ORAL ARGUMENT NOT YET SCHEDULED
FINAL BRIEF

Nos. 04-1242, 05-1145 (Consolidated)

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

FINANCIAL PLANNING ASSOCIATION,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

On Petition for Review of an Order of the
Securities and Exchange Commission

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

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CERTIFICATE AS TO PARTIES, RULINGS AND RELATED CASES

Parties and Amici. All parties and amici appearing in this Court are listed in the Opening Brief of Petitioner, the Financial Planning Association. There are no intervenors. The Financial Planning Association and all amici provided comment to the Commission on the rule under review.

Rulings Under Review. The official citation to the final rule of the Securities and Exchange Commission under review is *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release Nos. 34-51523; IA-2376 (April 12, 2005), *published at* 70 FR 20424 (April 19, 2005), *codified at* 17 C.F.R. 275.202(a)(11)-1.

Related Cases. The consolidated cases on review have not previously been before this Court and there are no related cases.

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GLOSSARY

Adopting Release – the release accompanying the IA/BD Rule.

CFA – Consumer Federation of America.

Commission – Securities and Exchange Commission.

CR__ – The Commission's Certificate Listing and Describing the Record at item #.

Decl. – Declaration of Daniel Moisand, President of the Financial Planning Association, attached to FPA's Opening Brief.

FD – Fund Democracy, Inc.; *FD Br.* __ – Amici Curiae Brief of Fund Democracy Inc. and Consumer Federation of America at page #.

FPA – Financial Planning Association; *FPA Br.* __ or *Br.* __ – FPA's Opening Brief at page #.

FR – Federal Register.

HA__ – Historical materials in the Commission's Addendum of Statutory and Historical Materials at page HA#.

IAA – Investment Advisers Act of 1940, 15 U.S.C. 80b-1, *et seq*.

IA/BD Rule or *Rule* – the final rule at issue in this proceeding, cited as: *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release Nos. 34-51523; IA-2376 (April 12, 2005), *published at* 70 Fed. Reg. 20424 (April 19, 2005). The Rule is codified at 17 C.F.R. 275.202(a)(11)-1.

ICA – Investment Company Act of 1940, 15 U.S.C. 80a-1, *et seq*.

JA__ – the deferred appendix at page #.

NASAA – North American Securities Administrators Association; *NASAA Br.* __ – NASAA's Corrected Amicus Curiae Brief at page #.

PIABA – Public Investors Arbitration Bar Association; *PIABA Br.* __ – PIABA's Amicus Curiae Brief at page #.

*SA*__ – Statutory materials in the Commission's Addendum of Statutory and Historical Materials at page SA#.

COUNTERSTATEMENT OF JURISDICTION AND STANDING

The Securities and Exchange Commission had authority to issue its final rule, *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release Nos. 34-51523; IA-2376 (April 12, 2005), *published at* 70 FR 20424 (April 19, 2005) (JA1-32) ("IA/BD Rule"; "Rule"; "final rule" or Rule 202(a)(11)-1), under Sections 202(a)(11)(F), 15 U.S.C. 80b-2(a)(11)(F), and 211(a), 15 U.S.C. 80b-11(a), of the Investment Advisers Act of 1940, 15 U.S.C. 80b-1 *et seq.* ("IAA"). Under 15 U.S.C. 80b-13, this Court has jurisdiction over challenges to administrative actions such as the Rule. *Investment Co. Inst. v. Board of Governors,* 551 F.2d 1270, 1277-78 (D.C. Cir. 1977). Because the Financial Planning Association ("FPA") lacks standing to challenge the Rule, however, this Court is without jurisdiction here.

The sole—conclusory—assertion in FPA's brief that the Rule "injures the FPA's members by creating a dual standard for providing investment advice," Br. 1 (*citing* Moisand Decl. ¶¶7-20), is insufficient to establish the injury required for constitutional standing. *See Sierra Club v. EPA*, 292 F.3d 895, 899-901 (D.C. Cir. 2002) (party must produce, with opening brief, evidence establishing standing, including a "substantial probability" of injury); *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992) (requiring "concrete and particularized" injury that is "actual or imminent, not 'conjectural' or 'hypothetical' ").

Nor does the cited declaration remedy the deficiency. Paragraph twenty's statement that the final rule "harms the financial planning profession" (Decl. ¶20) adds

nothing to the bare allegation in FPA's brief. And, although paragraph eighteen alleges devaluation of the "higher-quality" services of financial planners and other damage to their reputation, it does so only in describing FPA's February 7, 2005 comments on the reproposed rule. *See* Decl. ¶18. Even if FPA could use the comment letter to supplement the declaration, the letter, like the declaration, merely contains broad, unsupported assertions of reputational harm.[1] *See* 2/7/05 Letter at 2, 22-23 (JA128, 148-49). It is insufficient to demonstrate standing. *See Center for Law and Educ. v. DOE*, 396 F.3d 1152, 1161 (D.C. Cir. 2005).

Indeed, the letter underscores the lack of current injury, stating that "[i]ndependent studies have concluded that the public generally has a highly favorable, albeit fuzzy, picture of the benefits of financial planning." JA148. Other record

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1 The letter also asserts competitive injury. JA148. If, ignoring that the Rule subjects financial planning to the IAA, FPA asserts competitive harm here, it lacks prudential standing. Nothing in the language or legislative history of IAA Section 202(a)(11) shows an intent to protect the *market position* of investment advisers vis-à-vis other providers of legitimate investment advice; FPA's members are therefore not intended beneficiaries. *See Hazardous Waste Treatment Council v. EPA*, 861 F.2d 277, 283 (D.C. Cir. 1988) (*per curiam*). Further, in defining "investment adviser," Section 202(a)(11) merely determines the level and type of regulation of advice—*e.g.*, broker-dealer regulation alone or broker-dealer regulation and adviser regulation. It does not prohibit rendering advice, and is therefore not an "entry-restriction" competitors have prudential standing to challenge. *See, e.g., Honeywell v. EPA*, 374 F.3d 1363, 1370-71 (D.C. Cir. 2004) (*per curiam*), *opin. withdrawn in part on other grounds*, 393 F.3d 1315 (D.C. Cir. 2005). Accordingly, FPA's members are not "suitable challengers." *See*, *e.g.*, *Hazardous Waste Treatment Council v. Thomas*, 885 F.2d 918, 922, 924-25 (D.C. Cir. 1989).

evidence undermines any assertion of future harm. *See, e.g.*, T.D. Waterhouse, *2004 U.S. Investor Perception Study* at JA118 (over 80% of investors surveyed would likely seek advice from an investment adviser, and likely not from a broker-dealer, if aware of differing standards of conduct). Any claim that a diminution in the public perception of the integrity of financial planners is "certainly impending" would thus be pure conjecture. *See Advanced Mgmt. Tech. v. FAA*, 211 F.3d 633, 636-37 (D.C. Cir. 2000); *J. Roderick MacArthur Found. v. FBI*, 102 F.3d 600, 606 (D.C. Cir. 1996).

COUNTERSTATEMENT OF ISSUES

1. In adopting the IA/BD Rule, did the Commission properly act, as Congress intended in IAA Section 202(a)(11)(F), to except from the definition of "investment adviser" in paragraph (11) broker-dealers (other than those already identified in the paragraph) not within the paragraph's intent?

2. Did the Commission make reasonable judgments about other matters—such as the Rule's benefits—committed to its assessment?

STATUTES AND REGULATIONS

Pertinent statutes and regulations are set forth in FPA's brief and in the Commission's separately bound Addendum of Statutory and Historical Materials.

COUNTERSTATEMENT OF CASE

A. *Nature of Case*

This petition for review is from a final rule addressing application of the IAA to broker-dealers offering two relatively new types of brokerage programs: (a) full-service programs in which brokerage services, including investment advice,[2] are provided for a fixed or asset-based fee ("fee-based brokerage") instead of the traditional commissions, mark-ups, or mark-downs charged for "commission-based brokerage";[3] and (b) discount programs, such as execution-only programs ("discount brokerage"). The final rule also addresses, regardless of the type of compensation, the IAA's application to certain broker-dealer advisory services.

Paragraph (11) of IAA Section 202(a), 15 U.S.C. 80b-2(a)(11), defines an "investment adviser" as "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or . . . the advisability of investing in, purchasing, or selling securities . . . ." FPA's Statutory Appendix at 1. Excepted from that definition are five groups of persons who would otherwise fall within its broad scope, including, in subparagraph (C), 15 U.S.C. 80b-2(a)(11)(C), any broker-dealer

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2 Full-service brokerage includes services traditionally provided throughout a securities transaction, including providing research and advice prior to the decision to buy or sell, executing the transaction, arranging for delivery of securities by the seller and payment by the buyer, and providing records of the transaction. *See* JA6 n.37 (discussing "traditional brokerage services").

3 References in this brief to "commissions" likewise include dealer mark-ups or mark-downs. *See* JA3 & n.10.

"whose performance of [advisory] services is solely incidental to the conduct of [its] business as a broker or dealer and who receives no special compensation therefor." *Id.* The paragraph concludes with subparagraph (F), 15 U.S.C. 80b-2(a)(11)(F), giving the Commission express authority to issue rules, regulations or orders designating "other persons" to be excepted from the definition because they are "not within the intent of this paragraph." *Id.*

The IA/BD Rule (Commission's Addendum of Statutory and Historical Materials at SA4-5) addresses fee-based brokerage through an exercise of the Commission's subparagraph (F) authority. It excepts broker-dealers offering such accounts from the definition of investment adviser (and hence from the IAA). It does so in response to changes in the brokerage industry: when the IAA was passed, no broker-dealers offered fee-based brokerage—and they could not do so until decades later. As explained below, the new exception reflects the Commission's conclusion that Congress would not have intended that broker-dealers offering a traditional package of brokerage services for a fee be regulated under the IAA.

The Rule separately interprets the term "special compensation" in subparagraph (C) of paragraph (11) to address discount brokerage. SA4. Finally, it addresses what broker-dealer advisory services should be governed by the IAA through an interpretation of the phrase "solely incidental to" in subparagraph (C) and the exception for fee-based brokerage. SA4-5.

