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November 22, 2004

Via Electronic Mail

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: File No. SR-NYSE-2004-13; Proposed Rule Changes Regarding Non-Managed Fee-Based Account Programs

Dear Mr. Katz:

The Securities Industry Association ("SIA")[1] appreciates the opportunity to comment on new Rule 405A proposed by the New York Stock Exchange, Inc. ("NYSE") that would prescribe certain requirements for Non-Managed Fee-Based Account Programs ("NFBA Programs").[2] NFBA Programs, as defined in the proposed Rule, are arrangements in which no investment advisory services are provided and in which customers are charged a fixed fee and/or a percentage of account value, rather than transaction-based commissions.[3] The requirements for proposed new Rule 405A would

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[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 790,600 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated $213 billion in domestic revenue and an estimated $283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

[2] *See* Securities Exchange Act Release No. 34-50586 (October 25, 2004) *Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. to Adopt Rule 405A ("Non-Managed Fee-Based Account Programs—Disclosure and Monitoring)* ("Release No. 50586").

[3] The proposed Rule would not apply to arrangements in which a fixed fee and/or a percentage of account value is charged as payment for investment advisory services. Most such accounts are "managed accounts" or "advisory accounts" and are subject to the regulatory scheme set out in the Investment Advisers Act of 1940. 15 U.S.C. 80b-1 *et seq.* It should be noted that the fees involved in many NFBA Programs cover non transaction-related services such as annual account fees, credit cards, and other benefits, in addition to trade execution costs.

include disclosure, an appropriateness determination, monitoring of transactional activity, and a follow-up system to contact customers whose account activity may be inconsistent with costs incurred under the Program. SIA supports the objectives of the proposed Rule but believes that more general guidance, versus the very prescriptive rules the NYSE has proposed, would achieve the regulatory objective without discouraging firms from offering this pricing option.[4]

NFBA Programs offer many benefits for investors and have become increasingly popular over the last several years.[5] SIA supports the objectives of the proposed rule changes, insofar as investors clearly must understand the ramifications of pricing alternatives in the conduct of their securities transactions. However, we believe the NYSE's proposal (versus the strategy embraced to date by the NASD) will impose requirements as to which the costs will outweigh the benefits. Accordingly, the NYSE strategy may have the unintended consequence of discouraging firms from providing this beneficial alternative to traditional commission-based charges for brokerage services.

As between a firm and a customer, the customer is clearly in the better position to know how frequently he will want to trade in an account, and thus, whether an NFBA Program is more beneficial than a commission-based account from a purely financial perspective. This is especially true when you consider that customers are likely to revisit this decision in response to changed market conditions and personal factors, none of which can be predicted, least of all by a broker. Thus, a prescriptive approach is unnecessary where, as here, a broker cannot hope nor plan to benefit from keeping a customer in a particular account type. Stated differently, a broker cannot possibly expect to profit, and may actually lose, from a mismatched account type when the broker cannot predict how or when a customer's trading activity might change.

As the NASD strategy discussed below would suggest, providing guidance to members and member organizations regarding their obligations with respect to such accounts under existing NYSE rules could be equally effective and less likely to discourage firms from offering this pricing option. This approach has the added benefit of providing consistent regulation across self-regulatory organizations ("SROs"). At a minimum, clarification and flexibility in certain areas, as discussed below, is needed.

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[4] Several SIA Committees have an interest in the proposal and have provided input to this comment letter. They include, among others, the Self-Regulation and Supervisory Practices Committee, the Operations Committee, the Investment Adviser Committee, and the Sales and Marketing Committee.

[5] At the end of 2003, $225 billion in assets was held in fee-based brokerage accounts. *See* Cerulli Edge, Managed Accounts Edition, First Quarter 2004, p. 12.

I. Background and Summary of Proposed Rule Change

NFBA Programs provide investors with the ability to choose from payment alternatives with a broker-dealer that best address their particular needs. For many investors, the NFBA Programs may offer a lower-priced alternative to traditional transaction-based commission accounts. NFBA Programs also have other advantages. In 1995, the Report of the Committee on Compensation Practices (the "Tully Report") identified fee-based programs as a "best practice" because they more closely align the interests of the broker-dealer and customer, and reduce the likelihood of abusive sales practices such as churning, high pressure sales tactics, and recommending unsuitable transactions.[6] However, the Tully Report acknowledges, and the SIA agrees, that NFBA programs are not beneficial in all circumstances. For example, with the benefit of hindsight, it would be easy to conclude that a fee-based account was not the optimal choice for customers who engage in a low level of trading activity if the NFBA Program does not offer additional services or benefits. In those cases, greater cost savings would have been realized in a traditional pay per trade commission structure. Thus, NYSE believes that because NFBA Programs may not be appropriate for all customers, a specifically tailored approach for such accounts is warranted.

