NOS. 04-1242, 05-1145

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

THE FINANCIAL PLANNING ASSOCIATION
Petitioner

v.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION.
Respondent

PETITION FOR REVIEW OF FINAL ORDER OF THE SECURITIES AND EXCHAGE COMMISSION

CORRECTED BRIEF OF AMICUS CURIAE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC. IN SUPPORT OF PETITIONER

Dated: April 12, 2006

Respectfully submitted,

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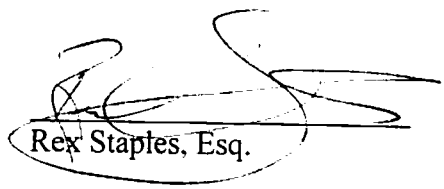
CERTIFICATE AS TO PARTIES, RULINGS AND RELATED CASES

Pursuant to District of Columbia Cir. R. 28(a)(1), the undersigned counsel for *Amicus Curiae* North American Securities Administrators Association, Inc., hereby certifies the following:

A. **Parties and Amicus.** All parties and amicus are listed in the brief for the Petitioner.

B. **Rulings Under Review.** References to the rulings at issue appear in the Brief for the Petitioner.

C. **Related Cases.** No court has previously reviewed this Rule.



CORPORATE DISCLOSURE STATEMENT

Pursuant to Fed. R. App. P. 26.1 and Circuit R. 26.1. the North American Securities Administrators Association, Inc. states that it is the nonprofit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. There is no publicly-held corporation or other entity that owns more than 10% of the stock of the North American Securities Administrators Association, Inc. that has a direct financial interest in the outcome of this litigation.

Rex Staples
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North American Securities
Administrators Association, Inc.

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GLOSSARY

BD/IA Rule or Rule	17 C.F.R. § 275.202(a)(11)-1, *published* 70 Fed. Reg. 20,424 (April 19, 2005)
Broker-Dealer Exception	15 U.S.C. §80(b)-2(C)
Commission or SEC	United States Securities and Exchange Commission
IA Act or Act	Investment Advisers Act of 1940. 15 U.S.C. §§ 80b-1 through 80b-21
NASAA	North American Securities Administrators Association
NASD	National Association of Securities Dealers
Release	The Release "Certain Broker-Dealers Deemed not to be Investment Advisers" *published* 70 Fed. Reg. 20,424, 40427 (Apr. 19, 2005)

IDENTITY AND INTEREST OF THE *AMICUS CURIAE*

The North American Securities Administrators Association, Inc. (NASAA) is the nonprofit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. NASAA has 67 members, including the securities regulators in all 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Formed in 1919, it is the oldest international organization devoted to protecting investors from fraud and abuse in the offer and sale of securities.

Members of NASAA include the state securities agencies responsible for regulating securities transactions, broker-dealers, and investment advisers under state law. Their fundamental mission is protecting investors, and their jurisdiction extends to a wide variety of investment products and financial services. Their principal activities include registering certain types of securities; licensing the firms, agents, and representatives who offer and sell securities or provide investment advice; investigating violations of state law; and initiating enforcement actions where appropriate.

Through the various records maintained by state securities regulators, including information related to securities offerings, the individuals who promote the offerings, and the individuals who offer investment advice,[1] state securities regulators help protect investors. These records enable investors to receive important information about

[1] The National Association of Securities Dealers ("NASD") and NASAA, through a contractual relationship, operate the Central Registration Depository, a computer database for centralized filing of licensing information for broker-dealer firms and agents. NASAA has also contracted with the NASD as a vendor for the operation of the Investment Adviser Registration Depository, which functions in a similar manner to CRD. Industry participants file information with state regulators through the CRD and IARD. This information, which includes disclosures relating to any disciplinary history of the broker-dealer agent or investment adviser representative, is available to members of the public through state securities regulators.

investments before they part with their money and to ensure that the broker-dealer agents and investment adviser representatives offering those investments are properly qualified and licensed.

NASAA supports the work of its members in many ways: coordinating multi-state enforcement actions, offering training programs, publishing investor education materials, and offering its views on proposed legislation governing financial services. Another core function of NASAA is representing the membership's position, as *amicus curiae*, in significant cases involving financial services regulation.

NASAA and its members have three important interests in this matter. First, the rule at issue enables a large number of brokerage firms offering investment advice to escape registration as investment advisers, to the detriment of the investing public. The SEC's unwarranted expansion of the broker-dealer exception is harmful to investors because it removes an important array of protections that Congress intended the public to receive when dealing with investment advisers: a fiduciary duty that requires those dispensing investment advice to place the interests of clients before their own and to disclose any conflicts of interest that might taint their advice.

Second, the rule also has a direct impact on the important licensing and regulatory functions that NASAA's members perform, as they are the sole regulators of the entire population of investment adviser representatives, and also the sole regulators of investment adviser entities with assets of twenty-five million dollars or less under management. The rule deprives state regulators of the ability to subject many entities and individuals *acting* as investment advisers and representatives to the licensing and regulatory oversight intended by Congress under the Investment Advisers Act of 1940.