B. *Proceedings Below*

1. *Proposed Rule*

In 1999, the Commission issued for notice and comment a proposed rule to address uncertainty about application of the IAA to broker-dealers offering fee-based or discount brokerage programs. Release Nos. 34-42099; IA-1845 (November 4, 1999), *published at* 64 FR 61226 (November 10, 1999) (JA33-39) ("Proposing Release"). The Commission viewed these new programs as positive developments for investors, explaining first that "fee-based programs benefit customers by better aligning their interests with those of their broker-dealers and thus are responsive" to the suggestions in a report—prepared by a committee formed in 1994 at then-Commission Chairman Levitt's request—that identified the brokerage industry's "best practices." JA35 & n.9, *citing* Report of the Committee on Compensation Practices (April 10, 1995) ("Tully Report") at JA69-90. The Commission continued:

> Under these programs, broker-dealers' . . . compensation no longer depends on the number of transactions or the size of mark-ups or mark-downs charged, thus reducing incentives for . . . churn[ing] accounts, recommend[ing] unsuitable securities, or engag[ing] in high-pressure sales tactics.

JA35. Second, discount brokerage programs, which resulted from the "unbundling" of traditional brokerage services, enhanced customer choice by, for example, offering customers who did not want or need investment advice the ability to trade securities at lower commission rates. *Id.*

Uncertainty about whether the IAA applied to firms offering these programs arose from past interpretations of certain terms in Section 202(a)(11)(C) of the Act. As stated, subparagraph (C) excepts from paragraph (11)'s definition of "investment adviser" any broker or dealer whose performance of advisory services is solely incidental to its business and "who receives no special compensation therefor." Unlike broker-dealers offering only "commission-based" traditional brokerage services—who have always been covered by the exception—full-service broker-dealers offering fee-based or discount brokerage accounts might not be covered by the exception because they might be seen to have received "special compensation." The proposing release explained (JA35):

> Fee-based compensation may constitute special compensation . . . because it involves the receipt . . . of compensation other than traditional brokerage commissions. . . . [A]ddition[ally], the introduction of execution-only services at a lower commission rate may trigger application of the Act to . . . full service accounts . . . because the difference between full service and execution-only commission rates represents a clearly definable portion of a brokerage commission that is attributable, at least in part, to investment advice.[4]

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4 Historically, *Congress and the Commission* interpreted "special compensation" to include "compensation other than brokerage commissions or dealer compensation." JA3 & n.10. *Commission staff* further viewed "special compensation" as embracing a "clearly definable" charge for advice. *See* JA3 & n.11, *citing*, *e.g.*, Rel. No. IA-2 (October 28, 1940); Rel. No. IA-626 (April 27, 1978) (setting forth "staff views on the meaning of the term 'special compensation'"). *See also* Rel. No. IA-640 (October 5, 1978) (staff "intend[ed] for the present to continue to interpret [the term] in the manner described in . . . Release No. 626"). Under this staff view, a two-tiered commission

(continued...)

In examining the new programs, however, the Commission concluded that Congress would not have intended that the IAA govern broker-dealers offering them. For example, fee-based brokerage was "not . . . fundamentally different from traditional brokerage . . . not subject to the [IAA]," thus "suggest[ing] strongly" that compensation had become an unreliable guide to identifying the broker-dealer advice Congress intended the Act to cover. *Id.* Furthermore, widespread customer acceptance of the new programs could subject most brokerage arrangements to dual regulation under the IAA and the Securities Exchange Act of 1934 ("Exchange Act")—a result the Commission concluded Congress could not have intended. *Id.*

In light of these developments, the Commission proposed to exercise its authority under IAA Section 202(a)(11)(F) to except, as not within the intent of the definition of "investment adviser," persons offering fee-based brokerage programs. *See* JA39. Under the proposed fee-based brokerage provision, a broker-dealer providing investment advice to customers, regardless of the form of compensation received, would be excepted from the Act's coverage if: (i) the advice was provided on a non-discretionary basis; (ii) the advice was solely incidental to brokerage services; and (iii)

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4 (...continued)
structure involved special compensation when the difference in price for upper tier service was attributable to the provision of advice. *See, e.g., Robert S. Strevell*, Staff No-Action Letter (April 29, 1985).

the broker-dealer disclosed to its affected customers that their accounts were brokerage accounts. JA34.

Also consistent with the Commission's understanding of congressional intent, the proposal included a "discount-brokerage" provision designed to keep full-service broker-dealers from being subject to the IAA simply because they introduced discount brokerage services and, conversely, to keep discount broker-dealers from being subject to the IAA simply because they introduced full-service brokerage. JA36. Under this exercise of the Commission's authority to interpret statutory terms, a broker-dealer would not be considered to have received "special compensation" under Section 202(a)(11)(C) simply because it charged one customer more or less for brokerage services than it charged another ("two-tiered" pricing). *Id.*

2. *First Petition for Review, Reopening of Comment Period, and Stay of Appellate Proceedings*

In July 2004, FPA petitioned for judicial review of the pending proposal. The Commission then reopened the comment period and stated its intention to take final action by December 31, 2004. Release Nos. 34-50213; IA-2278 (August 18, 2004), *published at* 69 FR 51620 (August 20, 2004) (JA40). The Commission also sought, and this Court issued, an order holding the petition in abeyance. In a December 2004 status report, the Commission stated it had determined to repropose the rule. The reproposal was necessary in light of comments raising significant issues extending

beyond those contemplated in the proposing release. *See* Release Nos. 34-50979; IA-2339 (January 6, 2005), *published at* 70 FR 2712 (January 14, 2005) (JA101-05).

3. *Reproposal and Order Continuing Abeyance*

The Commission reproposed the rule in January 2005. Release Nos. 34-50980; IA-2340 (January 6, 2005), *published at* 70 FR 2716 (January 14, 2005) (JA41-66) ("Reproposing Release"). In some respects—including the discount brokerage interpretation—the reproposal mirrored the proposal. In other respects, it was significantly different. For example, while the fee-based brokerage provision continued to except persons offering such accounts from the IAA, the reproposal enhanced disclosure about the nature of fee-based brokerage accounts. JA48-49.

In response to comments, the Commission proposed to provide greater guidance on when the performance of advisory services is "solely incidental to" brokerage services, tentatively concluding that such advisory services are performed "in connection with and reasonably related to" brokerage services. JA51-52. The Commission explained the legal and policy reasons that led it to reject narrower interpretations while, at the same time, adhering to the "limitation inherent in the 'solely incidental' standard." JA52. Additionally, the reproposed rule provided that discretionary asset management is not "solely incidental to" brokerage services—regardless of the type of compensation paid for that advisory service. JA49-51.

The Commission stated that it intended to take final action by April 15, 2005. *See* JA103. The Commission then sought, and this Court issued, an order continuing to hold the review proceeding in abeyance.

4. *Final Rule*

a. *The Rule*

On April 12, 2005, the Commission adopted a final rule now codified at 17 C.F.R. 275.202(a)(11)-1. *See* SA4-5. The Rule has three separate, yet related, parts:

- *Paragraph (a)* is closely patterned after the "fee-based" and "discount" brokerage provisions of the proposed and reproposed rules. It has two parts.

Fee-Based Brokerage. Under paragraph (a)(1), a broker-dealer receiving from a customer compensation that can be considered "special compensation" is eligible for a new exception from the IAA (adopted pursuant to Section 202(a)(11)(F)) if the broker-dealer provides:

(i) advice solely incidental to brokerage services provided to the customer's account; and

(ii) disclosure enhanced from that originally proposed and reproposed. All customer documents, including advertisements, must state:

> Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy.

> Therefore, our profits, and our salespersons' compensation, may vary by product and over time.

Discount (Two-Tier) Brokerage. Paragraph (a)(2) provides that a broker-dealer will not be deemed to have received "special compensation"—and thereby lose entitlement to the subparagraph (C) exception—merely because it charges one customer more or less for brokerage services than it charges another customer.

- *Paragraph (b).* The second part of the Rule gives examples of broker-dealer advisory activities included within the IAA because their performance is not "solely incidental to" the conduct of the business of a broker or dealer (within the meaning of the statute) or to the brokerage services provided to accounts covered under paragraph (a)(1) of the Rule. It applies regardless of the type of compensation charged. It identifies three non-exclusive circumstances in which advisory services would not be performed "solely incidental to" brokerage:

  1. *Separate Fee or Contract.* Under paragraph (b)(1), when a broker-dealer charges a customer a separate fee or enters into a separate contract for advisory services, it must treat the customer as an advisory client.

  2. *Financial Planning.* Under paragraph (b)(2), a broker-dealer must, under certain circumstances, treat a customer who receives financial planning services as an advisory client.

3. *Discretionary Asset Management.* Under paragraph (b)(3), with limited exceptions, all accounts over which a broker-dealer has investment discretion are treated as advisory accounts.

- *Paragraph (c).* The third part of the Rule clarifies that broker-dealers registered under both the Exchange Act (as broker-dealers) and the IAA (as investment advisers) are investment advisers "solely with respect to those accounts for which [they] provide[] services or receive[] compensation that subject [them] . . . to the Advisers Act."

b. *The Rationale*

At the outset of the Adopting Release (JA2) and again later (JA20), the Commission stated that the rulemaking was limited in scope and was "not the appropriate mechanism for resolving" the wide-ranging policy concerns expressed by commenters about broker-dealer conduct in general. JA20. Instead, many of those concerns (including concerns about investor confusion, broker-dealer marketing, and the extent of a broker-dealer's fiduciary obligations to its customers) were more appropriately addressed under the Exchange Act and would be the subject of a study, which has recently been announced. *Id.*; *see also* JA2, 13 n.122, 14, 17 n.163.[5]

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5 On March 3, 2006, Chairman Cox announced that "a study will be conducted to address the issues specified" in the Adopting Release. Rel. Nos. 34-53406; IA-2492 (March 3, 2006), *published at* 71 FR 12224 (March 9, 2006). *See also* Chairman Cox, *Opening Remarks to the Practising Law Institute's SEC Speaks Series* (continued...)

Next, the Commission reiterated that its goal in fashioning the Rule was to respond to change—the advent of brokerage programs that could not have been foreseen when the IAA was enacted—and, in light of that change, to ensure that the IAA continues to apply only to broker-dealers providing advice in a context that Congress intended to cover. JA4, 5. To discern that intent, the Commission analyzed the language, legislative history, and contemporaneous construction of Section 202(a)(11), including subparagraph (C), as well as the brokerage customs of 1940. JA6-12 (and materials cited, *see* CR5B-5F, 3H (JA106, 111, 113, 114, 115-16, 95-96) and Addendum of Statutory and Historical Materials at HA1-170).

