THE FINANCIAL PLANNING ASSOCIATION

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BY ELECTRONIC MAIL

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 Financial Planning Association ("FPA"®)[1] appreciates the opportunity to comment on the "Temporary Rule Regarding Principal Trades with Certain Advisory Clients" (the "temporary rule" or "rule 206").[2] The temporary rule would establish an alternative means for investment advisers who are registered with the Securities and Exchange Commission (the "SEC" or "Commission") as broker-dealers to satisfy the requirements of the Investment Advisers Act of 1940 (the "Advisers Act")[3] when acting in a principal capacity in transactions with certain of their advisory clients. The Commission adopted the temporary rule on an interim final basis as part of its response to a recent court decision invalidating a rule 202(a)(11)-1under the Advisers Act,[4] which provided that fee-based brokerage accounts were not advisory accounts and were thus not subject to the Advisers Act.

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[1] The Financial Planning Association™ is the largest organization in the United States representing financial planners and affiliated firms, with approximately 28,000 individual members. Not all are investment advisers. Approximately 47 percent are affiliated with SEC-registered investment adviser firms and 25 percent with state securities administrators. Two-thirds of members hold at least one securities license, such as the Series 6, 7 or 24. FPA is incorporated in Washington, D.C., with administrative headquarters in Denver.

[2] 17 C.F.R. 275.206(3)-3T.

[3] 15 U.S.C. 80b.

[4] Any references to 202(a)(11)-1 are to the invalidated version of the rule and not to the proposed new rule.

Following the ruling in *Financial Planning Association v. SEC*[5] (the "*FPA* decision"), the Court granted a stay of its order, effectively giving broker-dealers until October 1, 2007 either to convert their fee-based brokerage accounts to commission-based brokerage accounts or to transition those accounts to advisory accounts.

One of the primary benefits to brokers of the now-invalidated broker-dealer rule, was the ability to engage in principal transactions with clients without having to comply with the notice and consent requirements of section 206(3) of the Advisers Act.[6] Recognizing this, FPA wrote to the SEC[7] to caution that the issue of principal trading relief should be treated separately from any interim guidance to brokerage firms that were in the process of transitioning fee-based brokerage programs. While acknowledging some potential benefit from principal transaction, FPA also noted that the inherent conflicts of interest and risks involving such trades have not changed over time, even as the securities markets have become more transparent. Then, as now, FPA's message was that should the SEC proceed with granting only interim relief from the Advisers Act notice and consent requirements for principal transactions, and that it should do so in a measured way. Any rule should be very limited in duration and scope, and must be consistent with the principal intent of the Advisers Act, namely investor protection. As the Commission noted in the adopting release for the temporary rule:

> "Congress intended section 206(3) of the Advisers Act to address concerns that an adviser might engage in principal transactions to benefit itself or its affiliates, rather than the client. In particular, Congress appears to have been concerned that advisers might use advisory accounts to "dump" unmarketable securities or those the advisers fear may decline in value…. Congress's concerns were and continue to be significant. Self-dealing by investment advisers involves serious conflicts of interest and a substantial risk that the proprietary interests of the adviser will prevail over those of its clients."[8] [Footnotes omitted]

I. Scope of Temporary Rule

We strongly support the Commission's decision to reject calls for a blanket exclusion from the requirements of Rule 206(3) for broker-dealers. Clearly, such a move would be contrary to the intent of the Advisers Act and would create dual standards for compliance with principal trading disclosure. We are encouraged by the limitations provided in the temporary rule; given the uncertainty of the benefits to investors and the potential risks involved, we suggest that further expansion of the temporary rule's scope is inappropriate.

A. Support for Limitations

[5] 482 F.3d 481 (D.C. Cir. 2007).

[6] 15 U.S.C. 80b-6(3).

[7] See Letter from Duane Thompson, Managing Director, Washington Office, Financial Planning Association to Robert E. Plaze, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission, dated July 27, 2007 (the "FPA Letter").

[8] Release No. IA-2653; File No. S7-23-07 at 13.