Finally, the SEC, through promulgation of this rule, has attempted to preempt states from shoring up the now weakened regulation of those offering investment advice. Preemption of state regulatory authority is a matter of central concern to NASAA and its members, who seek to limit the erosion of their authority by federal agencies. State regulators in the areas of securities, banking, and insurance all play a vital role in protecting the public. Although Congress can and does set limits on the scope of state regulation, those limits must be fairly interpreted and applied, in light of Congressional intent and the important benefits that state regulators offer to the investing public. In this case, the SEC's rule effects preemption – both explicit and implicit – that simply cannot be justified in light of Congressional intent, the best interests of investors, or even the vitality of the brokerage industry.

On January 20, 2006, the Court granted NASAA's unopposed motion for leave to file a brief as amicus curiae in support of Petitioner Financial Planning Association. Accordingly, the Court's grant of leave to NASAA to participate constitutes our authority to file this brief.

SUMMARY OF THE ARGUMENT

The SEC's improper interpretation of the congressional intent and application of the IA Act has resulted in the promulgation of Rule 202(a)(11)-1, which has seriously compromised investor protection and created confusion among investors in the marketplace. Further, the Commission's adoption of this Rule is inconsistent with the SEC's previous interpretation of the Broker-Dealer Exception provided for in the IA Act and marks a significant change in the manner in which the Broker-Dealer Exception applies to broker-dealers providing investment advice. Today, the Rule leaves gaping

holes in investor protection and allows broker-dealers to provide virtually unlimited investment advice, all while avoiding compliance with the IA Act and the fiduciary obligations that normally attach to professionals who are rendering investment advice. The SEC has compromised investor protection, thwarted Congressional intent, and attempted to preempt state law. Therefore, the Court should grant the Petitioner's Petition and hold that Rule 202(a)(11)-1 is inconsistent with the Investment Advisers Act of 1940.

ARGUMENT

I. SEC RULE 202(A)(11)-1 IS INVALID BECAUSE IT IS CONTRARY TO THE PLAIN MEANING OF THE INVESTMENT ADVISERS ACT OF 1940, THE LEGISLATIVE INTENT OF THE ACT, AND THE SEC'S OWN INTERPRETATION OF THE ACT FOR OVER 60 YEARS

SEC Rule 202(a)(11)-1, 17 C.F.R. 275.202(a)(11)-1, ("BD/IA Rule" or "Rule") clearly contradicts the provisions of the Investment Advisers Act of 1940 ("IA Act" or "Act"). The Rule is out of step with what the IA Act says and what Congress intended it to mean. The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather it is, "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." *Dixon v. U.S.*, 381 U.S. 68, 74, (1965), quoting *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129, 134, (1936). A regulation that does not carry out the will of Congress but instead conflicts with the statute as written is invalid. *Manhattan General Equipment Co.*, 297 U.S. 129, 134. The SEC's rule is inconsistent with the language and intent of the IA Act, as well as the agency's own long-standing interpretation of the law, and the Rule is therefore invalid.

A. In the Investment Advisers Act of 1940, Congress Clearly and Broadly Defined "Investment Advisers" as Part of a Regulatory Scheme Enacted Primarily for the Protection of Investors

Congress passed the IA Act following the stock market crash of 1929 and the Great Depression. In adopting the IA Act, Congress observed that it was necessary to protect "the public from...unscrupulous touts and tipsters and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful." H.R. Rep. No. 2639, 76th Cong., 3d Sess. at 28 (1940). The IA Act followed on the heels of the 1933 Securities Act and the 1934 Securities Exchange Act, and was passed in conjunction with the Investment Company Act of 1940. These legislative enactments were part of a much-needed reform package aimed at the operation and regulation of the securities markets and the professionals who provide investment services.

In drafting the IA Act, Congress clearly defined the class of professionals who would fall under the statute. It did this by first broadly defining the term "investment adviser" as follows:

> [A]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regulator business, issues or promulgates analyses or reports concerning securities...

15 U.S.C. §80b-2(a)(11). Congress then enumerated six exceptions to this definition:

> (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company, except that the term "investment adviser" includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such

services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser;

(B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession;

(C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore;

(D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation;

(E) any person whose advice, analyses, or reports related to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934, as exempted securities for the purposes of that Act; or

(F) such other person not within the intent of this paragraph as the Commission may designate by rules and regulations or order.

15 U.S.C. §80b-2(a)(11)(A) through (11)(F)

At issue here is exception (C), a clearly worded provision that narrowly limits the class of broker-dealers excepted from investment adviser registration to those whose advisory services are *solely* incidental to their brokerage business *and* who receive *no* special compensation for such incidental advice.

