ABA Section of
BUSINESS LAW
Practical Resources for the Business Lawyer

Defending Liberty
Pursuing Justice

AMERICAN BAR ASSOCIATION

Section of Business Law
321 North Clark Street
Chicago, Illinois 60610-4714
(312) 988-5588
FAX: (312) 988-5578
e-mail: businesslaw@abanet.org
website: www.ababusinesslaw.org

April 18, 2008

By Electronic
and United States Mail

Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: ***Temporary Rule Regarding Principal Trades With Certain Advisory Clients***
(Release No. IA-2653; File No. S7-23-07)
Interpretive Rule Under the Advisers Act Affecting Broker Dealers
(Release No. IA-2652; File No. S7-22-07)

Dear Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities (the "Committee") of the Section of Business Law (the "Section") of the American Bar Association (the "ABA") in response to a request for comments by the Securities and Exchange Commission (the "SEC" or "Commission") on the SEC's recent rulemakings related to the application of the Investment Advisers At of 1940 (the "Advisers Act") to broker-dealers, specifically:

- Rule 206(3)-3T, Temporary rule for principal trades with certain advisory clients ("Interim Final Rule"), as contained in Release No. IA-2653, 72 FR 55022 (Sept. 28, 2007) (the "Interim Final Release"); and

- Proposed Rule 202(a)(11)-1 – Certain broker-dealers, as contained in Release No. IA-2652, 72 FR 55126 (Sept. 28, 2007) (the "Interpretive Release").

The comments expressed in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the Section, nor does it necessarily reflect the view of all members of the Committee.

I. INTRODUCTION AND GENERAL COMMENTS

The Committee appreciates the prompt action by the Commission and its staff to address the consequences of the March 30, 2007 decision by the U.S. Court of Appeals for the District of Columbia Circuit (the "Court") in *Financial Planning Association v. SEC,* 482 F.3d 481 (D.C. Cir. 2007) (the "*FPA v. SEC* decision"), which vacated Advisers Act Rule 202(a)(11)-1. Given the number of broker-dealers who had built business models around the fee-based brokerage exemption provided by Rule 202(a)(11)-1 and related interpretations, we applaud the Commission's pragmatic approach to providing guidance to the industry and the investing public.

Unfortunately, the limited duration of the Court's temporary stay to allow the industry to react to the decision's repercussions required the Commission to take these actions without the benefit of the findings of the study it sponsored to compare the different regulatory schemes for broker-dealers and investment advisers, particularly in light of the diminished distinctions between the business activities of these types of financial institutions (the "RAND Study").[1]

The Committee urges the Commission to use the RAND Study findings to develop a holistic approach to the regulation of financial intermediaries under the securities laws. Among other things, such an approach should reflect the types of financial services and accounts available to investors as well as the layers of regulatory requirements, including not only the requirements of the Advisers Act and the Securities Exchange Act of 1934, but the rules and regulations under each statute, the role of the self-regulatory organizations, and the examination and inspection cycle for each type of entity. Regulation based on business activities and services provided is particularly important given that, as noted in the RAND Study, investors generally have difficulty distinguishing among different types of financial industry participants. The Committee would welcome the opportunity to provide input to the Commission and its staff to on proposed revisions to its regulation of the customer-related activities of financial intermediaries.

II. THE INTERIM FINAL RULE REGARDING PRINCIPAL TRADES WITH CERTAIN ADVISORY CLIENTS

A. The Commission Should Not Limit Principal Trading Relief to Dual Registrants

The Interim Final Rule limits its principal trading relief to investment advisers that are also registered with the Commission as broker-dealers ("dual registrants"). We understand the genesis of this restriction: the Interim Final Rule was primarily designed to address fee-based accounts that, until the *FPA v. SEC* decision, had been held at broker-dealers. Broker-dealers are more likely to have converted fee-based accounts to advisory accounts held at the same entity rather than attempting to transfer these accounts to affiliates registered only as investment

[1] LRN-RAND Center for Corporate Ethics, Law, and Governance, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (Mar. 2008).

advisers. However, we do not believe the Commission has adequately justified the dual registrant limitation in the Interim Final Rule, and believe instead that it should offer the principal trading relief to entities registered only as an investment adviser, but affiliated with a broker-dealer.