The Commission concluded that subparagraph (C) reflected a congressional intent *to except from coverage* under the IAA broker-dealers who provided advice to customers as part of a package of traditional brokerage services and, conversely, *to cover* those that provided advice as a distinct service for which clients separately contracted and paid. JA8-9. Congress thus intended to distinguish between broker-dealers offering advice as a component of traditional brokerage services and broker-dealers offering the sort of "purely advisory" or "discretionary" accounts investors typically maintained in special investment advisory departments. JA6-7. By covering broker-

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5 (...continued)
(March 3, 2006) (available at www.sec.gov); Commissioner Glassman, *Remarks Before the SEC Speaks Conference: The Light at the End of the Tunnel—What's Next?* (March 3, 2006) (available at www.sec.gov).

dealers under the IAA only to the extent that they offered advice as a distinct service, Congress avoided additional and largely duplicative regulation of other broker-dealers—only six years earlier Congress had enacted the Exchange Act, including provisions regulating broker-dealers, and had modified it to provide for further oversight of broker-dealers only two years earlier. JA8 & n.67.

Focusing on fee-based brokerage, the Commission considered whether Congress would have intended to subject broker-dealers offering such accounts to the IAA simply because customers pay compensation other than commissions. JA9. The Commission concluded that the answer was "no." First, doing so would subject many brokerage relationships to the regulatory overlap the historical evidence demonstrated subparagraph (C) was drafted to avoid: "If anything, broker-dealers today are subject to a level of regulation far greater than in 1940," and much of that regulation concerns their advice-giving function. JA9; *see also* JA10-11 & nn.93, 94.

Additionally, the Commission concluded that there is no historical evidence that Congress viewed the type of compensation a broker-dealer received as having "any *independent* relevance in terms of the advisory services the [IAA] was intended to reach"—beyond identifying the advice that was being supplied by broker-dealers in a context that Congress intended the Act to cover. JA9 (emphasis in original). When the IAA was enacted, broker-dealers charged commissions for their traditional package of services (including advice), and Congress understood "no special compensation" to

mean "only brokerage commissions." *Id.* & nn.74-75; *see* HA164, 168. As such, to the extent that a broker-dealer was charging something *other than traditional transaction-based broker-dealer compensation* for advice, it was not eligible for the subparagraph (C) exception. The "no special compensation" limitation thus served as a reliable bright-line test for broker-dealers that should be subject to the Act. JA9 & n.76.

In the decades following 1940, however, things changed, undermining the continuing validity of that test. In 1975, Congress and the Commission eliminated the fixed commission rate structure, and thereby allowed broker-dealers to charge something other than traditional broker-dealer compensation for their services. *See* Exchange Act Section 6(e), 15 U.S.C. 78f(e); JA9 n.74. More recently, broker-dealers began offering fee-based brokerage programs that provided the broad package of brokerage services, including advice, formerly available only to commission-paying customers. JA3, 9. Accordingly, the Commission concluded that these changes called for the exercise of its authority under Section 202(a)(11)(F) to except broker-dealers offering fee-based brokerage. JA9 n.78. "To the extent fee-based brokerage programs offer a package of the same types of services that Congress intended the Advisers Act *not* to cover, [the fee-based brokerage provision of] the [R]ule . . . is necessary to prevent the Act from reaching beyond Congress' intent." JA9 (emphasis in original).

In so concluding, the Commission rejected a number of comments as contrary to congressional intent. For example, although commenters urged that the fee-based

brokerage exception might harm investors by depriving them of IAA protections, it was evident to Congress that excepted broker-dealers would be regulated not under the IAA but under a different regulatory regime, that they would have certain conflicts of interest with their customers, and that they would not in all instances function as full fiduciaries. JA10-11 & n.93. Moreover, while acknowledging that the lines between full-service broker-dealers and persons providing investment advice as a distinct service had blurred, the Commission concluded that Congress drafted a statute that accommodated—and empowered the Commission to respond to—change. JA12.

The Commission's focus on the nature and context of the advice provided by broker-dealers culminated in its interpretation of the phrase "solely incidental to the conduct of his business as a broker or dealer." In interpreting the phrase "solely incidental to" to mean "in connection with and reasonably related to," the Commission considered, among other things: (a) the dictionary; (b) the statutory context of the phrase; (c) the legislative history of Section 202(a)(11); and (d) the pertinent practices of broker-dealers. JA14-15 & nn.134-135, 139-143 (*see* CR3I (JA97-98)); HA98; 119-120, 154, 157, 172-174, 175-181); *see also* JA51-52 & nn.100, 101.

The Commission acknowledged the phrase is not susceptible to a "bright-line" definition and requires judgment based on the facts and circumstances. JA9 n.76. In paragraph (b) of the Rule, however, the Commission identified three non-exclusive circumstances in which the performance of advisory services would not be solely

incidental to brokerage. *See supra* pp. 12-13. In each of these circumstances, either the advice is not rendered "in connection" with brokerage services (*i.e.*, it is provided essentially independently of brokerage services (*e.g.,* JA16-17) or otherwise does not follow as a consequence of conducting brokerage business (JA17)), or it is not "reasonably related" to brokerage (*i.e.*, it has a character that cannot reasonably be understood to be part of the traditional package of brokerage services).[6]

5. *Petition for Review and Consolidation*

FPA petitioned for review of the final rule, and that petition was consolidated with the earlier one. FPA's brief does not press the earlier petition.

SUMMARY OF ARGUMENT

1. In light of IAA Section 202(a)(11)'s language, history, and background, the Commission reasonably concluded, under subparagraph (F), that: (a) broker-dealers offering fee-based brokerage accounts covered by the Rule—who indisputably could not have existed in 1940—are "other persons" than the subgroup of broker-dealers already excepted from the Act; and (b) it would be inconsistent with congressional intent to subject them to IAA regulation. FPA and the amici offer no supportable basis for overturning these determinations.

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6 *See*, *e.g.*, JA18 (exercise of discretion is not "reasonably related" to brokerage because it is "qualitatively distinct from simply providing advice as part of a package of brokerage services"—its "quintessentially supervisory or managerial character warrants [IAA] protection"); *see also id.* at n.176.

They argue, in essence, that the Commission lacked authority to except the broker-dealers at issue because Congress did not except them when it excepted other broker-dealers in 1940. But, they fail to appreciate that, to address circumstances unforeseen when the IAA was drafted, subparagraph (F) gives the Commission express authority to determine whether persons who fall within the literal definition of "investment adviser" are nonetheless persons Congress would have intended to except from the Act. Subparagraph (F) thus expressly contemplates disconnects between the literal definition of "investment adviser" and congressional intent—and empowers the Commission to remedy such variances as it did in this case.

The arguments about "rewriting" the statute and the impropriety of looking behind the statute's plain language are thus inapposite. Similarly, because subparagraph (F) exceptions apply to situations in which Congress intended no IAA regulation, there is no merit to arguments—raised only by amici—that the Commission was required to consider alternatives to a blanket exception or that the Rule's disclosure requirement was intended to "substitute" for IAA protections.

Finally, the inflammatory and baseless contention that the Commission distorted the IAA's legislative history to "protect broker-dealers"—who FPA likens to the unregulated tipsters and touts that were principal targets of the Act—misconstrues the Commission's findings and the relevant history, and ignores Congress's determination

that not all broker-dealers who supply investment advice should be regulated as investment advisers.

2. FPA's remaining attacks on the Rule as harming investors are similarly misplaced. Its claims of a "shrinking statute" and facilitation of conflicts of interest reflect a basic disagreement with Congress's judgments about which advice providers should be subject to the Act's fiduciary obligations. Its challenges to the Commission's assessment of the Rule's benefits misstate the Commission's views and distort the Rule's effect.

3. The Court should not countenance the repeated attempts by the amici to raise issues on which FPA is silent or to which it only vaguely alludes, including the propriety of the Commission's approaches to "special compensation" (in the context of discount brokerage) and "solely incidental to" and the efficacy of the Rule's disclosure requirement. In any event, the confused contentions about discount brokerage offer no basis for overturning the Rule. The Commission's interpretation of "solely incidental to"—unlike the challengers'—reasonably accounts for all words in that phrase and the relevant statutory and historical context. And, finally, the challengers' critique of the disclosure requirement misapprehends its purpose and misjudges its likely effectiveness.

STANDARD OF REVIEW

Under the Administrative Procedure Act, 5 U.S.C. 706, this Court considers whether an agency action is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law. The Commission's findings of fact are conclusive if supported by substantial evidence. 15 U.S.C. 80b-13. In informal rulemakings, the substantial evidence standard and the "arbitrary [or] capricious" test converge, *Williams Natural Gas v. FERC*, 943 F.2d 1320, 1328 (D.C. Cir. 1991), requiring a "rational connection between the facts found and the choice made." *Public Citizen v. NHTSA*, 374 F.3d 1251, 1260 (D.C. Cir. 2004) (internal quotation omitted). Under *Chevron v. NRDC*, 467 U.S. 837, 842-44 (1984), this Court defers to the Commission's interpretation of the IAA, so long as Congress has not "unambiguously forbidden [the interpretation] and it is . . . 'based on a permissible construction of the statute.' " *Northpoint Tech. v. FCC*, 414 F.3d 61, 69 (D.C. Cir. 2005) (quoting *Chevron*); *see also Consumer Electronics Ass'n v. FCC*, 347 F.3d 291, 297 (D.C. Cir. 2003) (applying *Chevron* to whether FCC had authority to promulgate rule).

ARGUMENT

I. THE COMMISSION ACTED WITHIN ITS AUTHORITY IN ADOPTING THE FEE-BASED BROKERAGE PROVISION.

In adopting the Rule's fee-based brokerage provision—paragraph (a)(1) of the Rule—the Commission did not, as FPA and NASAA repeatedly assert (*e.g.*, FPA Br. 27-29; NASAA Br. 8, 14), "rewrite" IAA Section 202(a)(11)(C). The fee-based

brokerage provision makes no change to subparagraph (C). Instead, the Commission exercised its express authority under Section 202(a)(11)(F) to except certain broker-dealers from the "investment adviser" definition—after properly finding that: (1) those broker-dealers offering fee-based brokerage covered by the Rule are "other persons" under subparagraph (F); and (2) it would be inconsistent with the intent underlying Section 202(a)(11) to regulate them under the IAA. *Supra* pp. 14-17; *see also*, *e.g.*, JA6 n.35, 9 n.78, 31 & n.284.

