

April 24, 2008

*VIA ELECTRONIC MAIL*

The Honorable Christopher Cox  
Chairman  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

**Re: Policy Considerations Implicated by RAND Report on Broker-Dealers  
and Investment Advisers**

Dear Chairman Cox:

The Investment Adviser Association (IAA)<sup>1</sup> recently met with the SEC staff task force charged with developing policy options in response to the RAND report.<sup>2</sup>

We greatly appreciated the opportunity to discuss the RAND Report with task force members and understand that they will shortly be providing a list of policy options to the Commission for its consideration. In order to assist you in your review of these options, following is a brief summary of our views on the underlying policy issues concerning broker-dealer and investment adviser regulation implicated by the RAND Report.

Investment Adviser Regulation

The Investment Adviser Association believes that the principles-based structure of the Investment Advisers Act of 1940 (Advisers Act)<sup>3</sup> – and its reliance on disclosure and broad anti-fraud authority rather than rigid regulatory requirements – is both appropriate and effective.<sup>4</sup> We believe the strong investor protection aspects of the

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<sup>1</sup> The Investment Adviser Association is a not-for-profit association that represents the interests of SEC-registered investment advisory firms. Founded in 1937, the IAA's membership today is comprised of more than 500 firms that collectively manage in excess of \$9 trillion for a wide variety of institutional and individual clients. For more information, please see [www.investmentadviser.org](http://www.investmentadviser.org)

<sup>2</sup> *Technical Report: Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, RAND Corporation 2008, available at [http://www.sec.gov/news/press/2008/2008-1\\_randiabdreport.pdf](http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf). The RAND Report's principal finding was that "[i]nvestors had difficulty distinguishing among industry professionals and perceiving the web of relationships among service providers." *Id.* at xix.

<sup>3</sup> Pub. Law No. 76-768, 54 Stat. 847.

<sup>4</sup> The investment advisory profession is extremely broad and diverse. There are more than 10,000 SEC-registered investment advisers, representing a very broad spectrum of firms. For example, there are a few relatively large firms that oversee the lion's share of assets under management – 472 investment

Advisers Act have served both the investing public and the investment advisory profession well. Further, we believe that the fiduciary culture fostered by the Advisers Act has been a key element in the effectiveness of the regulatory framework governing our profession.

### Fiduciary Duty

Among financial service providers, investment advisers alone are uniformly subject to a strict fiduciary duty. This duty, which has been upheld by the U.S. Supreme Court<sup>5</sup> and reiterated by the SEC in various pronouncements over the years,<sup>6</sup> is one of the primary distinctions between investment advisers and others in the financial services industry.<sup>7</sup> As a fiduciary, “an investment adviser must at all times act in its clients’ best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions.”<sup>8</sup> We believe this standard promotes a high level of investor protection. In considering various options presented by the task force, we strongly urge the Commission to consider whether the interests of investors will be served by diminishing – or expanding – the applicability of the fiduciary duty imposed on all investment advisers.

### SEC as Primary Regulator

We believe the role of the SEC as primary regulator of the investment advisory industry is critically important in terms of reducing inefficiencies associated with multiple regulators, providing a system that fosters accountability of the regulator, and encouraging subject matter expertise. As a corollary to our support for a single primary regulator, we remain strongly opposed to the creation of a self-regulatory organization (SRO) for the advisory profession.<sup>9</sup>

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advisory firms (less than 0.5 percent) have investment management authority with respect to 84 percent of the \$34 trillion in discretionary assets managed by all SEC-registered advisers. Many of these larger firms are affiliated with other investment advisers, banks, broker-dealers, and insurance companies. However, the vast majority of investment advisory firms are quite small. SEC data reflect that 90 percent of all federally registered investment adviser firms have fewer than 50 employees and 68 percent (more than 7,000 firms) have ten or fewer employees. See IAA/NRS, *Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession* (Aug. 2007), available on our website.

<sup>5</sup>*SEC v. Capital Gains Research Bureau*, 375 U.S. 180 at 186 (1963).

<sup>6</sup> See, e.g., *In re: Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948).

