Via Electronic Submission

November 30, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Release No. IA-2653; File No. S7-23-07

Dear Ms. Morris:

The National Association of Personal Financial Advisors (NAPFA) appreciates the opportunity to provide comments in connection with the Commission's "Temporary Rule Regarding Principal Trades with Certain Advisory Clients" (Temporary Rule). NAPFA is the nation's leading organization dedicated to the advancement of Fee-Only® comprehensive financial planning. NAPFA is comprised of over 1,700 members, and nearly all of NAPFA's individual members are registered as investment advisers or investment adviser representatives.

NAPFA is pleased that the Commission continues to require transaction-by-transaction consent to principal trades, even if the consent is now (by virtue of the Temporary Rule) only a verbal one. The circulation of proposals for "blanket consent" to principal trading by dual registrants for investment advisory clients were the source of one of NAPFA's primary objections to principal trading relief. NAPFA firmly supports the Commission's decision to reject calls for a blanket exclusion from the requirements of Rule 206(3) for broker-dealers.

Summary - As we stated in our earlier comment letter on this issue, even though the securities markets have become more transparent over time, the inherent conflicts of interest and risks to individual investors involving principal trades have not changed. In fact, the broad range of investment products available today makes the financial world a much more complex one for individual investors. This is illustrated by the subprime mortgage crises which arose this year, and the already-reported upon potential abuses by broker-dealer firms in seeking to unload debt securities upon unsuspecting investors (both institutional and individual), despite the presence of fiduciary duties owed by the broker-dealer firm to the client.

We remain concerned that the real reason behind calls for principal trading relief is to preserve the profits of Wall Street firms at the expense of individual investors. We call upon the Commission to emphasize to the community of securities firms that fiduciary duties owed to investors are not met merely by disclosure, but rather by avoiding material conflicts of interest. In fact, disclosure of a conflict of interest does not negate the continuing duty of a fiduciary investment adviser to act in the best interest of the client.

Judge Cardozo, in his opinion *in Meinhard v Salmon*, described in modern terms the standard to which fiduciaries will be held:

> **Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct fiduciaries been kept at a level higher than that trodden by the crowd.**

Meinhard, 164 N.E. at 548 (N.Y.1928). The Commission should undertake the same stance as a protector of the fiduciary standard and its duty of loyalty to the client. The Commission itself, in describing its mission, stated: "As more and more first-time investors turn to the markets to help secure their futures, pay for homes, and send children to college, our investor protection mission is more compelling than ever." SEC web site, "About Us" (August 2007).

We are very concerned about the Temporary Rule and/or its possible future expansion or extension.

(1) ***Informed consent is still required.*** We remain concerned that the Commission, in the Temporary Rule, has deemphasized the need for *informed* consent to a principal trade by the client of an investment adviser, as has long been required by the Commission and, indeed, by the investment adviser's broad fiduciary duties to the client. Furthermore, we submit that the material disclosures required in order to provide the information necessary

for informed consent may not occur. We also note that disclosures, even if undertaken in detail, may not lead to the necessary understanding of the conflicts of interest and consequences of the transaction (and alternatives to the transaction) so as to enable individual investors to provide informed consent.

(2) ***No expansion of the Temporary Rule should occur at this time.*** Based upon recent comments by the Commission Staff, we are concerned that the Commission may seek to expand the Temporary Rule prior to comprehensive and intensive review of its effects following an appropriate trial period. While principal trading had long occurred in fee-based brokerage accounts, the Commission has little experience in applying fiduciary standards of conduct to a large volume of principal trading in investment advisory accounts. The Temporary Rule may well result in a substantial increase in the volume of principal trading within investment advisory accounts. There is a strong need to review principal trades under the fiduciary standard of conduct in order to determine if abuses have occurred, and whether record-keeping is adequate to permit comprehensive inspections of principal trading and the disclosures of material facts required in connection therewith. We believe that the Temporary Rule should remain limited in duration and scope in order to provide adequate time to study the impact on the consumer. A full two years of experience with the Temporary Rule would be proper prior to consideration of either its repeal, limitation, or expansion.