A. The Challengers Misperceive the Commission's Authority under IAA Section 202(a)(11)(F).

Most of the challenges to the Commission's authority rest on the assumption that it was "extraordinary" and inconsistent with governing law for the Commission (1) to except broker-dealers that are otherwise expressly covered by the language of Section 202(a)(11), and (2) to do so based on the conclusion that, *despite* subparagraph (C)'s language, such broker-dealers are not within the intent of paragraph (11). *See*, *e.g.*, FPA Br. 25-35, 38-41; NASAA Br. 4-9. These arguments ignore the plain language and purpose of subparagraph (F): Every person excepted under subparagraph (F) is one who otherwise falls within the definition of "investment adviser" in paragraph (11) (and does not fall within an exception), and the only basis for a subparagraph (F) exception is a Commission finding that it nonetheless would be inconsistent with the paragraph's "intent" to subject that person to the Act. Subparagraph (F) thus recognizes the fact that—due to circumstances unforeseen when the Act was

drafted—applying the express *language* of paragraph (11) (including the specific exceptions adopted by Congress in 1940) will sometimes lead to results that conflict with the *intent* underlying that paragraph.

The challengers never recognize this essential and dispositive point. None of the cases cited for the proposition that an agency may not deviate from a statute's plain language (FPA Br. 27-30; NASAA Br. 7-9) or "update" its reach (FPA Br. 20, 31) involves a provision like subparagraph (F). Subparagraph (F) is neither "vague" nor "ancillary" (FPA Br. 31), but a critical component of Congress's intentionally flexible regulatory scheme—one that expressly vests the Commission with authority to make adjustments by a rule or order to carry out congressional intent. *See NASD v. SEC*, 420 F.2d 83, 92 (D.C. Cir. 1969) (noting, in discussing Commission's authority under Investment Company Act (ICA) Section 6(c), 15 U.S.C. 80a-6(c) (SA2)—which, in this regard, is similar to subparagraph (F)—that "[t]he Commission has exercised this authority to exempt persons not within the intent of the Act and generally to adjust its provisions to take account of special situations not foreseen when the Act was drafted"), *vacated on other grounds*, *Investment Co. Inst. v. Camp*, 401 U.S. 617 (1971).

The Commission's reliance on subparagraph (F) also distinguishes *American Bankers Ass'n v. SEC*, 804 F.2d 739 (D.C. Cir. 1986) (*see* FPA Br. 34-35), which concluded that neither the Commission's general authority to define technical, trade, accounting, or other terms under the Exchange Act nor the phrase "unless the context

otherwise requires" preceding Exchange Act definitions authorized the Commission to "redefine" the term "bank" in that Act. 804 F.2d at 753-55. Here, rather than relying on a non-specific source of authority, the Commission acted pursuant to subparagraph (F)'s explicit delegation of authority to formulate a definitional exception. The *American Bankers* court itself suggested that this sort of delegation to "take account of future changes" could allow an agency wide latitude to implement a statute. *Id.* at 749.

The challengers' failure to recognize the purpose and effect of congressional grants of authority like subparagraph (F) also is shown by their extended discussions of Congress's intent to protect investors through the IAA (*e.g.*, FPA Br. 41-44; NASAA Br. 10-11, 16-17; PIABA Br. 5-6)(discussing, *e.g.*, the *Capital Gains* decision and the Commission's recent brief in *Chamber of Commerce v. SEC*, No. 04–1300 (filed D.C. Cir. Feb. 16, 2005) (addressing the ICA)). In fact, the Commission explicitly and carefully considered this intent in ensuring that the IA/BD Rule comported with the purposes of the Act. *See* JA7-8. But, unlike the Commission, the challengers exclusively emphasize this aspect of Congress's intent, while downplaying the exceptions in subparagraphs (A)-(E) and essentially *ignoring* subparagraph (F). In so doing, they disregard the balance Congress struck in paragraph (11) and, in particular, its express determination in subparagraph (F) that the Commission should maintain that balance.

The Commission's reliance on subparagraph (F) also defeats claims—which are raised only by amici and therefore should not be considered by this Court[7]—that the Rule is "arbitrary and capricious" because the Commission was required to consider alternatives to a "blanket exemption" from the IAA (FD Br. 4-12) or because the Rule "substitutes" a "notice" provision for the IAA's "comprehensive fiduciary obligations and genuine ongoing disclosure" requirements. PIABA Br. 2; *see also* 3, 6-9, 13; FD Br. 8. These arguments ignore the Commission's finding that Congress would not have intended the broker-dealers covered by the fee-based brokerage exception to be regulated as investment advisers. Consistent with that finding, the Commission could not have considered any "alternative" that involved IAA regulation.[8] Nor would it have fashioned a disclosure requirement as a "substitute" for IAA fiduciary obligations or disclosures it concluded Congress did not intend to impose. Instead, the fee-based brokerage provision's disclosure requirement is a limited response to investor

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7 *See*, *e.g.*, *Knetsch v. U.S.*, 364 U.S. 361, 370 (1960); *Narragansett Indian Tribe v. National Indian Gaming Comm'n*, 158 F.3d 1335, 1338 (D.C. Cir. 1998); *cf. Lamprecht v. FCC*, 958 F.2d 382, 389 (D.C. Cir. 1992); *see also Cellnet Comm. v. FCC*, 149 F.3d 429, 443 (6th Cir. 1998) (refusing to consider challenge to rule as arbitrary and capricious, raised only by amicus, that went beyond scope of petitioner's particular challenge to the rule as arbitrary and capricious).

8 *Chamber of Commerce v. SEC*, 412 F.3d 133, 136, 144-45 (D.C. Cir. 2005), *review granted*, 443 F.3d 890 (D.C. Cir. 2006), is not to the contrary. *See* FD Br. 10-11. In that case, the challenged provisions were adopted pursuant to ICA Section 6(c), which, unlike Section 202(a)(11)(F), does not require a determination that regulation under a statute is precluded by congressional intent. Thus, in *Chamber*, unlike here, the Commission had authority to consider various options under a statute for achieving its regulatory goal.

confusion that could result from the same change in circumstances— compensation no longer reliably identifying advisory services the IAA was intended to cover—that justified the fee-based brokerage exception in the first instance. *See supra* pp. 15-16 and *infra* pp. 50-51.

Beyond this, the Commission properly concluded that it was appropriate to study ways to use applicable *broker-dealer* regulatory authority to address investor protection concerns identified in the rulemaking. *See supra* pp. 13-14 & n.5. This was not, as amici erroneously assert (FD Br. 9), a concession that an exception from the IAA might be unwarranted. Instead, it was an acknowledgment that, as between the pertinent two of the family of statutes Congress empowered the Commission to administer, Congress would have intended that the broker-dealers excepted by the Rule be regulated under the Exchange Act (and related Commission and self-regulatory organization authority) and not under the IAA.

There is likewise no merit to NASAA's position (NASAA Br. 24)—on an issue that only it raises and thus is outside the scope of this appeal (*see supra* n.7)—that the Commission acted inconsistently with the public interest by excepting broker-dealers under subparagraph (F) and thereby "preempting the authority of state securities regulators to perform an independent assessment of the proper treatment of those acting as investment advisers." It assumes, contrary to the Commission's finding, that the broker-dealers at issue are acting as those that Congress intended to regulate as

"investment advisers." And, ultimately, it quarrels with Congress's judgment that where, as here, the Commission acts pursuant to subparagraph (F), certain state laws are preempted.[9] 15 U.S.C. 80b-3a(b)(1) (SA1).

Finally, FPA's argument (Br. 34-35) that the Commission lacked sufficient authority under IAA Section 211(a) *alone* to promulgate paragraph (a)(1) of the Rule is irrelevant. The Commission acted pursuant to *both* Section 202(a)(11)(F) (which expressly authorized the exception) and Section 211(a) (*see* SA2), which buttresses the subparagraph (F) authority by giving the Commission the power to issue rules "necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this title." 15 U.S.C. 80b-11(a); *see Action on Smoking and Health v. CAB*, 699 F.2d 1209, 1212 (D.C. Cir. 1983) (quoting *Mourning v. Family Publications Serv.,* 411 U.S. 356, 369 (1973)), *opin. supplemented*, 713 F.2d 795 (D.C. Cir. 1983).[10]

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9 NASAA did not raise this preemption issue in its comment letters. Moreover, this challenge, as well as its authority challenge, is inconsistent with statements of support in those letters. *See* CR6 (Letters 12, 1491) (JA120-23; 124-26).

10 Furthermore, because, as FPA correctly states (Br. 18, 36), the Commission did not rely on IAA Section 206A, 15 U.S.C. 80b-6a (*see* JA31 & n.284), it is unnecessary to address FPA's Section 206A argument (*see* Br. 36-38).

B. Broker-Dealers Excepted by the Fee-Based Brokerage Provision Are "Other Persons" within the Meaning of Section 202(a)(11)(F).

As FPA acknowledges (Br. 32), "other" has always meant "different" or "distinct from." FUNK & WAGNALL'S NEW STANDARD DICTIONARY OF THE ENGLISH LANGUAGE 1752 (1937); BLACK'S LAW DICTIONARY 761 (6th ed. 1991). But, contrary to FPA's further assertions (Br. 31-34), broker-dealers excepted under the Rule *are* "other persons" under subparagraph (F)—a class of persons "different from" those described in subparagraphs (A)-(E) of Section 202(a)(11). JA9 n.78.

Specifically, broker-dealers covered by the Rule's fee-based brokerage exception are those that offer advice as part of a package of brokerage services for which they receive compensation *other than* traditional transaction-based compensation—a subset of broker-dealers that could not have existed and was unforeseen when the IAA was passed. *Supra* p. 16. On its face, then, the Rule complies with subparagraph (F)'s "other persons" requirement by designating a class of broker-dealers different from those identified in subparagraph (C), who receive *only* traditional compensation for providing advice as part of brokerage. *Id.*

FPA argues (Br. 31-34) that the broker-dealers covered by the new rule are not "other persons" under subparagraph (F) because they are not "different from" broker-dealers covered by subparagraph (C). This argument—essentially, "a broker-dealer is a broker-dealer"—ignores the basic structure of Section 202(a)(11). Each of the groups of "persons" Congress excepted in subparagraphs (A) through (E) of paragraph (11) is

only one possible subset of a larger group of "persons" that meets the broad definition of "investment adviser" and is differentiated (and excepted) based on specific facts relating to the way in which advice is provided. The broker-dealers excepted by subparagraph (C) are *one* subset of broker-dealers covered by the definition; the broker-dealers excepted by the Rule are a *different* subset.

Thus, the Commission's determination that broker-dealers covered by paragraph (a)(1) of the Rule are "other persons" is not inconsistent with cases FPA cites in support of its argument that "other" means " '*different*' from things already mentioned." Br. 32-33 (emphasis FPA's). Further, none of those cases interprets a provision—like subparagraph (F)—that vests an administrative agency with authority to except persons from a statute based on a finding that literal application of the statutory language produces a result inconsistent with underlying intent. *See supra* pp. 22-24. Finally, in each of the cited cases, the interpretation of "other" adopted by the court was necessary, in context, to avoid contravening particular legislative—or contractual —intent. Here, the narrow reading of "other" FPA urges would, for the reasons discussed above, affirmatively undermine the purpose of subparagraph (F).