The Interim Final Release offers two justifications for the limitation of principal trading relief to dual registrants. The first justification is that Commission and SRO rules supply a comprehensive set of sales practice and best execution rules that apply to the relationship between a broker-dealer and its customer.[2] While this is true, it is equally true that the Advisers Act and the rules adopted thereunder *also* supply a comprehensive set of rules that apply to the relationship between an investment adviser and *its* customer. The Commission must believe that the Advisers Act and its rules are sufficient, generally speaking, to protect investment adviser customers - otherwise, it would amend those rules. There is simply no logical reason to apply both broker-dealer and investment adviser rules to accounts unless the Commission believes that one of those sets of rules is insufficient. If one of the sets of rules is insufficient, then the Commission should fix that set of rules, rather than requiring firms to comply with both. There are substantial costs, burdens and complexities involved in applying both broker-dealer and investment adviser rules to the same account, because broker-dealer and investment adviser rules are quite inconsistent. For example, broker-dealers are required to retain records for three years, must retain all records relating to their "business as such", and must retain electronic records in particular formats (so-called WORM storage). Investment advisers have a five-year record-retention requirement, but must retain only some specific records, and can retain electronic records in any format.[3] There are many other similar examples of inconsistencies between investment adviser and broker-dealer rules. Limiting principal trading relief to dual registrants imposes substantial regulatory burdens without any reason to believe there are any corresponding investor-protection benefits.

The Interim Final Release's second justification for the limitation is that advisory clients will most often need principal trading relief from firms that are dual registrants.[4] While this may be true as a factual statement (the Commission estimates that some one million fee-based accounts with $300 billion in assets were affected by the *FPA v. SEC* decision), we do not believe it is a sufficient justification for the dual registrant limitation. Virtually all of the largest broker-dealers, and a substantial number of regional and smaller broker-dealers, have affiliates registered only as investment advisers that advise mutual funds, private funds and individual accounts. Under the Interim Final Rule, if the best available price is quoted at the adviser's affiliated broker-dealer, the affiliated adviser's accounts will be denied the possibility of best execution of their orders. That there are more such accounts at the dual registrants is simply not a sound basis for limiting the opportunity for best execution for accounts held at affiliated advisers.[5]

---

[2] Interim Final Rule, Inv. Adv. Rel. No. 2653 (Sept. 24, 2007) at Section I.B.7.
[3] Compare Exchange Act Rules 17a-3 and 17a-4 with Advisers Act Rule 204-2.
[4] Interim Final Rule, Inv. Adv. Rel. No. 2653 (Sept. 24, 2007) at Section I.B.7.
[5] At a minimum, in order to perform a meaningful cost-benefit analysis of the Interim Final Rule, we believe it is incumbent on the Commission to estimate how many non-discretionary investment advisory accounts are held at

As noted above, we hope that the Commission will take the opportunity of the findings of the RAND Study to undertake the admittedly difficult process of harmonizing investment adviser and broker-dealer rules. As a threshold matter, we urge the Commission to create a construct that allows all investment adviser customers to have the opportunity to obtain best execution for their orders, whether those customers have their accounts at dual registrants or at investment adviser-only affiliates of broker-dealers.

B. The Commission Should Not Limit Principal Trading Relief to Non-Discretionary Accounts

The Interim Final Rule also limits its principal trading relief to non-discretionary accounts at investment advisers. Again, we understand the genesis of this restriction: the Interim Final Rule was primarily designed to address accounts that, until the *FPA v. SEC* decision, had been held at broker-dealers. Under former Rule 202(a)(11)-1, struck down in the *FPA v.* SEC case, broker-dealers could not hold discretionary accounts, so the decision did not affect them. However, we do not believe the Commission has adequately justified limiting the rule to non-discretionary advisory accounts.

The Commission cites two justifications in the Interim Final Release for limiting principal trading relief to non-discretionary accounts. First, allowing relief for discretionary accounts would be inconsistent with the requirement for a trade-by-trade oral reminder of the possibility that the trade may be executed as principal. Investment advisers to discretionary accounts typically do not discuss trades with customers on a trade-by-trade basis.[6] However, we believe the oral trade-by-trade reminder serves no significant investor protection objective not already provided by the pre-trade written consent requirement before an adviser can engage in principal trades (together with the post-trade confirm reminder and the annual summary of principal trading activity). The trade-by-trade oral reminder is difficult to supervise and, more importantly, may harm customers by delaying trade executions in fast-moving markets. If, as we strongly recommend, the Commission drops the trade-by-trade oral reminder requirement, that requirement can no longer serve as justification for limiting principal trading relief to non-discretionary accounts.

Second, the Interim Final Release states that in a discretionary account customers are less well positioned to protect against overreaching by the adviser.[7] However, we believe that this concern is substantially and effectively addressed by the provisions in the interim final rule that deny relief for issues underwritten by the adviser or its affiliates, with the exception of investment-grade debt. We believe these provisions provide substantial protection against the Commission's concern that advisers will use principal trades to "dump" otherwise unmarketable

---

investment adviser-only affiliates of broker-dealers, and to estimate how significant is the cost in terms of poorer quality executions to those accounts because of the denial of principal trading relief to those accounts.

[6] Interim Final Rule, Inv. Adv. Rel. No. 2653 (Sept. 24, 2007) at Section I.B.1.

