Release No. 1'')(emphasis added). It is also consistent with how our staff has construed section 202(a)(11)(B) of the Act, which provides an exception for lawyers, accountants, engineers and teachers ''whose performance of such services is incidental to the practice of [their] profession.'' *See* Hungerford,

We propose to read section 202(a)(11)(C) more broadly than some commenters suggest. Those commenters read the words ''solely incidental'' to mean that the advice provided must be only ''incidental'' in the sense of ''minor,'' ''insignificant,'' ''periodic,'' ''episodic,'' or ''advice about specific securities.''[99] This reading is based on the view that the statute excepts ''solely incidental'' advisory services instead of advisory services that are ''solely incidental to'' a broker-dealer's business, *i.e.*, advisory services that are ''liable to happen as a consequence of'' or ''follow[] as a consequence'' of the conduct of a broker-dealer's business.[100] Moreover, the view that only minor or insignificant advice is excepted by section 202(a)(11)(C) ignores the fact that the advice broker-dealers gave as part of their traditional brokerage services in 1940 was often substantial in amount and importance to the customer.[101] This has remained true throughout the following decades.[102] Indeed, the importance of the broker-dealer's role as advice-giver in connection with brokerage transactions has shaped how we and the self-regulatory organizations have regulated and continue to regulate broker-dealers.[103] On the other hand, some commenters would interpret ''solely incidental to'' a broker-dealer's business to permit broker-dealers to rely on section 202(a)(11)(C) broadly to provide any or all types of advisory services as part of a brokerage account. This interpretation would have the effect of negating any limitation inherent in the ''solely incidental'' standard, and we propose not to read ''solely incidental to'' so broadly. Do commenters agree with our view? Those who disagree with us should suggest alternative interpretive approaches that find support in the intent of Congress and the legislative history of the Advisers Act, and in contemporaneous industry practice.

Many commenters urged that we declare certain current practices to be inconsistent with advice being offered solely incidental to brokerage. They believed that the Advisers Act ought to apply more broadly to full-service brokerage that is, among other things, marketed based on advisory services. [104] Before we provide any interpretive guidance that could have an effect on brokerage practices, we believe it is appropriate and useful to seek additional comment from all interested persons.

The Commission is considering issuing an interpretive position or including some or all of its interpretations relating to ''solely incidental to'' in a rule when it acts on reproposed rule 202(a)(11)–1.[105] The interpretations would address the application of the ''solely incidental to'' requirement of section 202(a)(11)(C) of the Act and paragraph (a)(1)(ii) of rule 202(a)(11)–1 to certain common broker-dealer practices described below. Commenters should address whether, in their view, our proposed interpretations or any alternative interpretations find support in the Act or its legislative history. They should also address the costs and benefits of the proposed or any alternative interpretations. Where possible, commenters should quantify such costs and benefits. Should we apply the Advisers Act in the circumstances that we describe below in light of protections afforded investors by the Exchange Act?

A. Holding Out as an Investment Adviser

In the Proposing Release we expressed concern that many broker-dealers offering fee-based brokerage accounts have marketed them heavily based on the advisory services provided rather than securities transaction services,[106] and we expressed concern about whether investors would perceive these accounts to be advisory accounts

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Aldrin, Nichols & Carter, SEC Staff No-Action Letter (Dec. 10, 1991)(accountant); Myers Krauss, & Stevens, SEC Staff No-Action Letter (Aug. 31, 1988)(lawyer); Jan L. Warner, Esq., SEC Staff No-Action Letter (Dec. 27, 1988)(lawyer); Hauk, Soule & Fasani, SEC Staff No-Action Letter (Feb. 20, 1986)(accountant); Trejo & Associates, SEC Staff No-Action Letter (Dec. 19, 1985)(accountant); Marvin Drabinsky, SEC Staff No-Action Letter (Oct. 3, 1984)(accountant); David A. Hendelberg, SEC Staff No-Action Letter (Apr. 5, 1984)(accountant); LaManna & Hohman, SEC Staff No-Action Letter (Feb. 18, 1983)(accountant); Pros. Inc., SEC Staff No-Action Letter (June 22, 1973)(lawyer).

[99] *See, e.g.,* Comment Letter of Consumer Federation of America (Sept. 4, 2000); ICAA Sept. 22, 2004 Letter, *supra* note 28.

[100] *See Compact Oxford English Dictionary* (2004) (available on the Internet *http://www.dictionary.com*) (listing as synonyms of ''incidental to'' the words ''accompanying,'' ''attendant,'' and ''concomitant''). Prior to the Act's enactment, the term ''incidental'' was defined to include: ''Liable to happen or to follow as a chance feature or incident.'' *Webster's New Int'l Dictionary* 1257 (unabridged 2d ed. 1934). The same dictionary defined ''incident'' to include ''[d]ependent on, or appertaining to, another thing'' or ''directly and immediately pert[inent] to, or involved with, something else, though not an essential part of it.'' *Id.*; *cf.* Fowler, *A Dictionary of Modern English Usage* 264 (Oxford Press 1937)(stating that ''while *incidental* is applied to side occurrences with stress on their independence of the main action,'' the word ''incident''—particularly ''with 'to' as the link''—''is mostly used in close combination with whatever word may represent the main action or subject'' and ''implies that, though not essential to it, [the side occurrences] not merely happen to arise in connection with [the main action] but may be expected to do so'' (emphasis in original).

[101] *See supra* note 40–46 and accompanying text. It is also inconsistent with section 202(a)(11)(C) read as a whole. Following the broad description of the type of services rendered by advisers in paragraph (11)(*i.e.,* ''advising others * * * as to the value of securities or as to the advisability of investing in, purchasing or selling securities''), the provision in subparagraph (C) excepts broker-dealers ''whose performance of *such services* is solely incidental to the conduct of the broker-dealer's business and for no special compensation'' (emphasis added). This structure also supports our conclusion that the words ''solely incidental to'' do not operate to limit the ways in which broker-dealers can amrket their services.

[102] *See, e.g.*, Robert Bendiner, *Current Quotations on Stockbrokers*, N.Y. TIMES, May 10, 1953, at SM19 (''[W]hen the Korean War began * * * [c]ustomers then wanted to know whether to expect confiscatory taxes that would reduce corporate profits, how price controls might effect their securities, and whether some businesses would be squeezed out entirely for lack of materials. 'You have to talk to them,' one broker said. 'Buying and selling is the least part of the service we give them for our commissions.' ''); SEC, SPECIAL STUDY OF THE SECURITIES MARKETS (1963) at 330 (''SPECIAL STUDY'') (''Both the volume and the variety of the written investment information and advice originated by broker-dealers, who for the most part furnish it free to their customers as part of their effort to sell securities, are impressive.''); *id.* at 386 (terming investment advice furnished by broker-dealers an ''integral part of their business of merchandising securities'' even if only ''incidental'' to that business); *Interpretive Releases Relating to the Securities Exchange Act of 1934 and General Rules and Regulations Thereunder: Future Structure of Securities Markets* (Feb. 2, 1972) [37 FR 5286, 5290 (Mar. 14, 1972)] (''In our opinion, the providing of investment research is a fundamental element of the brokerage function for which the bona fide expenditure of the beneficiary's funds is completely appropriate, whether in the form of high commissions or outright cash payments.''); TULLY REPORT, *supra* note 13, at 3 (''The most important role of the registered representative is, after all, to provide investment counsel to individual clients, not to generate transaction revenues.'').

[103] Thus, for example, under the rules of self-regulatory organizations and consistent with Commission precedent, a broker must render advice that is based on a knowledge of the security involved and that is suitable for a customer in light of the customer's needs, financial circumstances, and investment objectives. *See* NASD Rule 2310; NYSE Rule 405. In addition, under certain circumstances, such as when a broker-dealer assumes a position of trust and confidence with its customer, it has been held to a fiduciary standard with its customer, akin to that of an adviser and a client. *See supra* note 54 and accompanying text.

[104] Letter of North American Securities Administrators Association, Inc. (Oct. 6, 2004) (''NASAA Letter''); AICPA Sept. 22, 2000 Letter, *supra* note 26; ICAA Sept. 22, 2004 Letter, *supra* note 28; Comment Letter of National Association of Personal Financial Advisors (Sept. 21, 2004) (''NAPFA Letter''); Comment Letter of Henry L. Woodward (Sept. 21, 2004); Dimitroff Letter, *supra* note 23; Patchett Letter, *supra* note 27; Heydri Letter, *supra* note 31; Comment Letter of Charles O'Connor (Sept. 14, 2004); Comment Letter of Consumer Federation of America (Jan. 13, 2000) (''CFA Jan. 13, 2000 Letter''); Comment Letter of Pamela A. Jones (Jan. 4, 2000).

[105] We note that reproposed rule 202(a)(11)–1 already contains one interpretation regarding the scope of section 202(a)(11)(C). Paragraph (c) of the rule explains that under the exception, a broker-dealer is an investsment adviser only with respect to those accounts for which it provides services or receives compensation that subject the broker-dealer to the Advisers Act.

[106] Proposing Relese, *supra* note 5.

rather than brokerage accounts. In August 2004, when we reopened the comment period on proposed rule 202(a)(11)–1, we asked for comment on whether the rule should be unavailable to a broker-dealer that uses terms such as ''investment advice'' or ''financial planning'' to promote its services.[107]

A large number of commenters expressed substantial concern that broker-dealer marketing efforts contribute to investor confusion about the differences between broker-dealers and advisers, and urged us to deny broker-dealers the ability to rely on the broker-dealer exemption if they held themselves out based on their advisory services.[108] Some of these commenters asserted that any marketing of advisory services by a broker-dealer, whether for a fee-based account or an account paying commissions, is inconsistent with those services being solely incidental to the brokerage business. These commenters expressed the view that broker-dealers should stop calling their registered representatives ''financial consultants,'' ''financial advisors,'' or similar names.

We are addressing these concerns in our reproposal of rule 202(a)(11)–1 by proposing to require broker-dealers offering fee-based brokerage to include a prominent statement on all advertisements for, and contracts, agreements, applications and other forms governing fee-based brokerage accounts. The statement must disclose that the accounts are brokerage accounts and not advisory accounts, that, as a consequence, the customer's rights and the firm's duties and obligations to the customer, including the scope of the firm's fiduciary obligations, may differ, and must identify an appropriate person at the firm with whom the customer can discuss the differences.[109] Does this approach address investor confusion concerns? Will the disclosures make sense to investors if broker-dealers continue to refer to their registered representatives as ''financial consultants'' or ''financial advisors''? Should we instead conclude that use by a broker-dealer of such terms is inconsistent with the broker-dealer exception?