(3) ***Erosion of the fiduciary standard may result.*** We continue to be concerned that the Temporary Rule's relaxation of principal trading restrictions will further result in an erosion of the fiduciary standard of conduct – the highest standard under the law. Investor protection is the primary purpose of the Advisers Act, and this purpose should be accorded the utmost attention by the Commission when enacting rules, especially in the conflict-of-interest-ridden area of principal trading.

(4) ***Erosion of the reputation of investment advisers may result.*** As most of NAPFA's members are investment advisers (or representatives thereof), and all of NAPFA's members adhere to its fiduciary oath, NAPFA is concerned that the Temporary Rule's expansion of principal trading will, over time, result in additional abuses in connection with principal trading which will impair the reputation of investment advisers. The adverse economic impact of the on the profession of investment advisers should be considered by the Commission whenever rules are considered which seek to not apply or to provide exceptions to fiduciary standards of conduct.

The following is a discussion of the identified issues and recommendations:

- ***The fiduciary duties of investment advisors***
- ***Section 206(3) of the Advisors Act: principal trading restrictions for investment advisors***
- ***The rise of principal trading***
- ***Principal trading: profiting from committed capital***
- ***Weighing competing interests of the firm and its clients; why the interests of the broker-dealer firm is so strong***
- ***The allure of many potential opportunities***
- ***The need for informed consent***
- ***Given the inadequacy of informed consent, further expansion of relief from principal trading restrictions should be opposed***
- ***The detrimental economic effect on the reputation of all investment advisors, and the capital markets, as trust Is eroded through conflicted transactions***
- ***The ability to opt out should be "real"***
- ***Disclosures should be amplified***

The fiduciary duties of investment advisers. Section 206 of the Advisers Act has been construed to impose broad fiduciary duties upon investment advisers, which includes broker-dealer firms who are acting as investment advisers to clients. The fiduciary duty has often been called "the highest standard under the law." The cornerstones of the investment adviser's fiduciary duty of loyalty involve giving precedence to client orders, disclosure of information obtained by the broker-dealer which could affect the decision of the client as to whether to proceed with the trade, not trading in contradiction of one's own recommendations, and – generally - acting in the clients' best interests at all times.

Section 206(3) of the Advisers Act: principal trading restrictions for investment advisers. Section 206(3) of the Advisers Act, among other things, prohibits an investment adviser that is duly registered as a broker/dealer or affiliated with a broker/dealer from knowingly selling a security to, or purchasing a security from, a client while acting as principal for its own account, without disclosing in writing to the client the capacity in which the adviser is acting and obtaining the prior consent of the client before completion of each proposed transaction. Section 206(3) was adopted to protect investors against self-dealing or other conflicts of interest relating to a fiduciary relationship. The substantial risks to clients of investment advisers which exist due to principal trades are so severe that Congress, through the Advisers Act, determined to substantially restrict principal trading activities when undertaken with investment advisory clients.

The rise of principal trading. Until 1975 the stock exchanges in the United States were effectively cartels. On May 1, 1975 the Commission prohibited the exchanges from requiring their members to adhere to a fixed commission structure for trades transacted through the exchanges. As a result, the fixed commission rate structure was abandoned and price competition was established for agency trades. Among the changes which have occurred since then, and especially in the last 10 years, is an increase in principal trading. As noted in studies by the IBM Institute for Business Value, in 2004 there was "essentially was a 50-50 split between the revenue contributions of agency trading ('risk-free') and principal trading (risk-incurring activities) for sell-side firms. By 2015, that split likely will be 70 percent for principal activities and 30 percent for agency." (IBM Global business Services, "Insights into the changing financial markets climate – What broker/dealers can do to stay out of the rain", 2006.)

Principal trading: profiting from committed capital. Taking principal positions in securities is a much more risky business than simply acting as an agent. In recent years, as profits from agency transactions have been reduced, large broker-dealer firms have committed increasing amounts of capital to principal positions and have emphasized principal trading. The allure of potentially large gains from taking principal positions in securities is a strong motivating factor behind this development. Of course, substantial losses from miscalculations can also result, as evidenced by the recent write-offs announced by many broker-dealer firms as the subprime mortgage crisis unfolds.