B. The BD/IA Rule Contradicts the Plain Meaning of the Investment Advisers Act

In 2005, the SEC adopted the BD/IA Rule in an effort to establish precisely when the IA Act would apply to certain advisory activities carried on by broker-dealers pursuant to the exception provided in 15 U.S.C. §80(b)-2(C) (the "Broker-Dealer Exception"). The BD/IA Rule was first proposed in 1999, and the final version was

adopted in 2005. The final version represents an apparent accommodation to the brokerage industry through a rule "designed to avoid application of the Advisers Act to broker-dealers merely because they reprice their full-service brokerage or provide execution-only or similar discount brokerage services in addition to full service brokerage." 70 Fed. Reg. 20,424, 40427 (Apr. 19, 2005) ("Release").

The Rule, released under the name "Certain Broker Dealers Deemed Not To Be Investment Advisers," generally exempts broker-dealers from compliance with the IA Act even where they receive "special compensation" for providing investment advice and regardless of how central the advice is to the broker-dealer's business. In short, contrary to the requirements of the Broker-Dealer Exception, the Rule allows broker-dealers who provide investment advisory services to escape registration under the IA Act, despite the receipt of special compensation or the true nature or extent of the advisory services provided. The Rule, as adopted, is contrary to the plain meaning of the statute.

"[T]he starting point in any case involving the meaning of a statute[] is the language of the statute itself." *American Bar Assoc. v. Fed. Trade Comm'n*, 430 F.3d 457, 467 (D.C. Cir. 2005), citing *Group Life and Health Ins. Co. v. Royal Drug Co.*, 440 U.S. (1979). "It is a universally recognized rule of statutory construction that a court should look first to the language of the statute to determine the legislative purpose." *SEC v. Ambassador Church,* 679 F.2d 608, 611 (6th Cir. 1982); *see also Fashion Boutique of Short Hills, Inc. v. Fendi, USA, Inc.*, 314 F.3d 48, 56 (2nd Cir. 2002) ("It is a basic rule of statutory construction that a court begins with the plain and ordinary meaning of statutory terms."). "When the statute is clear in evidencing Congress' intent, there is ordinarily no warrant for resorting to legislative history." *Natural Resources Defense Council, Inc. v.*

EPA, 822 F.2d 104 (D.C. Cir. 1987). And while an agency's interpretation of a statute is sometimes entitled to deference, this deference is warranted only where "Congress has not directly spoken to the precise question at issue," *see. Chevron USA Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984), and then only if the agency has acted pursuant to "delegated authority," *see United States v. Mead Corp.*, 533 U.S. 218, 226 (2001). Because Congress has clearly spoken to the precise issue of when the IA Act applies to broker-dealers, and because the SEC has exceeded its authority by rewriting the Act, the SEC is not entitled to deference within the meaning of *Chevron*.

The plain language of the IA Act makes it clear that the Broker-Dealer Exception to the definition of investment adviser has two prongs. Both must be satisfied in order for a broker-dealer to avoid application of the IA Act. First, the broker-dealer cannot receive any special compensation for advisory services. Second, those services must be provided on a solely incidental basis. Both of these requirements must be present before the exception will apply.

In the Release, rather then attempt to compose a definition of "special compensation," the SEC announced that generally a broker-dealer "[w]ill not be deemed to be an investment adviser based solely on its receipt of special compensation." 70 Fed. Reg. at 20,454. "To read out of a statutory provision a clause setting forth a specific condition or trigger to the provision's applicability is...an entirely unacceptable method of construing statutes." *Natural Res. Def. Council v. EPA*, 822 F.2d 104, 113 (D.C. Cir. 1987). Furthermore, an agency's interpretation of a statute should abide by the principle of statutory construction that "all words and provisions of statutes are intended to have meaning and are to be given effect, and no construction should be adopted which could

render statutory words or phrases meaningless...." *U.S. v. Ven-Fuel, Inc.*, 758 F.2d 741, 751-52 (1st Cir. 1985). The SEC disregarded these cardinal principles of statutory construction. As a result the rule is invalid.

In addition to writing the "special compensation" language out of the IA Act entirely, the SEC also neutralized the "solely incidental" prong. Unlike the decision to simply eliminate the "special compensation" element, the Commission did make an attempt to define the types of advisory services that would be considered "solely incidental." However, as with the "special compensation" element, the SEC again abrogated Congress's language and negated its intent. According to the Release, "solely incidental means investment advice is solely incidental to brokerage services provided to an account when those advisory services are *in connection with* and *reasonably related to* the brokerage services." 70 Fed. Reg. at 20,436 (emphasis added). This broad formulation distorts the plain and ordinary meaning of the statute, encompassing virtually every occasion on which a broker-dealer might provide investment advice to a customer. Thus, the Commission has defined "solely incidental" in such a manner as to render it meaningless. Removing all doubt is the SEC's declaration that "even when the [investment] advice is substantial," broker-dealers would *still* be exempt from compliance with the Act. 70 Fed. Reg. at 20,434. This interpretation of the IA Act is unreasonable, and far from deserving deference under *Chevron*, it should be declared invalid. *See Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843, (1984).

