INVESTMENT ADVISER ASSOCIATION

2005 Comments & Statements

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ICAA

January 5, 2005

Via Electronic Mail

CFA Centre for Financial Market Integrity
560 Ray C. Hunt Drive
P.O. Box 3668
Charlottesville, Virginia 22903

Ladies and Gentlemen:

Thank you for the opportunity to review the CFA Centre for Financial Market Integrity's draft Asset Manager Code of Professional Conduct. We understand that the CFA Centre was established to develop practical solutions to the global capital market issues facing its members, and to promote general standards of ethics and professionalism. We look forward to working together with the CFA Centre on these objectives with respect to issues facing investment advisers. This letter includes our general comments on the purpose and scope of the CFA code. We will provide separate specific comments on particular sections of the CFA code in accordance with the Centre staff's request.

Purpose and Consequences of a CFA Code for Asset Managers

The Investment Counsel Association of America[1] strongly supports the fundamental requirement that all investment advisers adopt and implement written codes of ethics. We acknowledge the important role the CFA Institute has played in the development of standards related to performance advertising and to professional conduct for its individual members. We are concerned, however, that the development of a CFA code for a particular category of employers of CFA Institute members (*e.g.*, investment advisers) may create unnecessary confusion and burden for investment advisers that are already subject to detailed regulatory requirements in this respect.[2]

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1 The ICAA is a not-for-profit association that exclusively represents the interests of SEC-registered investment advisers. Founded in 1937, the Association's membership today consists of more than 350 investment advisory firms that collectively manage in excess of $4 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

2 In contrast, we note that the AIMR Code of Ethics and Standards of Professional Conduct appropriately apply to each individual member of the CFA Institute and candidates for the Chartered Financial Analyst. Similarly, we note that the AIMR's Global Investment Performance Standards provide guidance in an area with respect to which there has been minimal regulatory guidance.

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For example, as investment advisers registered with the U.S. Securities and Exchange Commission, our members are subject to the requirements of rule 204A-1 under the Investment Advisers Act of 1940. This rule requires all SEC-registered investment advisers to establish, maintain and enforce a written code of ethics that contains: (1) general standards of business conduct reflecting firms' fiduciary duties to their clients and provisions requiring compliance with applicable federal securities laws; (2) a requirement that "access persons" report their personal securities holdings and securities transactions and pre-clear investments in initial public offerings and private placements; (3) a requirement that supervised persons of the adviser promptly report any violations of the code to a designated person; and (4) a requirement that the firm provide a copy of the code and any amendments to all supervised persons and obtain their written acknowledgment of receipt of those documents.

The fiduciary nature of an investment adviser's obligations creates an ethical component to essentially all of the firm's activities. Nevertheless, most SEC-registered advisory firms do not address policies and procedures related to their basic business activities in their codes of ethics beyond the scope of discussion of general ethical principles, [3] but address these subjects in a detailed manner as part of their compliance program. This approach is consistent with language in the adopting release to rule 204A-1 that states "while the code of ethics would have to contain certain minimum provisions, our proposal left advisers with substantial flexibility to design individualized codes that would best fit the structure, size and nature of their advisory practices."[4] In contrast, the CFA code addresses many subject areas that are not typically addressed in codes of ethics of SEC-registered investment advisers and in many instances include specific detail that is inconsistent with permissible practices.[5] Many of our members are concerned that if the CFA Centre publishes a code of this nature that they could be required to spend valuable time and resources justifying to clients and potential clients that their approach to code of ethics issues is directed by the requirements of rule 204A-1 and grounded in the principles of U.S. securities laws.

We appreciate that the CFA Institute is a global professional organization and that its members and candidates live and work in many different countries and are subject to many different securities regulation regimes. The scope of the CFA Institute's membership makes developing a code of ethics for a particular category of firms, *i.e.*, investment advisers, very challenging and somewhat impractical. Accordingly, we recommend as an alternative to publishing a CFA code of conduct for asset managers, issuing a CFA Center research paper on approaches to code of ethics and conduct issues in various jurisdictions. Such a study

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3 For example, in addition to provisions addressing personal trading, the ICAA recommends in its *Best Practices for Investment Adviser Codes of Ethics* that codes of ethics include provisions regarding: (1) gifts and entertainment; (2) political and charitable contributions; (3) confidentiality; (4) service on boards of directors of publicly traded companies and other outside activities; (5) marketing and promotional activities; and (6) compliance policies and procedures related to the scope of the code.

4 *Final Rule: Investment Adviser Codes of Ethics*, SEC Release Nos. IA-2256, IC-26492; File No. S7-04-04 (July 2, 2004) at 3.

5 For example, we do not feel it is appropriate or reasonable to suggest that firms should be obligated to "determine whether a benefit generated from a commission directly assists in the investment decision-making process related to that client." This is a highly controversial position that is approached by different jurisdictions in different manners.

would be a valuable resource for financial service providers, their employees and investors, and could serve as an important point of reference for the financial services industry.

Scope of the CFA Code

In the event the CFA Centre determines to finalize the CFA code, we suggest the following modifications and enhancements. First, the CFA code should include prominent language clarifying that adoption of the code is voluntary and investment advisers, as employers of CFA Institute members, are *not* obligated to adopt or follow the CFA code.

Second, the CFA code should appropriately acknowledge in clear, prominent language the competing obligations of the majority of investment advisory firms to comply with the requirements of regulatory authorities in their governing jurisdictions and to develop codes of ethics that reflect the expectations and practices of that jurisdiction.[6] Such language should also note that practices by investment advisers inconsistent with the CFA code should not necessarily be deemed unethical or even inappropriate.[7]

Third, the scope of the CFA code should be limited to broad principle-based concepts that emphasize the firm's fiduciary duty and address fundamental ethical concepts related to the firm's employees.[8] These concepts can then be supplemented by compliance policies and procedures that assist the investment adviser's employees in fulfilling their responsibilities under their code, as well as any additional responsibilities under applicable laws and regulations. While the CFA code's preamble embraces this objective,[9] many sections in the CFA code appear not to follow this model. It would be particularly helpful if the Recommendations and Guidance section had a preamble stating that it contains only suggestions for use where and if appropriate. Further, we would strongly recommend *against* addressing the following topics in a CFA code of ethics beyond a general discussion of conflicts of interest issues:

1. Investment analysis, objectives, styles, and suitability, and general communications with clients;
2. Use of commissions generated from client trades;
3. Seeking best execution for client transactions;
4. Trade allocation;

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6 We note that the language in the penultimate paragraph of the CFA code's introduction does not address this critical issue, but confuses it by stating that "managers must adhere to any applicable laws or regulations governing their activities," and further stating that the CFA code "provides a universal set of principles relevant to all asset managers."

7 For example, SEC-registered investment advisers are not currently required to have anti-money laundering policies and procedures and failure to do so is not unethical.

8 Another important reason to limit the CFA code to broad principle-based concepts is to increase the likelihood that it will be adopted by managers not already required to have codes.

9 The introductory language states that the CFA code "is meant to be general in nature and allow flexibility for asset managers of various sizes and structures to develop the particular policies and procedures necessary to implement the Code."

5. Qualifications of employees and sufficient resources to address investment decisions and actions;
6. Business continuity and contingency planning; and
7. Performance and valuation.

We believe that the inclusion of these types of specific compliance topics detracts from more important codes of ethics issues and will add unnecessary confusion for many investment advisers that will be required to expend valuable time and resources explaining why their codes do not include them.

We hope these comments have been helpful and trust you will not hesitate to contact us to further discuss these or related issues. We very much look forward to working together with the CFA Centre on these and future issues.

Very truly yours,

Caroline Schaefer

Caroline Schaefer
Associate General Counsel

ICAA

February 7, 2005

Via Electronic Filing

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release Nos. IA-2340, 34-50980; File No. S7-25-99

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates the opportunity to submit comments on re-proposed rule 202(a)(11)-1 under the Investment Advisers Act of 1940.[2] The rule addresses the application of the Investment Advisers Act of 1940 to broker-dealers offering various types of services. We applaud the Commission for its careful and thorough consideration of the important issues raised by this rule. While we still have a number of comments and concerns, we believe the reproposal represents a significant improvement from the original proposal.

Under the reproposed rule, a broker-dealer providing investment advice to customers and charging asset-based compensation would be excluded from the definition of investment adviser as long as: (1) the advice is provided on a non-discretionary basis; (2) the advice is solely incidental to the brokerage services; and (3) the broker-dealer discloses to its customers that their accounts are brokerage accounts and not advisory accounts, and that as a consequence, the customer's rights and firm's duties and obligations to the customer may differ. The broker would be required to identify an appropriate person at the firm with whom the customer can discuss the differences. The rule would also prevent a broker-dealer providing advice to customers from being subject to the Advisers Act solely because it also offers execution-only brokerage services at reduced commission rates. Significantly, the

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1 The ICAA is a not-for-profit association that exclusively represents the interests of SEC-registered investment advisers. Founded in 1937, the Association's membership today consists of approximately 400 investment advisory firms that collectively manage in excess of $4.5 trillion for a wide variety of institutional and individual clients. For additional information, please consult our web site at www.icaa.org.

2 *Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers*, SEC Release Nos. IA-2340, 34-50980; File No. S7-25-99 (Jan. 6, 2005) ("Reproposal").

reproposed rule provides that discretionary advice provided on a commission basis is not "solely incidental" to brokerage services.

The ICAA Applauds the Commission for Addressing Our Previous Comments

During the initial comment period, the ICAA expressed concern that the proposed rule failed to give appropriate guidance regarding the circumstances under which a broker will have to treat an account as an advisory account.[3] Specifically, the ICAA agreed "with the Commission that a functional test focusing on the nature of services provided (rather than the form of the broker-dealer's compensation) is appropriate in determining whether and under what circumstances a brokerage account may be excluded from provisions of the Advisers Act."[4] The ICAA requested, however, that the functional test be modified as follows:

- The rule should treat discretionary brokerage accounts that charge commissions in the same manner that it treats discretionary brokerage accounts that are fee-based.

- The rule should clarify that an account that receives discretionary advisory services is by definition not "solely incidental" to a broker-dealer's business.

- The rule should prohibit broker-dealers from advertising advisory services that are "solely incidental" to the conduct of the broker's primary business. Alternatively, the rule should require more meaningful disclosure in advertisements and any other materials that market advisory services of broker-dealers – and in contracts and agreements governing such accounts – in order to inform consumers of the significant differences between advisory and brokerage accounts, functions, and legal responsibilities.[5]

In subsequent comment letters, we also urged the Commission to address more fully the definition of "solely incidental" and to withdraw its longstanding no-action position permitting broker-dealers to treat certain asset-based accounts as brokerage accounts.[6]

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[3] Letter from David G. Tittsworth, ICAA Executive Director, to Jonathan G. Katz, Secretary, SEC, re: Release Nos. 34-42009; IA-1845; File No. S7-25-99*: Certain Broker-Dealers Deemed Not To Be Investment Advisers* (Jan. 12, 2000).

[4] Contrary to the implication of the SEC's reproposal (*see* n.28), the ICAA does not believe that the form of compensation should be the decisive indicator of whether an account is an advisory account. The ICAA, throughout its comment letters, consistently has supported functional regulation based on the nature of the services provided. Indeed, we opposed the original proposal to deem discretionary commission-paying accounts as brokerage accounts based on the nature of the service provided rather than the form of compensation.

[5] *Supra* n.3.

[6] Letter from Consumer Federation of America (CFA), Certified Financial Planner Board of Standards (CFP Board), ICAA, and National Association of Personal Financial Advisors (NAPFA) to Jonathan G. Katz, Secretary, SEC, re: Release Nos. 34-42009; IA-1845; File No. S7-25-99: *Certain Broker-Dealers Deemed Not To Be Investment Advisers* (May 31, 2000); Letter from CFA, Fund Democracy, ICAA, Financial Planning Association, CFP Board, and NAPFA to the Honorable William Donaldson, Chairman, SEC (May 6, 2003).

We are pleased that the Commission has proposed to adopt many of our recommendations. The reproposed rule will treat discretionary brokerage accounts consistently regardless of the form of compensation charged. The reproposal states that the provision of discretionary advisory services is not "solely incidental" to the conduct of brokerage business. The Commission has enhanced the disclosure proposed for asset-based brokerage accounts. Further, the Commission intends to issue an interpretation tackling the previously uncharted seas of the "solely incidental" definition and has withdrawn its no-action position in favor of more formal rulemaking. We commend the Commission for all of these significant improvements.

The "Discretionary" Account Test Should Not Contain Loopholes

We strongly agree with the SEC's decision to treat all discretionary accounts as advisory accounts regardless of the compensation charged, for the reasons stated in our prior comment letters. Having made this decision, the Commission should consistently apply it. Thus, in response to the SEC's request for comment, we do not believe the Commission should create exceptions, such as situations where the broker has discretion over an account during a client's vacation or other limited period of time. Creating exceptions would defeat the utility of a bright-line test in favor of a more vague facts-and-circumstances analysis. Further, a client's decision to grant such authority to a broker even for a limited period is indicative of the type of relationship of trust and confidence that may confer a fiduciary duty on the broker.[7]

The Commission's Proposed Disclosure Should Be Strengthened Further

The Commission originally proposed that brokers charging asset-based fees be required to disclose only that the account is a brokerage account. We and many other commenters found this proposed disclosure to be seriously inadequate. The reproposal substantially enhances that disclosure by requiring that advertisements for, and contracts and other forms governing, accounts for which the broker receives asset-based or other non-commission-based compensation include a prominent statement that:

- accounts are brokerage accounts and not advisory accounts;
- 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
- identifies an appropriate person at the firm with whom the customer can discuss the differences.