The Advisers Act also provides an exception for lawyers and accountants, and our staff has viewed the availability of that exception as turning on whether the lawyer or accountant has held himself out as providing financial planning, pension consulting, or other financial advisory services.[110] Should we apply a similar standard to broker-dealers? Would such an approach address confusion among investors as to the differences between advisory accounts and brokerage accounts? On the other hand, would applying such an approach to broker-dealers ignore salient distinctions between broker-dealers and other professionals in terms of their advice-giving role?

B. Financial Planning Services

Financial planning services typically involve preparing a financial program for a client based on the client's financial circumstances and objectives. A financial planner generally seeks to address a wide spectrum of the client's long-term financial needs, including insurance, savings, and investments, taking into consideration anticipated retirement or other employee benefits.[111] A financial planner also may develop tax or estate plans for clients or refer clients to attorneys, accountants or other professionals. In most cases, financial planners who provide advice about the advisability of investing in securities, advice about market trends, or advice about retaining an investment manager are subject to the Advisers Act.[112]

The advisory services provided by financial planners and the context in which they are provided may extend beyond what Congress, in 1940, reasonably could have understood broker-dealers to have provided as an advisory service ancillary to their brokerage business.[113] We are concerned that some broker-dealers have promoted ''financial planning'' as a way of acquiring the confidence of customers to promote their brokerage services without actually providing any meaningful financial planning.[114]

We request comment on whether we should interpret financial planning as not solely incidental to the brokerage business. We understand that most broker-dealers that today offer financial planning services for a separate fee treat the customers receiving such services as advisory clients. Is our understanding correct? Should we limit our interpretation to circumstances where investors separately contract for financial planning services? If so, would such an approach discourage the use of separate contracts by broker-dealers? Should we limit our interpretation to circumstances where a separate fee is charged? Should our interpretation turn on whether the financial planning services are ongoing?

Many financial planners registered under both the Advisers Act and Exchange Act are compensated exclusively from commissions received on the sale of securities, including mutual fund shares. Would an interpretation that financial planning is incidental to brokerage business permit those many financial planners to withdraw their registration under the Advisers Act? Would an interpretation

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[107] Investment Advisers Act Release No. 2278 (Aug. 19, 2004)[69 FR 51620 (Aug. 20, 2004)]. *See* Investment Advisers Act Release, *supra* note 2 (A lawyer or accountant who holds himself out to the public as providing financial planning, pension consulting, or other financial advisory services would not be able to rely on the exclusion in Section 202(a)(11)(B) of the Advisers Act.)

[108] *E.g.,* NASAA Letter, *supra* note 104; AICPA Letter, *supra* note 26; ICAA Sept. 22, 2004 Letter, *supra* note 28; Comment Letter of Financial Services Institute (Sept. 22, 2004); NAPFA Letter, *supra* note 104; FPA June 21, 2004 Letter, *supra* note 30; Joint Comment Letter of Consumer Federation of America, Certified Financial Planner Board of Standards, Investment Counsel Association of America and the National Association of Personal Financial Advisors (May 31, 2000); FPA Jan. 14, 2000 Letter, *supra* note 23); CFA Jan. 13, 2000 Letter, *supra* note l104.

[109] Rule 202(a)(11)–1(a)(1)(iii).

[110] *See* Advisers Act Release No. 1092; *supra* note 2.

[111] *See* Jonathan R. Macey, *Regulation of Financial Planners: A White Paper Prepared for the Financial Planning Association* (Apr. 2002) at 5 (''In short, a financial planner develops plans that address all financial aspects of an individual's life. The breadth and scope of the advice given by financial planners is what distinguishes them from other, more specialized participants in the financial services industry. Unlike stock brokers, insurance salesmen, accountants, tax planners, lawyers, and trust and estate experts, financial planners may give advice on investments, savings, taxes, insurance, retirement, estate planning, trusts, and real estate. In addition to a broad rangae of technical advice, typically important components of financial planning are the initial assessment of a clinet's overall financial, familial, personal, and professional needs and goals as well as further monitoring and revision of the client's financial plan.'').

[112] *See* Advisers Act Release No. 1092, *supra* note 2. In advisers Act Release No. 1092 we published the views of our staff as to the applicability of the Advisers Act to financial planners and other persons who provide investment advice as a component of other financial services.

[113] Our staff has expressed similar views in the past. *See* Townsend and Associates, SEC Staff No-Action Letter (Sept. 21, 1994) (advice is not incidental that is provided ''as part of an overall plan that addresses the financial situation of a customer and formulates a financial plan.'') *See also* Investment Management & Reserach, Inc., SEC Staff No-Action Letter (Jan. 27, 1977). It is also consistent with views expressed in two of the leading treatises on invesstment advisers, See Thomas P. Lemke & Gerald T. Lins, REGULATION OF INVESTMENT ADVISERS § 1:20 (2004); Clifford E. Kirsch, INVESTMENT ADVISER REGULATION (May 2004) at 2:5:1. It may, however, be inconsistent with statements made in a few of our staff's other letters. *See, e.g.,* Nathan & Lewis Securities, SEC Staff No-Action Letter (Mar. 3, 1988) (''Nathan & Lewis No-Action Letter''); Elmer D. Robinson, SEC Staff No-Action Letter (Dec. 6, 1985).

On the other hand, the brokerage business has evolved significantly since 1940, and it may be appropriate to consider financial planning to be part of the traditional package of services broadly understood.

[114] *In the Matter of Haight & Co., Inc.,* Securities Exchange Act Release No. 9082 (Feb. 19, 1971).

that yielded such a result serve to protect investors?

We recognize that full-service broker-dealers must consider some aspects of financial planning when determining that their recommendations are suitable.[115] We would not want our interpretation to interfere in any way with a broker's suitability analysis. In order to avoid this result, how should we draw the line between planning services that are incidental to brokerage and those that are not? Can such a line be drawn? Are there other ways to distinguish a broker-dealer's suitability analysis from an adviser's financial planning services?

At present we propose to address financial planning by issuing an interpretation stating that if a broker-dealer holds itself out as a financial planner or as providing financial planning services,[116] it cannot be considered to be giving advice that is solely incidental to brokerage. Is this approach workable? Should we also (or alternatively) attempt to identify specific types of financial planning services that would or would not be incidental to the brokerage business? We solicit comment on whether we should include any interpretation regarding financial planning in rule text. If so, are there any particular concerns raised by codification? If so, how should they be addressed? We solicit comment on these and other approaches we could take as well.

C. Wrap Fee Sponsorship

Broker-dealers often serve as sponsors of wrap fee programs, under which broker-dealers effect securities transactions for one or more portfolio managers, which may be independent investment advisers.[117] Although a ''wrap fee'' involves the receipt of ''special compensation,'' such broker-dealers may have available the exception provided by rule 202(a)(11)–1 if, among other things, the portfolio manager selection and asset allocation services typically provided by the broker-dealer sponsor could be viewed as solely incidental to the business of brokerage.[118] However, we have not viewed the asset allocation or portfolio manager selection advice as incidental to the brokerage transactions initiated by the portfolio manager.[119] Does this interpretation continue to make sense? Should we re-affirm it? We understand that broker-dealer sponsors of wrap fee programs are today registered under the Advisers Act and treat wrap fee customers as advisory clients. Is our understanding correct?

D. Other Interpretive Questions

Finally, we request comment whether there are other interpretive questions that have arisen under section 202(a)(11)(C) and, in particular, whether there are any questions regarding any particular advisory service that we might address in an interpretive statement.

IV. General Request for Comment

The Commission requests comment on the rule and interpretations proposed in this release, suggestions for other additions to the rule and interpretations, and comment on other matters that might be affected by the proposals contained in this release. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission also requests information regarding the potential impact of the proposed rule and interpretations on the economy on an annual basis. Commenters should provide empirical data to support their views.

V. Cost Benefit Analysis

A. Background

The Commission is sensitive to the costs and benefits of its rules. Under the proposed rule, broker-dealers would not be deemed to be investment advisers with respect to accounts for which they receive asset-based fees, fixed fees, or similar non-commission compensation, provided that: (i) They do not exercise investment discretion over the account, (ii) their investment advice is solely incidental to the brokerage services provided to the account, and (iii) they make certain disclosures in their advertising and agreements for such accounts. The rule would also clarify that broker-dealers are not subject to the Advisers Act solely because, in addition to full-service brokerage services, they also offer discount brokerage services, including execution-only brokerage, for reduced commission rates. These provisions of the proposed rule are designed to permit broker-dealers to offer these new types of fee-based and discount brokerage programs without triggering regulation under the Advisers Act.

The proposed rule would also specify that broker-dealers exercising investment discretion over customer accounts are not providing advice that is solely incidental to their business as brokers or dealers, regardless of the form of compensation. Thus, broker-dealers providing discretionary brokerage would not be eligible for the Advisers Act broker-dealer exception with respect to discretionary accounts, and would be subject to the Act and its requirements for those accounts.

The Commission is also proposing to interpret the application of the ''solely incidental to'' requirement of section 202(a)(11)(C) of the Advisers Act to certain broker-dealer practices. A broker-dealer holding itself out as a financial planner would not be considered to be providing advice that is solely incidental to its brokerage services, and thus would be subject to the Advisers Act with respect to accounts offering such advisory services.

We have identified certain costs and benefits, which are discussed below, that may result from the proposed rule and interpretations.[120] We request comment on the costs and benefits of the proposed rule and interpretations.

B. Discussion

1. Fee-based and Discount Brokerage Accounts

a. Benefits

i. Avoidance of Compliance Costs

Proposed rule 202(a)(11)–1(a) would keep broker-dealers from being subject to the Advisers Act as a result of charging asset-based fees instead of commissions for accounts receiving the

[115] A broker must have a reasonable basis for believing that a recommendation to buy or sell a particular security is suitable for the broker's customer considering the customer's risk tolerance, other securities holdings, financial situation, financial needs, and investment objectives. *See supra* note 52.

[116] *See supra* note 110.

[117] Under some wrap fee programs, the broker-dealer sponsor retains discretionary authority and thus must treat its wrap fee customers as advisory clients because the broker-dealers receive special compensation and would not have available the exception provided by proposed rule 202(a)(11)–1, which is limited to non-discretionary accounts. Wrap fee programs are today often referred to as ''separately managed accounts'' or ''separate accounts.''

[118] With regard to portfolio manager selection, our staff has viewed this to be so regardless of whether such services were carried out through a wrap fee program or provided as separate services. *See* FPC Securities Corporation, SEC Staff No-Action Letter (Nov. 1, 1974)(staff viewed broker's advice about selection of investment advisers and monitoring advisers' performance not incidental to business of broker-dealer).

[119] We have viewed broker-sponsored wrap fee programs as being subject to the Advisers Act. *Disclosure by Investment Advisers Regarding Wrap Fee Programs,* Investment Advisers Act Release No. 1401 (Jan. 13, 1994) [59 FR 3033 (Jan. 20, 1994)], at n.2 (proposing amendments to Form ADV); Investment Advisers Act Release No. 1411 (Apr. 19, 1994)(adopting amendments to Form ADV)[59 FR 21657 (Apr. 26, 1994)].

