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December 20, 2010

Elizabeth M. Murphy
Secretary
U.S. Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: File Number S7-23-07, Temporary Rule Regarding Principal Trades with Certain Advisory Clients

Dear Secretary Murphy,

Fiduciary360 ("fi360")[1] appreciates the opportunity to comment on the Commission's proposal to extend the sunset date of the temporary rule regarding principal trades with certain advisory clients.[2] In our comments, we seek to specifically address the following three (3) questions raised by the Commission related to the appropriateness of extending the temporary rule:

1. Is it appropriate to extend the rule 206(3)-3T for a limited period of time in its current form while the Commission completes its study and its broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers? Or should the Commission allow the rule to expire?

2. Given the compliance issues observed, is extending the rule appropriate?

3. Is two years an appropriate period of time to extend the rule? Or should the Commission extend the rule for a different period of time? If so, for how long?

[1] Fi360 offers a full circle approach to investment fiduciary education, practice management, and support. Our mission is to promote a culture of fiduciary responsibility and improve the decision making processes of investment fiduciaries, including investment advisors, managers, and stewards. With legally substantiated Practices as our foundation, we offer training, tools, and resources in support of that mission. We manage the Accredited Investment Fiduciary® (AIF®) and Accredited Investment Fiduciary Analyst™ (AIFA®) designation programs. AIF designees receive training that provides a unique comprehensive overview of fiduciary standards of excellence, asset allocation, preparation of investment policy statements, manager search and due diligence, performance measurement, and other related subjects. AIFA designee training builds on that foundation and prepares students to provide Fiduciary Assessments to institutions. At present, there are over 4,500 active AIF and AIFA designees.

[2] Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Advisers Act Release No. 3118, 75 Fed. Reg. 75,650 (Dec. 6, 2010) ("2010 Release").

Dodd-Frank Act

In the 2010 Release, the Commission notes that it intends to deliver a report to Congress no later than January 21, 2011 addressing its study of the obligations, including the standards of care, of broker-dealers and investment advisers, in compliance with the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[3] The Commission further states that as a part of its study and any subsequent rulemaking it expects to consider issues raised by principal trading including the operation of rule 206(3)-3T. The Commission also states that it believes that firms' compliance with the substantive provisions of rule 206(3)-3T provides sufficient protections to advisory clients to warrant the rule's continued operation for an additional limited period of time.[4]

While we understand that the Commission would like to consider the temporary rule in its study of broker-dealer and investment adviser obligations and any subsequent rulemaking, it is unclear why the Commission does not feel that it has had sufficient time to consider and analyze rule 206(3)-3T. The rule has been in effect for more than three years, and the Commission presumably has completed most of its study and is in the final stages of drafting its report for Congress, which is due in a little more than thirty (30) days. In addition, on August 9, 2010, when the Commission was well aware of its obligations under the Dodd-Frank Act, the Division of Investment Management sent a letter to the Securities Industry and Financial Management Association stating that the rule would likely expire at the end of 2010 and that only a "few" firms are relying on rule 206(3)-3T.[5] In light of these facts, it is unclear what has changed to warrant an extension of the temporary rule.

It is also unclear why the Commission has made its proposal to extend the rule without providing supporting data and analysis of the rule's operation. In the 2010 Release, the Commission indicates that "some" firms are relying on the rule,[6] but does not quantify how many firms exactly. Moreover, the Commission indicates that "certain" firms would be required to make substantial changes to their disclosure documents, client agreements procedures, and systems,[7] but again does not quantify the number of firms, and more importantly, the number of investors

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[3] 2010 Release, 75 Fed. Reg. at 75,651.

[4] *Id.*

[5] Letter from Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission, to Ira D. Hammerstein, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association (Aug. 9, 2010), *available at* http://www.sec.gov/rules/final/2009/ia-2965a-sifma-letter.pdf. The Division's observation in the August 2010 letter is consistent with the Commission's previous acknowledgement in December 2009 that fewer firms than expected used the rule. *See* Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Advisers Act Release No. 2965, 74 Fed. Reg. 69,009, 69,012 (Dec. 30, 2009) and Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Advisers Act Release No. 2965A, 75 Fed. Reg. 742 (Jan. 6, 2010) (collectively, "2009 Release").

[6] *See* 2010 Release, 75 Fed. Reg. at 75,651.

[7] *Id.*

that would be affected if the temporary rule expires. In addition, the 2010 Release does not acknowledge that these firms received notice in August 2010 that the rule would likely expire.

Furthermore, in light of the Commission's current efforts to seek greater consistency in the regulation of broker-dealers and investment advisers providing similar advisory services, extending a rule that perpetuates different disclosure requirements for investment advisers subject to the same fiduciary standard would appear to be counter-productive.[8] Because the temporary rule only applies to those advisers who are dually registered as investment advisers and broker-dealers and who serve non-discretionary accounts, new legal and policy questions will likely arise related to the application of the fiduciary standard as the Commission continues its analysis under the Dodd-Frank Act. The issues are further complicated by the temporary rule's use of enhanced disclosure to deal with conflicts of interest that are inherent to principal trades. The focus on disclosure ignores other key fiduciary protections, including an adviser's duty of care to ensure a principal trade is in a client's best interest and the duty to act in utmost good faith to ensure the client fully understands the conflict and that the client's economic interest comes first. Moreover, the efficacy of the disclosure requirements under the temporary rule are in question given that significant compliance concerns have been identified by Commission staff,[9] as discussed below. Recent academic research also has shown that disclosures are not as effective as regulators would like to believe.[10]

Taking into consideration the policy risks associated with a rule that promotes inconsistent regulatory requirements and may not be as effective at protecting investors as originally intended, it is not clear that a second extension of a temporary rule is in the public interest. If significant policy reasons exist to support extending the rule until the Commission completes its study and consideration of broker-dealer and investment adviser obligations, we urge the Commission to provide greater clarity on those policy reasons. We would note, however, that a two (2) year extension seems to be unreasonable in light of the compliance issues that Commission staff has identified while observing firms' use of the rule.

