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SEC ADOPTS TEMPORARY RULE EXCLUDING CERTAIN BROKERS FROM THE ADVISERS ACT AND SEEKS COMMENT ON ADOPTION OF PERMANENT RULE

[18397] January 7, 2005 TO: INVESTMENT ADVISERS COMMITTEE No. 1-05 SEC RULES COMMITTEE No. 1-05 RE: SEC ADOPTS TEMPORARY RULE EXCLUDING CERTAIN BROKERS FROM THE ADVISERS ACT AND SEEKS COMMENT ON ADOPTION OF PERMANENT RULE On January 6th, the Securities and Exchange Commission adopted a temporary rule, Rule 202(a)(11)T under the Investment Advisers Act of 1940, to provide an exclusion from the Act for certain broker-dealers.1 In a companion release, the Commission proposed permanent adoption of the temporary rule with certain modifications.2 The Companion Release also seeks comment on an interpretive position the Commission expects to issue relating to when certain broker- dealer advisory services are “solely incidental” to the broker-dealer’s brokerage services for purposes of Section 202(a)(11)(C) of the Advisers Act.3 The temporary rule and the Companion Release are summarized below. Comments on the Companion Release are due to the Commission no later than February 7th. Please provide any comments you have on the proposal to the undersigned no later than Monday, January 24th. Comments may be provided by phone (202-326-5825) or e-mail (tamara@ici.org). 1 See SEC Release Nos. 34-50979 and IA-2339, Certain Broker-Dealers Deemed Not To Be Investment Advisers (Jan. 6, 2005). A copy of the Commission’s Release is available on the Commission’s website at: http://www.sec.gov/rules/final/34-50979.htm. The Commission adopted the Temporary Rule in response to the comments it received on it proposed exclusion from the Advisers Act for certain broker-dealers. See Certain Broker-Dealers Deemed Not to be Investment Advisers SEC Release No. IA-1845 (Nov. 4, 1999) (the “November 1999 Release”). The SEC reopened the comment period on the proposed rule in August 2004. 2 See SEC Release Nos. 34-50980 and IA 2340, Certain Broker-Dealers Deemed Not To Be Investment Advisers (Jan. 6, 2005) (the “Companion Release”). A copy of the Companion Release is available on the Commission’s website at: http://www.sec.gov/rules/proposed/34-50980.pdf. Because the comments the Commission received on its November 1999 Release and its August 2004 reproposal raised issues that extended beyond those contemplated in the proposals, the Commission determined to issue the Companion Release seeking comment on these additional issues prior to finalizing a rule that would make permanent the exclusion provided by the temporary rule. 3 Section 202(a)(11)(C) of the Advisers Act provides an exclusion from the Act for those broker-dealers “whose performance of [advisory] services is solely incidental to the conduct of his