Although the reproposed disclosure is significantly improved, we believe that it does not go far enough. A broker should be required to identify the duty it has undertaken with respect to these accounts, whether fiduciary or otherwise, both in its marketing and its contracts with customers. A non-discretionary account holder should not be led to believe that the broker is continuously supervising the account and proactively alerting the customer to market, economic, issuer or other changes that require action, if the broker is not subject to an investment adviser's overarching fiduciary duty. Further, the disclosures regarding duties made in marketing or advertising material should be consistent with duties undertaken in the

[7] *See* Reproposal at n.54.

brokerage agreement. In other words, the marketing should not tout a relationship of trust and confidence while the contract is disclaiming fiduciary duty.

The Commission has requested comment whether the rule should designate the level of seniority of the person identified with whom customers may discuss the differences between a brokerage account and an advisory account. We believe that the person identified should be sufficiently senior and knowledgeable about the regulatory differences to provide useful and accurate information to customers. In addition, the disclosure should include the person's phone number and e-mail address. The firm and the Commission should conduct reviews, including interviews of customers, to determine whether the information provided is accurate and sufficient.[8] In addition, we respectfully submit that the Commission should set standards for the definition of "prominent" disclosure. Disclosure that is in materially smaller font than the substance of the advertisement should not be deemed "prominent."

The Commission Should Recognize the Fundamental Differences Between Brokers and Advisers in Issuing "Solely Incidental" Guidance

We strongly support the Commission's intention to issue an interpretation clarifying what constitutes "solely incidental" advice by a broker. An interpretive release is particularly necessary because the SEC proposes to define "solely incidental" advice as "in connection with and reasonably related to the brokerage services provided to that account."[9] This proposed definition on its face is overly broad and appears to be inconsistent with both the plain meaning of the term and with the legislative history of the Advisers Act.[10] If the Commission does not issue a limiting interpretation, "any or all types of advisory services" could be rationalized to fall within that broad definition, contrary to the Commission's intent and the plain language of the statute.[11] Appropriate interpretation of the term is critical to a test that is truly based on the "nature of the services provided." As the Commission states, brokers 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."[12] Thus, the Commission must consider the fundamental differences between brokerage services and advisory services in issuing its interpretation.

One important starting point in examining the roles played by advisers and brokers is fiduciary duty. Investment advisers are subject to a strict fiduciary duty, flowing from a

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[8] Ideally, the Commission would publish guidelines regarding the information to be provided by the individual designated by the broker-dealer, as well as post similar information for the public on the SEC's web site.

[9] Reproposal at 43.

[10] *See* Letter from Barbara Roper, Consumer Federation of America re File Number S7-25-99 to Jonathan G. Katz (Feb. 7. 2005).

[11] Reproposal at 46 (an interpretation that any or all types of advisory services are part of a brokerage account "would have the effect of negating any limitation inherent in the 'solely incidental' standard, and we propose not to read 'solely incidental' so broadly.").

[12] Reproposal at 23.

relationship of trust and confidence between advisers and their clients.[13] Similarly, when brokers assume "positions of trust and confidence with their customers similar to those of advisers," brokers have been held to fiduciary standards.[14] Thus, as the Commission recognizes, there are circumstances where brokers are held to a fiduciary duty outside of the discretionary management context. These circumstances are more likely to occur when a broker moves beyond the traditional role of securities salesman providing brokerage services and begins to assume the role of trusted adviser.

In their traditional role, registered representatives provide periodic or intermittent advice with respect to particular securities being considered by the investor or that the broker recommends for consideration by the investor. We believe that such advice is part of traditional brokerage services and should continue to be considered to be solely incidental to such services.

On the other hand, portfolio management, selection of portfolio managers, and asset allocation services, even where performed on a non-discretionary basis, should not be considered to be solely incidental to brokerage transactions.[15] Such services are core investment advisory services that should be subject to the fiduciary protections of the Advisers Act.[16] These services have a "quintessentially supervisory or managerial character" that the Commission recognizes "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."[17]

Consistent with these general concepts, we support the Commission's intention to affirm that certain financial planning services and wrap fee sponsorship are not solely incidental to brokerage services. We also urge the Commission to consider issues raised by brokers holding out as "financial advisers," as well as providing other advisory services.

Financial Planning Services

We support the Commission's proposed interpretation that "if a broker-dealer holds itself out as a financial planner or as providing planning services, it cannot be considered to be giving advice that is solely incidental to brokerage." Financial planners generally prepare a

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[13] *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963); *In re Arleen Hughes*, Exchange Act Release No. 4048 (February 18, 1948).

[14] Reproposal at 22.

[15] For example, the Commission may wish to consider the factors used in determining accounts over which the broker exercises "continuous and regular supervisory or management services" for purposes of Form ADV. The instructions to Item 5F of Part 1A of Form ADV indicate that a firm does not provide continuous and regular supervisory management to an account if the firm provides advice on a periodic or intermittent basis, such as in response to a client request or market event. On the other hand, a firm does exercise such management if it has ongoing portfolio management responsibility even on a non-discretionary basis.

[16] The Commission has already recognized that such functions are core advisory functions in requiring sponsors of wrap fee programs to treat wrap fee accounts as advisory accounts.

[17] Reproposing Release at 36.

program for a client based on the client's financial circumstances and goals, which involves a wide range of subjects, typically including investments, insurance, savings, and tax considerations. This is a separate type of service that should not be deemed to be inherently "connected with and reasonably related" to brokerage services. In addition, a financial planner's provision of such wide-ranging advice and access to such extensive information about a client may well lead the client to believe he or she is in a relationship of trust and confidence with the planner.

While we understand the Commission's questions regarding suitability, we believe the "holding out" element of the interpretation will serve to distinguish provision of financial planning services from the suitability analysis that is required as part of traditional full-service brokerage. This analysis could apply to both the firm's registration requirements as well as treatment of each account as a brokerage or advisory account. Thus, if the broker holds out as providing financial planning services, any accounts that are part of the marketed program would be subject to the Advisers Act. Further, any financial planning that is the subject of a separate contract or fee would also be subject to the Advisers Act because it would not necessarily flow from the brokerage relationship.

Wrap Fee Sponsorship

Wrap fee programs offer clients a combination of brokerage services, asset allocation, adviser selection, and portfolio management for a bundled or "wrapped" fee. The portfolio management services may be offered by the broker-sponsor or its affiliate or by an independent investment adviser. Under the current regulatory structure, broker-dealers that sponsor wrap fee programs are required to be registered as investment advisers and to treat such programs as being subject to the Investment Advisers Act. The Commission has traditionally regarded the portfolio manager selection and asset allocation services involved in such programs as advisory services that are not solely incidental to brokerage services.[18] We strongly urge the Commission to reaffirm this interpretation, as well as to apply it more broadly, as discussed below.

Holding Out As an Investment Adviser

The Commission requests comment on whether a broker's use of the terms "financial consultant" or "financial adviser" is inconsistent with the broker-dealer exception. We believe it is. In our view, the opportunity for investor confusion persists where a broker is permitted to use terms that imply a relationship of trust and confidence but, in effect, disclaims fiduciary responsibility for such relationships. Part of the confusion fostered by brokers marketing advisory services stems from testimonials from actual or simulated clients regarding their "trusted" adviser. Ironically, investment advisers – who actually do have a fiduciary relationship of trust with their clients – are prohibited from using such testimonials, while brokers, who disclaim such a relationship, are permitted to do so. At a minimum,

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[18] Reproposal at 53. *See also* NASD Regulation: Fee-Based Account Questions and Answers ("Wrap accounts typically include services such as asset allocation and portfolio management for a fixed fee. Most wrap accounts with these features are subject to the Advisers Act.").

brokers should be prohibited from holding themselves out as financial consultants or advisers/advisors in combination with a testimonial that implies such an advisory relationship.

Other Interpretive Questions

The Commission's interpretation of "solely incidental" should provide additional guidance sufficient to address new services and programs as they are developed. Undoubtedly, over time broker-dealers will create new programs and services involving non-discretionary accounts that test the limits of the current interpretation and rule. The Commission's interpretation should make clear that non-discretionary advice bearing the core characteristics of investment advisory services is not solely incidental to brokerage services. As discussed above, this includes relationships of trust and confidence (from the client's perspective, not the broker's), ongoing supervisory or managerial services, portfolio management, asset allocation services, and advice regarding selection of investment advisers.

CONCLUSION

We would be pleased to work with the Commission's staff in drafting language to modify appropriately the reproposed rule. Please do not hesitate to contact us if we may provide additional information or clarification to the Commission regarding any of these matters.

Sincerely,

David G. Tittsworth
Executive Director

cc: The Honorable William H. Donaldson
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos

May 31, 2005

Via Electronic Mail

Paul Craig
Wholesale and Prudential Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Dear Mr. Craig:

The Investment Adviser Association (formerly known as the Investment Counsel Association of America)[1] appreciates this opportunity to comment on the Financial Services Authority's Consultation Paper 05/5 (CP 05/5) entitled *Bundled brokerage and soft commission arrangements: proposed rules* (March 2005).

The Investment Adviser Association is a not-for-profit organization that represents the interests of investment advisers registered with the U.S. Securities and Exchange Commission. Our members collectively manage more than $4 trillion in assets worldwide for a wide variety of institutional and individual clients, including pension funds, trusts, investment companies, endowments, foundations and corporations. Although the Investment Adviser Association is a U.S.-based association, many of our members conduct substantial investment advisory business in the United Kingdom, primarily through UK affiliates that are registered with the FSA, or provide investment management services to UK clients.

In 2003, the FSA issued Consultation Paper 176 (CP 176) entitled *Bundled brokerage and soft commission arrangements*, which would have required investment managers to rebate to clients the value of goods and services that are softed or bundled. We expressed serious concerns regarding the proposal to require rebates and commented[2] that a disclosure regime would more appropriately address the FSA's concerns regarding softing and bundling arrangements.[3] Subsequently, the FSA refined and developed its thinking on soft commission

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1 The Investment Counsel Association of America (ICAA) changed its name to the Investment Adviser Association in April 2005.

2 Letter to Ashley Kovas, Business Standards Department, FSA, from Karen L. Barr, ICAA General Counsel (October 9, 2003).

3 In CP 176 the FSA concluded that the use of soft dollar and bundled brokerage arrangements are a source of conflicts of interest between managers and their clients because these arrangements create incentives for managers "to make trading decisions, or to engage in dealing arrangements, that do not necessarily serve

and bundled brokerage arrangements and set out its proposed policy approach in two Policy Statements: Policy Statements 04/13 entitled *Bundled brokerage and soft commission arrangements: Feedback on CP 176* and 04/23 entitled *Bundled brokerage and soft commission arrangements: Update on issues arising from PS 04/13*.

In PS 04/23 the FSA recognized that its goal of providing more transparency and accountability to investors regarding softing and bundling arrangements could be achieved by means other than the rebate proposal. Specifically, PS 04/23 proposed that commissions should be used only for the purchase of "execution" and "research" and promised further clarification of these terms. The FSA also challenged the UK asset management industry to develop a meaningful disclosure proposal. To assist the industry disclosure effort, PS 04/23 provided insight into the FSA's views regarding which products or services may fall within "non-permitted services," "execution," and "research." At that time, we commended the FSA for addressing these difficult issues and offered comments on, among other things, the scope of the terms "research" and "execution."[4]

After public comment on PS 04/23, the FSA issued proposed rules regarding softing and bundling arrangements in CP 05/5. CP 05/5 presents a dual pronged solution to the FSA's concerns mentioned above: (i) new proposed rules limiting a manager's use of dealing commission to the purchase of "execution" and "research" goods and services; and (ii) an industry-led enhanced disclosure régime. This dual approach provides (i) reasonable, flexible parameters for managers to determine which goods and services may be classified as "research" or "execution;" and (ii) the UK asset management industry with a significant role in identifying and addressing, through disclosure, transparency and accountability issues regarding soft commission and bundled brokerage arrangements.

We are pleased that the FSA continues to have discussions with SEC staff on issues surrounding dealing commission and on ways that the FSA and the SEC might be able to coordinate their efforts in this area. Because of the global implications of the FSA's actions and increasing globalization of the asset management industry, we continue to believe that this dialogue is critical to facilitating compliance with and clarification of the rules discussed in CP 05/5. We offer the FSA our specific comments below.

Research

Manager Discretion. CP 05/5 defines "research" as goods or services that provide new insights, which inform investment managers when making investment decisions about a client's portfolio. Research goods and services must also represent original thought, intellectual rigor and analysis or manipulation of data to reach meaningful conclusions. The FSA does not specify

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the best interests of their customers." For example, a manager may over-consume services/goods purchased with commissions, engage in excessive dealing in order to obtain particular quantities of additional services, and select brokers who offer generous bundling or softing terms but inferior execution quality. See CP 176 paragraphs 3.15 through 3.22.

[4] Letter to Paul Craig, Wholesale and Prudential Policy Division, FSA, from Karen L. Barr, ICAA General Counsel (December 16, 2004).

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in what form research needs to be provided as long as it meets the parameters set by the FSA's rules. Rather a manager must itself make a judgment as to whether a good or service may be classified as research in compliance with FSA guidelines. We consider this a reasonable approach.

Case-by-Case Assessment. Under the proposed rules in CP 05/5, a manager may use dealing commission to purchase only goods and services that are related to "execution" or comprise the provision of "research." We note that CP 05/5 encourages managers to make forward looking agreements with broker-dealers regarding whether a good or service is "research" or "execution." [5] We assume that a manager will also have the flexibility to determine that additional types of goods or services that were not originally contemplated/negotiated with a broker-dealer may, nonetheless, be considered as "research" or "execution" on a case-by-case basis.

