January 14, 2000

Mr. Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW, Stop 6-9
Washington, D.C. 20549

Re: Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers; Release Nos. IA-1845, 34-42099; File No. S7-25-99

Dear Secretary Katz:

Please accept this comment letter on behalf of the North American Securities Administrators Association ("NASAA")[1] regarding the above-referenced release (the "Release"). NASAA appreciates the opportunity to comment on the Commission's rule proposal that would permit brokerage firms to charge asset-based fees to their customers without automatically meeting the definition of investment adviser.

The proposed rule addresses important issues affecting both investment advisers and broker-dealers. Historically, payment of "special compensation" to brokerage firms has been the principal factor for determining that broker-dealers need to register under the Investment Advisers Act of 1940 (Advisers Act). Under the rule proposal, if adopted, the benchmark will become a three factor test that is based on whether the broker exercises discretion, the activities for which special compensation is received are solely incidental, and, the broker's advertising of investment advisory services is appropriately limited. As noted in our comments to follow, NASAA supports the Commission's efforts through this rule proposal to permit brokerage firms more flexibility in accommodating their clients' needs while maintaining investor protection through the continued registration of broker dealers as investment advisers under appropriate circumstances.

In this age of merging financial services it is important to recognize the distinction between the roles of investment advisers and broker-dealers that lead states to regulate certain broker-dealers as investment advisers. Broker-dealers generally execute trades while investment advisers render investment advice. However, this distinction is sometimes blurred based on the "bundling" of services provided either by a single individual or by multiple associated parties.

[1] NASAA is the association of the 65 state, provincial and territorial securities regulatory agencies of the United States, Canada and Mexico. NASAA serves as a forum for state regulators to work with each other in an effort to protect investors at the grassroots level and to promote fair and open capital markets.

WRAP FEES

Similar to the asset-based fee arrangements the broker dealer community is now marketing to investors, over the past ten years, broker-dealers have marketed wrap fee programs as an accommodation to their clients. Wrap fee arrangements consolidate the services of a broker-dealer with either an inside or third party investment adviser. In an effort to accommodate asset-based fee arrangements without triggering investment adviser registration requirements, the potential effects of the rule proposal on registration requirements for registered representatives participating in wrap fee arrangements are of significant interest to NASAA.

The states register broker-dealers as investment advisers under wrap fee arrangements for two reasons. First, many states include solicitors in the definition of investment adviser representative. Thus, an individual, including a broker dealer and any participating agents, must register as an investment adviser or as an investment adviser representative respectfully if they solicit or sell advisory services to a client. Second, a broker-dealer meets the definition of investment adviser when it assists a client in evaluating and selecting an investment adviser.

NASAA strongly supports the Commission's stand on maintaining the current treatment of broker dealer sponsored wrap fee accounts as advisory accounts.[2] As the Release points out, although wrap fee sponsors may not have discretionary authority over accounts, the non-discretionary services they provide as part of the wrap fee arrangement could not be viewed as incidental to their brokerage services. Thus, the broker dealer would continue to meet the definition of investment adviser and employees of wrap fee sponsors that participate in wrap fee arrangements would continue to meet the definition of an investment adviser representative. We suggest the Commission, in their adopting release, make very clear that wrap fee arrangements will be treated as advisory accounts because although, as noted above, the text of the proposing release is clear, the concluding sentence in footnote 12 causes significant confusion.

PROPOSED TEST

NASAA supports the Commission's view that a more functional test based on the nature of the services rendered, rather than the form of compensation, needs to be implemented to define when broker-dealers are subject to the Advisers Act. The proposed rule identifies three conditions that must be met in order for fee-based compensation not to be considered "special compensation" that, under the circumstances, would subject a broker-dealer to the Advisers Act. Each of the three conditions - no discretion over accounts from which special compensation is received, only "incidental" advisory activities are provided, and limited advertising - play a role in formulating what expectations investors may have regarding their relationship with broker dealers. In order to provide clearer

[2] *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release No. 34-42099, IA-1845, November 4, 1999. Release p. 5, "[u]nder the proposed rule, broker-dealer sponsors of wrap fee programs would continue to treat wrap fee accounts as advisory accounts."

guidance to the regulated community in this area, NASAA respectfully suggests that the Commission take the opportunity presented by the rule proposal to clarify the issues detailed below.