In crafting its definition of "solely incidental," the Commission stated that the "in connection with" and "reasonably related to" elements of the Rule comport with the

statutory language. Yet it is difficult to imagine any type of investment advice that could not be deemed either "reasonably related" or in some way "in connection with" a brokerage service. Thus the practical effect of the BD/IA Rule is just the opposite of what Congress intended: it creates a broad exception that makes brokerage services incidental to advisory services. The SEC contends that those who urge the Commission to interpret "solely incidental" to mean "minor" or "secondary" are taking a "very narrow view of the meaning." 70 Fed. Reg. at 20437. But this "narrow" interpretation is precisely what the words chosen by Congress actually mean.[2]

C. The BD/IA Rule Cannot Be Reconciled With Congressional Intent

"The most reliable guide to congressional intent is the legislation the Congress enacted." *Sierra Club v. EPA*, 294 F.3d 155, 161 (D.C. Cir. 2002). The general purpose of the IA Act is to protect the public and investors against malpractice by persons paid for advising others about securities. *Johnston v. CIGNA Corp.*, 916 P.2d 643 (Colo. Ct. App. 1996). Congress set out to accomplish this goal in large part by establishing a federal fiduciary standard to govern the conduct of investment advisers. *Transamerica Mortgage Advisers, Inc. et al v. Lewis*, 444 U.S. 11 (1979). The standard set forth in the IA Act serves to eliminate, or at least expose, all conflicts of interest that might incline an investment adviser to render advice that is not disinterested.

The Supreme Court has recognized this regulatory cornerstone for decades. In *SEC v. Capital Gains Research Bureau, Inc. et al.* 375 U.S. 180. (1963). the Supreme Court addressed the practice of an investment adviser recommending a certain stock to the recipients of its newsletter and then later selling the stock for a profit. Specifically,

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[2] American Heritage College Dictionary, 4th Ed., 2002. Merriam Webster's Collegiate Dictionary, 10th Ed. 1997. Black's Law Dictionary, 6th Ed., 1990.

employees of Capital Gains would purchase a stock, recommend it to their customers, and then sell the stock as the price increased. The Supreme Court closely examined Congress' intent in adopting the IA Act to determine whether or not this practice violated the IA Act's provisions. The Court noted that the IA Act was passed in recognition of "the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser-consciously or unconsciously to render advice which was not disinterested." *Capital Gains,* 360 U.S. at 191. It was, therefore, investor protection, in the form of full and fair disclosure, that was the guiding principle behind the IA Act and not, as suggested in the Release, a fear of duplicative regulation for broker-dealers.

The SEC's Rule runs counter to this well-established Congressional intent. Congress crafted a broad definition of investment adviser and coupled it with narrowly tailored exceptions. By virtue of the plain language of the broker-dealer exception, it is clear that it was the intent of Congress to exclude only broker-dealers who: (1) did not receive any special compensation for advisory services: and (2) provided such services as a purely incidental part of their business. Clearly Congress was not primarily concerned about shielding broker-dealers from compliance with the IA Act, for it easily could have formulated a much more generous exception in favor of broker-dealers but declined to do so.

Congress drafted the Broker-Dealer Exception at a time when a majority of brokerage accounts were commission-based and it understood that the primary source of income for these broker-dealers was commissions. Commissions can only be earned

when trades are executed. The primary business of broker-dealers was executing trades, not providing investment advice. It was, therefore, consistent with the investor protection purposes of the IA Act to craft a narrow exception for rendering advice that was truly incidental to the core activities of broker-dealers. The Rule violates this intent by conferring the exception even on those who offer plentiful and frequent investment advice to their brokerage clients.

While it may be true that the brokerage industry has evolved over the years, nothing in that evolution justifies the regulatory accommodation embodied in the rule. On the contrary, the IA definition and the exception as originally written remain eminently well-suited to the changing world of financial services. To the extent broker-dealers are increasingly inclined, for their own business reasons, to offer advisory services to clients, then they increasingly *should be* subject to the important regulatory restrictions imposed by the IA Act for the benefit of investors. Certainly the record of the SEC's rule-making in this case offers no convincing rationale for a change in the law. The licensing burdens under the IA Act are not unreasonable and investors need the protections of the IA Act more than ever, as they grow in number and increasingly depend on honest advice in a complex financial world. What the industry may find burdensome is the fiduciary duty and the related obligations of honesty and full disclosure that investment advisers must observe. But this is hardly a legitimate complaint, for those burdens are precisely the ones that Congress deemed it necessary to impose on investment advisers for the protection of investors.[3]

[3] In the Release, the Commission labors over the legislative history of the IA Act in an attempt to explain why the language of the statute should be read in a restrictive fashion. The analysis is, however, unconvincing and cannot be reconciled with the statute as

D. The BD/IA Rule is Contrary to the SEC's Prior Interpretation and Enforcement of the Broker-Dealer Exception to the IA Act

The adoption of the BD/IA Rule represents a dramatic shift in the SEC's own interpretation of the IA Act. For decades prior to adoption of the Rule, the SEC generally adhered to the plain meaning and intent underlying the Act. Shortly after the passage of the IA Act, representatives of the NASD inquired of the SEC as to the application of the Act in certain scenarios. The response was provided by then SEC General Counsel, Chester T. Lane ("Lane"). *See Opinion of the General Counsel Relation to Section 202(a)(11)(C) of the Investment Advisers Act*, 1940 WL 975 (October 28, 1940). While recognizing that broker-dealers provide a certain amount of advice to their customers in the course of their regular broker-dealer business, Lane pointed out that the "special compensation" prong was a clear recognition that broker-dealers who are "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 they are also engaged in effecting market transactions in securities." *Id* at 2. This point underscores the importance of the "special compensation" prong that the SEC, with the BD/IA Rule, has repealed from the statute.