Execution

Post-Trade Analytics. The FSA views "execution" as goods or services linked to the arranging and conclusion of a specific investment transaction (or series of related transactions) and provided between the point at which the investment manager makes an investment decision and the point at which the investment transaction (or series of related transactions) is concluded. The FSA has acknowledged that post-trade analytical software can assist in assessing whether best execution has been achieved, and may have considerable value to fund managers for that reason. However, the FSA is not convinced that post-trade analytical software may form a part of "execution." We respectfully urge the FSA to reconsider this position since analysis of experiences with prior trades may play an important role in a manager's best execution decisions for current transactions. As such, post-trade analytics are inherently part of the execution decision for any particular trade and should fall within the definition of "execution." Practices that aid best execution analysis and competition among brokers based on execution quality should be encouraged rather than stifled.

The FSA acknowledges that post-trade analytics may be considered "research." We support this conclusion since post-trade analytics clearly add value to the investment and trading decision-making process.

Raw Data Feeds. In response to the FSA's request for comment on whether raw data feeds could be included as an execution service, we submit that such data should be considered an execution service where appropriate. As with post-trade analytics, such information may play an important role in a manager's best execution decisions for current transactions.

Non-Permitted Services

Publicly Available Information. The text of COB rule 7.18.8 lists "publicly available information" as a non-permitted service (*i.e.*, a service that may not be considered as research or execution). Paragraph 3.33 of CP 05/5 gives the following examples of "publicly available

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[5] CP 05/5 paragraphs 3.9 and 3.15.

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information:" information through mass media, specialist journals or other publications, and associated subscriptions. We recognize that certain information that is readily available to the public, such as magazines or periodicals that may be purchased at newsstands should not be classified as "research." We are concerned, however, that the term "publicly available information" and the guidance provided in CP 05/5 will be construed broadly to include research that is based on public information but not widely disseminated, or research that may be literally publicly available but not marketed to the general public. Therefore, we request that the FSA further refine the term "publicly available information."

Disclosure Regime

Industry-Led Solution. We support the FSA's decision to encourage an industry-led solution on transparency and accountability regarding softing and bundling arrangements. We are pleased that the draft rules require investment managers to disclose to their clients information regarding execution and research goods and services purchased through dealing commission. We also agree with the FSA's approach of requiring investment managers to provide information to clients about services received, but allowing managers the flexibility to comply with this obligation through the Disclosure Code, drawn up by a joint working party of the members of the Investment Management Association and the National Association of Pension Funds, or other appropriate means.

Territorial Scope

Delegation to Non-UK Sub-Adviser. We understand that the final adopted rules will apply to firms authorized to carry on investment management business in the UK, regardless of the client's location.[6] We understand this to mean that a non-UK manager would not be compelled to comply with the final adopted rules in situations where the non-UK manager is acting as sub-adviser for a UK manager. In this circumstance, the UK manager delegating the mandate to the non-UK sub-adviser would remain responsible for ensuring that delegation is appropriate and does not disadvantage its clients.

* * * *

We truly appreciate your consideration of our comments on CP 05/5. Please do not hesitate to contact the undersigned or Karen L. Barr, the Investment Adviser Association's General Counsel, for additional information or assistance regarding these issues.

Sincerely,

/s/ Maureen Magner

Maureen Magner, Counsel
Investment Adviser Association

[6] CP 05/5 paragraph 3.22.

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June 22, 2005

Via Electronic Filing

The Honorable William H. Donaldson
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release Nos. IA 2376; 34-51523; File No. S7-25-99

Dear Mr. Chairman:

The Investment Adviser Association[1] is taking this opportunity to discuss certain aspects of the final rule[2] recently issued by the Commission relating to the exception for broker-dealers under the Investment Advisers Act of 1940. In addition, we are writing to provide our initial reactions to your request for Commission staff to prepare a report on options and recommendations for a study that would, among other things, compare the "levels of protection afforded retail customers of financial service providers under the Securities Exchange Act and the Investment Advisers Act, and to recommend ways to address any investor protection concerns arising from material differences between the two regulatory regimes."[3]

Our organization has been actively involved in the debate involving this rule for many years. Since the original rule was proposed in 1999,[4] we have filed numerous comment letters with the Commission on the subject, both on behalf of our organization as well as joint letters with other interested parties.[5] We believe the rulemaking is of

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that exclusively represents the interests of SEC-registered investment advisory firms. Founded in 1937, our membership today consists of nearly 400 firms that collectively manage about $5 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

[2] *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release Nos. IA 2376; 34-51523; File No. S7-25-99 (Apr. 12, 2005) ("Release").

[3] *Id.*, at 68.

[4] *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release Nos. 34-42099; IA-1845; File No. s7-25-99 (Nov. 4, 1999).

[5] *See Letter from the Investment Counsel Association of America to Jonathan G. Katz* (Jan. 12, 2000); *Letter from Consumer Federation of America, Certified Financial Planner Board of Standards, Investment Counsel Association of America, and National Association of Personal Financial Advisors to Jonathan G.*

fundamental importance for many investment advisers and broker-dealers. Of primary concern for the Commission, however, we believe the rulemaking represents a significant opportunity to provide better notice and information to investors regarding the differences that exist between the core activities of broker-dealers and investment advisers – particularly when they are engaged in similar activities – as well as the rules, legal standards, and other regulations that govern broker-dealers and investment advisers.

In our initial comment letter to the Commission – written 5½ years ago – we noted that "[d]espite dramatic changes that are occurring in financial services, fundamental differences remain that distinguish core investment advisory functions from core brokerage activities, including the fact that investment advisers owe a strict fiduciary duty to their clients." We also agreed with the Commission's core proposition that a "functional test focusing on the nature of services provided (rather than the form of the broker-dealer's compensation) is appropriate in determining whether and under what circumstances a brokerage account may be excluded from provisions of the Advisers Act." [6] We further requested modification of three specific areas of the proposed rule:

- The rule should treat discretionary brokerage accounts that charge commissions in the same manner that it treats discretionary brokerage accounts that are fee-based.
- The rule should clarify that an account that receives discretionary advisory services is by definition not "solely incidental" to a broker-dealer's business.
- The rule should prohibit broker-dealers from advertising advisory services that are "solely incidental" to the conduct of the broker's primary business. Alternatively, the rule should require more meaningful disclosure in advertisements and any other materials that market advisory services of broker-dealers – and in contracts and agreements governing such accounts – in order to inform consumers of the significant differences between advisory and brokerage accounts, functions, and legal responsibilities.[7]

We are pleased that the final rule approved by the Commission addresses many of the concerns that we identified. We believe the changes in these areas collectively represent a major improvement to the rule as it was initially proposed. First, the final rule generally treats commission-based accounts in the same manner as fee-based accounts.[8]

Katz (May 31, 2000); *Letter from Consumer Federation of America, Fund Democracy, Investment Counsel Association of America, Financial Planning Association, Certified Financial Planner Board of Standards, and National Association of Personal Financial Planners to Hon. William H. Donaldson* (May 6, 2003); *Letter from the Investment Counsel Association of America to Jonathan G. Katz* (Sept. 22, 2004); *Letter from the Investment Counsel Association of America to Jonathan G. Katz* (Feb. 7, 2005).

[6] *Letter from the Investment Counsel Association of America to Jonathan G. Katz* (Jan. 12, 2000).

[7] *Id.*, at 2.

[8] The final rule clearly states that a broker or dealer is providing advice that is *not* solely incidental if it exercises "investment discretion" (as defined in section 3(a)(35) of the Securities Exchange Act) over any customer accounts. The rule also contains an exception from the definition of investment discretion where such discretion is "granted by a customer on a temporary or limited basis." Release, at 116-117. The release cites several specific examples of situations that would constitute "temporary or limited" grants of

Second, the final rule explicitly provides that accounts over which the broker or dealer exercises investment discretion are *not* solely incidental to their primary business.[9] Finally, the final rule requires broker-dealers to include a prominent disclosure statement in advertisements, contracts, agreements, applications, and other forms related to accounts for which they receive special compensation. While we would have preferred additional disclosures,[10] the disclosure statement in the final rule reflects significant progress from the original proposal. On balance, our organization appreciates the serious consideration given to these important issues by the Commission and we certainly recognize the improvements that were adopted in the final rule in response to suggestions made by the Investment Adviser Association and other interested parties.[11]

Going forward, we respectfully suggest two additional issues for further action by the Commission and its staff. First, we urge the Commission to dedicate adequate resources to ensure that the rule is properly implemented and that broker-dealers comply fully with its requirements. Particularly given the lengthy period of time that elapsed since the original rule was proposed, we believe it is both appropriate and reasonable to give this matter serious attention during the rule's initial implementation period. Focusing resources at an early stage of the proceedings will help to promote and ensure compliance with the rule in the future, will help reduce any uncertainties associated with the rule by promoting clear recognition and adherence to the final rule, and will assist in restoring the demarcation between brokerage and advisory activities under provisions of the Investment Advisers Act.

Second, we believe the Commission can and should play a much more proactive role in educating investors and consumers about the fundamental issues involved in this rulemaking. The Commission's Office of Investor Education and Assistance, for example, could take a leading role in developing and providing educational information to the public about the confusion that may arise when broker-dealers provide investment

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discretion. We trust the Commission will closely monitor this aspect of the rule to ensure that the exception does not swallow the general rule.

[9] *Id.*

[10] Our Feb. 7, 2005 comment letter on the Commission's reproposed rule stated as follows: "Although the reproposed disclosure is significantly improved, we believe that it does not go far enough. A broker should be required to identify the duty it has undertaken with respect to these accounts, whether fiduciary or otherwise, both in its marketing and its contracts with customers. A non-discretionary account holder should not be led to believe that the broker is continuously supervising the account and proactively alerting the customer to market, economic, issuer or other changes that require action, if the broker is not subject to an investment adviser's overarching fiduciary duty. Further, the disclosures regarding duties made in marketing or advertising material should be consistent with duties undertaken in the brokerage agreement. In other words, the marketing should not tout a relationship of trust and confidence while the contract is disclaiming fiduciary duty."

[11] We are, of course, aware of the petition for review filed by the Financial Planning Association related to the rulemaking. *The Financial Planning Association v. Securities and Exchange Commission* (July 20, 2004; D.C.Cir.). It is clear to us that the final rule would not have been issued in the absence of the FPA's initiation of its lawsuit and thus we recognize and commend FPA's key role in resolving these important regulatory issues.

advice to their customers. Our review of the on-line publications currently available on the Commission's web site indicates no information published by the Commission that addresses the potential confusion created in such circumstances.[12] As the Commission's own focus groups clearly revealed,[13] investors "were generally confused about the distinctions between brokers, financial advisors/consultants, investment advisers and financial planners."[14] Accordingly, we recommend that the Commission take this opportunity to inform investors and the public about the differences between brokerage and advisory activities, the laws and regulations governing each, and specific issues raised by this rulemaking. We would be pleased to work with the Office of Investor Education and Assistance and other interested parties, including consumer groups, to develop such educational materials. As we have previously expressed to you and your colleagues, we strongly believe the Commission must play a central role in educating the investing public about these important issues and we stand ready to assist the Commission in any way that may be helpful.[15]

The release accompanying the final rule also directs the Commission staff to provide "a detailed description or outline of any rulemaking that the staff would be prepared to recommend that the Commission undertake in the near term, or to recommend that the Commission ask the NASD or other SROs to undertake in the near term," and to report on options and recommendations "for a study to compare the levels of protection afforded retail customers of financial service providers under the Securities Exchange Act and the Investment Advisers Act, and to recommend ways to address any investor protection concerns arising from material differences between the two regulatory regimes." The release also includes several examples of questions the staff should consider in determining the scope of the study.[16] The staff report is due to be completed on or about July 11, 2005.

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[12] Indeed, some current publications possibly add to the confusion by failing to acknowledge even the most basic differences between brokerage activities and investment advisory activities. For example, the pamphlet entitled "Ask Questions" purports to provide advice to investors about making investments. But a fair reading of the document indicates that it only relates to investments with brokers (there is only one oblique reference to the term "investment adviser") despite the fact that much of the information appears to relate to investment advisory services.

[13] *Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosure* (Mar. 10, 2005).

[14] *Id.*, at 8.

[15] As one element of the disclosure required of broker-dealers in connection with the final rule, the prominent statement "also must identify an appropriate person at the firm with whom the customer can discuss the differences." Release, at 115. We are skeptical that this aspect of the rule will provide investors with *objective* information about the differences between brokers and investment advisers. This aspect of the rule underscores the need for the Commission: (1) to develop public information that is readily available to investors relating to these issues; and (2) to closely monitor how firms are complying with the new rule, including this particular requirement.

[16] Release, at 68.

The issues identified by the Commission to be addressed in the staff report are of great importance to our organization. These issues involve fundamental questions about regulations and legal standards governing the conduct of broker-dealers, investment advisers, and dually registered entities and whether such regulations and standards adequately protect the interests of investors and consumers. Should the Commission decide to move forward with this initiative, the Investment Adviser Association would welcome the opportunity to participate in a meaningful manner and to assist the Commission in understanding the concerns of the investment adviser community. However, we feel the Commission should proceed carefully to ensure that the interests of all interested parties are appropriately represented and that the study is conducted in a thorough and evenhanded manner. If the Commission determines that a study of these issues is appropriate, we feel strongly that the Commission should seek to include the views and participation of interested parties, including consumer and investor groups, the investment advisory profession, the brokerage industry, financial planners, practitioners, and other interested parties.