Ostensibly, the explosion of principal trading is often explained by broker-dealer firms as the provision of a more efficient service by brokers to their clients. In particular, it has been suggested that the provision of immediacy to clients explains the phenomenon. Immediacy occurs where brokers agree to buy on their own behalf, or have available to sell from their own holdings, blocks of securities for the immediate fulfillment of client orders. However, the argument that immediacy is the source of increases in principal trading is made suspect by the rise of electronic trading systems and the availability of information on an instantaneous basis on the offerings of many different dealers, all at the same time. A more likely reason for the increase in principal trading activities is the potential for greater profits, compared to the profits derived by broker-dealer firms from agency transactions.

Weighing competing interests of the firm and its clients: why the interests of the broker-dealer firm is so strong. While on the face of it there is nothing wrong with brokers trading with clients, the very fact that such trades can occur raises the possibility of conflict of interest between brokers and clients and opening up the possibility of abuse. A conflict of interest arises where two or more legitimate interests are in competition with one another and where the person making the decision or recommendation on behalf of both interests has a larger stake in one of the interests. Obviously in the case of principal trading the broker-dealer firm has a larger stake in its own profits, as compared to the stake it possesses in the profits enjoyed by the broker-dealer's clients.

While it could be argued that the reputation of the broker-dealer firm is enhanced by its clients' enjoying profits from their trading activities, and the reputation of the broker-dealer firm is detrimentally affected by abuse of its position as a fiduciary, broker-dealer reputations have seldom been measured by the returns enjoyed by their clients and their reputations have endured many blows to their reputations due to scandals over the past ten years. Hence, competitive effects are not that strong when it comes to protection of the broker-dealer's reputation, and the interest of the broker-dealer in enjoying profits from its principal trading activities is quite strong.

Since broker-dealer firms acting as investment advisers have the option of undertaking the trade as an agent, it must be asked as to when a principal trade would be chosen, instead. In many instances in which the investment advisory client desires to purchase or sell a security, the broker-dealer/investment adviser who enters the transaction in a principal capacity is necessarily taking a position which is contrary to the position taken by the client. In other words, and by way of example, if the client desires to sell on the view that the security is overvalued presently, then the broker-dealer acting as investment adviser who purchases the security would take a contrary view – either that the security is underpriced or that, at the minimum, the security is fairly priced. Hence, principal trading involves an inherent conflict of interest for the investment adviser. Again, given the allure of large profits from principal trading activities the conflict of interest can be quite strong.

The allure of many potential opportunities. Principal trading presents the opportunity for substantial gains for broker-dealers, which are likely to attract broker-dealers acting as investment advisers away from their fiduciary duty. What are these opportunities? The number of possibilities for self-dealing, overreaching, and dumping of securities is quite large, and the contours of the potential for abuse very complex, as these five examples indicate.

First, if the broker-dealer possessed material information about a security which was not disclosed to the client, the opportunity would exist to take advantage of that information. While fiduciary rules mandate disclosure of material information possessed by the firm, it must be asked how information about a security, possessed by a broker-dealer firm, is instantaneously transmitted to all registered representatives / investment adviser representatives of the firm, and how clients are therefore also assured to receive this information in advance of any trade.

Second, the broker-dealer may have information, or perhaps a view or opinion, regarding general economic conditions that could affect the broker-dealer's desire to trade. This was seen in the very low interest rate environment which occurred several years ago. One NAPFA member reports a conversation with a registered representative of a broker-dealer firm who was distressed at the conduct of his firm. He had been told to call his clients to unload his broker-dealer firm's substantial inventory of long-term bonds, as the broker-dealer firm believed that interest rates would likely rise in the future. Of course, as interest rates rise, the price of bonds generally falls, and this drop in value is stronger with respect to bonds of longer duration. The registered representative was concerned that his customers would be harmed. Of course, in a fiduciary relationship such a material fact – the broker-dealer firm's opinion that bond prices would likely fall – would have to be disclosed to the client before recommending the principal trade.