Thirty-five years later in Release Number IA-628, 43 Fed. Reg. 19224 (May 4, 1978) following the "unbundling" of brokerage commission charges and charges for research and other advice, the staff of the SEC's Division of Investment Management revisited the 1940 opinion cited above. In this release, the staff referenced with approval

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written and as interpreted by the courts for decades. Ultimately the Rule, as adopted, allows broker-dealers to offer abundant investment advice to clients without any obligation to comply with the investor protection provisions in the IA Act. This is not the result that Congress intended and the rule should accordingly be declared invalid.

the position taken in 1940 and noted that if a broker-dealer has two general fee schedules, with a higher fee for accounts involving advice and the difference is primarily attributable to this factor, then the Commission would consider the higher fee as "special compensation." 43 Fed. Reg. at 19,226. Unlike the position taken by the SEC in BD/IA, the agency's staff in 1978 articulated an understanding of the "special compensation" prong such that a broker-dealer who charges and receives fees for advisory services is subject to the IA Act because such services are not solely incidental. In fact, the staff actually stated in the release that compliance with the IA Act was not unduly burdensome, a direct contradiction of the Commission's pronouncements in the release accompanying the BD/IA Rule.

Yet again, in 1987, the Commission discussed these issues in Release Number IA-1092 addressing a number of issues related to investment advisers, including the necessity of satisfying all of the elements of an exemption. The Commission pointed out that "A person relying on an exclusion from the definition of investment adviser must meet all of the requirements of the exclusion." *Applicability of the Investment Advisers to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services*, 987 WL 11,2702, *6 (October 8, 1987). The SEC wrote that the exclusion contained in 202(a)(11)(C) would not be available to a broker-dealer who received special compensation for providing advisory services.

Clearly, the Commission's interpretation and application of the provisions of the IA Act have now changed so dramatically that it has seen fit to rewrite the law. According to the Commission, the Rule is designed to "keep a full service broker-dealer

from being subject to the Act solely because it also offers electronic trading or some other form of discount brokerage. Conversely, a discount broker-dealer would not be subject to the Act solely because it introduces a full-service brokerage program." 70 Fed. Reg. at 20,436. As argued above, these shifting industry practices simply do not warrant a change in the law or in the regulations devised to implement the law.

II. THE BD/IA RULE STRIPS INVESTORS OF ESSENTIAL PROTECTIONS PROVIDED UNDER THE IA ACT AND PROMOTES UNNECESSARY CONFUSION IN THE MARKETPLACE

As more and more people turn to the financial markets "to help secure their futures, pay for homes, and send children to college," investor protection becomes "more compelling than ever." *See* http://www.sec.gov/about/whatwedo.shtml. Yet the BD/IA Rule snubs this increasingly important public policy in favor of an accommodation to the changing business models preferred by broker-dealers. The BD/IA Rule allows broker-dealers to provide investment advice without being subject to the higher fiduciary standard that Congress created for all investment advisers. Underpinning this profound shift away from investor protection is the notion that the industry's new products, such as fee-based accounts, necessarily align the interests of broker-dealers and their customers. This is an erroneous premise. Moreover, the BD/IA Rule has intensified investor confusion. Precisely at a time when the public needs simplification and clarity in financial services, the new Rule thoroughly confuses the relationship between broker-dealers and investment advisers, and places investors at a further disadvantage in the perplexing world of financial products and investment advice.

A. The Rule Harms Investors By Allowing Broker-Dealers to Provide Virtually Unlimited Investment Advice While Escaping the Legal Obligations of a Fiduciary Relationship

In its Release, the SEC acknowledged that many commenters feared "adoption of the rule would deny investors important protections provided by the Advisers Act, in particular, the fiduciary duties and disclosure obligations to which advisers are held." 70 Fed. Reg. at 20,426. Despite this overwhelming current of opposition to the Rule, the SEC insulated broker-dealers from the legal responsibilities of a fiduciary relationship even where those broker-dealers offer significant and regular investment advice to their clients.