We believe the Commissioners, based on input and recommendations from staff, should take overall responsibility for all aspects of any such study. Before making a decision to proceed with any rulemaking or major policy recommendation (including any legislative changes), we believe the Commission should seek written comment from interested parties. The Commission also should consider whether a public forum would be appropriate for the purpose of encouraging a dialogue among various interested parties and viewpoints.[17] If the Commission chooses to enlist the assistance of outside persons in conducting the actual study,[18] we feel very strongly that the Commission should seek persons who can demonstrate knowledge of applicable laws and regulations, who represent a balanced perspective, who do not have a personal interest in a particular regulatory outcome, and who can demonstrate a commitment to investor protection. Enlisting the assistance of outside persons may be helpful in considering "outside-of-the-box" perspectives and in potentially identifying institutional or jurisdictional barriers that may impede consideration of appropriate policies. An outside party, for example, may bring a fresh and objective perspective to certain issues in which various divisions of the Commission have a vested interest. However, the Commission should avoid designating any person or organization that has a perspective favoring a particular outcome or constituency. For example, NASD clearly would not constitute an impartial third party. Written comments filed by NASD in the subject rulemaking underscore how institutional and proprietary concerns can override an objective discussion of the salient issues. NASD's most recent comment letter[19] represents a vigorous statement advocating in

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[17] The Commission's *Roundtable on Investment Adviser Regulatory Issues* (May 23, 2000) is a good example of how a forum may be structured to help identify relevant issues, concerns, and potential solutions.

[18] Among other items, the staff is directed to report on "appropriate persons, both within and *outside* of the Commission, to be involved in the study." Release, at 69 (emphasis added).

[19] *Letter from Elisse B. Walter to Jonathan G. Katz* (Apr. 4, 2005).

favor of NASD's broker-dealer regulatory scheme. The letter echoes NASD's longstanding argument that investment adviser standards are not as protective for consumers in comparison to broker-dealer requirements.[20] The point here is not to debate the merits of NASD's position on these issues, but simply to suggest that NASD certainly is not an appropriate third party the Commission should designate for purposes of conducting such an important study.[21]

We would be pleased to provide any additional information you or the staff may require regarding these important issues.

Respectfully submitted,

DAVID G. TITTSWORTH
Executive Director

Cc: Hon. Cynthia A. Glassman
Hon. Harvey J. Goldschmid
Hon. Paul S. Atkins
Hon. Roel C. Campos
Ms. Annette L. Nazareth
Mr. Meyer Eisenberg
Ms. Susan F. Wyderko
Ms. Mary L. Schapiro
Ms. Elisse B. Walter

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[20] For example, NASD describes an investment adviser's fiduciary duty as "imprecise and indeterminate" and "more implied than expressed", concluding that such an "implied duty *simply cannot* afford retail investors with the same level of protection as the explicit regulatory standards governing the conduct of business as a broker-dealer…" (emphasis added) *Id.* at 2.

[21] In the spirit of full disclosure, our organization has for many years opposed the creation of a self-regulatory organization for the investment adviser profession, as well as NASD's potential role as such. For example, the following is an excerpt of our written testimony from the Commission's *Roundtable on Investment Adviser Regulatory Issues*: "We continue to oppose the creation of a self-regulatory organization for the advisory profession. An investment adviser SRO is unwarranted and would impose a new layer of cost and bureaucracy on the profession. And the reasons that persuaded Congress to authorize the creation of an SRO for broker-dealers – the high level of interconnectivity between broker-dealers, the number of documented cases involving investor fraud, conflicts of interest, and overly aggressive sales practices, as well as the highly technical issues related to settlement, execution, and reconciliation involving broker-dealer transactions – simply do not exist in the investment advisory profession. NASDR seems to have its hands full in dealing with problems that exist at the core of the broker-dealer industry. Instead of worrying about extending its reach to another industry, it would do well to stick to its core mission of regulating the brokerage industry and to coordinate with the SEC and other regulators in addressing novel issues that may be created by changes occurring in financial services." *Statement of David G. Tittsworth, Executive Director, Investment Counsel Association of America* (May 23, 2000). We continue to endorse these previous comments.

INVESTMENT ADVISER
ASSOCIATION

July 14, 2005

The Honorable Howard M. Radzely
Solicitor
United States Department of Labor
200 Constitution Avenue, NW
Room S2002
Washington, DC 20210

Re: Form LM -10

Dear Solicitor Radzely:

On behalf of the Investment Adviser Association,[1] I would like to take this opportunity to thank you for taking time from your busy schedule to meet with us on July 12, 2005. We truly appreciate your willingness to listen to our concerns regarding the application of Form LM-10 filing requirements to investment advisory firms and other service providers to Taft-Hartley plans.

As we discussed, we have a number of serious substantive concerns regarding the legality and propriety of applying LMRDA requirements to investment advisers and other financial services providers, as well as potential civil and criminal liability issues raised by the Department's recent position regarding Form LM-10. We also have concerns about the information required to be submitted, including whether the $25 threshold is reasonable and appropriate. While we intend to discuss these issues further with the Department and the Office of Management and Budget, we are writing at this time to underscore our immediate concerns about the process – or lack thereof – that the Department has engaged in regarding Form LM-10.

Prior to June 22, 2005, when the Department posted an FAQ on its website regarding Form LM-30, investment advisers to Taft-Hartley plans were not aware of the Department's interpretive position that such service providers are required to file Form LM-10. To our knowledge, the Department has not previously informed advisers about LM-10 requirements, and, since the enactment of the LMRDA in 1959, the Department appears to have taken no action to enforce any such requirement against investment advisers whose sole connection with a labor union was providing services to Taft-Hartley

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plans. As we discussed, our members do not currently have procedures and systems in place to capture the types of information necessary to file Form LM-10 in a complete manner. It would be exceedingly difficult, costly, and burdensome for advisers to attempt to gather information for prior time periods in order to file the form. The last minute scramble required to produce the necessary historical data would provide little useful or comprehensive information to the Department, while posing potential liability risks for the filers and their signatories.

In addition to the difficulties of capturing historical information, it is a matter of fundamental fairness that new requirements and interpretations not be imposed on investment advisers or other companies retroactively. Once businesses are apprised of and understand their legal obligations, they can put systems in place to capture the necessary information on a prospective basis. Accordingly, we request the Department to publicly state that investment advisers to Taft-Hartley plans are not required to file Form LM-10 for fiscal years beginning before January 1, 2006. In the meantime, the Department should engage in formal rulemaking and provide notice and the opportunity for affected entities to comment on Form LM-10 and related instructions and interpretations. This comment period would afford financial services providers the opportunity to raise any substantive or interpretive questions they may have (and we understand there are many such questions) and receive a uniform and considered response from the Department.

We appreciate your consideration of these requests. Please do not hesitate to contact me if you require any additional information or if I may be of any assistance to you.

Best regards,

Karen L. Barr

Karen L. Barr
General Counsel

cc: Joshua B. Bolten, Director, Office of Management and Budget
Don Todd, Deputy Assistant Secretary, OLMS, Department of Labor

August 3, 2005

Via E-Mail

Ken Hojnacki, Chair
NASAA Investment Adviser Regulatory Policy
and Review Project Group
750 First Street, NE, Suite 1140
Washington, DC 20002

Re: Proposed Amendments to Model Rule on Unethical Business Practices

Dear Mr. Hojnacki:

The Investment Adviser Association[1] appreciates the opportunity to submit comments regarding the NASAA IA Regulatory Policy and Review Project Group's proposed amendments to the Model Rule on Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers ("Model Rule"). We understand that the Project Group was charged with reviewing existing investment adviser Model Rules for compliance with the 2002 Uniform Securities Act,[2] and we strongly applaud this mission.[3]

The Project Group is recommending two changes to the Unethical Business Practices rules: (1) applying the rules to investment adviser representatives of both state-registered and SEC-registered investment advisers; and (2) adding an advertising provision that parallels SEC advertising rules. We comment only with respect to the application of the rule to federal covered advisers and their supervised persons. Specifically, we strongly urge the Project Group to consider applying the Model Rule only to state-registered investment advisers and their investment adviser representatives, consistent with the Uniform Securities Act and NSMIA.[4] In the alternative, we suggest modifying the proposed language clarifying the extent to which NSMIA precludes the application of the Model Rule to federal covered advisers and their supervised persons.

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[2] See Memorandum dated July 12, 2005 to NASAA Members and the Public from NASAA IA Regulatory Policy and Review Project Group.
[3] The Investment Adviser Association endorsed the Uniform Securities Act after actively participating, along with NASAA, in the careful and deliberative four-year drafting process.
[4] National Securities Markets Improvement Act of 1996.

As we have discussed with NASAA over the past several years, the purpose of the adviser-related provisions of NSMIA was to eliminate overlapping and duplicative regulation of large advisers by the Commission and the states by dividing regulatory responsibilities. The plain language of NSMIA and accompanying legislative history unequivocally prohibit states from imposing a second layer of regulation on SEC-registered advisers. Senators Gramm and Dodd stated that Congress intended the Act to "preempt not only a state's specific registration, licensing or qualification requirements, but *all regulatory requirements imposed by state law* on investment advisers relating to their advisory activities or services, except for those activities specifically identified in the statute [*i.e.* fraud or deceit]."[5]

Importantly, the SEC has explained that "state regulatory provisions, such as those that establish recordkeeping, disclosure, and capital requirements, will no longer apply to advisers registered with the Commission."[6] The SEC also has correctly interpreted NSMIA to prohibit states from re-regulating SEC-registered advisers through the back door of defining "dishonest or unethical" business practices, except to the extent those practices would otherwise constitute actual fraud or deceit. If states are free to define "fraud or deceit" to include any and all manner of substantive regulation, NSMIA will be rendered meaningless. Indeed, in providing technical assistance to Senate personnel drafting NSMIA, the SEC staff stated that the provision "limiting the [states'] authority to bringing enforcement actions [for fraud and deceit] *precludes a state securities commission from re-regulating advisers by issuing anti-fraud rules.*"[7]

Despite the clear requirements of NSMIA, the Model Rule (and its specific state equivalents) was drafted several years ago to apply to federal covered advisers albeit with a clause that "the provisions of this subsection apply to federal covered advisers to the extent that the conduct alleged is fraudulent, deceptive, or as otherwise permitted by the National Securities Markets Improvement Act of 1996 (Pub. L. No. 104-290)." The subsequent enactment of the 2002 Uniform Securities Act, however, should prompt NASAA to reconsider applying these business practices provisions to federal covered advisers and their supervised persons at all. Section 502(b) of the 2002 Uniform Securities Act states that rules adopted under the Act "may define an act, practice of course of business of an investment adviser or an investment adviser representative, *other than a supervised person of a federal covered investment adviser,* as fraudulent, deceptive, or manipulative, and prescribe means reasonably designed to prevent investment advisers and investment adviser representatives, *other than supervised persons of a federal covered investment adviser*, from engaging in acts, practices, and courses of business defined as fraudulent, deceptive or manipulative." (emphasis added). The Uniform Act's grant of state rule-making authority extends only to state-registered

[5] Letter dated April 25, 1997 to SEC Chairman Arthur Levitt from Phil Gramm (R-Tex) and Christopher J. Dodd (D-Conn), at p. 1 (emphasis added).
[6] Rules Implementing Amendments to the Investment Advisers Act of 1940, 62 Fed. Reg. 99 at 28125 (May 22, 1997).
[7] Memorandum dated May 16, 1996 from the Division of Investment Management to the Senate Securities Committee Staff, File Docket No. F7-98 (emphasis added).

advisers and their investment adviser representatives to ensure consistency with NSMIA.[8] Accordingly, we respectfully request that NASAA conform the application of its Model Rule to Section 502(b) of the Uniform Securities Act by deleting references to federal covered advisers and using the term "investment adviser representative of an investment adviser" in lieu of the broader term "investment adviser representative."

At a minimum, should the Project Group decide to retain references to federal covered advisers and their investment adviser representatives, the introduction to the Model Rule should be amended to read: "The provisions of this subsection apply to federal covered advisers *and investment adviser representatives of federal covered advisers* to the extent that the conduct alleged is fraudulent, deceptive, or as otherwise permitted by the National Securities Markets Improvement Act of 1996."[9] This will ensure that federal covered advisers are not improperly regulated through the back door of imposing requirements on their investment adviser representatives. Similarly, subsection (m)(2) should be amended to read: "With respect to federal covered advisers *and their investment adviser representatives,* the provisions of this section apply only to the extent permitted by Section 203A of the Investment Advisers Act of 1940."[10]

Thank you for your consideration of these comments. Please do not hesitate to contact me if you would like additional information or if I may be of assistance in any way.

Best regards,

Karen L. Barr

Karen L. Barr
General Counsel

cc: Ed Reed (AL)
Jackie L. VanCura (NE)
J.R. Beauboeuf (MI)
David Smith (AR)
Paul Schwartz (PA)
Jay Knight (DC)
Joseph Brady (NASAA Legal)

[8] We do not, of course, object to regulation of business practices; we simply believe that such requirements should be imposed by the SEC rather than the various states, consistent with NSMIA.
[9] Suggested additional language italicized.
[10] Suggested additional language italicized.

August 4, 2005

Via Electronic Filing

Mr. Jonathan G. Katz
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

Re: Petition for Rulemaking; Request for Extension of Certain Compliance Dates filed by the Securities Industry Association relating to Investment Advisers Act Rule 202(a)(11)-1

Dear Mr. Katz:

The Investment Adviser Association[1] is writing to express its strong opposition to the request by the Securities Industry Association[2] to extend certain compliance dates for the rule adopted by the Commission earlier this year relating to the broker-dealer exception under the Investment Advisers Act.[3]

Specifically, we oppose the SIA's request to delay implementation of the aspect of the rule that requires brokerage firms to treat accounts as investment advisory accounts if the broker exercises investment discretion on more than a "temporary or limited" basis.[4]

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[1] The Investment Adviser Association is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the IAA's membership today consists of more than 400 firms that collectively manage in excess of $5 trillion. For more information, please visit our web site: www.investmentadviser.org.

[2] Letter from Ira D. Hammerman, Securities Industry Association, to Jonathan G. Katz, Securities and Exchange Commission (July 28, 2005). The SIA letter also requests an extension of time based upon provisions of the rule relating to financial planning. A similar request has been made by the American Council of Life Insurers. *See* Letter from Carl B. Wilkerson, American Council of Life Insurers to Jonathan G. Katz, Securities and Exchange Commission (July 27, 2005).