[120] In 1999, our Proposing Release also analyzed the costs and benefits of our first proposal to keep broker-dealers from being subject to the Advisers Act solely as a result of re-pricing their full-service brokerage services. As discussed below, the comments on our 1999 proposal have informed our analysis in preparing this cost benefit analysis.

kinds of services they have traditionally provided to brokerage customers, or in the case of discount brokerage, as a result of charging different commission rates for full-service accounts. To the extent they offer fee-based brokerage programs that fit within the activities excepted under the new rule, broker-dealers would not be subject to the Advisers Act with respect to such accounts. Similarly, under the proposed rule, broker-dealers offering both full-service brokerage services and discount brokerage services would not be deemed to have received special compensation solely because they charge reduced commission rates for their discount services.

Broker-dealers relying on the proposed rule with respect to these fee-based and discount brokerage programs would benefit in the form of saved costs they would otherwise expend in connection with Advisers Act compliance.[121] Broker-dealers, even those already dually-registered as investment advisers, would benefit in the form of costs saved by not having to convert their fee-based and full-service brokerage accounts into advisory accounts. For example, these accounts would not be subject to brochure delivery or other disclosure requirements under the Advisers Act. Similarly, such accounts also would not be subject to the principal trading restrictions under the Act. Securities markets would also benefit because the rule would preserve the ability of broker-dealers to engage in principal transactions with these fee-based brokerage customers, and principal transactions are a major source of market liquidity.[122] Commenters responding to our Proposing Release noted a large increase in the number of fee-based brokerage programs in the years since the Proposing Release.[123] The benefits of these compliance cost savings and market liquidity are difficult to quantify.[124]

Other broker-dealers relying on the proposed rule would not be subject to the Advisers Act at all. For these broker-dealers whose fee-based or discount brokerage programs would otherwise require adviser registration, we believe the rule's benefits would be significant in terms of avoiding an increased regulatory burden incurred as a result of changing the way they charge for their brokerage services. For example, if not excepted under the proposed rule, these broker-dealers would be required to prepare, submit and update adviser registration statements,[125] and to prepare and distribute client disclosures under Part II of Form ADV.[126] These broker-dealers would also be required to modify their compliance programs to address the Advisers Act and its requirements,[127] and to establish codes of ethics required under the Act's rules.[128] Because the costs of satisfying these and other requirements under the Advisers Act vary from firm to firm depending on its size and complexity, they are difficult to quantify.

ii. Investor Benefits

By eliminating regulatory disincentives to re-pricing of brokerage services, proposed rule 202(a)(11)–1 is expected to yield benefits for individual investors as a result of such re-pricing. Under the fee-based programs discussed above, a broker-dealer's compensation does not depend on the number of transactions or the size of mark-ups or mark-downs charged, thus reducing incentives for the broker-dealer to churn accounts, recommend unsuitable securities, or engage in high-pressure sales tactics. As such, these programs may better align the interests of broker-dealers and their customers. The rule would also benefit customers by enabling them to choose from among these new programs and other traditional brokerage services to select the program best for them. While it is difficult to quantify the value of these benefits, we believe they are substantial.

b. Costs

While we believe the benefits of proposed rule 202(a)(11)–1(a) are substantial, we believe the incremental costs associated with this provision of the proposed rule are small. The only incremental cost associated with this provision of the rule would be the cost of adding a disclosure statement to the affected account agreements and advertisements. As discussed in our Paperwork Reduction Act analysis, we believe this cost is insignificant.[129] We believe the proposed disclosure is necessary to prevent investor confusion. Furthermore, the cost of the disclosure would be incurred only by those broker-dealers electing to rely on the rule.

Because it would only operate to except from the Advisers Act certain brokerage accounts, proposed rule 202(a)(11)–1(a) would not increase the regulatory burden borne by investment advisers. Some commenters responding to our Proposing Release argued the proposed exception would grant broker-dealers—who give investment advice without complying with the Advisers Act—a competitive advantage over investment advisers subject to the Advisers Act, thereby indirectly imposing costs on investment advisers. However, because the proposed rule would be restricted to investment advice which is solely incidental to brokerage services (and broker-dealers have long been subject to this solely incidental standard under section 202(a)(11)(C) of the Advisers Act), the rule would not establish new opportunities for broker-dealers to compete with advisers on the nature of their investment advice. Also, in providing this advice, broker-dealers would remain subject to their own costs of regulation under the Exchange Act.[130]

Some commenters responding to the Proposing Release additionally asserted the proposed exception would impose

[121] In the alternative, broker-dealers could revert to charging commissions instead of asset-based fees, and cease offering discount brokerage services, thereby avoiding compliance costs under the Advisers Act. Given the growing popularity of these accounts, however, as discussed *infra* note 123, and the fact that most broker-dealers offering these accounts have already established (or an affiliate has established) a compliance infrastructure under the Advisers Act, we expect that, absent the exception that would be provided under proposed rule 202(a)(11)–(1)(a), broker-dealers would continue offering fee-based accounts and treat the accounts as advisory accounts.

[122] *See* Section II.A.1. of this Release, *supra.*

[123] Although commenters on our Proposing Release did not quantify this increase, one consulting firm estimates that assets in fee-based brokerage programs grew by 33.7% from the second quarter of 2003 to the second quarter of 2004. Cerulli Edge 3rd Quarter, *supra* note 47.

[124] Commenters on our 1999 Proposing Release did not provide data quantifying the potential costs of treating such a large number of accounts as advisory accounts.

[125] Advisers registered with the Commission must prepare Part 1A of Form ADV and file it with the SEC on the IARD system. Since Part 1A requires advisers to answer basic questions about their businesses, and can be completed using information readily available to the registrant, costs to prepare the form are typically small, but for some larger registrants with complex operations and many employees and affiliates, the costs may be somewhat higher, and may include professional fees. Adviser registrants submitting their Form ADVs through the IARD are required to pay filing fees to the operator of the system which range from $150 to $1,100 initially and $100 to $550 annually. *See Designation of NASD Regulation, Inc. to Establish the Investment Adviser Registration Depository; Approval of IARD Fees,* Investment Advisers Act Release No. 1888 (July 28, 2000) [65 FR 47807 (Aug. 3, 2000)].

[126] Rule 204–3 [17 CFR 275.204–3].

[127] Rule 206(4)–7 [17 CFR 275.206(4)–7].

[128] Rule 204A–1 [17 CFR 275.204A–1].

[129] *See* Section VII.A. of this Release, *infra.* Broker-dealers would be required to include prominent statements that the account in question is a brokerage account, not an advisory account, and that, as a consequence, the customer's rights and the firm's duties and obligations to the customer, including the scope of the firm's fiduciary obligations, may differ. The firm would also be required to direct the customers to a person who can discuss with the customers the differences between the accounts.

[130] *See supra* note 58 and accompanying text.

costs on investors, who would not receive the same treatment afforded a client of an investment adviser under the Advisers Act. While these commenters argued that the fiduciary duties of an adviser outweigh the duties of a broker-dealer, their comments do not fully recognize the extent of broker-dealers' obligations.[131] Just as we do not believe that the congressional exception for certain broker-dealers from the Advisers Act harms investors, so too we do not believe that proposed rule 202(a)(11)–1(a) would result in investor harm. In addition, we have enhanced the proposed rule's disclosure requirements, and these would, at a minimum, put broker-dealer customers on inquiry as to the nature of the account.[132]

2. Discretionary Accounts

a. Benefits

Under proposed rule 202(a)(11)–1(b), broker-dealers providing discretionary investment advice would not be able to rely on the broker-dealer exception under the Advisers Act, and would be subject to the Act with respect to their discretionary accounts. Proposed rule 202(a)(11)–1(b) would benefit investors to the extent they are confused as to the nature of discretionary brokerage. As previously noted, in many respects discretionary brokerage relationships are difficult to distinguish from investment advisory relationships.[133] By definitively treating such accounts as advisory accounts, the proposed rule would promote understanding by investors of the nature of the service they are receiving. More importantly, we believe that it may ensure that accounts that have the supervisory or managerial character we have identified as warranting Advisers Act coverage are, in fact, covered.

b. Costs

Proposed rule 202(a)(11)–1(b) would entail costs for broker-dealers that maintain discretionary accounts, in the form of Advisers Act compliance costs for these accounts. These costs would be lower for dually-registered broker-dealers that have already established a compliance infrastructure under the Advisers Act (or that could shift affected accounts to an affiliated investment adviser), and would be higher for broker-dealers that would have to become newly-registered under the Advisers Act. Because these costs of compliance and registration would vary from firm to firm depending on its size and complexity, these costs are difficult to quantify.

For broker-dealers already dually-registered as investment advisers, the proposed rule would result in costs to treat discretionary accounts as advisory accounts. Based on staff experience, we believe that many dual registrants currently treat discretionary accounts as advisory accounts, and would be in compliance with the proposed rule without further action. To the extent that other dually-registered broker-dealers would be required to treat discretionary accounts as advisory accounts, they would incur costs associated with subjecting such accounts to the Advisers Act and its requirements.[134] For example, under the Advisers Act, they would be required to deliver brochures and make other required disclosures with respect to these accounts, and observe principal trading restrictions. Nonetheless, we believe these costs would be mitigated because as advisers, these broker-dealers already have systems in place to satisfy such requirements, and the costs are account-specific. Dually-registered broker dealers converting discretionary accounts may also incur additional documentation costs to execute new account agreements with affected clients.

In many instances, broker-dealers that are not dually registered are affiliated with investment advisers. Based on staff experience, we believe that many of these broker-dealers have refrained from engaging in the discretionary brokerage business, and have instead looked to their advisory affiliates to provide portfolio management to investors seeking this kind of service. Other broker-dealers that have not refrained from accepting discretionary brokerage services could implement the requirements of the proposed rule by shifting these customers to their advisory affiliates. In so doing, they would incur the lesser compliance costs of the types discussed above for dual registrants, rather than the greater costs discussed below for new registrants.

For broker-dealers whose maintenance of discretionary accounts would require them to register as investment advisers for the first time, the proposed rule would result in costs associated with registration under the Advisers Act and compliance with the Act's requirements. Although we acknowledge that the costs of registration and compliance under the Advisers Act are significant,[135] we believe that such costs would be mitigated by the fact that these firms could build upon the infrastructure they already have in place as broker-dealers, much of which overlaps with Advisers Act requirements. For example, these broker-dealers are already subject to rules requiring designation of a chief compliance officer, establishment and maintenance of written compliance procedures, maintenance of books and records, and oversight of employee personal securities trading.[136] These broker-dealers will ordinarily also be in compliance with the adviser custody rule.[137]

In addition, the number of broker-dealers that would be required to register as investment advisers as a result of the proposed rule should be small. Based on information submitted by broker-dealers on Form BD, approximately 40 percent of all broker-dealer firms engage exclusively in specialized types of broker-dealer activities that are extremely unlikely to involve discretionary customer accounts.[138] Although approximately

[131] As we discuss *supra* in notes 52—54 and accompanying text, broker-dealers are subject to their own obligations to disclose conflicts, and are subject to an extensive investor protection regime.