As discussed earlier, Congress recognized that "the essential purpose" of the IA Act was "to protect the public from...unscrupulous touts and tipsters and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful." H.R. Rep. No. 2639, 76th Cong., 3d Sess. At 28 (1940). Courts have also recognized that "the Investment Advisers Act of 1940 was the last in a series of Acts designed to eliminate certain abuses in the securities industry," and that its fundamental purpose was to "substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus achieve a high standard of business ethics in the securities industry." *Capital Gains* 375 U.S. at 186. In *Capital Gains*, the Supreme Court observed that "investment advisers could not completely perform their basic function...unless all conflicts of interest between investment counsel and the client were removed." *Id.* at 187. Additionally, the Commission recognized the concern with the industry was "not limited to deliberate or conscious impediments to objectivity." *Id* at 188. Rather, industry and the SEC itself recognize that a subconscious

prejudice exists "in favor of one's own financial interests." *Id.* The IA Act was aimed "not only at dishonor, but also at conduct that tempts dishonor." *Id.* at 200, (citing *United States v. Mississippi Valley Generating Co.* 364 U.S. 520, 549 (1961)). Thus, adequate protection of investors requires that those dispensing investment advice be subject to a fiduciary obligation with its attendant disclosure requirements.

These obligations are fundamentally distinct from the obligations that apply to broker-dealers, and contrary to the SEC's suggestion, the "substantial oversight and regulation of broker-dealers" is simply not adequate in the context of investment advisers. 70 Fed. Reg. at 20,430.[4] The Securities Exchange Act of 1934 defines a broker as a person "engaged in the business of effecting transactions in securities for the account of others," and a dealer is defined as a person "engaged in the business of buying and selling securities for its own account." 15 U.S.C. § 78c-3(a)(4)(A) and 3(a)(5)(A). Thus, the principal function of a broker-dealer is the execution of transactions. It is undisputed that in effectuating these services, broker-dealers provide their customers with a wide range of ancillary services, including trade settlement and accounting functions, recordkeeping, and even research. Barbara Black, *Brokers and Advisers – What's in a Name?,* 11 Fordham J. Corp. & Fin. L.31, 36 (2005). However, in connection with all of these functions, the duties of broker-dealers fall significantly short of the obligations of investment advisers regulated under the IA Act.

[4] Similarly, the SEC's claim that "broker-dealers today are subject to a level of regulation far greater than in 1940" is beside the point. 70 Fed. Reg. at 20,431. While this is a positive development in broker-dealer regulation and investor protection, it does not logically follow that broker-dealers acting as investment advisers should be excused from compliance with the IA Act.

For example, to the extent a broker-dealer recommends a security to a customer, it is subject only to a "suitability" standard, under which a broker must consider the customer's tax status, financial status, and investment objectives. *See* NASD Rule 2130. In conjunction with this standard,

> a broker ordinarily has no duty to monitor a non-discretionary account, or to give advice to such a customer on an on-going basis. The broker's duties ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice, or warnings concerning the customer's investments.

De Kwiatkowski v. Bear Stearns & Co., 306 F.3d 1293, 1302 (2d Cir. 2002). The suitability obligation imposes only a "limited duty to serve [a] customer's financial interests within the framework of a single transaction only." *Leib v. Merrill Lynch Pierce, Fenner & Smith, Inc.* 461 F.Supp. 951, 952-53 (E.D. Mich. 1978)

In sharp contrast, an investment adviser's duty is to furnish "clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments." *Capital Gains* 375 U.S. at 187. Thus, an investment advisor *does* have an obligation to monitor a customer's account and provide continuous advice. Moreover, the pillar of undivided loyalty, which characterizes an investment advisory relationship, goes well beyond the standard of conduct to which a broker-dealer must adhere. The Commission long ago acknowledged the added layer of protection that the Advisers Act affords, stating in a 1978 release that "the Advisers Act provides individuals with certain protections not available under the Exchange Act." 43 Fed. Reg. 19,224.[5]

[5] Congress has implicitly recognized that it would be impossible to act as a broker-dealer without to some degree recommending the purchase or sale of securities or expressing opinions on the merits of various investment opportunities and it would not be in the

The profound importance of the fiduciary obligation imposed under the IA Act is illustrated somewhat ironically in the SEC's own desire to ensure that broker-dealers remain free to engage in undisclosed principal transactions with their clients. In the SEC's view, an important benefit of the generous exemption for broker-dealers under the Rule is "[the] preservat[ion] [of] the ability of broker-dealers to engage in principal transactions." 70 Fed. Reg. at 20,443. The SEC presumably fears that applying a disclosure obligation to these transactions would enlighten clients that such trades are not necessarily in the client's best interest and would interfere with the now unfettered ability of broker-dealers to trade opposite their customers.

In contrast, under section 206(3) of the IA Act, investment advisers are strictly prohibited from engaging in principal transactions unless the customer has been fully informed and given consent:

> An investment adviser cannot, either as a principal or broker, knowingly engage in a securities transaction with a client unless he discloses in writing to the client the capacity in which he is acting and obtains the client's consent to the transaction, prior to completion of the transaction.

Barbara Black, *Brokers and Advisers – What's in a Name?*, 11 Fordham J. Corp. & Fin. L at 36. The inability of an investment adviser to engage in principal transactions without obtaining prior, informed consent is a direct benefit of the duty of "undivided loyalty" owed to an investment advisory client, and this duty makes regulation under the IA Act and application of the fiduciary relationship so critical to investor protection.