FPA also argues (Br. 27-31)—ironically—that the broker-dealers covered by the Rule cannot be excepted because they *are* "different from" the broker-dealers excepted by subparagraph (C) in a critical sense—they receive compensation other than the commissions to which the subparagraph (C) exception is limited. But, of course,

subparagraph (F) was written precisely to allow the Commission to except persons who are *not* covered by the paragraph's existing exceptions. *See supra* pp. 22-23.[11]

Even if the Court concluded that "other persons" in subparagraph (F) is ambiguous, it should defer to the Commission's interpretation because it is consistent with the statute's language and reasonably achieves the administrative flexibility that delegations such as subparagraph (F) are intended to promote. *See United States v. Mead Corp.*, 533 U.S. 218, 227 (2001); *see also NASD v. SEC*, 420 F.2d at 92. FPA's reading would unreasonably limit the Commission's ability to respond to unanticipated circumstances—a result contrary to Congress's intent. *See In re Permanent Surface Mining Regulation Litig.*, 653 F.2d 514, 522 (D.C. Cir. 1981) (*en banc*) (*quoting American Trucking Ass'ns v. U.S.*, 344 U.S. 298, 309-310 (1953)).

C. The Commission Reasonably Concluded That Congress Did Not Intend the IAA to Apply to Broker-Dealers Excepted by the Fee-Based Brokerage Provision.

Contrary to the challengers' arguments (Br. 29-31, 38-41; NASAA Br. 7-8, 11), it was not merely permissible but *necessary* under subparagraph (F) for the Commission to look not only to the IAA's language but also to the context in which the Act was written to determine whether—notwithstanding the literal language of Section

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11 FPA's argument that the Commission's interpretation of subparagraph (F) could result in an "unconstitutional delegation" of legislative and/or judicial power (Br. 30-31) is baseless. Subparagraph (F) permits only those exceptions necessary to comply with Congress's intent, and the Commission's determination of that intent is subject to judicial review.

202(a)(11) and subparagraph (C)—Congress's "intent" would have been to apply the Act to a group of broker-dealers that could not have existed when it was drafted.[12]

As a general matter, courts have long recognized the propriety of considering the historical background of an enactment in discerning the intent underlying statutory provisions. *See*, *e.g.*, *South Dakota v. Yankton Sioux Tribe,* 522 U.S. 329, 343-44, 351-52 (1998); *Penn Allegh Coal v. Holland,* 183 F.3d 860, 864 (D.C. Cir. 1999). That is especially true where, as here, the circumstances to which a particular provision is being applied did not exist when the provision was enacted. *See*, *e.g.*, *SEC v. VALIC*, 359 U.S. 65, 75-76 (1959) (concurring opinion) ("At th[e] time [the exclusions were drafted] . . . the sort of 'variable annuity' contract . . . in this case did not exist. . . .[I]f a brand-new form of investment . . . emerges . . . labeled 'insurance' or 'annuity' by its promoters, the functional distinction that Congress set up in 1933 and 1940 must be examined to test whether the contract falls within the sort of investment form that Congress was then willing to leave exclusively to the [states]. . . . [T]he regulatory and protective purposes of the Federal Acts and of state insurance regulation as it then existed becomes relevant.").

The Commission thus properly analyzed the intent of Section 202(a)(11) by examining that provision and its legislative history in the context of the prevailing

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12 For the same reason, there is no merit to FPA's argument (Br. 42) that the Commission improperly ignored statements in congressional committee reports essentially reciting the language of Section 202(a)(11)(A)-(E).

practices in the financial services industry that gave rise to the IAA. JA6-8 & nn.37-66 (and authorities cited). Against that background—which FPA does not challenge—the Commission determined that, in two respects, it would be contrary to congressional intent to regulate broker-dealers as "investment advisers" simply because they may be receiving "special compensation."

First, the Commission determined (JA9) that supplying advice for compensation other than commissions is no longer in itself sufficient to establish that the broker-dealer is providing advice in a context that Congress intended to subject to the IAA. Although the challengers disagree with that determination (Br. 38-39; NASAA Br. 11-12), they do not contest the Commission's underlying findings (*supra* pp. 14-16). Critically, they have not disputed that—until the emergence of the fee-based brokerage programs at issue—the requirement that broker-dealers receive only traditional broker-dealer compensation ("no special compensation") for investment advice meant that the Act applied to broker-dealers who supplied advice as a distinct service and did not apply to those who supplied advice as part of a package of brokerage services. Instead, they dispute only the Commission's conclusion that the "no special compensation" requirement was intended to serve that line-drawing function.

Although FPA's argument assumes some *alternative* purpose for "no special compensation" (*see* Br. 39-40), FPA does not suggest one.[13] Instead, FPA attacks—as "ambiguous" and "weak"—evidence the Commission identified as indicating the contemporaneous understanding of "no special compensation" in particular and the scope of the subparagraph (C) exception in general. But, the lack of clarity that FPA professes to find in the legislative history relied on by the Commission (Br. 45-52) results in large part from FPA's own failure to read that history in the broader context of contemporaneous industry and regulatory practice set forth in the Adopting Release (JA6-12, 14-15; *see also supra* pp. 14-16 and *infra* p. 55). When read consistently with those undisputed background facts, the legislative history FPA discusses fully supports the Commission's findings (JA8-9).[14]

Those findings are supported even by certain statements by members of Congress and witnesses that FPA distorts and then falsely accuses the Commission of

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13 FPA does note (Br. 8, 40) that the "no special compensation" requirement is included in the exception for broker-dealers but not for the other professionals excepted in Section 202(a)(11)(B), but it offers no suggestion as to why Congress made this distinction. We note that—unlike lawyers, accountants, engineers, and teachers—in 1940, *only* broker-dealers charged a particular type of compensation (commissions, mark-ups, or mark-downs) for the advice that Congress intended to except from the Act and another type of compensation (fees) for advice Congress intended the Act to govern.

14 *See* HA1-34 (contemporaneous industry practice); HA84-85, JA9 n.72 (Johnston); HA134-146, JA8 nn.66 & 69, JA10 n.83 (Illinois Legislative Council Report); HA153-158 (Boren and White); HA132-133, JA8 n.64 (Schenker); HA173-174, JA15 & nn.139 & 143 (Hinshaw and Sabath); HA153-158, JA8 n.65 (Cole and White); HA97-112, JA8 n.64 (Wagner and Hughes).

improperly omitting. For example, the statement from Senator Boren that FPA purports to reproduce (Br. 48-49) was actually a *question*, the premise of which the responding witness *did not accept*. Read in context, and in light of the undisputed historical background, the witness's testimony clearly echoed the prevailing view that broker-dealers supplying advice would be subject to the IAA only to the extent that they were specifically compensated for that advice—"the term as used in this bill includes only investment advisers who get paid for giving advice" (HA154)—as distinguished from those supplying advice as part of a package of brokerage services for which they received only commissions. *See also* HA8-11, 41 n.1, 95.[15]

Likewise, FPA's reading of the statements of Representatives Sabath and Hinshaw (Br. 50-51) makes no sense in context. *See* HA172-174. The concerns the representatives expressed about excepting brokers and other advice providers make sense only if, as the Commission concluded, they understood that the exceptions for broker-dealers and others broadly excepted those advice givers. Further, FPA mischaracterizes the additional statement of Representative Sabath quoted on page 51 of its brief, which referred not to the IAA alone, but also to the ameliorative effects of

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15 The other testimony FPA accuses the Commission of improperly omitting (Br. 49) is irrelevant. It involves the ICA—not the IAA—and concerns restrictions on broker-dealer management and oversight of investment companies at the same time as they are supplying investment advice to individual investors. HA127-129 (testimony of L. Smith, not SEC Chief Counsel Schenker).

all of the legislation that had been passed in the seven years preceding the IAA to deal with the problems that led to the market crash in 1929. HA173-174.

Second, the Commission concluded (JA9) that extending the Act to broker-dealers supplying fee-based brokerage would run afoul of Congress's intent to avoid unnecessary and duplicative regulation of broker-dealers. Although FPA disagrees with that determination as well (Br. 38-40), it again does not dispute the Commission's underlying findings as to broker-dealer regulation (*supra* pp. 15, 17 and *infra* p. 37). Instead, FPA mischaracterizes the Commission's conclusion as based on a purported congressional "intent to protect broker-dealers" that is irreconcilable with Congress's intent to protect investors. *See*, *e.g.*, Br. 41, 42, 45; *see also* NASAA Br. 11.

The Commission never stated or implied that Section 202(a)(11)—or the Rule—was based on or drafted to further a congressional intent to "protect" broker-dealers rather than investors. (Nor, as described *infra* pp. 41-47, 49-50, is this the effect of the IA/BD Rule). Rather, the Commission correctly stated (*see supra* p. 16-17) that Congress decided that only *certain* broker-dealers supplying investment advice should be subject to the IAA. In so deciding, Congress necessarily determined that, with regard to the broker-dealers that it was excepting from the Act, investors were adequately protected by existing broker-dealer regulation. This has long been the accepted view of the underlying purpose of this and other such exceptions. JA8 n.66 (citing Illinois Legislative Council Report (1939), HA137 (describing as one of the

reasons for such exceptions "that [excepted] persons and firms are already subject to governmental regulation of one type or another")); *see also* JA8 n.68.[16]

The challengers again offer no alternative rationale for the statutory broker-dealer exception. Instead, they attempt to sidestep the logic of the Commission's reasoning by implying that, in 1940, Congress could not have intended *both* to relieve many broker-dealers supplying investment advice from the additional regulation of the IAA *and* to protect investors. *E.g.*, Br. 41-44; *see also* NASAA Br. 10-12. To bolster this position, they repeatedly liken broker-dealers to the "touts and tipsters" referred to in the legislative history (*e.g.*, Br. 26, 42, 44-45), suggesting erroneously that, when the Act was drafted, broker-dealers were in no different position than the members of the largely unregulated "fringe" who were a principal target of the Act (JA7).