Third, the broker-dealer may have information regarding a specific economic event that would trigger the desire to remove a specific type of inventory from the broker-dealer's account. For example, on

November 15, 2007, the *Wall Street Journal* reported in an article entitled "Bear Faces First Loss, Fraud Complaint" that "Massachusetts regulators accused Bear of fraud for improperly trading mortgage-backed securities with two internal hedge funds that collapsed this summer. Regulators in the office of Secretary of State William F. Galvin say Bear employees improperly made 'hundreds' of principal trades for the firm's own account with the hedge funds without notifying the funds' independent directors in advance." Obviously any decision by Bear to unload mortgage-backed securities, given knowledge of the subprime mortgage meltdown (a specific economic event), involved a decision to shift the risk of holding such securities to a buyer. "At issue in the Massachusetts case is a federal securities law that requires financial firms making principal trades with affiliated funds to notify the fund's investment advisers in advance of such trading. According to the Bear funds' offering documents, the sign-off of two independent directors was required before the entities could make trades with Bear to ensure the fairest prices. According to the administrative complaint, 47% of the principal trades conducted by the less risky of the two funds between 2003 and 2006 didn't secure such approval. Investors lost $1.6 billion when the funds collapsed in July." As seen, the allure of principal profits, or avoidance of principal losses, when acting upon information relating to a current or impending economic event, is a very strong allure. If the allegations in the administrative complaint are true, it is evident that this allure overpowered not only general fiduciary duties arising under the common law but also the firm's adherence to specific securities laws addressing requirements for the conflicted trades.

Fourth, the broker-dealer may be able to aggregate orders in order to effect additional profits. For example, the pricing of a $1,000,000 corporate or municipal bond purchased in the secondary market is likely to be substantially better than the pricing offered for the same bond if purchase were to be made in a much smaller amount, such as $5,000 or $10,000. A broker-dealer firm can take advantage of this pricing disparity by purchasing for its inventory larger blocks of securities, then parceling them off to its customers (and, in its investment adviser capacity, to its clients). The broker-dealer / investment adviser's pricing to the client of the smaller block may be wholly in line with the price of the market for similar size trades in such security, but the broker-dealer may still make a substantial profit as a result of the overall transaction. Disclosure of this fact should occur to the client, along with a disclosure that the dual registrant has provided aggregation of purchases from many clients in order to effect better pricing. In such circumstances it must also be asked if aggregation of purchase orders, in order to seek better pricing, is not part of the fiduciary's duty of seeking best execution, and if so, whether the benefits of better pricing should adhere not to the firm but rather flow down to the client.

Fifth, there is the opportunity to value securities, even fairly liquid ones, at prices which could generate additional profits for the firm or which could hide losses. As the *Wall Street Journal* reported on October 26, 2007: "Growing distrust about Wall Street's ability to determine accurate prices for securities -- a foundation of the financial system -- isn't confined to esoteric mortgage-backed bonds. In a series of emails to senior bank executives, a former … trader alleged that some of his colleagues intentionally 'mismarked,' or improperly valued, plain-vanilla government agency and corporate bonds in a bid to boost profits at the firm's New York-based investment-banking unit." Additionally, the difficulty of establishing a fair price in a principal transaction was even noted by a Commission staff member, “Historically, the prohibitions [against principal trading] go back to common law times and middle ages, the agent never deals with a principal. A principal never deals with his agent in establishing a price. It's not an arm's length price so how do you create a price.” Robert E. Plaze, *Roundtable On Investment Adviser Regulatory Issues* (2001) (transcript).

The need for informed consent. The Commission has long held that, *when a firm has a fiduciary relationship with a customer*, it may not execute principal trades with that customer absent full disclosure of its principal capacity, *as well as all other information that bears on the desirability of the transaction from the customer's perspective*. *See Arleen W. Hughes*, 27 S.E.C. 629, 635 (1948)("It is well settled that a fiduciary, as, for example, an agent, who sells his own property to his principal must disclose his cost to the principal so that the principal will know what profits the fiduciary will realize by effecting the transaction."), *aff'd sub nom., Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949); *William J. Stelmack Corporation*, 11 S.E.C. 601, 618 (1942) (agent must disclose not only that he "is acting on his own account, but also all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction from the viewpoint of the principal [including] the price paid by the agent for the property which he sells to the principal . . . and the price he receives for the property he buys from the principal."). *See also Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 194 (1963) ("Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients.").