The temporary rule provides an alternative means of complying with the notice and consent requirement of Rule 206(3), but subject to certain limitations. One such limitation is that it is only available for non-discretionary accounts, or accounts where discretion is temporary or limited. The alternative means of compliance are also not available to the dually registered broker-dealer/investment adviser (the "dual registrant") if the dual registrant is the issuer or underwriter of the security that is the subject of the principal transaction, with an exception for non-convertible investment grade debt securities.

FPA strongly supports these limitations and cautions against any erosion of the limitations established by the temporary rule. As the Commission has stated, "Congress appears to have been concerned that advisers might use advisory accounts to 'dump' unmarketable securities or those the advisers fear may decline in value."[9] It is precisely these situations – discretionary accounts and issuer or underwriter transactions - that are most subject to abuse and self-dealing. The Commission was wise to limit the scope of the temporary rule in this manner, and we urge you to reject any calls to weaken these restrictions.

The exception for investment grade debt securities is grounded in the suggestion that they "may be less risky" than other securities offered by a principal, and less likely to be "dumped" on investors. While the review by the ratings organizations to ensure the debt is investment grade limits the likelihood of dumping, FPA is concerned about the potential for abuse in the pricing of these securities. The SEC suggests that "it may be easier for clients to identify whether the price they are being quoted for a nonconvertible investment grade debt security is fair given the relative comparability, and the significant size, of the non-convertible investment grade debt markets."[10] As a practical matter, we are not convinced of the efficacy of market transparency as a deterrent to abuse in these circumstances. When being orally advised to purchase such a debt security that "may be" a principal transaction, an advisory client is not likely to hold off on approving the transaction while he goes out to independently verify pricing of the instrument, nor should he be expected to do so. The potential for abuse in pricing these instruments then, is not likely to be adequately addressed by market transparency. Execution of these transactions is subject to Financial Industry Regulatory Authority ("FINRA") rules and standards on best execution and mark ups.[11] We strongly urge the SEC to work closely with FINRA to scrutinize these and other transactions conducted pursuant to the temporary rule to ensure full compliance with relevant rules. We also encourage the Commission to carefully monitor in-house analyst ratings for bonds that are subsequently sold on a principal basis to their clients. The Commission can monitor potential 'dumping' of bonds that have been downgraded by requesting and retrieving email communications between the analysts and registered representatives to determine if there are any timing issues involved in the sale of certain bonds. Finally, we would urge the Commission not to expand principal trading activity to other bond issues.

[9] *Id.*

[10] *Id.* at 21-22

[11] NASD Rules 2320 and 2440

With regard to accounts for which the dual registrant obtains temporary or limited discretion, we urge the SEC to exercise particular caution and closely scrutinize principal transactions in such accounts. We suggest the Commission mark such accounts for special review to ensure dual registrants do not use temporary or limited discretion as a means by which to avoid the requirements of Rule 206(3) or as a vehicle to dump certain securities or otherwise engage in abusive conduct.

B. Suggestions for Further Limitations

The temporary rule does not distinguish between wealthy or sophisticated clients and those with more limited assets and less investment acumen. The Commission asks whether the rule should be available only with regard to sophisticated or wealthy clients, such as "qualified clients" defined by Rule 205-3 of the Advisers Act.[12] We believe such a limitation is required given the intent of the Advisers Act to guard against potential abuses of principal trading. Generally, qualified clients are better positioned to understand the nature of principal transactions and the potential conflicts. Equipped with proper disclosures, they are also better able to protect themselves against potential abuses than are smaller, less sophisticated investors. In the FPA letter, we suggested that the Commission should limit blanket principal trading authorizations only to institutional clients or natural persons who are deemed to be "qualified clients" for purposes of Advisers Act Rule 205-3.[13] The temporary rule should be limited to such clients.

If, as it has been asserted by proponents of interim relief, that principal trades are a significant benefit for a firm's retail customers, then we recommend that the Commission track principal trading activity in retail customer accounts as well as in institutional accounts of their brokerage customers. The purpose is to determine if there is any unusual bias towards principal trading in retail customer accounts. Logic would suggest sophisticated and institutional investors would jump at the investment opportunities touted by proponents; if they don't, and most of the principal trading activity is occurring in smaller retail accounts, then this should suggest to SEC examiners that there may be a problem.