The proposed Rule would require members and member organizations to provide each customer, prior to the opening of an NFBA Program account and annually thereafter, a disclosure document describing the types of NFBA Programs available to the customer, which should be sufficient for the customer to make a reasonably informed determination as to whether the Program is appropriate for him. The document would include, for each account type, a description of the services provided, eligible assets, fees charged, including projected customer costs, any conditions or restrictions imposed, and a summary of the Program's advantages and disadvantages. Prior to opening an account in an NFBA Program, the member or member organization would be required to make a determination that the Program is appropriate for the customer taking into account the services provided, anticipated costs, and customer objectives.

Proposed Rule 405A also would require a member or member organization to establish and maintain systems and procedures adequate to monitor, on an ongoing basis, transactional activity by customers in NFBA Programs. The systems and procedures would have to include specific transactional parameters or criteria for identifying customer account activity that may be inconsistent with the Program costs incurred by the customers. Finally, the proposed Rule would require a member or member organization to maintain written procedures for contacting and following up, at a minimum, every 12 months with those customers whose level of activity in an NFBA Program over a specified period of time has been identified, pursuant to the member or member organization's transactional parameters or criteria, as possibly inconsistent with their incurred Program costs.

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[6] SEC Committee on Compensation Practices, Report on Broker-Dealer Compensation (April 10, 1995).

II. The NASD Approach Protects Investors and is in the Public Interest, While the Proposed NYSE Rule Change Would Create Regulatory Inconsistency

SIA has been a strong advocate over the years for consistency and uniformity of regulation across SROs. Last November, the NASD released a Notice To Members reminding members that fee-based compensation programs must be appropriate for the individual customer.[7] The NASD stated that it could be a violation of existing rules dealing with just and equitable principles of trade and suitability, *i.e.*, Rules 2110 and 2310, to place a customer in an account with a fee structure that reasonably can be expected to result in a greater cost than an alternative account offered by the member that provides the same services and benefits to the customer. Likewise, the Notice stated that members should implement supervisory procedures to require a periodic review of fee-based accounts to determine whether they remain appropriate for their respective customers. Under the NASD guidance, members may, but are not required to, create reports that compare the asset-based fees to those that would have been generated in the same account on a commission basis.

SIA supports the approach adopted by the NASD. The guidance puts firms on notice of regulatory concerns that have been identified in connection with NFBA Programs and provides firms with flexibility to tailor their internal controls to prevent and detect abuses, without a prescriptive set of new regulations that may serve to discourage such pricing options.

III. Existing Rules Require a Proactive Approach to NFBA Programs

Proposed Rule 405A would impose specific requirements in areas adequately covered by existing NYSE Rules. NYSE Rule 405(1) requires members and member organizations to use due diligence to learn the essential facts relative to every customer, every order, and every cash or margin account accepted or carried by the member organization. Therefore, members are already required to make a determination, prior to opening an account in an NFBA Program, that the Program is appropriate for the customer. It would, we believe, be equally effective simply to remind members and member organizations of their obligations and highlight these obligations specifically as they apply to NFBA Programs.

The proposed Rule appears to contemplate a disclosure document regarding the available NFBA Program options that would be required to be provided prior to account opening and thereafter on an annual basis. This disclosure can be incorporated into existing account opening documentation; it does not have to stand alone. Virtually all firms have materials that describe various pricing options, which typically are sent to customers in a welcome letter. Because NFBA Programs are more a pricing option than

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[7] Notice To Members 03-68.

a type of account, SIA believes the disclosures provided after the account is opened, *e.g.*, with the welcome letter, should be sufficient. Adding more disclosure on top of the existing disclosure provided to investors in the welcome letter is not necessarily more informative to investors and would require a change in long-standing industry practices. We urge that it be made clear that disclosure in the account opening documentation will suffice. In this way, the objective of providing the customer with information upon which he can make an informed decision with respect to available NFBA Program options can be achieved with minimal disruption to current practices. Additionally, although many firms might choose to make an annual disclosure about the availability of NFBA Programs, such disclosure should be voluntary because it relates to a pricing option and not a type of account. Too much disclosure can be counterproductive, and we note that there is no comparable annual disclosure requirement regarding wrap fee programs under the Investment Advisers Act of 1940.

The disclosure document would be required to include, among other things, projected customer costs. It would be difficult and potentially misleading to project customer costs with any degree of accuracy because costs will depend on the value of the assets in the account, which can and will vary. In addition, pricing can vary based on the type of assets in the account. For example, fixed income investments may have a lower annual fee percentage rate than equity investments. We suggest that, instead of being required to project costs, firms be directed to explain how the costs will be computed or to provide examples of the costs that would be incurred on a hypothetical portfolio, perhaps of a size and composition specified by the Rule.