[3] *See Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release Nos. IA 2376; 34-51523; File No. S7-25-99 (April 12, 2005).

[4] The rule provides that a broker-dealer will not be deemed to be an investment adviser based solely on its receipt of special compensation, provided that "[a]ny 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 (including, in particular, that the broker or dealer does not exercise investment discretion as provided in paragraphs (b)(3) and (d) of this section)…" 17 CFR §275.202(a)(11)-1(a)(1)(i). Paragraph (b)(3) provides: "A broker or dealer 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 or to the brokerage services provided to accounts from which it receives

Our opposition to the SIA's request is based on several considerations: (1) the determination of whether a broker-dealer exercises investment discretion is not difficult or time-consuming and therefore an extension of time is unwarranted; (2) in its previous comment letter, the SIA requested the Commission to modify the final rule to include the "temporary or limited" provisions but never indicated that making such a determination was difficult or time-consuming and, therefore, it is unfair to further delay implementation of this rule based on inclusion of this provision in the final rule; (3) the SIA and its members have been aware for several years of the inevitability that the final rule would require brokers to treat discretionary accounts as advisory accounts; and (4) the rule already has been delayed for several years and acceding to the SIA's request will further delay efforts to inform investors about differences between brokerage and advisory accounts and thus will not serve the Commission's mission of protecting investors.

1. **The determination of whether a broker-dealer exercises investment discretion is not difficult or time-consuming and therefore an extension of time is unwarranted.** The final rule in relevant part states that a broker-dealer provides advice that is not solely incidental to its primary business if the broker-dealer provides "investment discretion" over the account. In turn, the term "investment discretion" is referenced to section 3(a)(35) of the Securities Exchange Act – the primary law governing the conduct and activities of broker-dealers. The definition of investment discretion is not a new term for broker-dealers and there is no evidence that making a determination of whether a broker-dealer exercises investment discretion is a difficult or time-consuming activity. In numerous previous comment letters related to this proceeding, the SIA and its member firms did not request a lengthy implementation period in order to make such a determination.

2. **In its previous comment letter, the SIA requested the Commission to modify the final rule to include the "temporary or limited" provisions but never indicated that making such a determination was difficult or time-consuming and, therefore, it is unfair to further delay implementation of this rule based on inclusion of this provision in the final rule.** In its most recent comment letter to the Commission,[5] the SIA argued that the definition of "investment discretion" set forth in the Securities Exchange Act is "too broad" for purposes of the rulemaking and that the Commission should

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special compensation within the meaning of paragraph (a)(1)(i) of this section if the broker or dealer (among other things, and without limitation):…(3) Exercises investment discretion, as that term is defined in paragraph (d) of this section, over any customer accounts." Paragraph (d) provides: "For purpose of this section, the term investment discretion has the same meaning as given in section 3(a)(35) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(35)), except that it does not include investment discretion granted by a customer on a temporary or limited basis."

[5] Letter from Ira D. Hammerman, Securities Industry Association to Jonathan G. Katz, Securities and Exchange Commission (February 7, 2005).

modify the rule to recognize "discretion limited by customer instructions" in certain circumstances.[6] However, the SIA certainly did not argue that such a determination is either difficult or time-consuming and did not request a lengthy implementation period in order to accommodate such a provision. In response to the request by SIA (and others), the final rule permits broker-dealers to exercise investment discretion on a temporary or limited basis without having to treat such accounts as advisory accounts.[7] Having requested this special accommodation in the rule, we believe it is a bit disingenuous to now argue that determining compliance with this provision will involve "a labor-intensive and time-consuming process."[8] If complying with this aspect of the rule requires such an extraordinary effort by its members, the SIA certainly should have informed the Commission at the time it was asking the Commission to include such a provision in the final rule.

3. **The SIA and its members have been aware for several years of the inevitability that the final rule would require brokers to treat discretionary accounts as advisory accounts.** The SIA has been an active participant in this proceeding during the 5½ years this rulemaking has been pending. In fact, the SIA and some of its members were actively engaged in requesting the Commission to initiate such a rulemaking in 1999. While the rule has gone through various changes during its lengthy history, the central rationale for the rule has remained unchanged, *i.e.*, imposing fees (instead of commissions) should not automatically "convert" brokerage accounts into advisory accounts. And the primary mechanism for achieving this result – and to create a bright line test between brokerage and advisory accounts – is to focus on whether a broker-dealer exercises "investment discretion" over the account. The SIA consistently has supported the central rationale for the rule[9] and has never argued that a lengthy implementation period will be required to effect such a result. Now, more than three months after the final rule was adopted by a unanimous vote of the Commission, the SIA has – for the first time – indicated that at least a year will be needed to effectuate the rule's provisions. As noted above, we do not believe that making the determination

[6] *Id.*, at 17. "We recommend that the Commission, while continuing to provide investors with the benefits and choices afforded by limited discretionary accounts, modify the Rule so as to provide that broker-dealers' having discretion limited by written customer instructions as to: (1) time periods of a temporary nature; (2) one or more specific securities or types of securities; or (3) prices at which they can be purchased and, in some cases, sales can be made, are not exercising discretionary investment advice."

[7] *Supra* n. 3 at 64-65. "Therefore, the final rule permits broker-dealers to exercise investment discretion on a temporary or limited basis without becoming ineligible for the exception under the rule. In such cases, the customer is granting discretion primarily for execution purposes and is not seeking to obtain discretionary supervisory services. Such discretion must be limited to a transaction or series of transactions and not extend to setting investment objectives or policies for the customer."

[8] *Supra* n. 2 at 3.

[9] *Supra* n. 5 at 3. "SIA strongly believes that the central position reflected in the Rule is beneficial to broker-dealer customers."

of "investment discretion" (and, in certain cases, whether the customer has granted the broker-dealer discretion on a "temporary or limited" basis) is difficult, time-consuming, or burdensome. Having made the decision to provide discretionary investment services (and many brokerage firms having done so before the final rule was adopted), we believe it is reasonable, fair, and appropriate to ask broker-dealers to comply with the rule within the six-month time frame specified by the rule.

4. **The rule already has been delayed for several years and acceding to the SIA's request will further delay efforts to inform investors about differences between brokerage and advisory accounts and thus will not serve the Commission's mission of protecting investors.** While there are major differences among the various interests that have participated in this rulemaking, no one disputes the proposition that this rule has important consequences in terms of investor protection – including the prominent statement that must accompany advertisements, agreements, and other forms relating to brokerage accounts that receive special compensation. Following the Commission's unanimous vote on April 6 approving the new rule, the SIA issued a press release calling the rule a "victory for investors" and stating that the SEC "made the right decision." The press release touted the alleged virtues of fee-based brokerage accounts and noted that the SIA had led the victorious fight resulting in the Commission's action to make the former "no-action" position permanent, arguing that many brokers would "stop offering fee-based accounts rather than be subject to such a burdensome and redundant regulatory arrangement."[10] More than three months later, the SIA obviously is now balking at actually following through with the changes that the rule entails. Despite praising the Commission's adoption of the new rule, it is abundantly apparent that the SIA and its members are seeking to delay any rule that requires brokers to treat accounts as advisory accounts, whatever the circumstances.[11] In fulfilling its fundamental mission to protect investors, we believe the Commission should deny the SIA's request to extend the compliance date and should seek to enforce the rule as adopted.

We also take this opportunity to reiterate the concerns we expressed in our recent letter related to this important rulemaking.[12] First, we urge the Commission to dedicate adequate resources to ensure that the rule is properly implemented and that broker-dealers comply fully with its requirements. Second, we urge the Commission to take a proactive role in educating investors and consumers about the fundamental issues involved in this

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[10] Press release, Securities Industry Association (April 6, 2005).

[11] The SIA letter states: "The SIA believes an extension would be consistent with the need for a study, and would provide the Commission time to determine the most prudent course in response thereto." Evidently, the SIA hopes to delay this proceeding in hopes that the proposed Commission study will lead to a reconsideration of the aspects of the final rule the SIA dislikes.

[12] Letter from David G. Tittsworth, Investment Adviser Association to The Honorable William H. Donaldson (June 22, 2005).

rulemaking. After more than five years since the rulemaking was initiated, we believe it is time for the Commission to move forward to implement and enforce the rule it has adopted and to educate investors and the public about these issues.

As always, we appreciate the opportunity to provide our views on this important subject and we stand ready to assist the Commission and its staff in any manner. Please do not hesitate to contact us if you have any questions or need any additional information.

Sincerely,

David G Tittsworth

DAVID G. TITTSWORTH
Executive Director

Cc: The Honorable Christopher Cox
The Honorable Cynthia A. Glassman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette Nazareth
Mr. Giovanni Prezioso
Mr. Meyer Eisenberg
Mr. Robert L.D. Colby
Mr. Robert E. Plaze

August 29, 2005

Via Facsimile

Victoria A. Lipnic
Assistant Secretary for
Employment Standards
United States Department of Labor
200 Constitution Avenue, NW
Room S2321
Washington, DC 20210

Re: OLMS Question and Answer Website Posting, June 22, 2005

Dear Assistant Secretary Lipnic:

We represent thousands of employers potentially affected by a new position taken by the Department of Labor (Department).[1] These employers include financial services firms that provide services to Taft-Hartley pension and benefit plans. On June 22, 2005, the Department publicly interpreted Section 203(a) of the Labor Management Relations Disclosure Act (LMRDA) to require detailed public disclosure of any "payment" made by an "employer" to a labor organization, union official, employee, or labor relations consultant unrelated to collective bargaining relationships for the first time through a website posting. Further, the Department's website indicated that the reporting requirement would apply retroactively. This new interpretation raises a number of procedural, substantive, and liability issues for the members of our trade associations and all employers who conduct business or may potentially conduct business with a labor organization covered by the LMRDA.

The LMRDA was enacted to address abuses of power by union leadership. The legislation provides a "bill of rights" for rank and file workers and was specifically focused on union organizing activities.[2] The legislation requires labor organizations and union officials to report payments on a Form LM-30 and "employers" must report their side of the payment on Form LM-10. The president and treasurer of each reporting employer must sign form LM-10. These officers are "personally responsible for its filing and accuracy." These individuals are subject to criminal and civil liability for failure to file or false reporting. Although section 203(a) was enacted in 1959, the Department

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[1] American Bankers Association, American Council of Life Insurers, Financial Services Roundtable, Investment Adviser Association, Investment Company Institute, National Association of Real Estate Investment Managers, Securities Industry Association, and The Real Estate Roundtable.

[2] 29 U.S.C. 401, Section 2(a), (b), and (c): Declaration of Findings, Purposes, and Policy.

concedes that the law has never been enforced with respect to employers who deal with unions outside the collective bargaining context.

Our members' first awareness of this new interpretation regarding Form LM-10 was through a posting on the Department website of a list of *frequently asked questions* (FAQs) relating to the filing of the LM-30 on June 22, 2005. Our concerns were further heightened because the website indicated that employers were required to file Form LM-10 for any payments made starting in 2004. We understand that the Department had a number of communications with labor organizations and their officials about the Department's new emphasis on compliance with these reporting requirements for a number of months prior. Specifically, we understand that union officials began receiving letters from the Office of Labor Management Standards no later than January of 2005 asking them to comply with the LM-30 filing requirements. We know of no such communications to employers.

Because most employers were unaware of any obligation to file the companion Form LM-10 until June 22, 2005, we respectfully request that any new requirements involving reporting be applied prospectively, not retroactively. The employer community does not currently have procedures and systems in place to capture the types of information necessary to file Form LM-10 in a complete manner. It would be exceedingly difficult, costly, and burdensome for businesses to attempt to gather information for prior time periods in order to file the form. The last minute scramble required to produce the necessary historical data would provide little useful or comprehensive information to the Department, while posing potential liability risks for the filers and their signatories. It is a matter of fundamental fairness that new requirements and interpretations not be imposed on the employer community retroactively. Once businesses are apprised of and understand their legal obligations, if any, they can put systems in place to capture the necessary information on a prospective basis.

Second, it is vital that the Department engages in formal rulemaking and provides notice and the opportunity for affected entities to comment on Form LM-10 and related instructions and interpretations. This comment period would afford employers the opportunity to raise any substantive or interpretive questions they have and receive a uniform and considered response from the Department. In addition, the opportunity for notice and comment would help ensure coordination on issues within the various branches at the Department as well as other federal agencies, including the Justice Department. In the meantime, the Department should publicly state that employers making "payments" unrelated to collective bargaining are not required to file Form LM-10 for fiscal years beginning before January 1, 2006.

Third, the undersigned trade associations are also concerned about extending this new requirement to virtually all employers as a matter of public policy. This new interpretation would require virtually any entity that provides anything at all to a union member to file Form LM-10. Whether Congress intended such a result should be a matter discussed in a public forum through notice and comment. In addition, a formal rulemaking process would help ensure that the myriad issues raised by this type of reporting are addressed consistently, in a manner that will be most effective and an efficient use of taxpayer dollars.

Finally, under various criminal statutes, as well as section 406 of ERISA, the making of payments to pension plan trustees or union officials may be prohibited under certain circumstances. Those circumstances have not been adequately clarified or explained. Financial services providers have operated under the understanding that reasonable and routine marketing expenses (e.g. dinner, reception) are permissible. Before requiring potentially self-incriminating reports, the DOL should provide guidance as to the parameters of permissible expenditures and enforce this guidance prospectively only.

Please do not hesitate to contact Karen Barr at (202) 293-4222 or Liz Varley at (202) 216-2000 or any of the undersigned trade associations if you need additional information.