<sup>7</sup> As stated in a recent report by the Treasury Department, “One critical factor that distinguishes investment advisers are fiduciaries, which means that they owe undivided loyalty to their customers and may not engage in any practices that conflict with their clients’ interests (unless their clients have consented)...Broker-dealers, while subject to strong standards of conduct and ‘suitability’ requirements, generally are not fiduciaries of their clients and thus are perceived by some as having weaker obligations to customers.” *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure*, U.S. Department of the Treasury (Mar. 2008), at 121.

<sup>8</sup> Lemke & Lins, *Regulation of Investment Advisers*, at 2-34 (2007).

<sup>9</sup> The Treasury Department Blueprint included a recommendation “that investment advisers be subject to a self-regulatory regime similar to that of broker dealers.” *Blueprint*, *supra* note 7, at 126.

In our meeting last month, the staff task force posed a number of questions relating to the advisability of establishing an SRO for investment advisers. In our discussions with the task force, we noted that there is no compelling evidence that an SRO is needed to deal with any broad concerns arising from the advisory profession or that it would enhance investor protection. Factors that led to the establishment of other SROs are not present in the advisory profession (for example, the level of interconnectivity among broker-dealers and the need to address issues relating to trade execution and other technical issues). Our view is that creation of an SRO for investment advisers is unwarranted and would create an unnecessary layer of cost and bureaucracy without any commensurate investor protection benefits. In this regard, we note that the record of current SROs to anticipate and deal with major investor protection issues is, at best, mixed. We note further that creation of an SRO for investment advisers would in no way address investor confusion, the principal finding of the RAND Report.

### Advisory Services by Broker-Dealers

Broker-dealers are engaged in providing investment advice and yet are subject to significantly different standards and regulations than those imposed on investment advisers registered under the Advisers Act. The RAND Report found that the blurring of lines resulting from such regulatory variations has resulted in substantial confusion among consumers.<sup>10</sup>

We remain convinced that the interests of investors and of the regulated community are best served by a regulatory scheme that focuses on the nature of services provided. Simply stated, if the service being offered bears the core characteristics of investment advisory services *from the investor's perspective*, it should be subject to the same duties and obligations of an investment advisory service and an exception should not apply.

As indicated in our comment letters responding to the proposed Broker-Dealer Rule,<sup>11</sup> we agreed with the Commission that discretionary investment management cannot be deemed “solely incidental” to brokerage services and that a “functional test focusing on the nature of the 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.”<sup>12</sup> We also concurred with the conclusion that brokers and advisers “should be held

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<sup>10</sup> Given the enormous disparity and complexity among different types of investment adviser firms, it is notable that 6,924 – or 66.3 percent – of the 10,446 investment advisers that were federally registered as of April 2007 were not engaged in any business activity other than giving investment advice. Only 628 investment advisers (6 percent) are dually registered as broker-dealers. *See Evolution/Revolution, supra* note 5.

<sup>11</sup> *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release Nos. 34-42099; IA-1845 (Nov. 4, 1999) (“*Proposal*”). *See also, Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers*, SEC Release Nos. IA-2340, 34-50980; File No. S7-25-99 at 7 (Jan. 6, 2005) (*Reproposal*).

<sup>12</sup> Letter from David G. Tittsworth, Executive Director, ICAA, to Jonathan G. Katz, Secretary, SEC (Jan. 12, 2000). While we agreed with the SEC that a functional test that focuses on the nature of services provided – rather than the form of the broker-dealer’s compensation – is appropriate in determining

to similar standards depending not on the statute under which they are registered, but upon the role they are playing.”<sup>13</sup> Our position on this issue remains unchanged and we recommend that the SEC endeavor to better define the meaning of “solely incidental.”

### Investor Education

We believe the Commission can play a more proactive role in educating investors and consumers about fundamental investor protection issues related to the issues discussed in the RAND report.<sup>14</sup> The Commission, for example, should take a leading role in developing and providing educational information to the public about investments and the various types of persons and entities that provide investment advice. We believe the Commission can and should inform investors and the public about the differences between brokerage and advisory activities, the laws and regulations governing each, and specific issues raised by its rulemakings.<sup>15</sup>

### SEC Resources

The IAA has long supported ensuring that the SEC has sufficient resources to enforce the existing regulatory scheme for investment advisers. In this regard, we supported the 1996 enactment of NSMIA.<sup>16</sup> As applied to the investment advisory profession, NSMIA divided regulatory responsibility between the SEC and the states by prohibiting an investment adviser from registering with the SEC unless it has more than \$25 million in assets under management (AUM), is an adviser to a registered investment company, or fits one of the limited exemptions.<sup>17</sup> One of NSMIA’s principal purposes

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whether a brokerage account falls within the Advisers Act, we expressed our view that the SEC’s functional analysis did not go far enough.

