



September 22, 2004

Jonathan G. Katz  
Secretary  
U.S. Securities & Exchange Commission  
450 Fifth Street, NW  
Washington, D.C. 20549

Re: File No. S7-25-99;  
Release No. IA-2278, Certain Broker-Dealers Deemed Not To Be Investment Advisers

Dear Mr. Katz:

Citigroup Global Markets Inc. ("CGMI") submits this letter to supplement its original comment letter, dated January 14, 2000 (the "2000 Letter"), on proposed Rule 202(a)(11)-1 (the "Proposed Rule") under the Investment Advisers Act of 1940 (the "Advisers Act").<sup>1</sup> We re-endorse our earlier position that the Commission's interest in promoting investor protection and reducing conflicts of interests between brokers and investors are best achieved by adopting Rule 202(a)(11)-1.

As an initial matter, we wish to express our support for the views advanced by the Securities Industry Association ("SIA") in both its initial and current response to the Commission on the Proposed Rule. In addition, we want to briefly outline below three reasons why the Commission should adopt the Proposed Rule. First, fee-based brokerage accounts help to align the interests of investors and their registered representatives and give investors a better product choice. Second, a sufficient regulatory regime exists to protect investors in fee-based accounts. Third, if the Commission essentially rescinds the Proposed Rule at this time it will have a highly disruptive effect on the investing public that has chosen the fee-based alternative.

#### **Aligned Investor/Broker Interests and Increased Investor Choice**

Fee-based brokerage accounts, such as CGMI's Smith Barney division's *AssetOne*<sup>®</sup> account, reflect another type of product enhancement and a response by broker-dealers to meet the evolving needs of individual investors - in this case, by providing a predictable compensation structure that aligns the interests of investors and brokers by (a) giving brokers an incentive to

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<sup>1</sup> Citigroup Global Markets Inc. is dually-registered with the Securities and Exchange Commission (the "Commission") as a broker-dealer and investment adviser and was formerly known as Salomon Smith Barney Inc., under whose letterhead the original comment letter was written. *AssetOne*<sup>®</sup> is a registered service mark of Citigroup Global Markets Inc.

provide a full and complete level of brokerage services with the knowledge they will be fairly compensated for their ongoing efforts on behalf of investors and (b) giving investors comfort that brokers will not be recommending trading or other account activity solely to generate commissions. In fact, this alignment was precisely why the Committee on Compensation Practices (the “Tully Committee”), in its 1995 report, included in its list of industry best practices the suggestion that compensation of registered representatives should be based upon investors’ assets, not upon transactional activity. And the Commission itself recognized the importance of this alignment when it stated in 1999 that:

*These fee-based programs benefit customers by better aligning their interests with those of their broker-dealers, and thus are responsive to the best practices suggested in the Report of the Committee on Compensation Practices.*

In addition to aligning investors’ and brokers’ interests, fee-based brokerage accounts offer another significant benefit: investor choice. Clients of fee-based brokerage accounts enjoy the many core features of a traditional brokerage account, such as custody, trade execution, and account statements, with the added benefits of level fee payments that are not tied to account activity, as well as enhanced performance reporting tools, online account access, and other product and technology developments intended to meet the evolving needs of today’s individual investor. So long as the nature of the client relationship is clear from the outset, clients should have access to these kinds of enhancements.

### **Current Regulations Protect Investors**

Critics of the Proposed Rule argue that investors need the protection of the Advisers Act because fee-based brokerage accounts are advisory in nature. The underlying premise fails, however, because such accounts are no more advisory in nature than commission-based accounts. And while it is true that both such brokerage accounts involve some rendering of advice, that advice is, by definition, incidental to the traditional brokerage services. Clients are paying merely for the services of a full-service brokerage account.