Anticipated costs are also to be taken into consideration when making the determination regarding appropriateness. Again, this would simply be guesswork. We are concerned about extending the suitability obligation based on determinations that can be made only by the customer himself. We suggest that it be made clear that representations by the customer regarding anticipated levels of trading activity should be considered in making the determination of whether an NFBA Program is appropriate for a particular customer, but that alone may not be determinative if the NFBA Program offers a preferred level of service or other benefits.

The most onerous aspect of proposed Rule 405A is the requirement to establish and maintain systems and procedures adequate to monitor, on an ongoing basis, transactional activity by customers in NFBA Programs. Such systems and procedures would be required to include specific transactional parameters or criteria for identifying customer account activity that may be inconsistent with the Program costs incurred by the customers. The requirement presupposes an automated surveillance system, which would be extremely costly to develop and of only marginal use for monitoring the appropriateness of NFBA Programs. The industry will need substantial time to develop these costly surveillance systems.

Even if sophisticated surveillance systems are developed to monitor such accounts, other factors besides cost may have been determinative for the customer in choosing this option. As the Commission acknowledges, various factors must be considered to determine whether a given NFBA Program is an appropriate investment vehicle for a particular customer. For example, customers may be attracted by other services provided as part of the Program.[8] Additionally, certain customers may prefer consistent and explicit monthly or other periodic charges and may prefer having the assurance provided by a fee-based compensation arrangement that the interests of the registered representative and member firm are aligned with the customer's. As SIA has previously noted, sometimes the best advice to a customer is to "do nothing."[9] Many customers in fee-based accounts are better off today because they were dissuaded by their brokers from selling positions during sharp market declines that occurred between 2000 and 2002. Thus, fee-based accounts can create an environment that encourages a "buy and hold" strategy when that is beneficial for investors.

Although some firms currently have the capability to compare costs under both pricing structures, many more firms would face significant costs to establish and maintain systems for this purpose, particularly in the limited time before the Rule would become effective. The requirement appears excessive given the fact that the data produced is but one of several factors to be considered in making the appropriateness determination.

Existing NYSE Rule 342 requires members and member organizations to exercise supervision and control over each business activity. New supervisory control requirements, which have been harmonized across SROs, should provide an additional mechanism for oversight and testing.[10] As an alternative to the very prescriptive automated review discussed above, the NYSE could adopt an interpretation to Rule 342 requiring a periodic review of fee-based accounts to determine whether they remain appropriate for their respective customers. At a minimum, there should be an acknowledgement in the Rule itself that other services provided and other non-price factors may be taken into consideration in determining whether the Program costs are consistent with the customer's objectives.

Proposed Rule 405A would require written procedures for contacting and following up, at least every 12 months, with those customers whose level of activity in an NFBA Program has been identified as possibly inconsistent with their incurred Program costs. The Commission acknowledges that, due to any number of variables, an NFBA Program's appropriateness may not be determinable except over a relatively extended period of time. SIA suggests that a longer period of time is necessary, *e.g.*, 24 months, before enough meaningful data is collected to assess the appropriateness of the pricing

[8] Similarly, mutual funds have on-going fees in recognition of the fact that servicing is not all transaction-related.

[9] *See* Letter to Jonathan G. Katz, Secretary, SEC, from Ira D. Hammerman, General Counsel, SIA, dated September 22, 2004.

[10] *See* Securities Exchange Act Release No. 34-49882 (June 17, 2004).

option. Of course, if a review conducted before 24 months revealed a level of account activity that was clearly inconsistent with the NFBA Program costs considering the services provided and customer preferences, customer contact would be appropriate and should be documented.

As currently drafted, the provision requiring procedures for follow-up could be read to create an endless loop. Once an account appears on a monitoring report, there would need to be follow-up every 12 months for the life of the account, even if the account never shows up on a monitoring report again. The Rule should clarify that once the initial identifying factors used by the firm are no longer evident, the additional contact and follow-up would no longer be necessary.

IV. NYSE Should Expand and Clarify Exceptions to the Rule

Proposed Rule 405A contains an exception for accounts opened on behalf of "Qualified Investors" as that term is defined in Section 3(a)(54) of the Securities Exchange Act of 1934.[11] Accordingly, accounts of registered investment companies, banks, insurance companies, certain employee benefit plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), any corporation, company or partnership that owns and invests on a discretionary basis not less than $25,000,000 in investments, or any natural person who owns and invests on a discretionary basis not less than $25,000,000 in investments are excepted from the Rule's provisions. The reason for the exception is that such accounts are generally directed by persons who are financially sophisticated and better able to make informed decisions regarding the appropriateness of available NFBA Programs.