[7] *Id.*

securities in advisory client accounts.[8] For securities trading in a secondary market, and thus subject to real-time quote and trade reporting, we believe the adviser's best execution responsibilities provides more than sufficient investor protection. What is true for non-discretionary advisory accounts is equally true for discretionary advisory accounts: in many cases, the best price available for a particular security will be a broker-dealer affiliated with the adviser (or at a dual-registrant broker-dealer/adviser). The Commission should not deprive customers of the opportunity for best execution of their trades merely because the customers have chosen discretionary accounts.[9]

At the time of the adoption of the Advisers Act, and consistently until the adoption of Rule 202(a)(11)-1 in 2005, broker-dealers were permitted to have discretionary accounts, and thus customers in discretionary accounts were able to have the execution-quality benefit of principal trades.[10] It is only in the past three years that the Commission has treated discretionary accounts as necessarily being advisory accounts, and thus limited these accounts to agency executions, absent trade-specific written consent.

We believe that limiting principal trading relief to dual registrants and to non-discretionary accounts is inconsistent with the concept of best execution, a duty that is imposed on investment advisers as well as broker-dealers, and will harm investors. The ability to trade as principal is particularly important to achieving best execution in the fixed income markets, especially for municipal securities. Increasing numbers of individual investors are investing in fixed income and municipal securities, and this increase will continue as a larger percentage of investors approach or enter retirement. The necessity of being able to trade as principal to achieve best execution is just as true for discretionary accounts and non-dual-registrant accounts as for non-discretionary accounts and dual-registrant accounts.

At the time the Advisers Act and its restriction on principal trading were passed in 1940, there was little in the way of a clearly articulated duty of best execution either in the broker-dealer or the investment adviser context.[11] As a result, Congress incorporated into the Advisers Act restrictions on principal trading to protect investors from poor quality trade executions. Indeed, a robust duty of best execution was not possible until the advent of consolidated

---

[8] We do not express an opinion on the limitation of principal trading relief with respect to underwritten securities, except that we note that it is our understanding that government agency securities (such as Ginnie Mae, Fannie Mae and Freddie Mac securities, among others) frequently are rated only by one rating agency at the time of issuance, while the Interim Final Rule would require underwritten debt securities to have investment-grade ratings from at least two rating agencies to qualify for principal-trading relief. We urge the Commission not to disrupt accepted, efficient and effective industry practices in the government securities market.

[9] We urge the Commission to perform a meaningful cost-benefit analysis of the Interim Final Rule, which we believe can be accomplished by surveying the industry to obtain an estimate of the number of discretionary accounts are affected by the Interim Final Rule's limit on principal trading relief, and comparing this number of customer accounts against execution statistics showing the disparity between agency and principal execution quality.

[10] *See* Letter of Steven W. Stone, Morgan Lewis & Bockius LLP, Certain Broker-Dealers Deemed Not to Be Investment Advisers (Mar. 29, 2005) (discussing history of discretionary accounts and discretionary trading by broker-dealers) (available at http://www.sec.gov/rules/proposed/s72599/swstone032905.pdf).

[11] The Commission did adopt a rudimentary best execution requirement for investment advisers in *Arleen Hughes,* Exch. Act. Rel. No. 4,048 (Feb. 18 1948), and the predecessor of current FINRA Rule 2320, adopted in the early 1940s, required broker-dealers to seek the best terms reasonably obtainable for clients.

quotation systems and firm quotes in the wake of the 1975 Act Amendments to the federal securities laws. Quickly thereafter, the Commission began to define and elaborate on best execution responsibilities.[12] During the 1990s, the Commission issued landmark releases further expanding on the duty of best execution.[13] The Commission has also pioneered a series of regulatory initiatives, such as limit order display, decimalization, order execution quality disclosure and the prevention of trade-throughs, to compliment the duty of best execution. Today, not only is there much greater legal and regulatory guidance concerning the duty of best execution, but there has evolved an entire industry of consultants to help broker-dealers and investment advisers measure and evaluate best execution. The Commission should recognize and build on this evolution of the duty of best execution.

We believe that where it is possible to measure and test best execution, that duty is the best protection for customers against poor quality executions. And, as a necessary corollary, rules that may impede best execution - such as a requirement forbidding investment advisers from trading in the best available market at the best available price, simply because that market is affiliated with the adviser, or because the adviser is not a dual registrant - can harm investor protection. Again, we ask the Commission to review these issues holistically in light of the findings of the RAND Study, but if it concludes that interim steps are necessary, we recommend that the Commission (1) not limit the exemption to dual registrants, and (2) not require oral trade-by-trade consent to principal trades for non-discretionary accounts, but instead look to the protections of broker-dealers and investment advisers' duties of best execution, and trade-by-trade confirmation disclosure of execution capacity and other information regarding trades.