In fact, both Congress and the Commission were fully aware of the progress that had been made in the preceding six years in the regulation of broker-dealers under the Exchange Act and otherwise. *See*, *e.g.*, JA8 n.64. Indeed, in contrast to the Exchange Act, the IAA as originally enacted was "little more than a continuing census of the nation's investment advisers." 7 Louis Loss & Joel Seligman, *Securities Regulation* 3312-

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16 Notwithstanding NASAA's contrary assertion (NASAA Br. 14), the Commission did not "pronounce" anywhere in the Adopting Release that complying with the IAA was "unduly burdensome," in "direct contradiction" of Rel. No. IA-626 (April 27, 1978), *published at* 43 FR 19224 (May 4, 1978). The Commission did, however, specifically consider and "reject" any statement in Release 626 that might be "interpreted to be inconsistent" with its judgments underlying paragraph (a)(1) of the Rule. JA12 n.102.

14 (3d ed. 2003); *see also* JA7. As such, it was entirely reasonable for Congress to conclude that, in order to protect investors, it was unnecessary to subject the broker-dealers who were supplying advice as part of the traditional package of brokerage services—and were already subject to a comprehensive regulatory scheme—to the IAA.

Thus, contrary to amici's arguments (FD Br. 5, 6, 8-9, 10; *see also* NASAA Br. 12), the Commission supported its conclusion that Congress would have considered it unnecessary and/or duplicative to apply the IAA's provisions to certain broker-dealers. It did so by specifically referring to the congressional action in the 1930s (described above) regulating broker-dealer conduct. JA8 & nn.67, 68. And, in concluding that the Rule "is consistent with the statute's intent to avoid largely duplicative regulation" (JA11), the Commission elaborated on those references, detailing the regulation that has continued to be and is now applicable to broker-dealers under the Exchange Act, resulting in an overall regulatory regime that today contains substantial duplication and overlap with IAA regulation. JA10-11 & nn.93, 94; *see also*, *e.g.*, JA23-24 (stating that certain costs engendered by paragraph (b) of the Rule to broker-dealers not already complying with the IAA would be "mitigated" by "infrastructure" already in place at those broker-dealers, "much of which overlaps with Advisers Act requirements" and giving examples).

D. FPA Confuses the Rule's Fee-Based Brokerage Exception with Its Discount (Two-Tier) Brokerage Interpretation.

FPA confuses (*e.g.*, Br. 9-14, 53-54, 56) "fee-based" brokerage—addressed in paragraph (a)(1) of the Rule through an *exception* adopted pursuant to IAA Section 202(a)(11)(F)—with discount (two-tier) brokerage—addressed in paragraph (a)(2) of the Rule through an *interpretation* of Section 202(a)(11)(C). Most pointedly, in asserting that the Rule's fee-based brokerage provision changes over 60 years of precedent interpreting subparagraph (C)'s "no special compensation" requirement, FPA relies, for the most part, on staff statements about two-tiered pricing that have nothing to do with fee-based brokerage. *See* Br. 53-54 (arguing that the Commission's treatment of "*fee-based* brokerage programs" deviates from precedent and citing Br. 9-11 (dealing, for the most part, with "special compensation" in the context of two-tier pricing)) (emphasis supplied); *see also* Br. 56 (the "large expansion of *fee-based programs* occurred notwithstanding . . . that . . . (2) the SEC had consistently interpreted *two-tiered pricing programs* as beyond the broker-dealer exception") (emphasis supplied).

Contrary to FPA's assertion, the Commission acknowledged that broker-dealers supplying fee-based brokerage might be receiving "special compensation" as it had been interpreted by Congress and the Commission (*see supra* n.4) and therefore be ineligible for the statutory exception. JA3, 9. The fee-based brokerage exception thus makes no change to the meaning of "special compensation." Instead, it states that a

broker or dealer (who meets certain requirements) "[w]ill not be deemed to be an investment adviser based solely on its receipt of special compensation . . . ." SA4.

To the extent that FPA's statements (*e.g.*, Br. 10-13, 14) could be construed as asserting that the discount (two-tier) brokerage interpretation (of paragraph (a)(2)) deviates from precedent, they do not raise an issue for this Court's consideration. FPA's statements only hint at a legal issue and are made in the brief's background section, unanalyzed, and without citation to relevant case law or other relevant sources. *See, e.g., Edmond v. Postal Service*, 953 F.2d 1398, 1399-1400 (D.C. Cir. 1992) (*per curiam*) (stating that this Court's precedent "makes it absolutely clear that, unless a legal argument is appropriately identified as such—appearing in a section of the brief devoted to that argument and not as an obscure or passing reference under an unrelated heading, with citations to authorities in its favor—the argument is waived"); *see also, e.g., SEC v. Banner Fund*, 211 F.3d 602, 613-14 (D.C. Cir. 2000) (*quoting Carducci v. Regan*, 714 F.2d 171, 177 (D.C. Cir. 1983)). Consequently, if NASAA challenges the discount (two-tier) interpretation (NASAA Br. 13-15), it should not be heard (*see supra* n.7).

In any event, the Commission properly exercised its inherent authority (*see Trans Union v. FTC*, 295 F.3d 42, 50 (D.C. Cir. 2002)) to interpret "special compensation" in a

way that "supersede[d]" the "odd result" of previous *staff* interpretations[17] "not compelled by the Act" (*see supra* n.4) that "a full-service broker-dealer cannot offer discount brokerage without treating its full-service brokerage accounts as advisory accounts even though the services offered to those full-service accounts remained unchanged" (JA14). The Commission's interpretation reasonably makes a broker-dealer's eligibility for an exception with respect to an account turn on the characteristics of that account and not other accounts. *Id.*; *see Kaseman v. DC*, 444 F.3d. 637, 642 (D.C. Cir. 2006) ("When possible, statutes should be interpreted to avoid 'untenable distinctions,' 'unreasonable results' or 'unjust or absurd consequences.' ") (citations omitted).

E. The Commission's Judgments in This Rulemaking Are Otherwise Consistent with Congress's Intent.

The challengers present no basis for this Court to conclude that the Commission lacked authority to promulgate the Rule. Consequently, they are relegated to urging, in an emotional and often misleading way, that the Rule is bad for investors. To the extent these arguments concern and ultimately disagree with Congress's policy judgments—rather than the Commission's (addressed *infra* pp. 46-52)—they are invalid bases for challenging the Rule as set forth here.

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17 Staff no-action letters and interpretations are not precedents binding on the Commission. *See*, *e.g.*, Rel. No. 33-5098 (October 29, 1970).

FPA is wrong when it asserts that the Commission "decide[d] that, because brokers are providing *more and more* investment advisory services, Congress would want the IAA to cover *less and less*." Br. 20 (emphasis FPA's); *see also* Br. 54. In fact, the Commission concluded that Congress would not have intended the IAA to apply to broker-dealers providing advice to customers maintaining the fee-based accounts at issue because of the context in which those advisory services are performed—as part of a package of traditional brokerage services—not because of the amount of advice provided. *See supra* pp. 15-17 and *infra* pp. 52-57.

It is uncertain whether, as an absolute matter, hewing to Congress's intent about which broker-dealer advice should and should not be covered by the Act will result in more or less broker-dealer advisory activity being subject to the IAA. While it is true that fee-based accounts have grown in popularity and industry observers expect firms will continue to move away from transaction-based compensation (*see, e.g.*, JA9), not all fee-based accounts will be exempt from the Act—the advice rendered to such accounts might not be solely incidental to brokerage. JA12, 14; *see also supra* pp. 12-13, 17-18 and *infra* pp. 52-58. Thus, the amount of advisory services subject to the IAA will, to a large extent, be determined by which services investors elect to purchase. Indeed,

investors may, in increasing numbers, seek advisory services, such as financial planning and discretionary management, that the Rule now expressly subjects to the IAA.[18]

FPA also wrongly claims (Br. 22, 54, 57; *see also* NASAA Br. 19-20) that the Rule "facilitates the making of self-interested principal transactions . . . *that would not take place*" (Br. 54, emphasis FPA's) *because* "*clients would otherwise object*" (Br. 57, emphasis supplied) if they received the pre-settlement disclosure required by IAA Section 206(3).[19] And FPA is doubly wrong when, by attributing its own views to the Commission and taking Commission statements out of context, it claims the Commission placed its imprimatur on such a result. *See* Br. 54; *id.* 22-23; *see also* FD Br. 5; NASAA Br. 20.

Although the Commission did conclude that one of the Rule's benefits would be to "preserve the ability" of broker-dealers to engage in principal transactions (*e.g.*,

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18 If the Rule's discount (two-tier) brokerage interpretation had been challenged on the ground that it too results in "less and less" advisory services being covered that argument would fail for the same reasons set forth above regarding fee-based brokerage.

19 IAA Section 206(3), 15 U.S.C. 80b-6(3), prohibits, among other things, an adviser, acting as principal, from knowingly selling to or purchasing from a client any security, without disclosing to the client in writing the capacity in which it (or an affiliate) is acting and obtaining the client's consent. SA1. Disclosure and consent must be obtained separately for each transaction (Rel. No. IA-40 (February 5, 1945)) prior to the transaction's settlement (Rel. No. IA-1732 (July 17, 1998)). The Section reflects Congress's recognition that principal transactions have a potential for abuse, such as price manipulation or the placing of unwanted securities into client accounts. Rel. No. IA-1732. Congress did not, however, prohibit these transactions. Instead, it addressed potential abuses by imposing disclosure and consent requirements. *Id.*

JA21), it did not do so to deprive investors of the opportunity to object to transactions to which they would "otherwise object." On the contrary, principal trading (*e.g.*, when a broker-dealer sells securities from its inventory) has long been a necessary and beneficial part of the U.S. securities markets. As the Commission stated, it is "an important source of liquidity in some market sectors" (JA21) and can provide customers with efficient execution and access to types of securities not widely available (*see* JA25). It is not client objections, but often the time and effort on the part of the client and the broker-dealer needed to satisfy Section 206(3)'s disclosure and consent requirements, that can make principal trading impractical and, hence, unavailable to persons who might otherwise benefit from it. *E.g.,* Clifford E. Kirsch, *Investment Adviser Regulation* (2005), § 15:2.2 at 15-10[C] (stating that, because of the "onerous" requirements of Section 206(3), advisers typically do not engage in principal transactions and rely instead on a Commission rule that permits them to engage in agency cross-transactions without obtaining consent before each specific transaction (*see* 17 C.F.R. 275.206(3)-2)).