C. Applicability to All Non-Discretionary Accounts

The SEC has adopted the temporary rule "to enable investors to make an informed choice between fee-based advisory accounts and commission-based brokerage accounts and to continue to have access to certain securities held in the principal accounts of certain advisory firms while remaining protected from certain conflicts of interest."[14] The intent of the temporary rule is to allow customers who had been in fee-based brokerage accounts to transition to a fee-based advisory account while continuing to engage in principal transactions.

[12] *Id.* at 18.

[13] FPA Letter, at 4.

[14] Release No. IA-2653; File No. S7-23-07 at 1.

The temporary rule, however, goes beyond this limited intent by opening up all non-discretionary advisory accounts of a dual registrant to the alternative compliance mechanism. The sole rationale for extending the rule to cover accounts that were not formerly fee-based brokerage accounts is that it would be "very difficult" to exclude them.[15]

While we have no reason to doubt the operational difficulties posed by treating the existing advisory accounts differently from the former fee-based brokerage accounts, we are very troubled by the question it raises: If the dual registrant cannot establish systems that allow for principal transactions in some accounts but not in others, how does it intend to comply with the temporary rule? Specifically, if an investor elects not to permit principal transactions in his or her account – as the temporary rule contemplates – how will the dual registrant accommodate this? Is it anticipated that allowing principal transactions will be required in order to open or maintain an advisory account? Clearly the temporary rule contemplates that clients may decline to engage in principal transactions.

If, in fact, a distinction can be made between advisory accounts that permit principal transactions and those that do not, we strongly urge the Commission to limit the application of the temporary rule to only those accounts that were previously fee-based brokerage accounts. We believe the temporary rule was, and is, intended to be narrowly designed to allow dual registrants to offer clients the same or similar services they received with the fee-based brokerage accounts, while providing appropriate protections. By opening up an entire new class of accounts to these transactions, we believe the Commission would be unnecessarily jettisoning a critically important investor protection.

II. Notice and Consent

A. Prospective Written Notice and Consent

Dual registrants may avail themselves of the temporary rule only after disclosing to the client the circumstances under which the investment adviser may engage in principal transactions, the nature and significance of conflicts with its client's interests as a result of the transactions, and how the investment adviser addresses those conflicts. The dual registrant must then obtain the client's written, revocable consent, prospectively authorizing principal transactions in the account.[16]

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[15] *Id.*at 18. The Commission explained, "We understand from our discussions with broker-dealers that maintaining principal trading distinctions between advisory accounts that were once fee-based brokerage accounts and those that were not would be very difficult. Trade execution routing for investment advisory programs often is derived through unified programs or electronic codes allowing or prohibiting certain kinds of trades uniformly for all accounts that are of the same type. As such, limiting relief to accounts that were formerly in fee-based brokerage programs would make the requested relief impractical for firms and would neither serve the best interests of clients (because the effect would be to limit their ability to continue to access the inventory of securities held by their brokerage firm) nor be administratively feasible to firms affected by the Court's ruling with respect to the transition and ongoing servicing of these and other accounts subject to the Advisers Act."

[16] We refer you back to the questions above regarding how the dual registrant intends to accommodate those who do not consent to principal transactions.

The Commission correctly asks whether the disclosure will be "meaningful for clients in understanding the conflicts and risks inherent in principal trading by a fiduciary counterparty?"[17] We are pleased that the SEC has included in the temporary rule an explicit provision that the dual registrant must meet its obligations under sections 206(1) and 206(2) of the Advisers Act.[18] These obligations include acting in the client's best interest and abiding by a blanket fiduciary standard that covers all activities under the Advisers Act. As the question posed by the Commission suggests, compliance with the disclosure and consent requirements of the temporary rule will not necessarily satisfy the fiduciary's obligation to ensure that the client understands the conflicts and risks, not merely that the client has been given notice.