III. INTERPRETIVE RELEASE – FINANCIAL PLANNING

The Commission has determined not to re-propose that portion of former Rule 202(a)(11)-1 dealing with financial planning. The rule provided that a broker-dealer was not providing advice that was solely incidental to brokerage within the meaning of Section 202(a)(11)(C) of the Advisers Act if the broker-dealer provided advice as part of a financial plan or in connection with providing financial planning services and also (i) held itself out as a financial planner or as providing financial planning services, (ii) delivered a financial plan to customers, or (iii) represented that advice given was part of a financial plan or in connection with financial planning services. As a result, prior to the Court's decision vacating Rule 202(a)(11)-1, financial planning was deemed an investment advisory rather than a brokerage activity. Noting that many financial services firms found this aspect of the rule difficult to apply, the Commission stated that it plans to consider issues related to financial planning after reviewing the RAND Study.

Notwithstanding the difficult implementation issues associated with this aspect of former Rule 202(a)(11)-1, financial service firms undertook a significant amount of effort in modifying

---

[12] *See, e.g.,* Exchange Act Rel. No. 15,671 (Mar. 22, 1979); Exch. Act Rel. No. 16,590 (Feb. 19, 1980); Exch. Act Rel. No. 17,583 (Feb. 27, 1981)
[13] *See, e.g.,* The Order Handling Release, Exchange Act Rel. No. 37,619A (Sept. 6, 1996); Market 2000: An Examination of Current Equity Market Developments at V-4 (Jan. 1994); *see also* Disclosure of Order Execution and Routing Practices Adopting Release, Exch. Act Rel. No. 43,590 (Nov. 17, 2000).

their financial planning programs to satisfy the requirements of the Advisers Act. Perhaps most importantly, firms have gone to great lengths – pursuant to the former rule – to clarify the nature of their various roles to customers, explaining in many instances the shift from acting in a brokerage capacity when providing financial planning activities, to acting in an investment advisory and fiduciary role when providing the same services. In doing so, these firms relied on guidance provided by the Commission staff on various interpretive issues generally related to distinctions between financial planning and brokerage services and issues of particular relevance to dual registrants.[14] The proposing release indicates that this guidance is no longer valid.[15]

We commend the Commission for its willingness to take a fresh look at financial planning activities in light of the RAND Study and encourage it to do so as promptly as possible following the study. The vacating of Rule 202(a)(11)-1 ultimately returns the industry back to status quo before the rule, where financial planning was, depending on the circumstances, a valid brokerage activity, but it does so with the threat of yet another change in regulatory status on the horizon. The attendant uncertainty neither is in the interests of financial services firms nor investors.

We also question the Commission's determination to terminate the staff interpretive guidance related to financial planning. Although Rule 202(a)(11)-1 has been vacated, there undoubtedly are a number of firms that have elected to continue providing financial planning services in an investment advisory capacity. Having informed customers of the firms' shift from acting as a broker-dealer to acting as a fiduciary, these firms may be understandably reluctant to risk confusing customers further by reversing course yet again to brokerage status. Viewed from this vantage point, the staff interpretations – which, among other things, emphasized the importance of clear disclosure, course of dealing, and the reasonable expectations of customers in assessing whether investment advisory or brokerage services were being provided by a dual registrant – provided useful guidance to firms. In sum, we urge the Commission to provide clear guidance on financial planning activities as soon as possible.[16]

III. CONCLUSION

The Committee applauds the expeditious efforts of the Commission and its staff to provide interim relief in light of the *FPA v. SEC* decision. Nevertheless, we believe that the haste in which the Commission was required to act has resulted in core broker-dealer activities being subject to the Advisers Act, despite the multiple levels of regulation and self-regulation already imposed on broker-dealers. Accordingly, as stated above, we ask that the Commission revisit the issue of the regulation of customer-facing activities of broker-dealers and investment advisers in light of the blurring of their activities and the findings of the RAND Study. We would welcome the opportunity to meet with the Commission and its staff and to discuss our

---

[14] Securities Industry Association, SEC Staff Letter (December 16, 2005).

[15] Proposing Release, note 18.

[16] The Committee does not express any opinion on whether financial planning should be a broker-dealer or investment adviser activity; only that the Commission act promptly to clarify this issue.

comments and to participate in the process of modernizing these regulatory schemes in light of the developments in the market place.

If the Committee can be of any assistance in this process, please let us know.

Respectfully submitted,

Keith F. Higgins

Keith F. Higgins
Chair, Committee on Federal Regulation of Securities

Drafting Committee
K. Susan Grafton
H. Hardy Callcott
Andre E. Owens
David Mishel
Paul B. Uhlenhop

cc: Hon. Christopher Cox, Chairman
Hon. Paul Atkins, Commissioner
Hon. Kathleen Casey, Commissioner