American Bankers Association
American Council of Life Insurance
Financial Services Roundtable
Investment Company Institute
Investment Adviser Association
National Association of Real Estate Investment Managers
The Real Estate Roundtable
Securities Industry Association

October 7, 2005

Via Electronic Delivery

Mr. Christopher J. Motta
U.S. Department of Labor
Office of Exemption Determinations
Employee Benefits Security Administration
Room N-5649
200 Constitution Avenue, N.W.
Washington, DC 20210

Re: PTE 84-14 Amendment

Dear Mr. Motta:

The Investment Adviser Association[1] appreciates the opportunity to comment on the amendments proposed by the U.S. Department of Labor to Prohibited Transaction Class Exemption 84-14, which applies to transactions negotiated by a qualified professional asset manager (QPAM exemption).[2] As managers of employee benefit and pension plan assets, many of our members are subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA) and rely on the QPAM exemption. The proposal would permit financial institutions that manage their or their affiliates' in-house retirement plan to rely on the QPAM exemption.

Background

In 2003, the Department proposed amendments to the QPAM exemption to respond to challenges of a consolidating industry.[3] As part of that proposal, the Department expressed its view that the QPAM exemption has never been available to a financial institution acting as a QPAM to its own in-house plan,[4] and proposed

1 The IAA, formerly known as the Investment Counsel Association of America (ICAA), is a not-for-profit association that represents the interests of the registered investment advisory profession. Founded in 1937, the IAA's membership today consists of more than 400 SEC-registered investment advisory firms that collectively manage in excess of $5 trillion for a wide variety of institutional and individual clients. See www.investmentadviser.org for more information.

2 70 F.R. 49305 (2005) (release)

3 68 F.R. 52419 (2003)(2003 proposal).

4 2003 proposal at 52423.

amendments to expressly require that the QPAM be independent of an employer with respect to a plan whose assets are managed by the QPAM. The IAA voiced its concerns surrounding the Department's proposed "independence" requirement and urged the Department to revise the proposal to clarify that an investment adviser may act as a QPAM for its own employee plan or the plan of its affiliates.[5] To address these and related concerns, the Department proposed additional amendments simultaneous with final adoption of the proposed independence requirement and other QPAM amendments.[6]

The IAA generally supports the proposed amendments, but requests two important modifications.

The Independence Requirement

We share the concerns of others that there has been significant confusion surrounding the availability of the QPAM exemption to financial institutions that manage their own and/or their affiliates' in-house employee benefit plans, and appreciate the Department's acknowledgement that the regulatory community has made good faith efforts to comply with the QPAM requirements.[7] To address this issue, in conjunction with finalizing the independence requirement as proposed, the Department provided the following retroactive and transitional relief to financial institutions that act as QPAMs to their own plan or the plan of an affiliate.

First, the Department included in the final amendments a transitional rule under which the exemption would remain available for transactions involving the in-house plans of QPAMs or their affiliates until such time as the Department adopts a final exemption dealing specifically with the application of the QPAM exemption to in-house plans.[8] Second, the Department proposed additional amendments that would allow a financial institution to provide QPAM services to its own in-house plan or the plan of its affiliate on a prospective basis, provided certain conditions are met.[9]

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5 *Letter from ICAA General Counsel Karen Barr to Ms. Karen E. Lloyd, Office of Exemption Determinations, U.S. Department of Labor,* Oct. 20, 2003 (IAA Comment Letter) at 2-4 (also noting that experienced industry practitioners have historically disagreed with the Department's view based on the language of the exemption itself.)

6 The IAA strongly supported the majority of the final amendments, which generally ease the QPAM exemption in several important respects and reflect many of the issues addressed in the IAA Comment Letter.

7 Release at 49307.

8 We ask the Department to expressly confirm our understanding that the final exemption provides retroactive and transitional relief to financial institutions that act as QPAMs to their own plans *and/or the plans of their affiliates*.

9 We refer generally to these financial institutions as "FINHAMs," and ask the Department to expressly confirm our understanding that the proposed amendments are intended to permit financial institutions to act as FINHAMs to their own plans *and/or the plans of their affiliates*.

The proposed conditions for transactions of plans managed by FINHAMs include: (1) the FINHAM has discretionary authority or control with respect to the assets involved in the transaction; (2) the FINHAM adopts written policies and procedures designed to ensure compliance with the conditions of the FINHAM exemption; and (3) an independent auditor conducts an annual exemption audit designed to review the FINHAM's compliance with its procedures and the exemption's objective requirements.

The proposed audit requirements are substantially similar to the audit requirements in the current INHAM exemption (PTE 96-23),[10] and are proposed to include a representative sample of transactions involving the FINHAM's plan in order to make findings regarding whether the FINHAM is in operational compliance with its written policies and procedures and the objective requirements of the exemption. A written report describing the steps performed by the auditor during the course of its review and the auditor's findings also would be required.

We very much appreciate the retroactive and transitional relief afforded by the amendments to financial institutions that manage their own plans or the plans of their affiliates. While we are still in the process of analyzing the impact the proposal and the audit requirement in particular will have on our membership, we recommend two important modifications to the proposal at this time. First, we suggest an alternate approach to the independent exemption audit requirement. Second, we recommend that the final release remove the independence requirements of Section I(e) of the QPAM exemption for FINHAMs

Alternative Exemption Requirement

The proposal would require FINHAMs to undergo an exemption audit by an independent auditor on an annual basis. While it is important to periodically review an FINHAM's compliance with the exemption's conditions, we do not believe an annual independent audit is necessary or appropriate. As a discretionary asset manager, a FINHAM is highly motivated to ensure compliance with its own exemption as it is ultimately responsible for any losses resulting from non-exempt transactions and is obligated to comply with its disclosures and representations regarding applicability of the exemption. Moreover, we have been advised that audit costs for INHAMs frequently exceed $20,000 and that because of the magnitude and diversity of investment operations of a typical FINHAM, the audit costs for FINHAMs will likely be much greater. We believe such a cost is difficult to justify for financial institutions whose primary business function is to manage assets for unaffiliated parties.

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10 Release at 49315. The INHAM exemption provides relief for various party-in-interest transactions that involve the assets of a plan managed by an in-house manager.

As an alternative to the annual independent audit requirement, we suggest that the proposal be modified to require an annual in-house review or audit of exemption compliance, together with an additional requirement that an independent firm conduct an exemption audit every five years. We believe this tiered approach to the audit provides the right balance of continual review and independent oversight.

Section I(e): Applicability for FINHAMs

The QPAM exemption was issued by the Department in 1984 to address the reality that causing a plan to engage in transactions with parties-in-interest to the plan was in many instances unavoidable. The QPAM exemption provides relief from specified parts of Section 406 of ERISA and companion sections of the Internal Revenue Code if certain conditions addressing the size, sophistication and independence of the asset manager are met. As an aspect of ensuring the “independence” of the asset manager, Section I(e) of the QPAM exemption conditions the availability of the exemption on the requirement that the assets of the plan (and affiliated plans) that would engage in the transaction not constitute more than 20% of the asset manager's assets under management.

As large plans began to develop in-house expertise and sought to manage their own plan assets, they needed QPAM-type relief. However, because all of the assets they managed were for their own plans, they could not meet the 20% test of Section I(e) of the QPAM exemption. Subsequent to issuing a number of individual exemptions, in 1996 the Department issued the INHAM exemption. The INHAM exemption acknowledges the fact that the asset manager is not independent of the plan and in lieu of the 20% test, requires the in-house asset manager, among other things, to adopt written policies and procedures and undergo an annual exemption audit.

The proposal takes into account that an asset manager may meet all of the conditions of the QPAM exemption as originally adopted, but be related to a plan for which it is an asset manager. The proposal as currently drafted would condition relief on the FINHAM meeting substantially the same requirements as are applied to INHAMs <u>and</u> meeting the applicable requirements of Parts I, III, or IV of the QPAM exemption.

We believe that it is duplicative and unnecessary for FINHAMs to be subject to the 20% test of Section I(e) in addition to INHAM-style requirements and safeguards. The Section I(e) independence safeguards would appear to be sufficiently addressed by the INHAM-style requirements. Moreover, as a result of being subject to the INHAM and Section I(e) requirements, FINHAMs would be disadvantaged as compared with INHAMs with respect to managing related plan assets.

For these reasons, we propose that the last sentence of proposed new Section V(d) be revised to read: "The transaction meets the applicable requirements set forth in Parts I *(other than section I(e))*, III, or IV of the exemption." (emphasis added)

We would be pleased to meet with the Department to discuss these and any other considerations related to the proposed and final amendments. Please do not hesitate to contact the undersigned or Karen Barr, General Counsel if you have questions or require additional information related to this submission.

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Very truly yours,

Caroline Schaefer

Caroline Schaefer
Associate General Counsel

INVESTMENT ADVISER ASSOCIATION

October 14, 2005

Via Electronic Filing

Federal Energy Regulatory Commission
Office of the Secretary
888 First Street, N.E.
Washington, D.C. 20426

Re: Docket No. RM05-32-000
Repeal of the Public Utility Holding Company Act of 1935 and Enactment of the Public Utility Holding Company Act of 2005

Dear Sir or Madam:

The Investment Adviser Association[1] appreciates this opportunity to submit comments related to the Commission's proposals for certain rules under the Energy Policy Act of 2005 (EPAct 2005),[2] which repeals, in relevant part, the Public Utility Holding Company Act of 1935 (PUHCA 1935)[3] and enacts the Public Utility Holding Company Act of 2005 (PUHCA 2005).[4] This letter responds to the Commission's request for comment on whether it should exempt classes or transactions involving mutual fund passive investors or other groups of passive investors from the new federal books and records access requirements set forth in Section 1264 of PUHCA 2005.

Sections 1264(a) and (b) of PUHCA 2005 provide generally that each "holding company" [5] shall maintain and make available to the Commission, such books, accounts,

1 The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that exclusively represents the interests of SEC-registered investment advisory firms. Founded in 1937, our membership today consists of more than 400 firms that collectively manage about $5 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

2 Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005).

3 15 U.S.C. §§ 79a *et seq*. (2000).

4 EPAct 2005 at §§ 1261 *et seq*.

5 The term "holding company" is defined generally as a company that directly or indirectly owns, controls, or holds, with power to vote, 10 percent or more of the outstanding voting securities of a public-utility company or of a holding company of any public-utility company (collectively referred to herein as "utilities").

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memoranda, and other records ("books and records"), as the Commission determines are relevant to the costs incurred by a public utility or natural gas company that is an associate company of such holding company and necessary or appropriate for the protection of public utility or natural gas company customers with respect to jurisdictional rates[6] ("federal access requirements"). Section 1261 of PUHCA 2005 would deem an investment adviser or fund that holds 10% or more of the voting securities[7] of a public utility to be a "holding company" subject to the federal access requirements. As discussed below, we support the arguments made by the Investment Company Institute in its comment letter dated October 14, 2005 and we request that the Commission exempt SEC-registered investment advisers and investment companies that passively invest in utilities ("advisers" and "funds," respectively) from the federal access requirements.[8]

Advisers and Funds that Passively Invest in Utilities Generally Exert No Influence or Control Over the Utilities.

Generally, advisers acting on their own behalf and on the behalf of funds and other advisory clients that passively invest in utilities do so in order to generate, among other things, a high level of income or return. These entities do not generally seek to influence or control the costs incurred by a utility or the rates set by a utility. Subjecting advisers and funds to the federal access requirements does not appear, therefore, to serve the purpose of PUHCA 2005, *i.e.*, protecting customers with respect to jurisdictional rates. Moreover, subjecting passive investors such as advisers and funds to regulation by the Commission seems to serve no other public benefit.

Exempting Advisers and Funds would be Consistent with the Commission's Current Exemptive Authority and Other Exemptions.

PUHCA 2005 directs the Commission to exempt a person or transactions from the federal access requirements if the Commission finds that the person's books and records or a class of transactions are not relevant to the jurisdictional rates of a public utility or natural gas company.[9] Because it is highly unlikely that advisers and funds passively investing in utilities would in fact control those utilities or influence their costs or rates, an exemption would be consistent with the Commission's current exemptive authority.

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[6] The term "jurisdictional rates" means rates accepted or established by the Commission for the transmission of electric energy in interstate commerce, the sale of electric energy at wholesale in interstate commerce, the transportation of natural gas in interstate commerce, and the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other usage.

[7] The term "voting security" means any security presently entitling the owner or holder thereof to vote in the direction or management of the affairs of a company.

[8] Letter from Frances M. Stadler, Investment Company Institute, to Federal Energy Regulatory Commission, (Oct. 14, 2005) (ICI Letter).

[9] §366.3 Exemption from Commission access to books and records.

An exemption for advisers and funds would also be consistent with the treatment of banks, savings associations, and trust companies. The definition of "holding company" excludes these entities to the extent they hold utility company securities in the ordinary course of business as fiduciaries. Advisers and funds, like these entities, play an important role in the financial industry and act as intermediaries and/or fiduciaries for investors. Therefore, the Commission should not discourage, through unnecessary regulation, an adviser or fund from investing in utilities as part of their ordinary course of business.

The SEC Regulates Advisers and Funds.

Advisers and funds are subject to comprehensive regulation under the federal securities laws. Therefore, exempting advisers and funds from the federal access requirements is consistent with the purposes of PUCHA 2005: namely to eliminate unnecessary regulation, while protecting the interests of consumers and investors. Advisers to mutual funds and other advisory clients must adhere to the investment policies, objectives and mandates of their clients, including prohibitions against acquiring securities for control or management purposes. Moreover, advisers must act in accordance with their fiduciary obligations and avoid acting in a manner that would materially conflict with the interests of a client. For example, an adviser could not ignore a client's directive to invest passively in a utility.

An Exemption for Advisers and Funds may Increase Investment in the Utility Industry and Preserve Commission Resources.