business as a broker or dealer and who receives not special compensation therefor." 2 THE TEMPORARY RULE The temporary rule excludes from the Act a broker-dealer that receives special compensation for providing investment advice to its brokerage customers provided two conditions are met. First, the broker-dealer does not exercise investment discretion over an account from which it receives special compensation. Second, the broker-dealer's investment advice to the account is solely incidental to the brokerage services it provides to the account. The rule clarifies that a broker-dealer will not be deemed to have received special compensation solely because it charges a commission, mark-up, mark-down, or similar fee for brokerage services that differs from one it charges another customer. The temporary rule also clarifies that, if a broker-dealer is registered under both the Securities Exchange Act of 1934 and the Advisers Act, it is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that would subject it to the Advisers Act. As such, a dual registrant can distinguish its brokerage customers from its advisory customers. This temporary rule, which was effective January 6, 2005, will expire on April 15, 2005. THE COMPANION RELEASE The Commission's Companion Release proposes permanent adoption of the temporary rule with certain additional provisions. It also proposes issuance of a statement of interpretive position by the Commission that would clarify when certain broker-dealer advisory services are considered to be "solely incidental" to a broker-dealer's brokerage business. The Proposed Permanent Rule The permanent rule, proposed Rule 202(a)(11)-1, is identical to the temporary rule discussed above with two exceptions. The first difference is that the permanent rule would include, as an additional condition of the exclusion, that advertisements for, and contracts, agreements, applications and other forms governing accounts for which the broker-dealer receives special compensation include a prominent statement that: • The accounts are brokerage accounts and not advisory accounts; • As a consequence of the accounts being brokerage accounts, 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 • Identifies an appropriate person at the firm with whom the customer can discuss the differences between a brokerage account and an advisory account. The second difference is that the permanent rule would add a provision stating that a broker-dealer's exercise of investment discretion over an account constitutes advice that is not solely incidental to the broker-dealer's conduct of its brokerage business.4 As such, under the permanent rule, all discretionary accounts of a broker-dealer would be treated as advisory accounts without regard to the broker-dealer's form of compensation. 4 Both the temporary rule and the proposed permanent rule condition the exclusion on the broker-dealer not exercising investment discretion over accounts for which it receives special compensation. 3 The Proposed Statement of Interpretive Position As mentioned above, Section 202(a)(11)(C) of the Advisers Act conditions a broker- dealer's exclusion from the Act on its advisory services being "solely incidental" to its brokerage services. As such, according to the Companion Release, the meaning of "solely incidental" is "a question of substantial significance to broker-dealers." In response to commenters' request that the Commission provide greater guidance on the meaning of this term, the Commission is considering issuing an interpretive position or incorporating its interpretation of this term in a rule when it acts on proposed Rule 202(a)(11)-1. According to the Companion Release, the Commission understands advice to be "solely incidental" to a broker-dealer's brokerage business "when the advisory services rendered to an account are in connection with and reasonably related to the brokerage services provided to that account."5 The Commission expects that its interpretation would address the application of "solely incidental" to the following common broker-dealer practices: • Holding Out As an Investment Adviser – The Companion Release notes that the Commission has previously expressed concerns with broker-dealers marketing their fee-based brokerage accounts

heavily based on the advisory services provided rather than the securities transaction services. The Commission proposes to address these concerns by requiring in the proposed permanent rule the additional disclosure included in the temporary rule. The Commission seeks comment on whether this disclosure satisfactorily addresses concerns with investor confusion about the nature of an account (brokerage vs. advisory) or whether additional investor protections are warranted (e.g., prohibiting broker- dealer representatives from holding themselves out as financial consultants or financial advisors). • Financial Planning Services – The Companion Release expresses the Commission's concern with broker-dealers promoting financial planning "as a way of acquiring the confidence of customers to promote their brokerage services without actually providing any meaningful financial planning."6 To address these concerns, the Commission proposes to provide in its interpretation that if a broker-dealer holds itself out as a financial planner or as providing financial planning services, it cannot be considered to be giving advice that is solely incidental to its brokerage business. The Commission seeks comment on the appropriateness of this interpretation. • Wrap Fee Sponsorship – Under existing Commission interpretations, although a "wrap fee" arrangement involves the receipt of special compensation, broker- dealers have been able to rely on the exclusion in Section 202(a)(11)(C) of the 5 Companion Release at p. 43. The Companion Release notes that this understanding is consistent with the legislative history of the Advisors Act, "which indicates Congress' intent to exclude broker-dealers providing advice as part of traditional brokerage services." 6 Companion Release at pp. 50-51. The Companion Release notes the Commission's view that most broker-dealers offering financial planning services for a separate fee treat the customers receiving such services as advisory clients. 4 Advisers Act provided, among other things, the portfolio manager and asset allocation services provided by the broker-dealer are solely incidental to the broker-dealer's brokerage business. By contrast, the Commission does not view the asset allocation or portfolio manager selection advice as incidental to the brokerage transactions initiated by the portfolio manager. Also, the Commission views broker-sponsored wrap programs as being subject to the Advisers Act. The Commission seeks comment on whether this interpretation continues to make sense and whether it should be reaffirmed in the interpretive statement. In addition to seeking comment on the meaning of "solely incidental" as applied to the practices described above, the Companion Release seeks comment on whether there are other questions relating to particular advisory services that should be addressed in the Commission's interpretive statement. * * * * Tamara K. Salmon Senior Associate Counsel