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investor's best interests to prevent broker-dealers from providing some limited measure of advice in connection with transactions. To the extent these are advisory activities rendered "solely incidental to" a broker's business and without special compensation, then Congress intended them to be exempted from the IA Act.

The SEC's desire to protect broker-dealer principal transactions from disclosure under a fiduciary standard is another example of rule-making according to industry practices and preferences, not according to the intent of Congress or the best interests of investors. If a broker-dealer is acting as an investment adviser under the IA Act, then it should be subject to the heightened duties of a fiduciary, whether or not that duty requires disclosure to investors of business practices that industry might otherwise prefer not to disclose.

B. Fixed Fee Brokerage Accounts Do Not Necessarily Align the Interests of Investors and Brokers

In its Rule release, the SEC declared that "a broker-dealer providing investment advice to its brokerage client is not required to treat those customers as advisory clients solely because of the form of the broker-dealer's compensation." 70 Fed. Reg. at 20,434. As discussed above, this aspect of the Rule is fundamentally flawed because it conflicts with the IA Act as written. In addition, however, it is based upon a mistaken premise.

The apparent basis for this aspect of the Rule is the belief that fee-based brokerage accounts have the effect of "align[ing] the interests of broker-dealers and their customers," 70 Fed. Reg. at 20,434, thus reducing the need to protect such investors under the IA Act. With respect to fee-based accounts, the SEC argues that because a "broker-dealer's compensation does not depend on the number of transactions or the size of mark-ups or mark-downs charged...incentives for broker-dealers to churn accounts, recommend unsuitable securities, or engage in high-pressure sales tactics" have been reduced. 70 Fed. Reg. at 20,443.

While fee-based accounts may in theory reduce the incidence of some types of fraud, such as churning, they hardly eliminate the potential for abuse and they certainly

do not warrant a wholesale exception from application of the IA Act. Fee-based accounts lend themselves to other equally pernicious forms of investor abuse. In a fee-based account, the registered representative will continue to generate income even when the customer is advised to do nothing. Because the broker-dealer agent does not have a duty to monitor the account or provide updated information to the client, representatives will continue to generate income by doing nothing. This "reverse-churning" is as harmful to investors as churning and it may induce broker-dealers and their agents to promote fee-based accounts without fully considering whether customers are actually suitable for this type of account. Both the firm's and the representative's interests are being served through a guaranteed stream of income through fee-based accounts and this reliable revenue stream may remove the incentive to recommend additional suitable transactions or otherwise attend to the client's needs.

Fee-based programs may also harm investors in that they "may encourage customers to engage in imprudent, excessive trading because of the volume discount." Barbara Black, *Brokers and Advisers – What's in a Name?*, 11 Fordham J. Corp. & Fin. L at 45. In fact, the New York Stock Exchange has identified the volume discount as the primary advantage of fee-based programs, not the enhanced alignment between the interests of customer and broker. *Id.* (citing NYSE Information Memo 05-51 at 1 (June 2005), available at http://www.nyse.com (follow "regulation" hyperlink; then follow "Information Memos" hyperlink; then follow "05-51" hyperlink)).

These concerns are borne out by data reflecting trends in brokerage customer complaints. While the BD/IA Rule has only been in effect for about a year, it was 1999 when the SEC first announced that it would not take enforcement actions against firms

with two-tiered pricing. The SEC's no-action position has created a favorable regulatory environment for the proliferation of fee-based accounts over the past six years. The Release points out that the number of these accounts has grown steadily and "[t]oday fee-based brokerage programs are offered by most of the larger broker-dealers, and hold over $268 billion in customer assets." 70 Fed. Reg. at 20,431. If the SEC's theory were correct, then the number of customer complaints should have declined as the fee-based accounts grew in popularity. Instead, according to statistics provided by the NASD, the number of customer complaints has actually increased.[6]

C. The Rule Engenders Confusion Among Investors

The SEC's Rule contributes to investor confusion in an era when the public needs more, not less, clarity in financial services regulation. From the way that broker-dealers market their services to the titles they bestow upon themselves, it is becoming increasingly impossible for investors to distinguish between brokers, who owe no fiduciary duty to their clients, and investment advisers who are statutorily obligated to put their client's best interests ahead of their own.

Broker-dealers now use nearly identical titles, they claim to provide the same services, and they market their services in essentially the same manner as investment advisers. Titles such as "financial consultants" and "financial advisers" are now commonplace among broker-dealers, and ad campaigns foster the image of broker-

[6] In 1999, 5,609 arbitration cases were filed with the NASD Dispute Resolution. Over the course of the next six years, the number of arbitration cases increased each year, with the exception of only one year, with the number peaking in 2003 when 8,945 cases were filed. Despite the growth of fee-based accounts, customer complaints still reflect an increase from 1999 with 6,074 arbitration cases filed in 2005. See Dispute Resolution Statistics, Summary Arbitration Statistics February 2006, available at http://www.nasd.com (follow "Arbitration and Mediation" hyperlink, then follow "View Dispute Resolution Statistics" hyperlink)

dealers and their agents as loyal friends who have embraced their clients' financial dreams as their own. "Investors are being encouraged to rely on brokers as trusted professional advisers, but brokers do not consistently act as trusted advisers in dealing with customers." See e.g. Comment Letter from Consumer Federation of America (February 7, 2005).