[132] *See supra* note 129.

[133] Indeed, it is in part this potential for confusion that counsels us to exclude discretionary accounts from the exception in proposed rule 202(a)(11)–1(a), above.

[134] As discussed below, there are approximately 900 dually-registered broker-dealers that engage in types of broker-dealer activities that might involve discretionary accounts. We do not collect data from broker-dealers on whether or how they maintain discretionary accounts for their customers, so we cannot estimate how many of these dual registrants would be affected by the proposed rule. The staff interpretations on which broker-dealers have relied to hold discretionary accounts not subject to the Advisers Act apply only to broker-dealers who hold a limited number of such accounts. To the extent that broker-dealers have limited their acceptance of discretionary accounts accordingly, there would be a correspondingly limited impact on broker-dealers if we adopt the proposed rule.

[135] As discussed above in Section V.B.1.a. of this Release, these costs include preparing and submitting Part 1 of Form ADV, the adviser registration form; preparing and distributing client disclosures under Part II of Form ADV; modifying their compliance programs to address the Advisers Act and its requirements, and establishing adviser codes of ethics.

[136] 136 *See, e.g.* NASD Conduct Rule 3013 (chief compliance officer); NASD Conduct Rule 3010(b) (compliance procedures); NASD Conduct Rule 3050 (personal trading); NASD Conduct Rule 3110 (books and records). *See also* Exchange Act rule 17a–3 [17 CFR 240.17a–3] (records to be maintained by brokers and dealers); Exchange Act rule 17a–4 [17 CFR 240.17a–4] (records to be preserved by brokers and dealers); Exchange Act rule 17a–7 [17 CFR 240.17a–7] (records of non-resident brokers and dealers); New York Stock Exchange Rule 342 (personal trading).

[137] Rule 206(4)–2. *See Custody of Funds or Securities of Clients by Investment Advisers,* Investment Advisers Act Rel. No. 2176 (Sept. 25, 2003) [68 F.R. 56692 (Oct. 1, 2003)] at n.23 and n.49, and accompanying text.

[138] These estimates are based on information reported on Form BD by broker-dealers whose registrations had been approved by the Commission as of December 15, 2004.

3,850 remaining broker-dealers engage in types of broker-dealer activities that might involve discretionary accounts, approximately 900 of these firms are already dually-registered as investment advisers, leaving a pool of 2,950 broker-dealers that are not registered advisers. Based on its experience, the staff believes it is rare for a broker-dealer that is not also dually-registered as an investment adviser to accept discretionary accounts, and the staff estimates that no more than five to ten percent of these 2,950 broker-dealers (or approximately 145–290 firms) maintain discretionary accounts.[139] We expect that several of these firms could convert all their discretionary accounts to nondiscretionary accounts, thereby avoiding the obligation to register under the Act.[140] We further estimate that one-third of these 145–290 firms that are not dually-registered have affiliations with investment advisers,[141] and would transfer these accounts to their advisory affiliates.[142]

3. Interpretation of ''Solely Incidental''

The Commission is also reviewing the application of the ''solely incidental to'' requirement of section 202(a)(11)(C) of the Advisers Act to certain broker-dealer practices in three additional areas, as discussed below:

a. Holding Out as an Investment Adviser

In the Proposing Release we expressed concern that many broker-dealers offering fee-based brokerage accounts marketed them heavily based on the advisory services provided rather than securities transaction services, and we expressed concern about whether investors would perceive these accounts to be advisory accounts rather than brokerage accounts. As discussed above, proposed rule 202(a)(11)–1(a) is designed to address these concerns by requiring prominent disclosures putting investors on inquiry as to the differences between these types of accounts.

i. Benefits

Some commenters responding to our Proposing Release urged the Commission to formulate an advertising ban for fee-based brokerage accounts, arguing it would benefit investors by eliminating customer confusion as to the nature of these accounts. However, this benefit would be obtained at the cost of prohibiting broker-dealers from marketing themselves based on services they are legally authorized to provide. We believe our proposal to require disclosure with respect to these accounts may be a better way of addressing potential customer confusion.

ii. Costs

As discussed in Section V.B.1.b. of this Release, above, the costs of disclosures for fee-based accounts under proposed rule 202(a)(11)–1(a) would be insignificant. The marketing ban suggested by commenters, however, could effectively prohibit broker-dealers from marketing these accounts in a fashion designed to appeal to interested investors, unless these broker-dealers were willing to treat them as advisory accounts and forego the benefits of the proposed rule as described in Section V.B.1.a. of this Release, above. The cost of being unable to attract new fee-based account customers through marketing, though not readily susceptible to being quantified, could potentially be significant, given the popularity of fee-based accounts as demonstrated by their recent growth.[143]

iii. Holding Out

We also request comments on the potential benefits and costs of applying a ''holding out'' standard to broker-dealers, similar to the one our staff has applied to lawyers and accountants.[144] Would such an approach offer greater benefits by reducing investor confusion as to the differences between advisory accounts and brokerage accounts? Would it impose costs on broker-dealers, by denying them the ability to compete with investment advisers on the basis of various advisory services that broker-dealers otherwise provide to their customers without registering under the Advisers Act?

b. Financial Planning Services

The Commission is also requesting comment whether to interpret financial planning as not solely incidental to brokerage. Because full-service broker-dealers must consider aspects of financial planning when determining that their recommendations are suitable, we are requesting comment whether our interpretation should turn on whether a broker-dealer holds its financial planning or other advisory services out to clients and prospective clients.

i. Benefits

Customers who obtain financial plans from broker-dealers that hold themselves out as financial planners may be confused as to the nature of the financial planning services they receive. The proposed interpretation would clarify to these customers that the financial planning services they receive are governed by the Advisers Act and its rules.

ii. Costs

If we interpret the Advisers Act to require broker-dealers holding themselves out as financial planners to treat preparation of financial plans as an advisory activity, affected broker-dealers would incur costs to comply with the Advisers Act. These costs would be lower for dually-registered broker-dealers that have already established a compliance infrastructure under the Advisers Act (or that could shift affected accounts to an affiliated investment adviser), and would be higher for broker-dealers that would have to become newly-registered under the Advisers Act. Because the costs of compliance and registration vary from firm to firm depending on its size and complexity, these costs are difficult to quantify.

To the extent that dually-registered broker-dealers would be required to treat financial planning as an advisory activity,[145] they would incur costs

[139] 139 We do not collect data from these broker-dealer firms specifically addressing whether they maintain discretionary accounts.

[140] We expect that the discretionary basis of these accounts has been a matter of convenience for the account customers, but that in the future, the broker-dealer and the customer would agree that the broker-dealer will obtain customer approvals before effecting transactions for these accounts. These broker-dealers would incur limited costs to contact these customers and, if necessary, change their account agreements from discretionary ones to nondiscretionary ones.

[141] 141 For the group of 2,950 broker-dealers, approximately one-third currently report on Form BD that they are affiliated with an investment advisory organization. For purposes of this estimate, we infer that the same one-third affiliation rate will apply in the case of the 145–290 broker-dealers that we estimate accept discretionary accounts.

[142] 142 For these firms that transfer their discretionary accounts to advisory affiliates, costs would be similar to those faced by dual registrants in converting discretionary accounts from brokerage accounts to advisory accounts.

For Paperwork Reduction Act purposes, we have estimated that 220 broker-dealers that are not dually-registered have discretionary brokerage accounts. This is approximately the midpoint of the range discussed above. We have further estimated that 50 of these firms would convert all their discretionary brokerage accounts to nondiscretionary accounts; that 75 firms would transfer all their discretionary accounts to existing advisory affiliates; and that the remaining 95 firms would register under the Advisers Act. We have requested comments on our assumptions in reaching this estimate. *See infra* 162—166, and accompanying text.

[143] *See supra* note 123.

[144] *See supra* note 110, and accompanying text.

[145] Approximately 320 dually-registered broker-dealers report on their Form ADVs that they provide financial planning services. This represents approximately one-third of all dually-registered broker-dealers. We do not collect data that would allow us to determine how many of these 320 broker-dealers actually hold themselves out as financial planners.

associated with subjecting such activities to the Advisers Act and its requirements (similar to the costs to dual registrants of our discretionary accounts proposal, as discussed in Section V.B.2.b. of this Release, above). For example, under the Advisers Act, they would be required to deliver brochures and make other required disclosures with respect to financial planning clients, and observe principal trading restrictions. Nonetheless, we believe these costs would be mitigated because as advisers, these broker-dealers already have systems in place to satisfy such requirements, and the costs are account-specific. These dually-registered broker dealers may also incur additional documentation costs to execute new account agreements with financial planning clients.

In many instances, broker-dealers that are not dually registered are affiliated with investment advisers, as discussed above. These broker-dealers could shift financial planning clients to their advisory affiliates. In so doing, they would incur the lesser compliance costs of the types discussed above for dual registrants, rather than the greater costs discussed below for new registrants.

For broker-dealers whose financial planning activities would require them to register as investment advisers for the first time, the proposed rule would result in costs associated with registration under the Advisers Act and compliance with the Act's requirements. Although we acknowledge (as discussed above in connection with discretionary accounts) that the costs of registration and compliance under the Advisers Act are significant,[146] we believe that such costs would be mitigated by the fact that these firms could build upon the infrastructure they already have in place as broker-dealers, much of which overlaps with Advisers Act requirements. For example, these broker-dealers are already subject to rules requiring designation of a chief compliance officer, establishment and maintenance of written compliance procedures, maintenance of books and records, and oversight of employee personal securities trading.[147] These broker-dealers will ordinarily also be in compliance with the adviser custody rule.[148]

We do not collect data from broker-dealers describing whether they hold themselves out as financial planners, so it is difficult to estimate the extent to which broker-dealers would be required to register under the proposed interpretation. Based on information submitted by broker-dealers on Form BD, approximately 40 percent of all broker-dealer firms engage exclusively in specialized types of broker-dealer activities that are extremely unlikely to involve any financial planning activities.[149] Of the approximately 3,850 remaining broker-dealers that engage in types of broker-dealer activities that might involve financial planning, approximately 900 are already dually-registered as investment advisers, and approximately 1,000 others are affiliated with investment advisers and could shift financial planning clients to the affiliates instead of registering. We do not collect data that would allow us to determine how many of the remaining 1,950 broker-dealers hold themselves out as financial planners. As discussed above, among dually-registered broker-dealers, only one-third report providing financial planning services (although this does not necessarily mean that they also hold themselves out as financial planners).[150] Applying the same ratio to these remaining 1,950 broker-dealers would yield 650 firms, but it seems likely the ratio would be significantly lower for firms that are not dual registrants, and even lower for those that hold themselves out as financial planners. Further, it seems likely some portion of these broker-dealers would find that the costs of registration outweigh the benefits to the firm of holding themselves out as financial planners, and would cease doing so.[151]

c. Wrap Fee Sponsorship

We are proposing to re-affirm our current interpretation regarding wrap program sponsorship. Since this would not change existing obligations or relationships, no new costs or benefits would result.