Exempting advisers and funds from the federal access requirements may increase the amount of investment capital available to the utility industry by removing the concern that these entities might be subject to regulation as public utility holding companies. In addition, a class exemption for advisers and funds is likely to conserve the Commission's regulatory resources and allow them to direct efforts elsewhere. Without an exemption, the Commission may likely receive and be required to process multiple applications presenting substantially identical fact patterns. In this case, a class exemption would prove more efficient.

For the above reasons, we propose that the Commission establish an exemption for advisers and funds based on the rationale underlying Rules 16a-1 and 13d-1 under the Securities Exchange Act of 1934 ("1934 Act"). These rules acknowledge that entities such as advisers and funds that passively invest in other issuers do not trigger the concerns that those rules are designed to address because these entities do not seek to change or influence the control of an issuer. For example, Rule 16a-1 excludes from the definition of "beneficial owner" securities holdings of persons who are unlikely to influence management or control the issuer, including registered investment companies and registered investment advisers, so long as the securities in question are "held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business. . .[and] are acquired by such institutions or persons without the purpose or effect of changing or influencing control of the issuer."[10] Moreover, Rule 13d-1(b)(1) permits certain institutions and persons (including advisers and funds) to file reports of beneficial

[10] 1934 Act Rule 16a-1(a)(1).

ownership of securities with the SEC on a short-form statement, Schedule 13G, rather than the long-form Schedule 13D because their acquisitions do not affect the control of issuers. Specifically, this Rule states that a person may submit Schedule 13G so long as the person has, among other things, "acquired such securities in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer…."

To implement the above approach, the Commission's rules should exempt from the federal access requirements any investment adviser registered under Section 203 of the Investment Advisers Act of 1940 and any investment company registered under Section 8 of the Investment Company Act of 1940 that owns, controls, or holds, with the power to vote, securities of a public utility company or holding company of a public utility company, so long as the investment adviser or investment company has acquired the securities in the ordinary course of business and without the purpose or effect of changing or influencing control of such public utility or holding company.

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We truly appreciate your consideration of our comments on PUCHA 2005. Please do not hesitate to contact the undersigned or Karen L. Barr, the Investment Adviser Association's General Counsel, for additional information or assistance regarding these matters.

Sincerely,

Maureen Magner

Maureen Magner, Counsel
Investment Adviser Association

November 23, 2005

Via Electronic Filing

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-9303

Re: Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Rel. No. 34-52635; File No. S7-09-05

Dear Mr. Katz:

The Investment Adviser Association[1] appreciates the opportunity to comment on the Commission's proposed interpretation of client commission practices by investment advisers under the safe harbor of Section 28(e) of the Securities Exchange Act of 1934.[2] We commend the Commission for providing guidance regarding the use of client commissions by a fiduciary to lawfully receive brokerage and research services that assist in the adviser's investment decision-making responsibilities. This is an important issue both for investment advisers and investors.

The IAA has actively supported full and fair disclosure of the use of client commissions for research and brokerage services under the safe harbor of Section 28(e).[3]

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment advisory firms. Founded in 1937, the IAA's membership today consists of more than 400 firms that collectively manage in excess of $5 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

[2] *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Rel. No. 34-52635; File No. S7-09-05 (Oct. 19, 2005), as published in 70 Fed. Reg. 61700 (Oct. 25, 2005) (Proposal). The Proposal uses the phrase "client commission" practices or arrangements under Section 28(e) to avoid any confusion that may arise over the phrase "soft dollars." Proposal at 3, n. 2. The Proposal is available at http://www.sec.gov/rules/interp/34-52635.pdf.

[3] *See* ICAA Statement Re: Soft Dollars (Mar. 3, 2004) ("ICAA Statement"); Written Statement of Geoffrey I. Edelstein, Managing Director of Westcap Investors, "*Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Examining Soft-Dollar Practices*," Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 31, 2004) ("ICAA Testimony"). Both documents are available on our website under "Comments & Statements."

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As a fiduciary, an investment adviser has an obligation to seek best execution in connection with client transactions and to disclose potential conflicts of interest to existing and prospective clients. The duty of best execution requires an adviser to seek to execute securities transactions for clients in such a manner that the client's total cost or proceeds is the most favorable under the circumstances.[4] In addition to enhanced disclosure requirements, we have supported the Commission's efforts to clarify the types of products and services that constitute permissible research under current law and have encouraged the preservation of third-party research under the safe harbor.[5] Further, we commented during the U.K. Financial Services Authority's rulemaking regarding the FSA's decision to encourage an industry-led solution on transparency and accountability regarding softing and bundling arrangements.[6]

We are pleased to provide our comments on the Proposal. Specifically, we respectfully request that the Commission:

1. Acknowledge that certain products and services, including order management systems, post-trade analytics, and proxy voting services, may be eligible under the safe harbor of Section 28(e) as brokerage or research services (either in full or under a "mixed-use" analysis);
2. Reconsider its discussion of bundled products in the mixed-use section of the Proposal;
3. Clarify the applicability of the Section 28(e) safe harbor to certain relationships and practices;
4. Confirm that advisers are not responsible for ensuring broker-dealers' compliance with the proposed guidance for commission-sharing arrangements; and
5. Allow firms sufficient time to implement the final interpretation.

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[4] *See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, SEC Rel. No. 34-23170 (Apr. 23, 1986), 51 Fed. Reg. 16004 (Apr. 30, 1986) ("1986 Release") at Section V.

[5] *See* ICAA Statement and ICAA Testimony, *supra*, n. 3.

[6] *See* IAA Letter to UK FSA regarding CP 05/5 on Bundled Brokerage/Soft Commission (May 31, 2005) (commenting on final FSA proposed rules regarding eligible criteria for research and execution services). *See also*, ICAA Letter to UK FSA regarding PS 04/23 on Soft Dollars/Bundled Brokerage (Dec. 16, 2004) (commenting on policy statement regarding which products and services may be paid for with commissions); ICAA Letter to UK FSA regarding CP 176 on Bundled Brokerage and Soft Commission Arrangements (Oct. 9, 2003) (commenting on proposal to mandate that the costs of non-execution services be rebated back to clients) ("2003 ICAA Letter to FSA"). Each letter is available on our website under "Comments & Statements."

Background

The Commission issued the Proposal for public comment after receiving recommendations from the Task Force on Soft Dollars.[7] We understand the Task Force evaluated soft dollar arrangements to recommend the parameters of eligible "brokerage and research services" under Section 28(e), as well as to consider requiring additional disclosure and recordkeeping requirements of client commission arrangements.[8] In particular, the Proposal seeks to clarify "the scope of 'brokerage and research services' in light of evolving technologies and industry practices."[9] The Proposal is the Commission's first comprehensive, substantive change in its interpretative views on client commission practices since its 1986 Release on the scope of Section 28(e).[10]

1. The Commission Should Clarify the Eligibility of Certain Brokerage or Research Services.

The Proposal provides that in determining whether a product or service is eligible "research," the adviser "must conclude that it reflects the expression of reasoning or knowledge and relates to the subject matter identified in Section 28(e)(3)(A) or (B)."[11] "Brokerage services" include activities required to effect securities transactions and functions incidental thereto.[12] The Commission introduced a new temporal standard in the Proposal, which provides that "brokerage begins when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or the account holder's agent."[13]

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[7] In 2004, Chairman William H. Donaldson created an agency-wide Task Force on Soft Dollars, which conducted a review of client commission practices. Proposal at 4, n. 7. The IAA and several of its members met with the Task Force, including the Divisions of Market Regulation and Investment Management, during 2004 to discuss advisers' soft dollar practices and how changes in soft dollar regulation would affect advisers and investors.

[8] The Proposal notes the Commission is also considering whether to propose requirements for disclosure and recordkeeping of client commission arrangements. Proposal at 4, n. 7.

[9] Proposal at 2-3.

[10] The Proposal provides a revised interpretation that replaces only Section II ("Definition of Brokerage and Research Services") and Section III ("Third Party Research") of the 1986 Release. Proposal at 20.

[11] Proposal at 28. We understand eligible products and services to include both written and oral communications and access to such communications where the content otherwise satisfies the criteria for research. *See id.* (seminars and conferences are eligible where the content satisfies the 28(e) criteria).

[12] Proposal at 32 (citing Section 28(e)(3)(C)).

[13] Proposal at 34.

The Commission requested comment on whether the guidance is sufficient with respect to the eligibility of "research" and "brokerage" services, functions, and products under Section 28(e).[14] We believe a few areas require additional guidance. Specifically, we request that the Commission reconsider its exclusion of order management systems (OMS) as eligible research or brokerage products or services, or acknowledge they may qualify as mixed-use items under the appropriate standard.[15] Further, we request confirmation that post-trade analytics and proxy voting services may be considered eligible research under the safe harbor, or at least mixed-use items.

a. Order Management Systems Should Be Eligible Under the Safe Harbor.

We respectfully request that the Commission reconsider its conclusion with respect to OMS used by advisers. We believe that the Proposal does not fully consider all the functions of OMS, which are clearly within the scope of lawful brokerage or research services, as defined in the Proposal. At a minimum, we urge the Commission to acknowledge that OMS are mixed-use products.

Activities that are required to effect securities transactions are protected under the statutory safe harbor under Section 28(e)(3)(C). The Proposal states that "trading software operated by a broker-dealer to route orders to market centers" is "brokerage" and that "brokerage services can include connectivity services and trading software where they are used to transmit orders to the broker, because this transmission of orders has traditionally been considered a core part of the brokerage service."[16] Further, it states that "connectivity service" between the adviser and the broker-dealer, including "dedicated lines between the broker-dealer and the money manager's order management system" satisfies the proposed temporal standard of "brokerage services."[17] In addition to activities required to effect securities transactions, Section 28(e)(3)(C) provides that functions "incidental thereto" are eligible for the safe harbor.[18]

Despite these conclusions, the Proposal provides that "order management systems ('OMS') used by money managers to manage their orders . . . are not eligible for the safe harbor as 'brokerage' because they are not sufficiently related to the order execution and

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[14] Proposal at 47.

[15] If the product or service has a mixed use, the adviser would be required to make a reasonable allocation of the cost of the product or service according to its use and keep adequate books and records concerning the allocation to make the required good faith showing. *See* Proposal at 37 (reiterating the Commission's guidance in the 1986 Release regarding the mixed-use standard). Moreover, an adviser should disclose the allocation determination itself, which is a potential conflict of interest. *See* Proposal at 36 (citing the 1986 Release).

[16] Proposal at 35, n. 97.

[17] Proposal at 34-35.

[18] Proposal at 32.

fall outside the temporal standard for 'brokerage' under the safe harbor."[19] We believe the Commission's approach to simply exclude OMS, but not their dedicated lines, is inconsistent and does not reflect the usage of brokerage services by advisers to communicate trades to broker-dealers and to make investment decisions about a client's portfolio.

Many advisers use OMS (supplied by vendors or created in-house) for a variety of functions, including electronic trading, portfolio modeling, FIX connections,[20] and compliance monitoring.[21] Importantly, OMS is a critical component of achieving straight-through-processing from the point of order through execution. OMS are used by advisers to maintain connectivity to broker-dealers and do in fact transmit orders to broker-dealers or an electronic exchange, and are thus sufficiently related to order execution. To the extent OMS provide electronic trading and FIX connections, they appear to fall within the statutory definition and proposed temporal standard of brokerage.

We believe the final interpretation should permit advisers to analyze the product under the statutory standard and under the Commission's 1986 mixed-use standard (reaffirmed in the Proposal). Advisers should be able to determine the extent to which the functions of OMS provide lawful and appropriate assistance in carrying out their responsibilities under Section 28(e). If the OMS are used for any purpose that is ineligible under the statutory definition of brokerage, advisers would be obligated to treat them as mixed-use items and the costs would be allocated between client commissions and the adviser's funds according to their use.

In addition to brokerage products or services, OMS may be considered research products or services. Many advisers use OMS to assist in the investment decision-making process regarding a client's cash balances, including monitoring cash in a real-time basis in order to determine how to invest a client's money. In addition, OMS are used for portfolio modeling and securities and sector allocations, and to analyze portfolio strategies. These functions assist in the investment-decision making process.

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[19] Proposal at 35. Indeed, the Commission may be too limited in its temporal interpretation of the statute. For example, it is unclear why management of orders or discussions with brokers prior to actually sending the trade should not be considered functions incidental to execution.

[20] The Financial Information eXchange ("FIX") Protocol is a technical specification for electronic communication of trade-related messages and allows broker-dealers to understand an adviser's order. *See* http://www.fixprotocol.org/.

[21] For example, some advisers use LongView Trading, which is a "global, multi-asset class order management system developed to support portfolio managers, traders, compliance officers and operations personnel. The comprehensive system provides portfolio modeling, electronic trading, compliance monitoring and FIX connections across all asset classes.…To further facilitate STP, the system offers unparalleled access to global liquidity through supported FIX connections." *See* http://www.fixprotocol.org/vendors/4951.

Accordingly, we request that the Commission remove the blanket exclusion for OMS and permit advisers to apply a mixed-use analysis as they would to other mixed-use items.

b. Post-Trade Analytics Should Be Eligible Under the Safe Harbor.

The Proposal states that "to the extent that money managers use trade analytics both for research and to assist in fulfilling contractual obligations to the client or to assess whether they have complied with their own regulatory or fiduciary obligations such as the duty of best execution or for other internal compliance purposes, the trade analytical software is a mixed-use product, and managers must use their own funds to pay for the allocable portion of the cost of the software that is not within the safe harbor because it is attributable to internal compliance purposes."[22] The Proposal seeks comment on whether the Commission provides appropriate guidance as to the eligibility of "trade analytical software" under Section 28(e).