SIA requests that the NYSE reconsider this standard. "Qualified Investor" is not the standard that is typically used to judge sophistication for private clients. More typical standards are "Accredited Investor" or "Qualified Purchaser," which would broaden the category of entities excepted from the Rule. Under the NASD's suitability rules, for example, an institutional customer is any entity other than a natural person. In determining the applicability of the interpretation regarding suitability obligations to institutional customers, the NASD considers the dollar value of the securities that the institutional customer has in its portfolio and/or under management. While the interpretation is potentially applicable to any institutional customer, the guidance is more appropriately applied to an institutional customer with at least $10 million invested in securities in the aggregate.[12] We believe a broader exception would be appropriate.

Additionally, member firms may maintain accounts for investors who have delegated management of their portfolios to independent advisers who determine not only what securities and other investments to buy and sell, but also the brokerage firm or firms

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[11] 15 U.S.C. 78c(a)(54).

[12] *See* NASD IM-2310-3 (Suitability Obligations to Institutional Customers).

where the investor's accounts are maintained. With respect to these accounts, the member firm's relationship, typically handled by a department or division dealing with institutional clients, is almost exclusively with the independent adviser. Management includes negotiation of pricing arrangements, whether commissions or fees, for the adviser's client accounts maintained at the member firm. Thus, the independent adviser, not the customer, makes both the investment and the pricing decisions for the account, and thus controls the primary determinants of whether a fee-based account is appropriate. Because the customer has delegated the investment decisions, including the frequency of trading, to the independent adviser, the adviser owes the customer a comprehensive fiduciary duty that includes a duty of best execution for which the cost of brokerage and related services is a primary factor.

The Rule should acknowledge that NFBA Programs do not include fee-based customer accounts managed by independent investment advisory firms. First, these fee-based accounts are "managed," not "*Non*-managed Fee-Based Accounts" (emphasis supplied), which, by its title, the Rule is intended to cover. Second, like the accounts of Qualified Investors currently exempted from the Rule, these accounts are "directed by persons who are financially sophisticated and thus better able to make informed decisions regarding the appropriateness of available NFBA Programs."[13] In fact, the independent advisers responsible for these accounts have an independent fiduciary duty to determine appropriateness; they are not compensated by, or registered representatives of, or otherwise associated persons of the member firm.[14]

Excepting independently managed fee-based accounts from the application of Rule 405A would be consistent with the treatment of these accounts for purposes of suitability and Rule 405. A member firm is not required to determine the suitability of transactions in an account managed by an independent adviser and in lieu thereof obtains representations from the independent adviser[15] that it knows the client's investment objectives and financial situation and will make suitable investment decisions based upon that knowledge.[16] Similarly, since the independent adviser, and not the member firm, negotiates the fee arrangement and determines the frequency of trading, and has its own fiduciary duty to determine the appropriateness of the fee-based arrangement with the

[13] *See* Release No. 50586 at II.A. 1. Purpose.

[14] The vast majority of these advisory firms are registered with the states or with the Commission under the Investment Advisers Act of 1940. A small minority of federally- or state-regulated banks or trust companies is exempt from registration. Both the Advisers Act and applicable banking or trust company regulation impose broad fiduciary duties on these advisers, including duties regarding suitability and best execution.

[15] Commonly in the form of letters long referred to in the industry as "Rule 405 letters."

[16] See NYSE Member Firm Educational Circular No. 273 *Requirements for Carrying Accounts for Clients of Investment Advisors* (August 13, 1969).

member firm, it would not serve the investor protection purpose of proposed Rule 405A to apply the Rule to accounts managed by independent investment advisers.

V. Conclusion

SIA sees no compelling reason for differing regulations between the NASD and NYSE in connection with fee-based accounts. Approval of proposed Rule 405A will undermine recent efforts of the SEC, SROs, and the industry to promote consistency across SROs. We urge the NYSE, in the interest of regulatory uniformity, to consider whether the objectives of the proposed Rule could be achieved by providing more general guidance or through interpretations to existing rules, consistent with the approach taken by the NASD for NFBA Programs.

We thank you for the opportunity to comment on this rule proposal. Any questions regarding this letter may be directed to Amal Aly, Vice President and Associate General Counsel, at 212.608.1500.

Sincerely,

Ira D. Hammerman
General Counsel

CC: Annette L. Nazareth, Director, Division of Market Regulation ("MR")
Robert L.D. Colby, Deputy Director, MR