C. Request for Comment

The Commission requests comments on the costs and benefits identified in this release.

- Are there other costs or benefits that may result from the proposed rule and interpretation?

We request commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits. In particular, we request data regarding the following:

- How many broker-dealers would be required to register under the Advisers Act absent proposed rule 202(a)(11)–1(a)? How many would not face new registration obligations, but would be required (absent proposed rule 202(a)(11)–1(a)) to begin treating these accounts as advisory accounts, or arrange for brokerage accounts to be shifted to advisory affiliates to be handled under the Advisers Act? What amount of costs would each of these different groups of broker-dealers incur?
- What is the value of the benefits we have identified under proposed rule 202(a)(11)–1(a) for investors, including better alignment between their interests and the interests of their broker-dealers and greater choice in paying for brokerage services? What is the value of liquidity that would be made available in the securities markets if the principal trading restrictions of the Advisers Act did not apply to fee-based accounts under rule 202(a)(11)–1(a)?
- What proportion of broker-dealers currently treat their discretionary accounts as advisory accounts? How many broker-dealers would be required to register under the Advisers Act as a consequence of proposed rule 202(a)(11)–1(b)? How many would not face new registration obligations, but would be required to begin treating these accounts as advisory accounts, or arrange for brokerage accounts to be shifted to advisory affiliates to be handled under the Advisers Act? In preparing our estimates of the number of broker-dealers that would be affected by proposed rule 202(a)(11)–1(b), have we drawn appropriate inferences from the limited data available to us? What amount of costs would each of these different groups of broker-dealers incur?
- What proportion of broker-dealers that currently hold themselves out as financial planners treat financial planning as an advisory activity? How many would be required to register as a consequence of the proposed financial planning interpretation? How many would not face new registration obligations, but would be required to begin treating these accounts as advisory accounts, or arrange for

[146] As discussed in Section V.B.2.b. of this Release, *supra,* these costs include preparing and submitting Part 1 of Form ADV, the adviser registration form; preparing and distributing client disclosures under Part II of Form ADV; modifying their compliance programs to address the Advisers Act and its requirements, and establishing adviser codes of ethics.

[147] *See supra* note 136.

[148] *See supra* note 137.

[149] *See supra* note 138.

[150] *See supra* note 145.

[151] For Paperwork Reduction Act purposes, we have estimated that 100 broker-dealers would register, and requested comment on our assumptions in reaching this estimate. The estimate is based on assumptions that approximately ten percent of the 1,950 broker-dealers (or 195) currently hold themselves out as financial planners, and that approximately half of the 195 would choose to stop holding themselves out rather than register under the Advisers Act. *See infra* notes 167–168, and accompanying text.

brokerage accounts to be shifted to advisory affiliates to be handled under the Advisers Act? In preparing our estimates of the number of broker-dealers that would be affected by the proposed interpretation, have we drawn appropriate inferences from the limited data available to us? What amount of costs would each of these different groups of broker-dealers incur?

VI. Effects on Competition, Efficiency and Capital Formation

Section 202(c) of the Advisers Act mandates that the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[152]

A. Fee-Based and Discount Brokerage Programs

Proposed rule 202(11)(a)–1(a) would provide that a broker-dealer providing nondiscretionary advice that is incidental to its brokerage services can retain its exception from the Advisers Act regardless of whether it charges an asset-based or fixed fee (rather than commissions, mark-ups, or mark-downs) for its services. The proposed rule would also provide that broker-dealers are not subject to the Act solely because in addition to offering full-service brokerage they offer discount brokerage services, including execution-only brokerage, for reduced commission rates.[153]

Proposed rule 202(11)(a)–1(a) is not expected to negatively affect competition. Many commenters addressing our Proposing Release raised concerns that the proposed rule would grant broker-dealers who give investment advice without registering under the Advisers Act a competitive advantage over investment advisers subject to the Advisers Act. However, as discussed in Section II.A.1. of this Release, above, broker-dealers have historically provided advisory services to their brokerage customers. As discussed in Section II.A.2 of this Release, above, broker-dealers do so subject to the cost implications of compliance with broker-dealer regulation. Because the proposed rule would not change the types of advice broker-dealers may provide (which advice must continue to be solely incidental to brokerage) or materially change their compliance costs, it is not expected not create a competitive advantage.

Proposed rule 202(a)(11)–1(a) could increase efficiency by removing impediments to fee-based brokerage programs. Fee-based brokerage programs, as we discuss above, respond to changes in the market place for retail brokerage, and concerns that we have long held about the incentives that commission-based compensation provides for broker-dealers to churn accounts, recommend unsuitable securities, and engage in aggressive marketing.[154] The availability of fee-based brokerage programs may better align the interests of broker-dealers and their customers. The availability of fee-based and discount brokerage programs should also enable brokerage customers to choose these new programs when they represent a more efficient alternative than commission-based brokerage.

If proposed rule 202(a)(11)–1(a) has any affect on capital formation, it would be indirect, and positive. By removing impediments to fee-based and discount brokerage programs which may be more desirable for customers than commission-based programs, the proposed rule may open the door to greater investor participation in the securities markets.

B. Discretionary Brokerage and Financial Planning

Proposed rule 202(a)(11)–1(b) would specify that broker-dealers exercising investment discretion over customer accounts are not providing advice that is solely incidental to their business as a brokers or dealers. The Commission is also proposing an interpretation under which broker-dealers holding themselves out as financial planners would not be considered to be providing advice that is solely incidental to brokerage. Thus, broker-dealers providing discretionary brokerage or holding themselves out as financial planners would not be eligible for the Advisers Act broker-dealer exception with respect to these activities, and would be subject to the Act and its requirements for them.

The proposed rule and interpretation would not negatively affect competition. Some broker-dealers would be required to begin treating discretionary or financial planning customers as clients under the Advisers Act. However, as discussed above, we believe the majority of broker-dealers already apply the Advisers Act to these relationships, so we expect the effects of the proposed rule and interpretation will not be widespread.[155] If the proposed rule and interpretation were adopted and remaining firms began applying the Advisers Act to these relationships as a result, they would be competing on a more even footing with broker-dealers who already do so. We do not believe the proposed rule and interpretation would have any effect on efficiency or capital formation.

VII. Paperwork Reduction Act

Proposed rule 202(a)(11)–1(a) contains ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995.[156] The title of this new collection is ''Rule 202(a)(11)–1 under the Investment Advisers Act of 1940—Certain Broker-Dealers Deemed Not To Be Investment Advisers,'' and the Commission has submitted it to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. OMB has approved, and subsequently extended, this collection under control number 3235–0532 (expiring on October 31, 2006).

Additionally, rule 202(a)(11)–1(b) would have the effect of requiring certain broker-dealers providing discretionary brokerage to register under the Advisers Act. The Commission's proposed interpretation of section 202(a)(11)(C) of the Advisers Act would also have the effect of requiring certain broker-dealers to register under the Advisers Act if they hold themselves out as financial planners. The proposed rule and interpretation would therefore increase the number of respondents under several existing collections of information, and, correspondingly, increase the annual aggregate burden under those existing collections of information. The Commission is submitting to OMB, in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11, the existing collections of information for which the annual aggregate burden would likely increase as a result of proposed rule 202(a)(11)–1(b) and the proposed interpretation. The titles of the affected collections of information are: ''Form ADV,'' ''Form ADV–W and Rule 203–2,'' ''Rule 203–3 and Form ADV–H,'' ''Form ADV–NR,'' ''Rule 204–2,'' ''Rule 204–3,'' ''Rule 204A–1,'' ''Rule 206(4)–3,'' ''Rule 206(4)–4,'' ''Rule 206(4)–6,'' and ''Rule 206(4)–7,'' all under the Advisers Act. The existing rules that would be affected by

[152] 15 U.S.C. 80b–2(c).

[153] Rule 202(a)(11)–1(c) further provides that a registered broker-dealer is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subjects it to the Advisers Act.

[154] *See supra* notes 13–16 and accompanying text.

[155] *See supra* Sections V.B.2.b and V.B.3.b.ii. of this Release.

[156] 44 U.S.C. 3501 to 3520.

proposed rule 202(a)(11)–1(b) and the proposed interpretation contain currently approved collection of information numbers under OMB control numbers 3235–0049, 3235–0313, 3235–0538, 3235–0240, 3235–0278, 3235–0047, 3235–0596, 3253–0242, 3235–0345, 3235–0571 and 3235–0585, respectively.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

A. Certain Broker-Dealers Deemed Not To Be Investment Advisers

Under proposed rule 202(a)(11)–1(a), broker-dealers would be deemed not to be ''investment advisers'' as defined in the Advisers Act with respect to certain accounts. With respect to these accounts, such broker-dealers would not be subject to the provisions of the Advisers Act, including the various registration, disclosure and recordkeeping requirements under the Act. Under proposed rule 202(a)(11)–1(a), a broker-dealer would not be deemed to be an investment adviser with respect to an account for which it receives special compensation, provided that: (i) It does not exercise investment discretion over the account, (ii) its investment advice is solely incidental to the brokerage services provided to the account, and (iii) it makes certain disclosures in its advertising and agreements for such accounts.

In the Proposing Release, we noted that broker-dealers taking advantage of the proposed exception would need to maintain certain records that establish their eligibility to do so, but that rules under the Exchange Act already require the maintenance of those records.[157] Therefore, we concluded that this facet of the proposed exception would not increase the recordkeeping burden for any broker-dealer.

To rely on the proposed rule with respect to a particular brokerage account, advertisements [158] and contracts or agreements for the account would be required to contain a disclosure, including a prominent statement that the account in question is a brokerage account, not an advisory account. This disclosure must explain that the customer's rights and the firm's duties and obligations to the customer, including the scope of the firm's fiduciary obligations, may differ. The firm would also be required to identify an appropriate person at the firm with whom the customer can discuss the differences.[159] This information is necessary to prevent customers and prospective customers from mistakenly believing that the account is an advisory account subject to the Advisers Act, and will be used to assist customers in making an informed decision on whether to establish an account. The collection of information requirement under the proposed rule is mandatory. In general, the information collected pursuant to the proposed rule would be held by the broker-dealers. Staff of the Commission, self-regulatory organizations, and other securities regulatory authorities would gain possession of the information only upon request. Any collected information received by the Commission would be kept confidential subject to the provisions of the Freedom of Information Act [5 U.S.C. 552].