Unfortunately, the disclosure requirements contained in the BD/IA Rule are inadequate. Allowing a broker-dealer to provide extensive advisory services only fosters misapprehension on the part of the customer, and providing a disclaimer on a trade confirmation will do little to resolve this problem. Additionally, the burden shifts to the investor to navigate extraordinarily complex legal distinctions in an attempt to decipher the true manner in which his or her account will be managed and the rights that he or she enjoys. In fact, many commenters shared this concern about the Rule and have "expressed a great deal of skepticism about the ability of any disclosures to convey to investors the differences between broker-dealers' and advisers' legal obligations to clients in a reasonably succinct way because of the complexity of the issues." 70 Fed. Reg. at 20,435.

To its credit, the SEC shares the "concern that there is confusion about the differences between broker-dealers and investment advisers" and has acknowledged that investor confusion results from the various titles broker-dealers use and the manner in which broker-dealers market their services. 70 Fed. Reg. at 20,424. Regrettably, however, the SEC has missed an opportunity in the rulemaking process to fight this trend and to ensure that anyone acting as an investment adviser be labeled and regulated as such. The SEC's Rule has only further clouded the issue by regarding these

developments as a natural shift in the brokerage business that the law should accommodate.

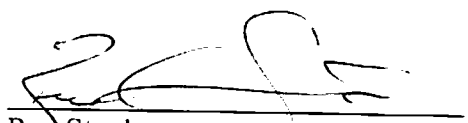
The Rule also performs a grave disservice to investors by preempting the authority of state securities regulators to perform an independent assessment of the proper treatment of those acting as investment advisers. The SEC chose to promulgate the Rule through Section 202(a)(11)(F) of the Act, instead of under their rule-making authority set forth in Section 206(a). In so doing, the SEC preempted state laws that are inconsistent with the provisions of the Rule. The SEC cites Section 206(a) as an "alternative ground" for their authority, but chose not to rely on this provision, which permits regulation only if it is "in the public interest and consistent with the protection of investors and the purposes intended in the Act." 15 U.S.C. § 80(b)-6(a). The states have played an important role in protecting investors, and without this additional layer of protection to compensate for the erosion of investor protection at the federal level, more and more investors are left with nowhere to turn. The BD/IA Rule is not consistent with the public interest and is in fact harmful to investors.

CONCLUSION

For the foregoing reasons, and the reasons stated in Petitioner's Brief, the North American Securities Administrators Association, Inc. respectfully requests that this Court grant the Petition. vacate the Rule, and remand the matter back to the Commission with instructions to act in accordance with the Court's opinion.

Dated: April 12, 2006

Respectfully Submitted,



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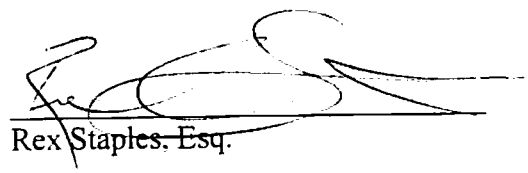
CERTIFICATE FOR SEPARATE BRIEF

The North American Securities Administrators Association, Inc. ("NASAA") is filing a separate *amicus curiae* brief in this case because the issues presented pose a unique threat to the investor protection mission and state regulatory jurisdiction of NASAA's members.



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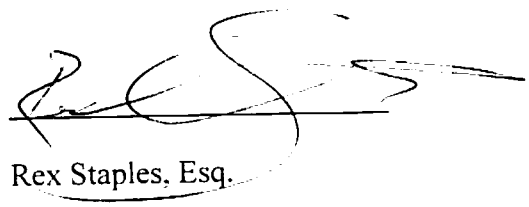
CERTIFICATE OF COMPLIANCE

Pursuant to Fed. R. App. 32(a)(7)(C) and Cir. R. 32(b), the undersigned attorney hereby certifies that this brief complies with the type-volume limitation in Fed. R. App. P. 32(a)(7)(B). The word processing system used to prepare this brief reflects that, excluding the portions of the brief Fed. R. App. P. 32(a)(7)(B)(iii) does not require counted, the brief contains 6,616 words.



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CERTIFICATE OF SERVICE

I hereby certify that on this 12th of April, 2006, copies of the Corrected Brief of *Amicus Curiae* North American Securities Administrators Association, Inc., in Support of Petitioner were mailed first-class, postage prepaid, to:

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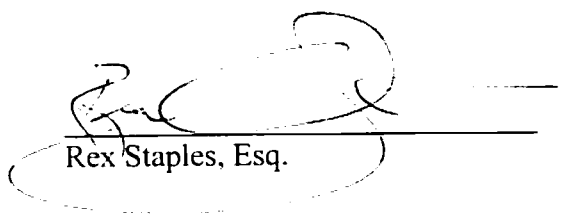

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