First, NASAA supports the Division's efforts to clarify that the phrase "solely incidental" relates to whether the investment advice being provided by the broker-dealer is solely incidental to an individual account and not to the broker-dealer's services overall. While NASAA agrees with this clarification, we urge the Commission to provide further guidance in this area. NASAA recommends the Commission set out factors for determining when advice is "solely incidental. NASAA recognizes that such a phrase cannot be defined by a laundry list of terms and is inextricably linked to the facts and circumstances of the arrangement. However, we recommend the Commission consider including in the rule the factors set out in IA Release No. 1092[3], supplemented by factors that have been included in numerous no-action letters on the subject. Release 1092 has long been a de facto rule of factors to look to when evaluating whether activities are solely incidental. By including directly in the new rule the factors set forth in Release 1092 and other factors that have been repeatedly included in the Commission's no-action letters in this area, the regulated community will be put on direct notice the factors by which their actions may be judged. Other regulators have already codified in their rules the factors in Release 1092.[4]

Second, the Commission asked for comment whether all discretionary accounts of broker-dealers should be treated as advisory accounts.[5] Discretionary authority allows a broker-dealer to execute trades without first obtaining the client's consent. Under such circumstances, the broker is performing the essential functions of an adviser and should be treated as such[6]. NASAA believes all discretionary accounts of broker-dealers, regardless of how compensation is paid, should be treated as advisory accounts and subject the broker to the requirements of the Advisers Act. NASAA acknowledges that if the Commission chooses to make "discretionary authority" a bright line test, principal accounts that have been established for many years as brokerage accounts might subsequently be treated as advisory accounts and require the registration of the broker

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[3] *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,* Release No. IA-1092, Oct. 17, 1987.

[4] For example, The Maryland Securities Act sets out in Section 11-101 (h)(2)(iii) Corporations and Associations Article, Maryland Code Annotated (1999 Repl.Vol.) that, "[a] lawyer, certified public accountant, engineer, insurance agent or broker, or teacher whose performance of investment advisory services is solely incidental to the practice of the profession, provided that the performance of such services is not solely incidental unless:" and then proceeds to list several factors. The factors include 1) the investment advisory services rendered are connected with and reasonably related to the other professional services rendered; 2) the fee charged for the investment advisory services is based on the same factors as those used to determine the fee for other professional services and 3) the lawyer, certified public accountant, engineer, insurance agent or broker, or teacher does not hold out as an investment advisor.

[5] Release p. 4.

[6] Under the 1934 Act Section 3(3)(35) defines a person exercising "investment discretion" with respect to an account to include such persons who directly or indirectly are "authorized to determine what securities or other property shall be purchased or sold by or for the account…"

dealer as an investment adviser. NASAA would recommend that such situations be dealt with by no-action positions or a narrowly crafted exemption to fit the circumstances.

Third, the Commission asked for comment whether to preclude brokers from relying on the proposed rule if they market their accounts in such a way as to suggest they are advisory accounts[7]. Several states'[8] laws provide that if a person holds out in any manner as providing advisory services or otherwise suggests through marketing that advisory accounts are available then such persons are treated as investment advisers. This approach creates a level playing field for offering advisory services between broker dealers and investment advisers and narrows the confusion factor for investors. NASAA respectfully suggests that although proposed 202(a)(11)-1(a)(3) would require broker dealers to make prominent disclosure that the "accounts" are brokerage accounts, it does not preclude broker dealers from packaging that disclosure with other marketing approaches that tout or highlight the additional availability of advisory services. We would recommend that the Commission consider revising the proposed language of 202(a)(11)-1(a)(3) to specifically preclude a broker-dealer from suggesting that the account is anything other than a brokerage account or that advisory services are also available.

NASAA would like to commend the Commission and the staff of the Division of the Investment Management for the proposed rule. Defining the parameters within which a broker-dealer would fall under the Advisers Act is an appropriate response to changing trends in brokerage services. We encourage the Commission to enhance investor protection and minimize investor and industry confusion by clarifying the other issues tied to the incidental practice of advisory services.

Please feel free to contact the undersigned directly at (317) 232-6681, Melanie Senter Lubin, NASAA Investment Adviser Section Chair, at (410) 576-6365 or the NASAA Legal Department at (202) 737-0900 if you should have any questions.

Sincerely,

Bradley W. Skolnik
President

Cc: Paul F. Roye
Robert E. Plaze
Cynthia M. Fornelli

[7] Release p. 4. The current rule proposal requires advertisements for and contracts/agreements for which broker-dealers receive special compensation to include a prominent statement that the accounts are brokerage accounts.

[8] The states include: Maryland, Washington, Florida, Alabama, Illinois, Indiana, Iowa, Idaho, Wisconsin, Missouri, South Carolina, North Carolina, Alaska, Arizona, Nebraska, District of Columbia and Colorado.