That being said, we believe it is important that - at every juncture - investors be made fully aware of what they are paying for, as well as what they are not, so we repeat here our suggestion that, rather than requiring only a disclosure that fee-based accounts are brokerage accounts, the disclosure should make clear that they are not advisory accounts. For example, all *AssetOne*<sup>®</sup> materials currently include the following legend:

*AssetOne<sup>®</sup> is a brokerage account and not an investment advisory account.*

Certain materials also contain the following legend:

*AssetOne<sup>®</sup> is not an investment advisory account and should not be treated as a substitute for one.*

Such disclosure sends a clear message to all investors that a fee-based offering is different from an advisory offering. Such clear disclosure also helps investors frame their understanding and

expectations at the outset and allows them to focus on the choice of compensation arrangement as the difference between fee-based and commission-based brokerage accounts.

Critics of the Proposed Rule also argue that the application of the Advisers Act is necessary to compensate for the absence of fiduciary duty in brokerage relationships. There is, however, a whole host of Commission and Self-Regulatory Organization regulations and rules - cited in detail in the SIA comment letter - governing suitability, business conduct, supervision, and compliance to which dual-registrants such as CGMI must adhere for all brokerage accounts. To require additional regulation for discretionary accounts simply because they are fee-based would, therefore, be duplicative and unnecessary.

On the related question whether to treat all brokerage discretionary accounts as advisory regardless of the method of compensation, we draw the Commission's attention to our 2000 Letter. We again urge the Commission to reject this approach. Investors who delegate limited investment discretion over their brokerage accounts do so with the understanding that their accounts will remain as brokerage accounts. Investment discretion is accepted as an accommodation to investors with unique circumstances that call for this approach as a matter of convenience. Current broker-dealer regulations ensure that discretionary accounts are properly supervised through heightened supervisory procedures and that investors are kept informed through transaction confirmations.

Finally, critics of the Proposed Rule argue that fee-based accounts run the risk of so-called reverse churning. Although we agree that reverse churning needs to be carefully controlled, we believe it presents a question of sales practices rather than revealing a flaw in the regulatory framework. In fact, the National Association of Securities Dealers has provided active oversight on this issue in recent months by reiterating guidance to its members that fee-based brokerage programs must be suitable given an investor's trading activity and by including such programs on its examination schedules. Whether fee-based accounts are treated as brokerage or advisory programs is irrelevant to the question of how they are implemented and monitored insofar as reverse churning is concerned. As a sales practices issue, reverse churning is already being addressed responsibly by the regulators and the member firms.

### **Impact on the Investing Public**

The Commission questions the practical impact on broker-dealers should it choose not to adopt the Proposed Rule. We believe, however, it is more important to focus on the practical impact on the investing public.

CGMI's Smith Barney division has over 100,000 *AssetOne*<sup>®</sup> accounts, totaling approximately \$18 billion in assets. According to the latest *Cerulli Associates* report, as of the second quarter of 2004 over \$254 billion in investors' assets have been placed in fee-based brokerage accounts. We believe that a decision to rescind the no-action relief and to defeat the Proposed Rule would cause significant harm to the investing community. Thousands of investors have specifically chosen the benefits offered by *AssetOne*<sup>®</sup> and similar products that allow them increased choice, complete services, and aligned interests with their brokers. These investors have come to rely on the level compensation structure and better-aligned financial interest. For

dual registrants like CGMI, the *AssetOne*<sup>®</sup> product fills a specific gap in the spectrum from traditional brokerage to managed accounts, and the account and asset numbers cited above speak to the popularity of the offering. To withdraw such programs and to cause the hundreds of thousands of investors who currently invest via such programs to have to contemplate whether to move to what could become a more expensive advisory relationship will inevitably have a negative impact on investors. We do not believe the Commission intends such an outcome, and urge the adoption of the Proposed Rule to avoid it.

### **Conclusion**

As individual investors become more knowledgeable and capable of managing their own assets, their needs evolve, and it is the responsibility of broker-dealers such as CGMI to meet those changing needs. Fee-based brokerage structures, developed in response to the Tully Committee's recommendations, simply represent an effort to meet investors' needs by giving them the important choice of compensation arrangement within the realm of traditional brokerage. As such, the question of whether the payment of a fee creates an advisory relationship within the scope of the Advisers Act must be answered "no," and should be clarified with finality by the Commission through adopting the Proposed Rule.

Please contact me if you need additional information.

Sincerely,

/s/ Michael J. Sharp  
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General Counsel  
Smith Barney  
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