<sup>13</sup> *Reproposal*, *supra* note 11, at 36. The SEC’s rulemaking relating to the broker-dealer exception under the Advisers Act was invalidated by the D.C. Circuit Court of Appeals in *Financial Planning Association v. S.E.C.*, 2007 WL 935733, C.A.D.C. (Mar. 30, 2007). In response to the court’s ruling, we, along with other groups, wrote the SEC noting that “[a] long-term response to the Court decision will require complex decisions about a variety of issues, including how best to draw a functional distinction between brokers and investment advisers, determining the appropriate standards to apply to the range of activities engaged in by investment service providers, how to educate investors to make informed choices among the various types of providers, and what disclosures are appropriate to inform investors of the differing roles of these providers and of the applicable legal protections.” See Letter from IAA, Consumer Federation of America, Financial Planning Association, Fund Democracy, National Association of Personal Financial Advisors, and North American Securities Administrators Association, to the Honorable Christopher Cox, Chairman (Apr. 24, 2007).

<sup>14</sup> See Letter from David G. Tittsworth, Executive Director, IAA, to the Honorable William H. Donaldson, Chairman, SEC (June 22, 2005).

<sup>15</sup> In 2006, the IAA worked with the Coalition on Investor Education -- comprised of the Consumer Federation of America, North American Securities Administrators Association, Investment Adviser Association, Financial Planning Association, and CFA Institute -- to publish an investor education brochure called “Cutting through the Confusion.” We urge the Commission to provide similar information to investors.

<sup>16</sup> National Securities Markets Improvement Act (NSMIA), Pub. Law No. 104-290.

<sup>17</sup> The \$25 million threshold was intended to provide a bright line test for allocating regulatory responsibility of advisers between the SEC and the states, representing a rough cut between advisers that generally do business in interstate commerce and those that generally have more localized practices. The report accompanying the Senate-passed bill notes that the SEC “may also use its exemptive authority under

was to leverage state and federal resources by “eliminating overlapping regulatory responsibilities.”<sup>18</sup> This legislative intent was well summarized in the SEC’s proposed rules to implement the law:

The reallocation of regulatory responsibilities grew out of Congress’ concern that the Commission’s resources are inadequate to supervise the activities of the growing number of investment advisers registered with the Commission, many of which are small, locally operated, financial planning firms. Congress concluded that if the overlapping regulatory responsibilities of the Commission and the states were divided by making the states primarily responsible for smaller advisory firms and the Commission primarily responsible for larger firms, the regulatory resources of the Commission and the states could be put to better, more efficient use.<sup>19</sup>

NSMIA’s allocation of regulatory responsibility between the SEC and the states is working well. It enhances investor protection, provides for more efficient use of limited regulatory resources, and reduces burdensome and unnecessary regulatory costs. However, we note that the \$25 million AUM threshold has not been revised in the 12 years since its enactment and that Congress expressly contemplated that the Commission would periodically adjust that threshold through its exemptive authority. The Commission may wish to work with state securities regulators to increase the \$25 million to a more appropriate level.

The Investment Adviser Association would be pleased to provide you with any additional information regarding these or related matters that may assist you in your consideration of these important issues.

Sincerely,



David G. Tittsworth  
Executive Director

Cc: Hon. Paul S. Atkins  
Hon. Kathleen L. Casey  
Mr. Andrew J. Donohue  
Mr. Erik R. Sirri  
Ms. Elizabeth Osterman  
Ms. JoAnne Swindler

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the bill to raise the \$25 million threshold higher as it deems appropriate in keeping with the purposes of the Investment Advisers Act” and concurred in a recommendation of NASAA to review the appropriateness of this threshold at least every three years. S.Rpt. 104-293, p. 5 (June 26, 1996).

<sup>18</sup> S.Rpt.104-293, pp. 3-4 (June 26, 1996).

<sup>19</sup> *SEC Proposed Rules Implementing Amendments to the Investment Advisers Act of 1940*, Release No. IA-1601, File No. S7-31-96 (Dec. 20, 1996).