COMMENTS TO SECURITIES AND EXCHANGE COMMISSION
PROPOSING RELEASE NO. IA-2653; FILE NO. 57-22-07
INTERPRETIVE RULE UNDER THE ADVISERS ACT
AFFECTING BROKER-DEALERS

I am writing this comment letter to request (i) that the SEC expand the list of examples of situations where a broker-dealer's discretion is considered to be temporary or limited within the meaning of Proposed Rule 202(a)(11) – 1(d) to include certain asset allocation programs under variable annuity and variable life insurance products; (2) that the SEC clarify that a limited or temporary discretionary appointment in and of itself would not be considered a separate contract for investment advisory services pursuant to Proposed Rule 202(a)(11) – 1(a)(1); and (3) that the SEC clarify under what circumstances would a separate fee charged for advisory services as set forth in proposed Rule 202(a)(11) – 1(a)(1) not also be considered special compensation under Section 202(a)(11)(C).

Analysis

Proposed Rule 202(a)(11) – 1(a) provides that:

> (a) *Solely incidental.* 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 (15 U.S.C. 80b – 2(a)(11)(C)) if the broker or dealer:
>
> (1) Charges a separate fee, or separately contracts, for advisory services; or
>
> (2) Exercises investment discretion (as that term is defined in section 3(a)(35) of the Securities Exchange Act of 1934 ("Exchange Act") (15 U.S.C. 78c(a)(35))), except investment discretion granted by a customer on a temporary or limited basis, over such account.

In its proposing Release No. IA-2652, the SEC commented, "We have long acknowledged that a broker-dealer's exercise of investment discretion over customer accounts raises serious questions about whether those accounts must be treated as subject to the Adviser's Act – even where no special compensation is received. . . . When a broker-dealer exercises investment discretion, it is not only the source of the investment *advice*, it also has the authority to make the investment *decision* relating to the purchase or sale of securities on behalf of its client. This, in our view, warrants the protection of the Advisers Act because of the 'special trust and confidence inherent' in such relationship . . ."

Asset Allocation Programs

As a general matter, I agree with those comments by the SEC. However, in my opinion certain asset allocation programs under variable annuity and variable life insurance products are much more limited than, as such do not rise to the same level of risk of abuse as, the typical discretionary brokerage account, and should fall under the exclusion for investment discretion granted by a customer on a temporary or limited basis.

Unlike traditional life insurance products, variable annuity and variable insurance products are considered securities under the Securities Act of 1933 and are typically distributed by registered broker-dealers, as selling agents of the contract issuer. Variable annuity and insurance products offer investment options for the contract cash values that are typically selected by the contract owner at the time of purchase and may be altered thereafter by the contract owner at certain intervals as set forth in the contract. The advice and assistance offered by the selling agent to contract owners in selecting investment options has long been considered "solely incidental" to the selling agent's business as a broker-dealer. Contract owners may select their own portfolio out of the investment options offered in the contract or may select a model portfolio pursuant to an asset allocation program offered by the contract issuer or a third party service provider. Most asset allocation programs offer model portfolios based on a conservative, moderate or aggressive risk tolerance that is chosen by the contract owner. The model portfolios are then updated periodically to account for changes in the contract investment options and/or to reflect the provider's views of prevailing economic and market conditions.

There are different ways a contract owner may rebalance or update the contract's asset allocation. A static rebalancing is where the contract values are rebalanced periodically to reflect the original asset allocation weightings in a portfolio. Rebalancing may be implemented automatically (if offered by the contract issuer) or by request of the contract owner. If a contract owner authorizes the broker-dealer selling agent to periodically rebalance the portfolio based on the original weightings on the contract owner's behalf (if an automatic option is not offered by the contract issuer), I submit that this is limited in nature and should be considered "solely incidental" to conduct of the agent's business as a broker-dealer.

A dynamic reallocation is where not only are contract values rebalanced but asset allocation weightings may change to reflect the updated model portfolio. A dynamic program would not cause a change in the contract owner's model selection of conservative, moderate or aggressive, but would merely provide the contract owner with the updated portfolio weightings. A dynamic program may be implemented either by (i) opt-in (i.e., where the contract owner gets a notice of the model change and must affirmatively consent before the change may be implemented); (ii) opt-out (i.e., where the contract owner gets a notice of the model change and the model change will be

implemented if the contract owner does not give notice to the contrary); or (iii) automatic (i.e., where no notice is given of, or notice is given after, the implementation of the contract change). Although all dynamic reallocation programs may result in changes to the investment options or their weightings, I submit that only the automatic implementation approach results in investment discretion that is neither temporary nor limited. Therefore, if the selling agent were authorized by the contract owner to implement asset reallocation under either the opt-in or opt-out method (i.e., the contract owner would receive notice before any change were implemented), the contract owner retains sufficient control over the investment options that I believe the selling agent's conduct is still "solely incidental" to its business as a broker-dealer, and the protections of the Advisers Act are not warranted.

Separate Contract

If the SEC agrees with my analysis that static rebalancing and/or opt-in and opt-out asset allocation programs do not involve investment discretion or are temporary or limited investment discretion, then the documentation of the appointment of authority to implement such rebalancing and reallocation should not be considered a separate contract for investment advisory services.

Separate Fee

If a broker-dealer charges a separate fee for investment advisory services, it appears that such separate fee would be considered "special compensation" within the meaning of Section 202(c)(11)(C). If that is the case, referring to a separate fee in Proposed Rule 202(a)(11) – 1(a)(1) creates an ambiguity and is unnecessary to make the exception of Rule 202(a)(1)(C) inapplicable to such broker-dealer. If that is not the case, examples of separate fee that is not also considered special compensation would be helpful in providing clarity.

I would be happy to discuss this letter and my views further with a member of the SEC staff. In the event the SEC disagrees with any of my views, clarification as to the SEC's position in the adopting release or by other means would be most appreciated. If the SEC feels the matters addressed herein are more appropriately handled through the no-action process, please so advise.

Respectfully submitted.