In *Arleen W. Hughes*, the Commission found that a registered broker-dealer who was also a registered investment advise violated the antifraud provisions of the securities laws by executing principal trades with her customers without disclosing fully the nature and extent of her adverse interest. Although the registrant had disclosed her principal status in her written agreement with her customers, the Commission determined that such disclosure was inadequate to alert the customers to the potential conflict of interest. The Commission held: “[I]f registrant chooses to assume a role in which she is motivated by conflicting interests . . . she may do so if, but only if, she obtains her client's consent after disclosure not only that she proposes to deal with them for her own account but also of all other facts which may be material to the formulation of an independent opinion by the client as to the advisability of entering into the transaction.” *Hughes*, 27 S.E.C. at 637. Moreover, the Commission also opined that an investment adviser has “an affirmative obligation to disclose all material facts to her clients in a manner which is clear enough so that a client is fully apprised of the facts and is in a position to give his informed consent. And this disclosure, if it is to be meaningful and effective, must be timely. It must be provided before the completion of the transaction so that the client will know all the facts at the time that he is asked to give his consent.”

In *William J. Stelmack Corporation*, 11 S.E.C. 601, 618-19 (1942), the Commission held that disclosure of principal status on confirmation and customer order blank did not relieve broker-dealer of "the fiduciary's duty of loyalty and its various incidents." The fiduciary standards of conduct have not lessened since 1942; hence, the Temporary Rule’s emphasis on disclosure of the mere fact that a principal trade may occur may inadvertently mislead broker-dealer firms that all is required to adhere to their fiduciary duties of loyalty, due care, and utmost good faith, when in fact far greater effort is required.

Likewise, the Commission in its "Information for Newly-Registered Investment Advisers" (2007) stated: "As a fiduciary, you are required to act in the best interests of your advisory clients, and to seek to obtain the best price and execution for their securities transactions. The term "best execution" means seeking the best price for a security in the marketplace as well as ensuring that, in executing client transactions, clients do not incur unnecessary brokerage costs and charges. You are not obligated to get the lowest possible commission cost, but rather, you should determine whether the transaction represents the best qualitative execution for your clients. In addition, whenever trading may create a conflicting interest between you and your clients, you have an obligation, before engaging in the activity, to obtain the informed consent from your clients after providing full and fair disclosure of all material facts. The Commission has described the requirement for advisers to seek best execution in various situations."

NAPFA is concerned that the Commission in its issuing release for the Temporary Rule did not emphasize the need for full disclosure of all material facts relating to the principal transaction. This may inadvertently lead some broker-dealer firms to surmise that such disclosure of material information relating to the transaction is no longer required to be ascertained, documented, and disclosed. Both the Advisers Act (as interpreted by the U.S. Supreme Court and other courts of this land), as well as common law fiduciary duties imposed upon investment advisers and others in relationships of trust and confidence with their clients, require mandatory disclosure of all material facts. Such disclosures include, but are not limited to, the profit which the broker-dealer stands to make from the principal trade, any information the broker-dealer may possess with respect to the specific security, views of the broker-dealer as to specific economic events which have or may occurred, the future direction of interest rates and its affect on the pricing of a fixed income security, and/or general economic conditions. Clients of investment advisers need complete candor and honesty from their investment adviser, and trusted counsel. Mere disclosure that the trade may be effected on a principal basis is not adequate disclosure where the firm has information material to the transaction of which the client should be made aware.