The burden to comply with this provision of the proposed rule would be insignificant. In preparing model contracts and advertisements, for example, compliance officials would be required to verify that the appropriate disclosure is made. In the Proposing Release, we estimated that the average annual burden for ensuring compliance is five minutes per broker-dealer taking advantage of the proposed rule.[160] We estimated that if all of the approximately 8,100 broker-dealers registered with us took advantage of the rule, the total estimated annual burden would be 673 hours.[161] As proposed in 1999, the rule only required a prominent statement that the account is a brokerage account. The rule we are proposing today modifies this provision to require that the prominent statement also indicate that the account is not an advisory account; that the firm's obligations with respect to such accounts may differ; and that, as a consequence, the customer's rights and the firm's duties and obligations to the customer, including the scope of the firm's fiduciary obligations, may differ. The firm would also be required to identify an appropriate person at the firm with whom the customer can discuss the differences. However, this modified disclosure will not increase the estimated paperwork burden for this collection.

B. Broker-Dealers Providing Discretionary Advice or Financial Plans

As discussed above, under proposed rule 202(a)(11)–1(b), broker-dealers providing discretionary advice will be deemed advisers subject to the Advisers Act for their discretionary accounts. Broker-dealers holding themselves out as financial planners would, under the Commission's proposed interpretation of section 202(a)(11)(C) of the Advisers Act, be deemed advisers subject to the Advisers Act with respect to their financial planning clients. This proposed rule and proposed interpretation would therefore increase the number of respondents under the existing collections of information identified above, and, correspondingly, increase the annual aggregate burden under those existing collections of information. All of these collections of information are mandatory, and respondents in each case are investment advisers registered with us, except that (i) respondents to Form ADV are also investment advisers applying for registration with us; (ii) respondents to Form ADV–NR are non-resident general partners or managing agents of registered advisers; (iii) respondents to rule 204A–1 include ''access persons'' of an adviser registered with us, who must submit reports of their personal trading to their advisory firms; (iv) respondents to rule 206(4)–3 are advisers who pay cash fees to persons who solicit clients for the adviser; (v) respondents to rule 206(4)–4 are advisers with certain disciplinary histories or a financial condition that is reasonably likely to affect contractual commitments; and (vi) respondents to rule 206(4)–6 are only those SEC-registered advisers that vote their clients' securities. Unless otherwise noted below, responses are not kept confidential.

We cannot quantify with precision the number of broker-dealers that will be new registrants with the Commission under the Advisers Act if proposed rule 202(a)(11)–1(b) is adopted. Based on information submitted by broker-dealers on Form BD, approximately 40 percent of all broker-dealer firms engage exclusively in specialized types of broker-dealer activities that are extremely unlikely to involve

[157] *See* Proposing Release at Section IV. Specifically, the proposed rule would limit its application to accounts over which a broker-dealer does not exercise investment discretion. Proposed rule 202(a)(11)–1(a)(1)(i). The proposed rule would also require a prominent statement be made in agreements governing the accounts to which the rule applies. Rule 202(a)(11)–1(a)(1)(ii). Under Exchange Act rules, broker-dealers are already required to maintain all ''evidence of the granting of discretionary authority given in any respect of any account'' [17 CFR 240.17a–4(b)(6)] and all ''written agreements * * * with respect to any account'' [17 CFR 240.17a–4(b)(7)].

[158] As discussed in the Proposing Release, broker-dealers already are required to maintain records regarding their advertisements under existing self-regulatory organizations' rules.

[159] Rule 202(a)(11)–1(a)(1)(iii).

[160] *See* Proposing Release.

[161] 0.083 hours × 8,100 broker-dealers = 673 hours.

discretionary customer accounts.[162] Although approximately 3,850 remaining broker-dealers engage in types of broker-dealer activities that might involve discretionary accounts, approximately 900 of these firms are already dually-registered as investment advisers, leaving a pool of 2,950 broker-dealers. Based on its experience, staff believes it is rare for a broker-dealer that is not also dually-registered as an investment adviser to accept discretionary accounts, and staff estimates that no more than five to ten percent of these 2,950 broker-dealers (or approximately 145–295 firms) maintain discretionary accounts.[163] Of those 220 broker-dealers (which is the midpoint of the range), we estimate approximately 50 will have so few discretionary accounts that they will make a business decision to cease to offer them and transform existing accounts into nondiscretionary accounts to avoid having to register under the Act.[164] We further estimate that one-third of these 220 broker-dealers, or 75 firms, will transfer their discretionary accounts to existing investment advisory affiliates.[165] Thus, for purpose of this analysis, we have estimated 95 new firms would be required to register with the SEC as investment advisers as a result of proposed rule 202(a)(11)–1(b).[166]

In addition, we cannot quantify with precision the number of broker-dealers that would be new registrants with the Commission under the Advisers Act if the Commission adopts its proposed interpretation of section 202(a)(11)(C) of the Advisers Act concerning broker-dealers that hold themselves out as financial planners. Based on information submitted by broker-dealers on Form BD, approximately 40 percent of all broker-dealer firms engage exclusively in specialized types of broker-dealer activities that are extremely unlikely to involve any financial planning activities.[167] Of the approximately 3,850 remaining broker-dealers that engage in types of broker-dealer activities that might involve financial planning, approximately 900 are already dually-registered as investment advisers, and approximately 1,000 others are affiliated with investment advisers and could shift financial planning clients to the affiliates instead of registering. We do not collect data that would allow us to determine how many of the remaining 1,950 broker-dealers hold themselves out as financial planners. For purposes of the following analysis, we estimate that 10 percent of these firms, or 195 broker-dealers, hold themselves out as financial planners.[168] Further, for purposes of the following analysis, we estimate that approximately half of these 195 broker-dealers would find that the costs of registration outweigh the benefits to the firm of holding themselves out as financial planners, and would cease doing so. Thus, for purposes of this analysis, we have estimated 100 new firms would be required to register with the SEC as investment advisers as a result of the proposed interpretation.

We request comment on the number of broker-dealers that would be subject to the applicable collections of information as a result of proposed rule 202(a)(11)–1(b) and the Commission's proposed interpretation of section 202(a)(11)(C) of the Advisers Act.[169]

1. Form ADV

Form ADV is the investment adviser registration form. The collection of information under Form ADV is necessary to provide advisory clients, prospective clients, and the Commission with information about the adviser, its business, and its conflicts of interest. Rule 203–1 requires every person applying for investment adviser registration with the Commission to file Form ADV. Rule 204–1 requires each SEC-registered adviser to file amendments to Form ADV at least annually, and requires advisers to submit electronic filings through the IARD. This collection of information is found at 17 CFR 275.203–1, 275.204–1, and 279.1. The currently approved collection of information in Form ADV is 102,653 hours.[170] We estimate that 195 new respondents will file one complete Form ADV and one amendment annually, and comply with Form ADV requirements relating to delivery of the adviser code of ethics. Accordingly, we estimate the proposed rule and interpretation would increase the annual aggregate information collection burden under Form ADV by 5,840 hours[171] for a total of 108,493 hours.

2. Form ADV–W and Rule 203–2

Rule 203–2 requires every person withdrawing from investment adviser registration with the Commission to file Form ADV–W. The collection of information is necessary to apprise the Commission of advisers who are no longer operating as registered advisers. This collection of information is found at 17 CFR 275.203–2 and 17 CFR 279.2. The currently approved collection of information in Form ADV–W is 578 hours. We estimate that the 195 broker-dealer/advisers that would be new registrants will withdraw from SEC registration at a rate of approximately 16 percent per year, the same rate as other registered advisers, and will file for partial and full withdrawals at the same rates as other registered advisers, with approximately half of the filings being full withdrawals and half being partial withdrawals. Accordingly, we estimate the proposed rule and interpretation would increase the annual aggregate information collection burden under

[162] These estimates are based on information reported on Form BD by broker-dealers whose registrations had been approved by the Commission as of December 15, 2004.

[163] We do not collect data from these broker-dealer firms specifically addressing whether they maintain discretionary accounts.

[164] We expect that the discretionary basis of these accounts has been a matter of convenience for the account customers, but that on a going-forward basis, the broker-dealer and the customer will agree that the broker-dealer will obtain customer approvals before effecting transactions for these accounts.

[165] For the group of 2,950 broker-dealers that might potentially maintain discretionary accounts subjecting them to adviser registration under the rule, approximately one-third currently report on Form BD that they are affiliated with an investment advisory organization. For purposes of this estimate, we infer that the same one-third affiliation rate will apply in the case of the 145–295 broker-dealers that we estimate accept discretionary accounts.

[166] 220 broker-dealers − 50 converting to nondiscretionary accounts − 75 transferring discretionary accounts to existing investment adviser affiliates = 95 broker-dealers.

[167] *See supra* note 162.

[168] Among dually-registered broker-dealers, only one-third report providing financial planning services (although this does not necessarily mean that they also hold themselves out as financial planners). *See supra* note 145. Applying the same ratio to these remaining 1,950 broker-dealers would yield 650 firms, but it seems likely the ratio would be significantly lower for firms that are not dual registrants, and even lower for those that hold themselves out as financial planners. Accordingly, for this analysis, we estimate that 10 percent of these 1,950 broker-dealers hold themselves out as financial planners.

[169] For purposes of the following analyses, we have assumed that all 195 of these broker-dealers will register with the Commission. However, some may be ineligible to register with us as a result of section 203A of the Advisers Act [15 U.S.C. 80b–3A], which generally prohibits investment advisers from registering with the Commission unless they have at least $25 million of client assets under management. We request public comment on how many of these broker-dealers will be ineligible to register with the Commission.

[170] We have previously submitted to OMB a request to increase the number of respondents to this collection. *See Registration Under the Advisers Act of Certain Hedge Fund Advisers,* Investment Advisers Act Release No. 2333 (Dec. 2, 2004) [69 FR 72,054 (Dec. 10, 2004)]. OMB has not yet approved this request.

[171] 195 filings of the complete form at 22.25 hours each, plus 195 amendments at 0.75 hours each, plus 6.7 hours for each of the 195 broker-dealer/advisers to deliver copies of their codes of ethics to 10 percent of their 670 clients annually who request it, at 0.1 hours per response. $(195 \times 22.25) + (195 \times 0.75) + (195 \times (670 \times 0.1) \times 0.1) = 5,840$.

Form ADV–W and rule 203–2 by 16 hours [172] for a total of 594 hours.