FPA strongly supports the requirement of a written notice and prospective, written, revocable consent to engage in principal transactions. The written consent, we believe, is a regulatory means, not an end. That is, the underlying purpose of the written consent is to effectuate the purpose of the Advisers Act by helping ensure the consent is informed and knowing. The temporary rule, however, does not go far enough in this regard. We are concerned that under the temporary rule the written notice and consent will merely be included as part of a new account or other document. Though it may be "conspicuous" its purpose may be undercut by including it as part of another document. Further, if the notice and consent are part of a new account document, we are very concerned that the consent will effectively become a condition of opening an advisory account. This result would clearly be contrary the purpose Advisers Act and the temporary rule which contemplates a knowing consent to principal trading. We urge the Commission to require that the notice and consent be contained in a separately delivered and executed document. Beyond merely authorizing principal transactions the client should represent that he or she understands the disclosures, including the potential conflicts. While effective disclosure is not always an appropriate remedy to avoid a fiduciary conflict of interest, if the activity would compromise the fiduciary duty of the adviser, it does bring the dual registrant closer to acting with, as noted in the remarks of a senior SEC staffer, the "due care and…utmost good faith" that is required of an investment adviser.[19]

B. Trade-by-Trade Consent

Section 206(3) of the Advisers Act requires that notification and consent for engaging in principal transactions be done on a transactional or trade-by-trade basis. We are generally pleased that the temporary rule also requires transactional disclosure and consent, as opposed to relying on the prospective blanket consent only. Section 206(3)-3T(a)(4) provides:

[17] Release No. IA-2653; File No. S7-23-07 at 23.

[18] 17 C.F.R. 275.206(3)-3T(b).

[19] *See* Lori A. Richards, Fiduciary Duty: return to First Principles, Address at the Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006), *available at* http://www.sec.gov/news/speech/spch022706lar.htm.

> The investment adviser, prior to the execution of each principal transaction:
> (i) Informs the advisory client, orally or in writing, of the capacity in which it ***may*** act with respect to such transaction; and
> (ii) Obtains consent from the advisory client, orally or in writing, to act as principal for its own account with respect to such transaction *[Emphasis added]*

FPA views this transactional disclosure as, at best, the bare minimum required to comply with the plain meaning and intent of Section 206(3) of the Advisers Act. We understand that as a practical matter at the time an order is being entered advisers will not always know if a transaction is being made out of the principal's account. However, we are concerned that this disclosure may not be sufficient to satisfy the adviser's fiduciary obligations under the Advisers Act. Precisely, with regard to a particular transaction the adviser is not disclosing prior to approval that that there is an *actual* conflict and what the *actual* benefit of the transaction is to the adviser and firm. We strongly urge the SEC to immediately engage broker-dealers and advisers to explore practical solutions to effectively identify principal transactions prior to order entry.

III. Monitoring and Enforcement

A. Dually Regulated Accounts

The temporary rule clearly concerns accounts governed by the Advisers Act, and in fact provides regulatory relief from the requirements of the Act. We are therefore puzzled as to why section 206(3)-3T(a)(7) requires that the relief is available only to dually registered investment adviser/broker-dealers ("IA/BDs") and accounts subject to both the Advisers Act and the Securities and Exchange Act of 1934 (the "Exchange Act")[20] and the rules of applicable self-regulatory organizations ("SRO").

The justification set forth in the adopting release is the SEC's desire to afford investors engaged in principal transactions the protections of both the investment adviser regulatory regime (*i.e.,* the Advisers Act and rules thereunder) and the broker-dealer regulatory regime (*i.e.,* the Exchange Act and rules thereunder and the rules of applicable self-regulatory organizations). While the FPA certainly endorses this goal, we note that it is not necessary to require dual registration in order to attain it. A customer engaging in a principal trade enjoys the benefits of two regulatory regimes whether his adviser is dually registered or whether it is simply affiliated with a broker-dealer. In the first case, a single firm is responsible for meeting all regulatory requirements. In the second case, one firm holds the broad fiduciary duties of an adviser, while the other firm complies with the broker-dealer's sales practice and best execution requirements. Simply put, current law and regulation provides investor protection through functional oversight, with the SEC responsible for enforcing the Advisers Act fiduciary responsibility and FINRA overseeing trade execution.[21] The

[20] 15 U.S.C. 78o.
[21] We note that FINRA (f/k/a NASD) has not supported a fiduciary standard for its members. During the debate in 2005 over the 202(a)(11)-1, the NASD strongly asserted that an analysis of SRO and Advisers Act standards "shows that protections afforded broker-dealer customers are equivalent to, and in many

temporary rule, therefore, rather than providing additional investor protection, instead provides special competitive advantage to dually registered IA/BDs.