We strongly believe that post-trade analytics should be considered research and thus agree with the portion of the Proposal that states that post-trade analytical software may be considered "research" to the extent that it assists with the adviser's investment decision-making responsibilities. The software provides information relating to the advisability of investing in securities and analysis concerning the performance of accounts, as provided for in Section 28(e)(3)(B). Specifically, these products provide advisers with important data to determine the effect of commissions and the market impact of a securities transaction on a portfolio's performance. They assist advisers in determining how poor execution by a broker-dealer and the rate of commission costs affect portfolio performance. Thus, these services provide an expression of knowledge about how a transaction in a specific security may affect the client's portfolio performance.[23]

c. Certain Aspects of Proxy Voting Services Should Be Eligible Under the Safe Harbor.

The Proposal does not address whether proxy voting services are an eligible product or service under the safe harbor.[24] We seek confirmation that advisers may continue to treat these services as research or a mixed-use item to the extent that the product or service is utilized to assist the adviser in its investment decision-making responsibilities.

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[22] Proposal at 35, n. 98.

[23] Moreover, the FSA in its final rules permitted post-trade analytics to be an eligible research service if it meets certain criteria. *See* FSA PS 05/5: Bundled brokerage and soft commission arrangements, Feedback on CP 05/5 and final rules (July 2005) at 10-11, at http://www.fsa.gov.uk/pubs/policy/ps05_09.pdf.

[24] *See* Proposal at 48.

Some proxy voting services, as a portion of their services, provide research assessing the impact of proxy proposals on shareholder value for important issues, such as a company's executive compensation and incentives; stock option plans (in which the services recommend the cost of pay plans and compare them to the company's peers); board structure and practices, including shareholder influence on the election of board members; mergers and acquisitions and their effect on board structure, practice and remuneration; requests for capital authorization; contested solicitations; shareholder proposals; and social and environmental responsibilities.[25] Firms that purchase the administrative and research portions of proxy voting services often pay for the administrative functions of the electronic services with their own money under a mixed-use allocation. Firms may have separate business unit functions that use the research and vote proxies. Depending on the issue raised on the ballot, many firms use that research to determine whether to purchase or sell a specific security. Accordingly, we request confirmation that proxy voting products or services that provide research are eligible under the statutory language of Section 28(e) and may also be considered a mixed-use item.

2. The Commission Should Reconsider its Discussion of Bundled Products in the Mixed-Use Section of the Proposal.

We request clarification regarding the Commission's guidance regarding mixed-use allocation in a bundled commission rate scenario, which provides:

> Similarly, if the money manager seeks the protection of the safe harbor and receives both Section 28(e) eligible and ineligible products and services for a bundled commission rate, the manager must use his own funds to pay for the allocable portion of the cost of products and services that are not within the safe harbor.[26]

We are concerned about this statement to the extent it implies that advisers should determine the cost and pay for ineligible products and services that a broker-dealer provides in addition to execution for a single commission charge. In the very common situation discussed below where an adviser does not and cannot specifically negotiate what it will receive as part of a bundled rate, the requirement simply does not work.

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[25] *See, e.g.,* Institutional Shareholder Services' website, which describes the proxy voting research services it offers, available at http://www.issproxy.com/institutional/research/index.jsp.

[26] Proposal at 37, n. 108. We note that the Proposal includes this requirement under the subject heading of "Mixed-Use." The general understanding of mixed-use allocation has to do with various uses by the adviser of the same item. This footnote, however, appears to address separating out the cost of a single commission charge among all the products and services provided by a broker-dealer in addition to execution, in order to pay for ineligible items with an adviser's own funds ("unbundling" the commission charge).

It would be very difficult for advisers to determine the actual cost or value of any ineligible products or services provided as part of a bundled commission charge.[27] Broker-dealers often provide many products and services in addition to execution, ***i.e.***, access to analysts, commitment of capital, advice regarding executions, access to investments, and capital introductions. There is no separate charge, line item, invoice, or discussion from broker-dealers regarding the costs of eligible or ineligible products that advisers may receive (solicited or unsolicited). As we noted in response to the FSA's initial proposal to mandate that advisers rebate non-execution services back to clients, no regulatory requirement exists for broker-dealers to provide invoices apart from commission charges for various components of the services they provide.[28] Therefore, an adviser cannot negotiate out and pay separately for those ineligible items that may be received as part of bundled commission charges, as the footnote appears to propose.

It has not been previously understood that an adviser must unbundle commissions charged by full-service broker-dealers between the execution cost and the various products and services generated by the broker-dealer that the adviser may or may not use. Moreover, we believe there is much confusion generally about the Commission's intent and expectation with respect to this footnote. Given the potential important and far-reaching effects, we request that the Commission reconsider the inclusion of this footnote in the release. If appropriate, the Commission could instead address this issue in a future disclosure and recordkeeping rule proposal regarding client commissions. This will permit all parties involved -- advisers, brokers, third-party research providers, and investors -- to provide meaningful input about the practical implications of the proposed guidance. If, however, the Commission determines to adopt the proposed guidance as is, we urge it to do so prospectively only and to provide advisers with specific guidance regarding how to achieve such results within the current industry framework.

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[27] The complexity of unbundling is illustrated by the results in the November 11, 2004 NASD Mutual Fund Task Force Report on Soft Dollars and Portfolio Transaction Costs ("NASD Report"). The Task Force was comprised of senior industry executives from broker-dealers and mutual fund management companies, as well as representatives from the academic and legal communities. It considered whether it is possible for an adviser to provide a mutual fund board with a good faith estimate of the total dollar amount of proprietary research obtained with fund brokerage commissions. The Task Force determined it was unable to reach a consensus on the issue. It noted that sharp disagreement exists over the value to fund boards and investors of estimates of the amount of proprietary research (and presumably other non-execution or research items) obtained with fund brokerage. *See* NASD Report at 9, available at http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf.

[28] *See* 2003 ICAA Letter to FSA, *supra*, n. 6. In addition to describing eligible criteria for research or execution service in CP 05/5 on Bundled Brokerage/Soft Commission, the FSA withdrew its rebate proposal and announced it expects that the Investment Management Association's Disclosure Code ("IMA Code") (Mar. 2005) will become the standard means of disclosure of client commissions for UK funds. The IMA Code requires firms to disclose their "negotiation process with respect to agreeing on an ex-ante basis for the execution component of the 'At Full Service' rate of commission and to agreeing on services received for the residual." IMA Code at 9.

3. The Commission Should Confirm the Applicability of Section 28(e) Safe Harbor to Certain Relationships and Practices.

We seek clarification that advisers may be deemed to satisfy the safe harbor when a broker-dealer provides or makes available unsolicited or incidental products or services as part of a package of brokerage or custodial services that would otherwise satisfy Section 28(e).

We respectfully submit that the eligibility standards for brokerage or research services under the safe harbor should apply only to those products or services that form the basis for which the adviser is paying more than the lowest available commission. The adviser should be deemed to be using client commissions to obtain products and services only when the adviser negotiates for, solicits, or values these services in the brokerage decision-making process and pays more than the lowest available commission for them. In other words, when a broker-dealer provides an adviser with products and services for which the adviser did not negotiate or solicit, the adviser should not be deemed to have paid for those products and services, and therefore, it is not *paying up for* them.

This situation commonly occurs in the context of an adviser's selection of full-service broker-dealers for execution of client trades. For example, the adviser may select a full-service broker-dealer based on its superior execution capabilities and determine that the commissions paid are reasonable in relation to the value of that superior execution capability (including willingness to commit capital for trades, ability to work difficult orders, and the like). The broker-dealer may then send or make available to the adviser unsolicited proprietary research reports for the bundled commission rate, including reports that the adviser may not use in the investment decision-making process. The adviser should not have to pay for unwanted and unsolicited reports in order to stay within the protection of the safe harbor.[29]

It is important to note that most advisers do not have the size or leverage to be able to negotiate bundled commission rates down to reflect their willingness to forego some or all research reports or other products and services. In this industry, most of the assets under management (and therefore commissions to be generated) are highly concentrated in a relatively few firms. SEC data (as of April 2005) reflect that firms with $10 billion or more under management represent 4% of all registered firms, but manage 83% of the assets.[30] Similarly, the vast majority (more than 5,800) of SEC-registered

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[29] If receipt of unsolicited products or services were to cause the adviser to lose the protection of the safe harbor, the Commission would effectively prohibit what in any other industry would be considered a good business practice. In a free market, all businesses seek to find new ways to improve client service in order to promote client goodwill and satisfaction. Often they do it at no charge, so that the customer may try out the new product or service and become familiar with it. If extra unsolicited services are discouraged, innovation may be chilled.

[30] IAA and National Regulatory Services, *Evolution/Revolution: A Profile of the Investment Advisory Profession* (June 2005) at 3. A copy of the report is available on our website.

investment advisers have ten or fewer employees. Accordingly, even though these firms may not want or use all of the products or services provided, they have no ability to negotiate a correspondingly lower commission cost.

Similarly, an adviser should not be deemed to be using client commissions outside the safe harbor to obtain products and services that broker-dealers provide as part of a custodial platform. In addition to custody and execution, these platforms may include technology that provides access to client account data, facilitates trade execution and allocation of client orders, provides research, market data and pricing information, and assists with back-office support, recordkeeping, and client reporting. In addition, as a sound business practice, these custodians/broker-dealers may provide educational and compliance materials to investment advisers to ensure that their business partners understand the relevant regulatory environment. These products and services, which may or may not be eligible, are made available to all advisers using the custodial platform as part of a total relationship, regardless of the amount of commissions generated. Accordingly, receipt or availability of these types of products or services should not cause an adviser to lose the protection of Section 28(e).

Regardless whether the relationship satisfies the framework of Section 28(e), we believe that an adviser should disclose products or services received from a third party that may create a conflict of interest. We understand that many custodian/broker-dealers encourage such disclosure as well.

4. The Commission Should Confirm that Advisers Are Not Responsible for Ensuring Broker-Dealers' Compliance with the Proposed Guidance for Commission-Sharing Arrangements.

The Commission seeks comment regarding its guidance on commission-sharing arrangements.[31] We request confirmation that an adviser is not responsible for ensuring an introducing broker-dealer's compliance with the Commission's proposed elements required for a commission-sharing arrangement.

As the Proposal notes, some advisers use commission-sharing arrangements to execute trades with one broker-dealer and obtain research or other services from a different broker-dealer.[32] The Proposal states that a commission-sharing arrangement under which research and brokerage services are provided under the safe harbor must be part of a normal and legitimate correspondent relationship in which each broker-dealer is engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to it by other broker-dealers for research services provided to advisers

[31] Proposal at 48.

[32] Proposal at 43.

(*i.e.*, the "effecting securities transactions" requirement).[33] The Commission provides that this requires that the introducing broker must: (i) be financially responsible to the clearing broker-dealer for all customer trades until the clearing-broker has received payment or securities; (ii) make and/or maintain records relating to its customer trades required by Commission or SRO rules, including blotters and memoranda of orders; (iii) monitor and respond to customer comments concerning the trading process; and (iv) generally monitor trades and settlements.[34]

Advisers are not in a position to determine the nature of the relationship or have knowledge of agreements between an introducing broker-dealer and a clearing broker-dealer. In addition, advisers do not have information regarding the broker-dealer's recordkeeping and monitoring systems. Accordingly, the Commission should confirm that advisers are not legally obligated to ensure that an introducing broker-dealer complies with the specific proposed elements.[35]

5. The Commission Should Provide Sufficient Time to Comply With the Final Interpretation.

The Proposal seeks comment on whether the Commission should afford firms time to implement the final interpretation.[36] We strongly encourage the Commission to provide advisers a meaningful opportunity to evaluate how the final interpretation will apply to their current soft dollar arrangements, including both full-service brokerage and third-party research arrangements, as well as policies and procedures that may need to be revised and implemented. In addition, advisers will need to consider their existing soft dollar credits. Further, many third-party research contracts are negotiated for the adviser's fiscal year during which an adviser may be bound by the terms of the agreement. Accordingly, we respectfully request that the Commission adopt a compliance date twelve months from the date the final interpretative release is published

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[33] Proposal at 41-46. The Proposal notes that in "the 1986 Release, the Commission indicated that payment of part of a commission to a broker-dealer who is a 'normal and legitimate correspondent' of the executing or clearing broker-dealer would not necessarily be a 'give-up,' outside the protection of Section 28(e)." Proposal at 42 (citing 1986 Release at III). In addition, a broker-dealer effecting the trade must be legally obligated to a third-party producer of research or brokerage services to pay for the service provided to the adviser. Proposal at 46.

[34] Proposal at 46.

[35] If the Commission decides that advisers have some responsibility in this area, it should confirm that advisers are permitted to rely on a good faith belief after reasonable due diligence that the commission-sharing arrangement satisfies the required elements. This could include, for example, receiving a certification, representation, or other such assurance that the introducing broker-dealer is compliant with the final interpretative guidance issued by the Commission regarding commission-sharing arrangements.

[36] Proposal at 49.

in the Federal Register.[37] However, for existing agreements, we request a compliance date of the later of twelve months or the expiration of the contract. This should ensure sufficient time to evaluate the arrangement in light of the final interpretation and prevent advisers from being out of compliance with the final interpretation if the terms of their current agreements have not yet expired.

* * *

We appreciate the opportunity to provide our views on these important issues and would be pleased to provide any additional information the Commission or its staff may request. Please do not hesitate to contact the undersigned, or Karen L. Barr, General Counsel, to discuss any questions the Commission or its staff may have.

Sincerely,

Monique S. Botkin

Monique S. Botkin
Counsel

cc: The Honorable Christopher Cox
The Honorable Cynthia A. Glassman
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth

Mr. Robert L.D. Colby, Acting Director, Division of Market Regulation
Mr. Larry E. Bergmann, Associate Director, Division of Market Regulation
Mr. Meyer Eisenberg, Acting Director, Division of Investment Management
Mr. Robert E. Plaze, Associate Director, Division of Investment Management

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[37] To the extent that the Commission does not take our suggestion with respect to footnote 108, we request additional time to address all of its implications.