3. Rule 203–3 and Form ADV–H

Rule 203–3 requires that advisers requesting either a temporary or continuing hardship exemption submit the request on Form ADV–H. An adviser requesting a temporary hardship exemption is required to file Form ADV–H, providing a brief explanation of the nature and extent of the temporary technical difficulties preventing it from submitting a required filing electronically. Form ADV–H requires an adviser requesting a continuing hardship exemption to indicate the reasons the adviser is unable to submit electronic filings without undue burden and expense. Continuing hardship exemptions are available only to advisers that are small entities. The collection of information is necessary to provide the Commission with information about the basis of the adviser's hardship. This collection of information is found at 17 CFR 275.203–3, and 279.3. The currently approved collection of information in Form ADV–H is 11 hours. We estimate that approximately one broker-dealer/adviser among the new registrants would file for a temporary hardship exemption and one would file for a continuing exception. Accordingly, we estimate the proposed rule and interpretation would increase the annual aggregate information collection burden under Form ADV-H and rule 203–3 by 2 hours [173] for a total of 13 hours.

4. Form ADV–NR

Non-resident general partners or managing agents of SEC-registered investment advisers must make a one-time filing of Form ADV–NR with the Commission. Form ADV–NR requires these non-resident general partners or managing agents to furnish us with a written irrevocable consent and power of attorney that designates the Commission as an agent for service of process, and that stipulates and agrees that any civil suit or action against such person may be commenced by service of process on the Commission. The collection of information is necessary for us to obtain appropriate consent to permit the Commission and other parties to bring actions against non-resident partners or agents for violations of the federal securities laws. This collection of information is found at 17 CFR 279.4. The currently approved collection of information in Form ADV–NR is 17 hours. We estimate that approximately one broker-dealer/adviser among the new registrants would make this filing. Accordingly, we estimate the proposed rule and interpretation would increase the annual aggregate information collection burden under Form ADV–NR by one hour [174] for a total of 18 hours.

5. Rule 204–2

Rule 204–2 requires SEC-registered investment advisers to maintain copies of certain books and records relating to their advisory business. The collection of information under rule 204–2 is necessary for the Commission staff to use in its examination and oversight program. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential.[175] The records that an adviser must keep in accordance with rule 204–2 must generally be retained for not less than five years.[176] This collection of information is found at 17 CFR 275.204–2. The currently approved collection of information for rule 204–2 is 1,724,870 hours, or 191.78 hours per registered adviser. We estimate that all 195 broker-dealer/advisers that would be new registrants would maintain copies of records under the requirements of rule 204–2. Accordingly, we estimate the proposed rule and interpretation would increase the annual aggregate information collection burden under rule 204–2 by 37,397 hours [177] for a total of 1,762,267 hours.

6. Rule 204–3

Rule 204–3, the ''brochure rule,'' requires an investment adviser to deliver to prospective clients a disclosure statement containing specified information as to the business practices and background of the adviser. Rule 204–3 also requires that an investment adviser deliver, or offer, its brochure on an annual basis to existing clients in order to provide them with current information about the adviser. The collection of information is necessary to assist clients in determining whether to retain, or continue employing, the adviser. This collection of information is found at 17 CFR 275.204–3. The currently approved collection of information for rule 204–3 is 6,089,293 hours, or 694 hours per registered adviser, assuming each adviser has on average 670 clients. We estimate that all 195 broker-dealer/advisers that would be new registrants will provide brochures as required by rule 204–3. Accordingly, we estimate the proposed rule and interpretation would increase the annual aggregate information collection burden under rule 204–3 by 135,330 hours [178] for a total of 6,224,623 hours. We note that the average number of clients per adviser reflects a small number of advisers who have thousands of clients, while the typical SEC-registered adviser has approximately 76 clients. We request comments on the number of advisory clients of the average broker-dealer registering because the firm maintains discretionary brokerage accounts for customers or holds itself out to its financial planning customers.

7. Rule 204A–1

Rule 204A–1 requires SEC-registered investment advisers to adopt codes of ethics setting forth standards of conduct expected of their advisory personnel and addressing conflicts that arise from personal securities trading by their personnel, and requiring advisers' ''access persons'' to report their personal securities transactions. The collection of information under rule 204A–1 is necessary to establish standards of business conduct for supervised persons of investment advisers and to facilitate investment advisers' efforts to prevent fraudulent personal trading by their supervised persons. This collection of information is found at 17 CFR 275.204A–1. The currently approved collection of information for rule 204A–1 is 1,060,842 hours, or 117.95 hours per registered adviser. We estimate that all 195 broker-dealer/advisers that would be new registrants will adopt codes of ethics under the requirements of rule 204A–1 and require personal securities transaction reporting by their ''access persons.'' Accordingly, we estimate the proposed rule and interpretation would increase the annual aggregate information collection burden under rule 204A–1 by 23,000 hours [179] for a total of 1,083,842 hours.

8. Rule 206(4)–3

Rule 206(4)–3 requires advisers who pay cash fees to persons who solicit clients for the adviser to observe certain procedures in connection with solicitation activity. The collection of

[172] 32 filings (195 × 0.16), consisting of 16 full withdrawals at 0.75 hours each and 16 partial withdrawals at 0.25 hours each. (16 × 0.75) + (16 × 0.25) = 16.

[173] 2 filings at 1 hour each.

[174] 1 filing at 1 hour each.

[175] *See* section 210(b) of the Advisers Act [15 U.S.C. 80b–10(b)].

[176] *See* rule 204–2(e).

[177] 195 broker-dealer/advisers × 191.78 hours per adviser = 37,397 hours.

[178] 195 broker-dealer/advisers × 694 hours per adviser = 135,330.

[179] 195 broker-dealer/advisers × 117.95 hours per adviser annually = 23,000.

information under rule 206(4)–3 is necessary to inform advisory clients about the nature of a solicitor's financial interest in the recommendation of an investment adviser, so the client may consider the solicitor's potential bias, and to protect investors against solicitation activities being carried out in a manner inconsistent with the adviser's fiduciary duties. This collection of information is found at 17 CFR 275.206(4)–3. The currently approved collection of information for rule 206(4)–3 is 12,355 hours. We estimate that approximately 20 percent of the 195 broker-dealer/advisers that would be new registrants would be subject to the cash solicitation rule, the same rate as other registered advisers. Accordingly, we estimate the proposed rule and interpretation would increase the annual aggregate information collection burden under rule 206(4)–3 by 275 hours [180] for a total of 12,630 hours.

9. Rule 206(4)–4

Rule 206(4)–4 requires registered investment advisers to disclose to clients and prospective clients certain disciplinary history or a financial condition that is reasonably likely to affect contractual commitments. This collection of information is necessary for clients and prospective clients in choosing an adviser or continuing to employ an adviser. This collection of information is found at 17 CFR 275.206(4)–4. The currently approved collection of information for rule 206(4)–4 is 11,383 hours. We estimate that approximately 17.3 percent of the 195 broker-dealer/advisers that would be new registrants would be subject to rule 206(4)–4, the same rate as other registered advisers. Accordingly, we estimate the proposed rule and interpretation would increase the annual aggregate information collection burden under rule 206(4)–4 by 255 hours [181] for a total of 11,638 hours.

10. Rule 206(4)–6

Rule 206(4)–6 requires an investment adviser that votes client securities to adopt written policies reasonably designed to ensure that the adviser votes in the best interests of clients, and requires the adviser to disclose to clients information about those policies and procedures. This collection of information is necessary to permit advisory clients to assess their adviser's voting policies and procedures and to monitor the adviser's performance of its voting responsibilities. This collection of information is found at 17 CFR 275.206(4)–6. The currently approved collection of information for rule 206(4)–6 is 119,873 hours. We estimate that all 195 broker-dealer/advisers that would be new registrants would vote their clients' securities. Accordingly, we estimate the proposed rule and interpretation would increase the annual aggregate information collection burden under rule 206(4)–6 by 3,257 hours [182] for a total of 123,130 hours.

11. Rule 206(4)–7

Rule 206(4)–7 requires each registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, review those policies and procedures annually, and designate an individual to serve as chief compliance officer. This collection of information under rule 206(4)–7 is necessary to ensure that investment advisers maintain comprehensive internal programs that promote the advisers' compliance with the Advisers Act. This collection of information is found at 17 CFR 275.206(4)–7. The currently approved collection of information for rule 206(4)–7 is 701,200 hours, or 80 hours annually per registered adviser. We estimate all 195 broker-dealer/advisers that would be new registrants would be required to maintain compliance programs under rule 206(4)–7. Accordingly, we estimate the proposed rule and interpretation would increase the annual aggregate information collection burden under rule 206(4)–7 by 15,600 hours [183] for a total of 716,800 hours.

12. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments with respect to the collections described in Section VII.B. of this Release to:

- Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility;
- Evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information;
- Determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and
- Determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements described in Section VII.B. of this Release should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 3208, Washington, DC 20503, and also should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609 with reference to File No. S7–25–99. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives the comment within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–25–99, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549.

VIII. Initial Regulatory Flexibility Analysis

The Commission has prepared the following Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with section 3(a) of the Regulatory Flexibility Act.[184] It relates to proposed rule 202(a)(11)–1, and to the Commission's proposal to interpret the application of the ''solely incidental to'' requirement of section 202(a)(11)(C) of the Act to certain broker-dealer practices.

A. Need for the Rule and Amendments

Sections I through III of this Release describe the reasons for and objectives of proposed rule 202(a)(11)–1. As discussed in detail above, proposed rule 202(a)(11)–1(a) is designed to permit broker-dealers to offer new types of accounts, which charge asset-based fees for full-service brokerage services or make discounts available for execution services, without unnecessarily triggering regulation under the Advisers

[180] 39 respondents (195 × 0.2) × 7.04 hours annually per respondent = 275.

[181] 34 respondents (195 × 0.173) × 7.5 hours annually per respondent = 255.

[182] We estimate that 195 broker-dealer/advisers would spend 10 hours each annually documenting their voting policies and procedures, and would provide copies of those policies and procedures to 10 percent of their 670 clients annually at 0.1 hours per response. (195 × 10) + 195 × (0.1 × 67) = 3,257.

[183] 195 broker-dealer/advisers at 80 hours per adviser annually = 15,600.

[184] 5 U.S.C. 603(a).

Act. Proposed rule 202(a)(11)–1(b) would subject all discretionary brokerage accounts to the Advisers Act. Under the proposed interpretation, the Commission would not consider broker-dealers holding themselves out as financial planners to be providing advice that is ''solely incidental to'' brokerage; these broker-dealers thus would be subject to the Investment Advisers Act with respect to accounts including a financial plan.

B. Objectives and Legal Basis

Sections II through III of this Release discuss the objectives of the proposed rule and interpretation. As we discuss in detail above, these objectives include fostering the availability of fee-based and discount brokerage programs to brokerage customers and reducing investor confusion as to whether they are receiving brokerage services or advisory services. Section IX of this Release lists the statutory authority for the proposed rule and rule amendments.