In summary, we oppose the section 206(3)-3T(a)(7) requirement that the temporary rule apply only to accounts of an IA/BD and accounts subject to both the Advisers Act and Exchange Act. It is unnecessary given the purpose of this limited and temporary rule and it provides no additional protection for investors engaging in principal transactions as any principal trades conducted for an advisory account would be subject to the Exchange Act and the rules and self-regulatory organization rules thereunder anyway. For all these reasons, we urge the Commission to eliminate section (a)(7) from proposed rule 206(3)-3T.

B. Assessing the Rule in Practice

The temporary rule's alternative method of compliance with section 206(3) of the Advisers Act is wholly untested. The SEC has recognized this and noted that "making the rule temporary allows us an opportunity to observe how those firms use the alternative means of compliance provided by the rule, and whether those firms serve their clients' best interests."[22]

Given the risks and conflicts inherent in principal transactions, we encourage vigorous oversight by the SEC of the how the accounts have been transitioned and the subsequent compliance with the temporary rule's strictures. With predictions that most of the estimated 1 million fee-based brokerage accounts would be converted to fee-based advisory accounts as of October 1, 2007, the compliance pitfalls are substantial, as application of the Advisers Act to these accounts is new. In addition, the temporary rule contemplates that all clients with existing non-discretionary advisory accounts at dually registered firms will likely be asked to consent to principal trading pursuant to the temporary rule. The volume and speed of the expected principal trading consents under the temporary rule suggest that the SEC must be extremely vigilant in identifying non-compliance and abuse.

Significant oversight will also be necessary because the rule is set to expire December 31, 2009. Less than two years from now, the SEC will be reviewing the rule and deciding whether to let the rule expire, extend it, or make it permanent. FPA encourages the SEC to obtain as much empirical data as possible to help assess the costs, benefits, and risks of principal trading under the temporary rule. [23]

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cases, exceed, those afforded to adviser customers." The NASD letter also questioned the effectiveness of a fiduciary standard, stating that "a general fiduciary duty cannot provide complete protection to customers."
See NASD letter to SEC, Apr. 4, 2005, at http://www.sec.gov/rules/proposed/s72599/nasd040405.pdf
Given FINRA's strong preference for its own suitability rules than for a common law fiduciary standard, we are unclear whether FINRA would energetically apply a fiduciary standard to Section 204-3 violations, anyway.

[22] *Id* at 13.

[23] We note that the benefits of investing in initial public offerings are questionable. See for example, IPO RESEARCH SYMPOSIUM REVIEW, *Sanjay Varshney*, *Rich Robinson*. Journal of Economics and Finance. Murfreesboro: Spring 2004. Vol. 28, Iss. 1; pg. 56, 12 pgs. We suggest the SEC obtain

IV. Conclusion

Though FPA expressed its concern with principal trading in the context of Rule 202(a)(11)-1's being vacated by the DC Circuit Court of Appeals, we appreciate that the Commission adopted rule 206(3)-3T on a temporary basis and limited the scope of its applicability. We believe it would be premature and even a reckless disregard of the strictures imposed by Congress years ago on behalf of investors if the Commission were to expand the temporary rule to other adviser clients at this time.

We therefore strongly encourage the Commission to use the next two years to conduct periodic sweeps of principal trading activity by dual registrants, and to evaluate both the potential benefits, and risks to investors based on empirical data, not industry rhetoric.

I am happy to respond to any specific questions or comments that you may have.

Very truly yours,

Daniel J. Barry
Director of Government Relations

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empirical data regarding any benefits associated with principal trading to help assess the benefit to investors of the temporary rule.