To a significant extent, the IA/BD Rule addresses the congressional concerns (*supra* n.19) underlying Section 206(3): discretionary authority is made subject to the Act and, in the absence of such authority, a broker-dealer does not have the power (unchecked by the customer) to sell a customer unwanted securities. In any event, when Congress passed the IAA, it was well aware of the conflicts posed when firms

functioned both as dealers and brokers while also advising customers about purchasing and selling securities. *See, e.g.*, JA10-11 & n.93 (citing, *e.g.*, SEC, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker (June 20, 1936) (HA35-39) (submitted to Congress)). Congress nonetheless excepted from the IAA broker-dealers providing advice as part of a package of brokerage services. And, notwithstanding FPA's assertion (Br. 26), the Commission's recognition of these undisputed facts does not mean it concluded that "Congress meant the [IAA] to *preserve* undisclosed self-dealing" (emphasis FPA's) that would harm investors.[20] If broker-dealer misconduct harms a customer, Exchange Act and self-regulatory organization remedies (such as actions for unsuitable recommendations) can redress that harm.

At bottom, this and other contentions about fiduciary duties (*e.g.*, NASAA Br. 17-18; PIABA Br. 9-13), including assertions—express and implied—that broker-dealer regulation is an inadequate substitute for adviser regulation, reduce to the contention that it would be preferable, in the challengers' view, for all (or almost all) broker-dealer advice to be subject to the IAA. Indeed, NASAA lays this bare, stating (NASAA Br. 17) that "adequate protection of investors requires that those dispensing investment advice be subject to a fiduciary obligation with its attendant disclosure

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20 In fact, broker-dealers are required to disclose their capacity in a given transaction. *See*, *e.g.*, 17 C.F.R. 240.10b-10; NASD Rule 2230.

requirements." Such a result, however, would contravene Congress's judgments in passing the Act with exceptions. *See* JA10 ("[w]hatever policy advantages . . . could be gained by" extending the IAA to all broker-dealers providing advice, "it would be inconsistent with the conclusions reached by Congress when it passed the Act").[21]

The distinction between Exchange Act and IAA regulation Congress recognized in Section 202(a)(11)(C) lets investors choose the type of relationships they want to establish with securities professionals, including the cost and contractual terms they prefer. FPA and the amici seek to impose a one-size-fits-all regulation of different relationships, together with attendant costs, when Congress determined otherwise. As the Commission recognized, "broker-dealers often play roles substantially different from investment advisers and in such roles they should not be held to standards to which advisers are held." JA11. And, notwithstanding FPA's contrary position (Br. 59), part of what determines the nature of a broker-dealer's role is its context. Consistent with congressional intent, the IA/BD Rule attempts to ensure that when broker-dealers render advice in connection with and reasonably related to brokerage services, they will be subject to broker-dealer—and not adviser—regulation. When they render advice of a different character or in a manner essentially independent of

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21 Of course, as the Commission explained, in some instances, "such as when broker-dealers assume positions of trust and confidence with their customers similar to those of advisers," broker-dealers are held to fiduciary standards under other law. *See* JA11 & n.98.

other brokerage services (*supra* pp. 17-18 & n.6 and *infra* pp. 53-55, 57), they also will be subject to the IAA.

II. THE RULE REFLECTS THE COMMISSION'S REASONABLE CHOICES ABOUT MATTERS ENTRUSTED TO ITS ASSESSMENT.

A. The Commission's Reasonable Determinations about Benefits and Protections of the Rule Should Not Be Disturbed.

Not only is the Rule within the Commission's authority, it also reflects the Commission's reasonable assessment of the benefits of the fee-based brokerage exception and its considered judgment about the content of a disclosure requirement designed to inform investors about excepted accounts.

As a matter of policy, the Commission determined that the fee-based brokerage provision could benefit investors by encouraging brokerage programs that enhance investor choice and remove incentives for improper practices such as churning and unsuitable recommendations. *See supra* p. 6. FPA and NASAA contest this assessment. First, FPA disputes the Commission's predictive judgment that the Rule will encourage fee-based brokerage, claiming that any expansion of such programs "is an independent event—fueled by brokers' own desire to provide steady revenue sources." Br. 21*; id.* 55-56. It is hardly unreasonable, however, to believe that the regulatory clarity supplied by the Rule will facilitate these programs. *See, e.g.*, JA103 (observing that "[m]any broker-dealers . . . established these programs since 1999 when [the Commission]

issued [its] Proposing Release, which announced a staff no-action position relating to such programs").

Second, FPA and NASAA are mistaken when they claim that the Commission concluded that fee-based brokerage "necessarily align[s] the interests" of broker-dealers and their customers. FPA Br. 56; NASAA Br. 20-22. The Commission actually concluded that, when compensation does not depend on the number of transactions, *certain* incentives, *e.g.*, to churn accounts, recommend unsuitable securities, or engage in high-pressure sales tactics, are *reduced*. *See* JA35; *see also* JA42-43 (fee-based brokerage "offer[s] at least a partial solution" to investor losses that "can be traced to individual representatives responding to the need to generate commissions rather than service customers"); JA3. That fee-based compensation may engender other sorts of conflicts and induce other sorts of misconduct does not undermine that conclusion. Moreover, as the Adopting Release notes (JA11 n.95), self-regulatory organizations have already taken steps to address those instances in which firms inappropriately maintain fee-based accounts for customers. *E.g.*, NASD Notice to Members 03-68 (November 2003) (JA91-94) (requiring firms to establish procedures to determine whether fee-based accounts are appropriate for customers and to provide periodic review to ensure they remain appropriate); *see also* NYSE Rule 405A (same).

FPA also attacks the Commission's cost-benefit analysis (*e.g.*, Br. 23-24, 57-59). First, it asserts (Br. 23; *id.* 58) that the Commission compared "apples" (the "overall

benefits" of excepting some broker-dealers from the IAA) to "oranges" (the "incremental cost" of not excepting others). But it is FPA, not the Commission, that compares "apples" to "oranges." The Commission viewed as benefits of *paragraph (a)* of the Rule—which includes the fee-based brokerage *exception* in paragraph (a)(1) and the interpretation in paragraph (a)(2) of "special compensation" *as not arising from* two-tiered pricing—the avoidance of IAA compliance costs, amelioration of certain conflicts, and enhancement of investor choice. JA20-21. The Commission then compared those benefits to like costs by addressing, *e.g.*, commenters' concerns about possible costs in the form of investor confusion and differences in fiduciary duties, as well as the "incremental costs" of the disclosure requirement of paragraph (a)(1). JA21-23. The Commission did not, however, view as costs of paragraph (a) the "incremental costs of not exempting others." Br. 23. Rather, those costs, which FPA describes as including "requiring broker-dealers to print brochures or not exempting those who do financial plans" (Br. 23), are the costs associated with an entirely different part of the Rule (*paragraph(b)*) that *subjects* broker-dealers, who, *e.g.*, offer financial plans, *to* the IAA. JA23-26.[22]

Nor, in considering costs, did the Commission "switch[] between assuming that protections do or do not already exist" (Br. 23) or, stated another way, that brokers will

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22 Contrary to amici's argument (FD Br. 8-9), this same portion of the Adopting Release (*i.e.*, JA23-26) discusses "how brokers that provide non-incidental advice" are affected by specific requirements of the IAA.

or will not be subject to the IAA (Br. 24, 58). Instead, the Commission reasonably concluded that although changing forms of compensation unanticipated in 1940 might now subject certain broker-dealers to the IAA absent the Rule, paragraph (a) of the Rule "does not establish *new* opportunities for broker-dealers to compete with advisers on the nature of their investment advice," because *neither* the practice of broker-dealers offering advice as part of a package of brokerage services *nor* the attendant costs of broker-dealer regulation under *the Exchange Act* were materially changed by the Rule. JA22 (emphasis added); *see also* JA26. This hardly equates to the Commission's assuming, in FPA's words, that either there is "no harm because broker-dealers were already covered" by the IAA or that there is "no harm because broker-dealers were not covered before" by the IAA. Br. 24; *see also* Br. 58.

FPA also asserts (Br. 57) that paragraph (a) is unjustified, in terms of its benefits, because many firms are dually registered. However, as even FPA seems to recognize, this argument ignores the benefits achieved by relieving firms of the costs associated with complying with the Act, with respect to those accounts for which it does not act as an adviser, on *an account-by-account* basis. That FPA does not believe the exception benefits investors or "honest advisers" (Br. 58) is simply another quarrel with congressional judgment (*see supra* pp. 44-46).

Again inappropriately expanding the scope of the appeal (*see* n.7, *supra*), the amici alone claim (*see* NASAA Br. 15, 22-24; PIABA Br. 3, 13) that the Rule harms investors

in yet another way—by exacerbating confusion—although how they believe it does so is at best unclear. To the extent NASAA asserts (NASAA Br. 23) that confusion may be engendered by "[a]llowing a broker-dealer to provide extensive advisory services," such confusion could be no worse after the Rule than before. By providing guidance about advice that is "solely incidental to" brokerage, the Commission has, if anything, more clearly circumscribed excepted advice. *See infra* pp. 52-58 and *see supra* pp. 10, 17-18.

PIABA may believe confusion is engendered by permitting broker-dealers, without complying with the IAA, to receive fixed or asset-based fees. Erroneously terming these fees "management fees," PIABA asserts (PIABA Br. 13) that they "create[] the illusion of ongoing monitoring and protection"—something not all broker-dealers (or, depending on contractual arrangements, even advisers) provide. To the extent investor confusion could be exacerbated by the fee-based nature of an excepted account, the Rule's disclosure requirement is aimed at alleviating it.

Nothing in the record necessarily suggests, however, that investor confusion is a function of the type of compensation an investor pays a financial services provider. *See* JA2. Instead, confusion extends beyond fee-based accounts (*id.*) and may stem from a variety of sources alluded to in the Adopting Release—lack of adequate investor education (*see*, *e.g.*, JA14), broker-dealer marketing of all types of accounts (including commission-based) (JA2, 17 & n.163), and blurring of functions in general (*see* JA12).

It was not the purpose of this Rule to resolve all concerns about investor confusion. *See supra* pp. 13-14 & n.5. Rather, the Commission reasonably focused on addressing confusion that might attend the fee-based accounts excepted by the Rule.

Alternatively, perhaps the amici believe (*see* NASAA Br. 22-24; PIABA Br. 4-5, 10-14) that the absence of a marketing restraint in the Rule will exacerbate confusion and limit the efficacy of the required disclosure.[23] But questions about whether and how to limit marketing are not susceptible to simplistic solutions. For example, the Commission declined repeated calls to place limits on titles used by broker-dealer representatives, such as "financial advisor" and "financial consultant," because such titles are descriptive of permissible services provided by excepted broker-dealers. JA17. And, to the extent marketing is misleading or untruthful, investors are not left without recourse—Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and other antifraud provisions can provide meaningful remedies. *See*, *e.g.*, JA36 n.19 (citing *In re Haight & Co.,* Release No. 34-9082 (February 19, 1971)).