C. Small Entities

The proposed rule and interpretation under the Advisers Act would apply to all brokers-dealers registered with the Commission, including small entities. Under Commission rules, for purposes of the Regulatory Flexibility Act, a broker-dealer generally is a small entity if it had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared and it is not affiliated with any person (other than a natural person) that is not a small entity.[185]

The Commission estimates that as of December 31, 2003, approximately 905 Commission-registered broker-dealers were small entities.[186] The Commission assumes for purposes of this IRFA that all of these small entities could rely on the exceptions provided by rule 202(a)(11)–1(a), although it is not clear how many would actually do so. Additionally, it is not clear how many of these small entities would be affected by proposed rule 202(a)(11)–1(b), which provides that discretionary brokerage accounts are not exempt from the Advisers Act, or by the proposed interpretation of section 202(a)(11)(C), which would subject broker-dealers that hold themselves out as financial planners to the Advisers Act with respect to accounts including a financial plan. Therefore, for purposes of this IRFA, the Commission also assumes that all of these small entities could be affected by the proposed rule and interpretation.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The provisions of proposed rule 202(a)(11)–1(a), pertaining to the new types of brokerage accounts, would impose no new reporting or recordkeeping requirements, and would not materially alter the time required for broker-dealers to comply with the Commission's rules. Proposed rule 202(a)(11)–1(a) is designed to prevent unnecessary regulatory burdens from being imposed on broker-dealers. Broker-dealers taking advantage of the proposed rule with respect to fee-based brokerage accounts would be required to make certain disclosures to customers and potential customers in advertising and contractual materials. Under Exchange Act rules, however, broker-dealers are already required to maintain these documents as ''written agreements * * * with respect to any account.''[187]

Under proposed rule 202(a)(11)–1(b), advice provided by a broker-dealer to accounts over which it has investment discretion would be outside the broker-dealer exception from the Advisers Act. Under the proposed interpretation of section 202(a)(11)(C), broker-dealers that hold themselves out as financial planners would be subject to the Advisers Act with respect to financial planning clients. Thus, broker-dealers providing discretionary advice or holding themselves out as financial planners would be subject to the Advisers Act. Although some broker-dealers providing discretionary accounts or holding themselves out as financial planners are already registered as investment advisers, the proposed rule and interpretation would result in other broker-dealers having to newly register as advisers, and would subject these brokers to the reporting, recordkeeping, and other compliance requirements under the Advisers Act.[188] For these broker-dealers, registration under the Advisers Act and compliance with its requirements would constitute new reporting, recordkeeping, and other compliance requirements. For broker-dealers already registered as investment advisers, the proposed rule and interpretation would require that broker-dealers treat affected accounts as advisory accounts. Thus, for these broker-dealers, the proposed rule and interpretation would impose new reporting, recordkeeping, and other compliance requirements with respect to these accounts.

Small entities registered with the Commission as broker-dealers would be subject to these new reporting, recordkeeping, and other compliance requirements to the same extent as larger broker-dealers. In developing these requirements over the years, we have analyzed the extent to which they would have a significant impact on a substantial number of small entities, and included flexibility wherever possible in light of the requirements' objectives, to reduce the corresponding burdens imposed.

E. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate or conflict with the proposed rule or interpretation.

F. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any adverse impact on small entities.[189] In connection with the proposed rule, the Commission considered the following alternatives: (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rule, or any part thereof, for such small entities.

With respect to the first alternative, the Commission presently believes that establishment of differing compliance or reporting requirements or timetables for small entities would be inappropriate in these circumstances. The provision of proposed rule 202(a)(11)–1(a) requiring prominent disclosures to customers and potential customers is designed to

[185] 17 CFR 240.0–10(c).

[186] This estimate is based on the most recent data available, taken from information provided by broker-dealers in Form X–17A–5 Financial and Operational Combined Uniform Single Reports filed pursuant to Section 17 of the Exchange Act and Rule 17a–5 thereunder.

[187] 17 CFR 240.17a–4(b)(7). As previously discussed, although proposed rule 202(a)(11)–1(a) would also limit its application to accounts that a broker-dealer does not exercise investment discretion over, under Exchange Act rules, broker-dealers are already currently required to maintain all ''evidence of the granting of discretionary authority given in any respect of any account.'' 17 CFR 240.17a–4(b)(6). Thus, this provision of the proposed rule would not create an additional recordkeeping requirement for broker-dealers.

[188] For Paperwork Reduction Act purposes, we have estimated that approximately 195 broker-dealers could be required to register as investment advisers as a result of the proposed rule and interpretation. *See supra* Section VII.B. of this Release.

[189] 5 U.S.C. 603(c).

prevent investors from being confused about the nature of the services they are receiving. To specify less prominent disclosures for small entities would only serve to diminish this investor protection to customers of small broker-dealers. Such a course would be inconsistent with the purposes of the Advisers Act. With respect to rule 202(a)(11)–1(b) and the proposed interpretation of section 202(a)(11)(C), the compliance and recordkeeping requirements are those generally applicable to any adviser registered under the Act. In developing these requirements over the years, the Commission has analyzed the extent to which they would have a significant impact on a substantial number of small entities, and included flexibility wherever possible in light of the requirements' objectives, to reduce the corresponding burdens imposed. It would be inconsistent with this design, and contrary to its purpose, to create special rules for small broker-dealers who would be subject to the Act as a result of proposed rule 202(a)(11)–1(b) or the proposed interpretation of section 202(a)(11)(C).

With respect to the second alternative, the Commission presently believes that clarification, consolidation, or simplification of the compliance and recordkeeping requirements under proposed rule 202(a)(11)–1 for small entities unacceptably compromises the investor protections of the rule. As discussed above, the rule's prominent disclosure requirement is designed to prevent investor confusion. We believe this requirement is already adequately clear and simple for those seeking to make use of the rule's exception for fee-based accounts. To further consolidate this requirement would potentially impede our objective of preventing investor confusion. With respect to rule 202(a)(11)–1(b) and the proposed interpretation of section 202(a)(11)(C), clarification, consolidation, or simplification would involve modification of the compliance and recordkeeping requirements generally applicable to registered investment advisers under the Act. As discussed above in connection with the first alternative, the Commission, in developing these requirements over the years, has included as much flexibility as can be introduced in light of the investor protection objectives underlying them.

With respect to the third alternative, the Commission presently believes that the compliance requirements contained in the proposed rule and the proposed interpretation already appropriately use performance standards instead of design standards. The proposed rule and interpretation are crafted to make regulation under the Advisers Act turn on the services offered by a broker-dealer rather than strictly on the type of compensation involved. Thus, eligibility for proposed rule 202(a)(11)–1(a)'s exception hinges on the services offered by the broker-dealer. Likewise, the treatment of discretionary accounts as advisory accounts under proposed rule 202(a)(11)–1(b), as well as the treatment of financial planning under the proposed ''holding out'' interpretation of section 202(a)(11)(C), also focus on the activities offered. The reporting, recordkeeping, and other compliance requirements stemming from these provisions of the proposed rule and interpretation are triggered by the performance of the entity in question, including small businesses.

Finally, with respect to the fourth alternative, the Commission presently believes that exempting small entities would be inappropriate. To the extent proposed rule 202(a)(11)–1(a) eliminates unnecessary regulatory burdens that might otherwise be imposed on broker-dealers, small entities, as well as large entities, will benefit from the rule. Small broker-dealers should be permitted to enjoy this benefit to the same extent as larger broker-dealers. Furthermore, the Commission believes the provisions of proposed rule 202(a)(11)–1(b) concluding that broker-dealers providing discretionary brokerage may not rely on the Adviser Act's broker-dealer exception for those accounts, and the proposed interpretation of section 202(a)(11)(C) that broker-dealers holding themselves out as financial planners may not rely on the exception with respect to accounts that include a financial plan, should apply to small entities to the same extent as larger ones. This proposed provision and interpretation are grounded in the view that such advice is not solely incidental to brokerage. Because the protections of the Advisers Act are intended to apply equally to clients of both large and small advisory firms, it would be inconsistent with the purposes of the Advisers Act to exempt small entities further from the rule.

IX. Statutory Authority

We are proposing rule 202(a)(11)–1 based on our authority set forth in section 202(a)(11)(F) of the Advisers Act, which expressly allows the Commission to except persons—in addition to those already excepted by sections 202(a)(11)(A)–(E)—that the definition of investment adviser was not intended to cover.[190] We are also acting pursuant to section 211(a) of the Advisers Act, which gives us the authority to classify, by rule, persons and matter within our jurisdiction and to prescribe different requirements for different classes of persons, as necessary or appropriate to the exercise of our authority under the Act. Additionally, section 206A of the Advisers Act authorizes us, by rules and regulations, to exempt any person or transaction, or any class or classes of persons or transactions, from any provision or provisions of the Act or of any rule or regulation thereunder, if such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the Act.

Text of Rule

List of Subjects in 17 CFR Part 275

Investment advisers, Reporting and recordkeeping requirements.

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for Part 275 continues to read as follows:

Authority: 15 U.S.C. 80b–2(a)(11)(F), 80b–2(a)(17), 80b–3, 80b–4, 80b–4a, 80b–6(4), 80b–6a, and 80b–11, unless otherwise noted.

* * * * *

2. Section 275.202(a)(11)–1 is added to read as follows:

§ 275.202(a)(11)–1 Certain broker-dealers.

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

(1) Will not be deemed to be an investment adviser based solely on its receipt of special compensation, provided that:

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

[190] Because we are proposing to use our authority under section 202(a)(11)(F), broker-dealers relying on the rule would not be subject to state adviser statutes. Section 203A(b)(1)(B) of the Act provides that ''[n]o law of any State or political subdivision thereof requiring the registration, licensing, or qualification as an investment adviser or supervised person of an investment adviser shall apply to any person * * * that is not registered under [the Advisers Act] *because that person is excepted from the definition of an investment adviser under section 202(a)(11).*'' (emphasis added).

(ii) Any investment advice provided by the broker or dealer with respect to accounts from which it receives special compensation is solely incidental to the brokerage services provided to those accounts; and

(iii) Advertisements for, and contracts, agreements, applications and other forms governing, accounts for which the broker or dealer receives special compensation include a prominent statement that the accounts are brokerage accounts and not advisory accounts; that, as a consequence, the customer's rights and firm's duties and obligations to the customer, including the scope of the firm's fiduciary obligations, may differ; and must identify an appropriate person at the firm with whom the customer can discuss the differences.

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

(b) A broker or dealer that exercises investment discretion, as that term is defined in section 3(a)(35) of the Exchange Act (15 U.S.C. 78c(a)(35)), over customer accounts provides advice that is not solely incidental to the conduct of its business as a broker or dealer within the meaning of section 202(a)(11)(C) of the Advisers Act (15 U.S.C 80b–2(a)(11)(C)).

(c) A broker or dealer registered with the Commission under section 15 of the Exchange Act is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subject the broker or dealer to the Advisers Act.

Dated: January 6, 2005.

By the Commission.

J. Lynn Taylor,

Assistant Secretary.

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