<u>Given the inadequacy of informed consent, further expansion of relief from principal trading restrictions should not occur.</u> Many studies of investment consumers have revealed the difficulties consumers possess in understanding basic investment concepts, much less the conflicts of interest which broker-dealers may possess. Moreover, individual consumers possess substantial barriers, resulting from behavioral biases, to the provision of informed consent, even after full disclosure. Additionally, not only can marketers who are familiar with behavioral research manipulate consumers by taking advantage of weaknesses in human cognition, but competitive pressures almost guarantee that they will do so. To accept the premise, which broker-dealer firms often advance, that investors are responsible for understanding what they read and acting prudently thereafter, it is necessary to conclude that investors are not only armed with timely and adequate disclosure, but also that they possess an ability to understand the disclosures which have been provided to them, both intellectually and unhampered by behavioral biases. Consumer ability to understand is not only difficult due to the enormous knowledge base required to undertake decisions in dealing with a highly complex world, but also due to bounds upon human behavior that limit the extent to which people actually and effectively pursue utility maximization. Individual consumers possess substantial barriers, resulting from behavioral biases, to the provision of informed consent, even after full disclosure. *See* Prentice, "Whither Securities Regulation? Some Behavioral Observations Regarding Proposals For Its Future," 51 Duke L. J. 1397 (2002).

The Commission should not rush to further relax principal trading restrictions. Rather, in recognition of the difficulties individual investors possess in providing informed consent, the Commission should consider rules which will avoid conflicts of interests for investment advisers with respect to their clients. Further requests from broker-dealers to preserve their profits at the expense of individual investors, through expanded principal trading relief, should be resisted by the Commission. The Commission should seek to have firms adopt the policy of eliminating conflicts of interest when reasonable to do so, as opposed to merely undertaking disclosures of conflicts of interest, given the difficulties in achieving individual investor understanding to the level required to provide informed consent.

The detrimental economic effect on the reputation of all investment advisors, and the capital markets, as trust is eroded through conflicted transactions. The mere existence of the conflict of interest presents a loss of image for investment advisors more strongly as to those associated with broker-dealer firms but extending to all investment advisers. In other words, where duty and interests conflict, damage to the reputation of the investment advisory profession necessarily occurs. Then, as individual investors are left with fewer options for conflict-free trusted advice, there exists a gradual diminution in investor confidence in the public markets. This results in less participation in the capital markets, which in turns leads to less efficiency, higher costs of capital, and/or stagnating economic growth.

The ability to opt out should be "real." Savvy individual investors will realize that great dangers result from principal trades. Hence, the ability to opt out from principal trades, either with respect to a particular transaction or with respect to all transactions, should *in fact* exists at the broker-dealer firm. The Commission should inspect the ability of the firm to adhere to this requirement through properly adopted systems and compliance procedures. In no instance should a broker-dealer firm mandate that the client participate in principal trades as a condition to entry by the client into any investment advisory program.

Disclosures should be amplified. While, as noted previously, disclosures of conflicts of interest and material facts do not often lead to true *informed* consent by the client, steps can be taken to enhance disclosures. For example, the disclosure that principal trading may occur should be made through the means of a separate written document, to be signed by the client (with a copy provided to the client). Such document should set forth an explanation of principal trading, the risks to clients which may arise from principal transactions and the conflicts of interest which may most commonly arise, that consent to principal transactions is not required to be given by the client, and that consent if given may be revoked at any time. To be effective in its design, the consent form should contain a space for the client to indicate both a withholding of consent to principal trades as well as the consent to principal trades, with each selection given equal prominence. Moreover, a copy of such document should furnished to the client on an annual basis, perhaps in connection with the Temporary Rule's requirement to furnish an annual listing of trades conducted on a principal basis, in order to remind the client of the ability to revoke the consent which has been provided.

Thank you for providing the opportunity for us to comment on this important issue. We would be pleased to discuss these issues with you further. If you would like to follow up with us, please contact our CEO, Ellen Turf, at 847-483-5400.

Very truly yours,

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About NAPFA. *NAPFA is the nation's leading organization of Fee-Only® comprehensive financial planning professionals. All NAPFA members adhere to a fiduciary oath to exercise their best efforts to act in good faith and in the best interests of their clients. NAPFA-Registered Financial Advisors adhere to the three basic principles – comprehensive planning, professional competency, and Fee-Only® compensation. Approximately one-half of NAPFA's Financial Advisers are with investment advisory firms which are SEC-registered. Since 1982 NAPFA members have sought to protect the interests of investment consumers through their advocacy programs and service. Our web site, containing more information about NAPFA and its members, can be found at www.napfa.org.*