Nonetheless, the Commission noted its concerns about broker-dealer marketing and investor confusion, including that such marketing might exacerbate confusion. *E.g.*, JA2. Given the nature of these concerns and the fact that they extend beyond the programs addressed in the Rule, however, the Commission determined that they were

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23 PIABA's further argument that the disclosure "does not communicate" (PIABA Br. 7-9 & n.12) is based in large part on speculation and criticisms of disclosure that the Commission proposed but did not adopt.

better addressed under the Exchange Act and in the upcoming study. *See supra* pp. 13-14 & n.5. An agency is not required to solve all problems at once, but may take a measured, graduated approach toward administering its statutes. *See National Mining Ass'n v. Mine Safety & Health Admin.*, 116 F.3d 520, 549 (D.C. Cir. 1997); *United States Air Tour Ass'n v. FAA*, 298 F.3d 997, 1010 (D.C. Cir. 2002). That is what the Commission has done here.

B. The Commission's Determination about When Advice Is "Solely Incidental to" Brokerage Is Entitled to Deference.

The Commission's interpretation of the phrase "solely incidental to the conduct of his business as a broker or dealer" is faithful to the language of Section 202(a)(11)(C) and Congress's intent. Therefore, notwithstanding amici's challenge (FD Br. 13-17; NASAA Br. 9-12), it should be upheld.[24] As the phrase was understood in 1940 (*see* JA52 & n.100, JA14 & n.134) and as it is understood today, it means "following as a consequence of," "attendant," "concomitant," and the like. *See* JA52 & n.100; *see also* WordNet 2.0, 2003 Princeton University (defining "incidental to" as "following as a consequence; 'an excessive growth of bureaucracy, with related problems'; 'snags incidental to the changeover in management' [syn: accompanying, attendant,

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24 Unlike the amici, FPA does not challenge the Commission's interpretation of "solely incidental to." Its handful of asides about the interpretation's being without limit (Br. 15-16, 25, 28, 59) do not raise an issue for this Court to resolve (*see supra* p. 39). Accordingly, this Court should not consider the amici's challenge to this aspect of the Rule. *Supra* n.7.

concomitant, incidental . . . .]" (available at http://www.dictionary.com)). Accordingly, the Commission properly concluded that the only limits on the importance, amount, continuity, quality, or other characteristics of the advice excepted brokers can give are that the advice be rendered "in connection with and reasonably related to the brokerage services provided." JA14-15 & n.135.

The amici maintain, however, that the Commission's reading is unreasonable, particularly its conclusion that even when advice is substantial, it can be "solely incidental to" brokerage. *E.g.*, NASAA Br. 9; FD Br. 15. Referring to "solely incidental," amici argue that the phrase limits excepted advice to that which is "incidental" in the sense of being "minor," "secondary," "occurring merely by chance" or execution-related. *E.g.*, FD Br. 14; NASAA Br. 10, 12. As the Commission explained (JA14-15 & nn.133-143), this construction is based on a misreading of both the statutory language and historical context of the IAA.

The amici's interpretation assumes erroneously that Section 202(a)(11)(C) excepts "solely incidental" advisory services instead of advisory services that are "solely incidental **to**" a broker-dealer's business. "[I]ncidental to"—the relevant statutory language—denotes a circumstance in which something occurs (here, the "performance of [advisory] services") that can be *expected to arise* in connection with an action (here, the "conduct of . . . business as a broker or dealer"), whereas "incidental" denotes a circumstance in which the occurrence is something that *merely happens* "*by chance*" or on

an "isolated," "unpredictable" and/or "occasional" basis. *See* JA52 & n.100; JA14-15 & n.135; *compare* COMPACT OXFORD ENGLISH DICTIONARY (2005)(available at http://www.askoxford.com) (defining "incidental to" as "liable to happen as a consequence of") *with id.* (defining "incidental" as "occurring as a minor accompaniment or by chance in connection with something else"). Unlike the amici, the Commission properly interpreted the phrase "solely incidental to" in a way that gives effect to all, not merely some, of its words. *See Association of Bituminous Contractors v. Andrus*, 581 F.2d 853, 861-62 & n.22 (D.C. Cir. 1978).[25]

The narrow construction amici urge also is inconsistent with the meaning indicated by the statutory context in which "solely incidental to" occurs. *See City of Roseville v. Norton*, 348 F.3d 1020, 1027-28 (D.C. Cir. 2003). As the Commission explained:

> Following the broad description of the type of services rendered by advisers in paragraph (11) (*i.e.*, "advising others . . . as to the value of securities or as to the advisability of investing in, purchasing or selling securities"), . . . subparagraph (C) excepts broker-dealers "whose performance of *such services* is solely incidental to the conduct of [their business as a broker or dealer] and for no special compensation."

JA52 n.101 (emphasis in original). If Congress had meant to restrict the nature, quality, or other substantive characteristics of the advice of excepted brokers as amici contend,

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25 Amici are wrong when they claim (FD Br. 15) that the Commission's interpretation conflicts with Congress's use of the term "solely." *See* JA14 n.135 (discussing the meaning of "solely" in context).

it would not have used the words "performance of such services" to refer back to the entire range of investment advice encompassed within the broad language of paragraph (11). *See id.*

The view that only minor, accidental, or transaction-specific advice can be excepted also is flawed because it ignores the IAA's historical backdrop. *See Yankton Sioux Tribe*, 522 U.S. at 343-44, 351-52; *Penn Allegh Coal,* 183 F.3d at 864. In 1940, the advice broker-dealers gave as part of their traditional brokerage services often was substantial in amount and importance to the customer. *See* JA52; JA6-7; JA15; CR5B-5F, 3H (JA106, 111, 113, 114, 115-16, 95-96); HA3-5, 8-21. Then, as now, brokers did not render advice only "by chance" or "without intention" or limit advice to situations in which trades are effected. In addition, as stated, by 1940, broker-dealers were already subject to regulation under the Exchange Act. It defies the historical evidence, therefore, to believe, as amici do (FD Br. 15-16; NASAA Br. 12), that, in enacting Section 202(a)(11), Congress would have sought to impose additional and largely overlapping regulation on broker-dealers who render advice as part of a package of brokerage services any time that advice is extensive and varied.

Finally, the amici erroneously contend that the Commission's interpretation of "solely incidental to" as meaning "in connection with and reasonably related to" is so broad as to "write[] [the phrase] out of" the statute (FD Br. 16) or "render it meaningless" (NASAA Br. 9). Indeed, NASAA argues that the Commission's

interpretation of the phrase "makes brokerage services incidental to advisory services" (NASAA Br. 10), and CFA and Fund Democracy claim that, under the Commission's interpretation, "advisory services may be the primary services, with brokerage services being 'solely incidental' thereto" (FD Br. 14).[26]

In fact, the standard is neither unlimited nor unprecedented. It is the standard Commission staff and state regulators traditionally have used to determine whether the investment advice of lawyers and certain other professionals is "solely incidental to" the performance of their professional functions. *See* JA51-52 n.98 (citing staff no-action letters); Md. Code Corps. & Ass'ns § 11-101(h)(2)(iii) (2001) (Maryland Securities Act) (SA2-3) (services by a lawyer, certified public accountant, or other professionals are not "solely incidental" unless, among other things, "[t]he investment advisory services rendered are connected with and reasonably related to the other professional services rendered").

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26 FPA similarly states (Br. 15-16) that the Commission "advised" in the Adopting Release that broker-dealer advisory services are not "more than 'solely incidental' " even if, in practice, " 'brokerage is incidental to the advisory services.' " To the contrary, the Commission merely so summarized the characterizations of brokerage advice included in comment letters opposing the rule proposal. JA10. It is at best inappropriate to use the background section, as FPA has in this and other instances, to mix fact and argument in a way that makes it difficult, if not impossible, to separate the two. *See, e.g., Hayes v. Invesco,* 907 F.2d 853, 854 n.3 (8th Cir. 1990) (*citing Markowitz & Co. v. Toledo Metro. Hous. Auth.*, 608 F.2d 699, 704 (6th Cir. 1979)).

The amici's statements that all advice meets the Commission's standard (*e.g.*, FD Br. 15; NASAA Br. 10) are further belied by the fact that both the Rule and the Adopting Release give examples of advice that will not be considered to be performed "solely incidental to" the conduct of brokerage business. *See* Rule 202(a)(11)-1(b); JA16-19. As explained *supra* p. 18 & n.6, advice provided essentially independently of other brokerage services,[27] that does not otherwise follow as a consequence of rendering brokerage services, or that cannot reasonably be understood to be part of the traditional package of brokerage services does not meet the Commission's standard. For example (and contrary to FD Br. 16), discretionary management does not meet the standard because it is not "reasonably related" to brokerage services. *See supra id.*

Although the interpretation depends on facts and circumstances (JA45 n.46), so too do many legal standards. Such non-bright-line tests are common in the law. *See, e.g., City of Monroe Employees Retirement Sys. v. Bridgestone*, 399 F.3d 651, 669 & n.18 (6th Cir.) (recognizing that the standard for materiality in the securities laws is a "fact-intensive test"), *cert. denied*, 126 S. Ct. 423 (2005).

In sum, the Commission's interpretation of "solely incidental to" as applied to broker-dealers is consistent with the language of the IAA and is appropriately tailored to the realities of the industry. By contrast, the amici's reading of the phrase would

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27 For example, under paragraph (b)(1) of the Rule, when a broker-dealer charges a customer a separate fee or enters into a separate contract for advisory services, it must treat the customer as an advisory client.

lead to illogical results, detailed in the Adopting Release, that neither Congress nor even they could have intended. *See* JA15. The Commission's interpretation is thus the only reasonable interpretation before this Court. *See FTC v. Ken Roberts Co.*, 276 F.3d 583, 590 (D.C. Cir. 2001). But even if any question of ambiguity remained, the Commission's reasonable interpretation is the one that must be chosen. *See Chevron,* 467 U.S. at 842-45.

CONCLUSION

The petition should be dismissed for lack of standing or, alternatively, the Commission's order should be affirmed.

Respectfully submitted,

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June 2006

CERTIFICATE OF SERVICE

I certify that on June 9, 2006, I caused the original and fourteen copies of the foregoing Final Brief of the Securities and Exchange Commission, Respondent, and fourteen copies of an Addendum of Statutory and Historical Materials to be served by hand on the Clerk of this Court. I also certify that I caused two copies of the brief and one copy of an Addendum of Statutory and Historical Materials to be served by Federal Express on counsel for petitioner as follows:

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1. This brief complies with the type-volume limitations of FRAP 32(a)(7)(B) because:

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