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[8] The extension of the rule is also inconsistent with the Commission's approach to self-dealing for other fiduciaries under its authority, such as municipal securities advisors. The Commission should look broadly at a fiduciary standard and its treatment under all securities laws under its jurisdiction. For example, Chairman Schapiro has recommended that municipal securities advisors in underwriting bonds should be prohibited from also acting as brokers, and such a rule amendment has been proposed by the Municipal Securities Rulemaking Board. *See* MSRB Notice 2010-27, Request for Comment on Rule G-23 on the Underwriting Activities of Financial Advisors (Aug. 17, 2010) *available at* http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2010/2010-27.aspx. In contrast, rule 206(3)-3T allows broker-dealers to act as underwriters for investment grade bonds and also engage in principal transactions. 17 C.F.R. 275.06(3)-3T(a)(2).

[9] *See* 2010 Release, 75 Fed. Reg. at 75,651-75,652.

[10] *See, e.g.*, Sunita Sah, George F. Loewenstein & Daylian M. Cain, *The Burden of Disclosure* (May 1, 2010), *available at* SSRN: http://ssrn.com/abstract=1615025; *see also* Elizabeth MacBride, *What we all feared: 'Better' disclosure yields worse results, according to Yale professor's study* (Sept. 27, 2010), *available at* http://www.riabiz.com/a/2322116.

Compliance Issues

Several compliance issues related to the temporary rule were discussed in the 2010 Release,[11] but do not appear to have been considered in the Commission's proposal to extend the rule. The temporary rule was originally issued to facilitate conversion of fee-based brokerage accounts to accounts that fall under the jurisdiction of the Investment Advisers Act of 1940.[12] In addition, the rule sought to promote investor choice by allowing advisers to provide different account, service and product offerings.[13] At the time the rule was first promulgated, however, the Commission expressed concern about whether the temporary rule struck an appropriate balance between investor choice and investor protection.[14] Therefore, the Commission stated that once the rule went into effect it would "observe how firms comply with their disclosure obligations under the rule, and whether, when firms conduct principal trades with their clients, they put their clients' interests first."[15] In December 2009, the Commission extended the expiration date to December 31, 2010.[16] At that time, the Commission indicated that it needed additional time to consider how advisers are using the rule because fewer firms than expected chose to rely on the rule and firms implemented the rule slower than expected. The Commission stated that in its consideration of the rule it would "assess whether the rule is operating, and firms are applying it, in a manner consistent with protecting investors."[17] The Commission also noted that further evaluation would help it determine whether to allow the rule to expire or adopt it in its current or an amended form.[18]

As indicated above, it is unclear that the rule should be extended given that few firms appear to be relying on its safe harbor. Of greater concern, however, are the numerous issues identified during Commission staff's review of the rule's operation. In fact, based on the list of violations in the 2010 Release, it appears staff identified violations of every single disclosure requirement under rule 206(3)-3T as well as failures in the application, monitoring and documentation of

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11 It appears that more compliance issues than those listed in the 2010 Release may exist as well. 2010 Release, 75 Fed. Reg. at 75,651-75,652 (stating that "staff did observe certain compliance issues, including but not limited to…").

12 Release Temporary Rule Regarding Principal Trades with Certain Advisory Clients, 72 Fed. Reg. 55022 (Sep.28, 2007) ("2007 Release").

13 *Id.*

14 2007 Release, 72 Fed. Reg. at 55,025 (requesting comment on the need for the rule and its potential impact on clients of the advisers and specifically asking, "Have we struck an appropriate balance between investor choice and investor protection?").

15 *Id.* at 55,029.

16 *See* 2009 Release, 74 Fed. Reg. at 69,012.

17 *Id.*

18 *Id.*

compliance with the temporary rule.[19] The Commission appears to be relying on the fact that no instances of "dumping" have been identified as satisfaction that the rule is "consistent with protecting investors."[20] However, it is not clear that the Commission has addressed other attendant conflicts of interest for fiduciaries that can exist with principal trades, such as price manipulation and differential compensation.[21] An analysis of compensation arrangements, for example, would help the Commission better understand whether there has been a pattern of breaches in an adviser's overriding duties of loyalty and care to the client.

In light of the compliance issues associated with the operation of the rule to date, the rule should not be extended without showing a clear benefit to investors and how such benefit outweighs any risks associated with the rule. The Commission has identified investor choice and convenience as a benefit derived from the temporary rule,[22] but it has not quantified the benefit or the risks associated with the rule. As discussed above, neither has the Commission publicly quantified the number of firms and investors that rely on the rule. While we understand that the Commission was not in a position to assess the operation of the rule in the past due to the rule's slow implementation, it appears that sufficient time has now passed for the Commission to obtain empirical data. We encourage the Commission to use this data to complete a thorough analysis of the rule's benefits and risks. In addition, we encourage the Commission to obtain qualitative data related to the disclosures that are being provided to investors and investor's reactions to those disclosures. For example: What do disclosures look like? Do investors appear to understand the disclosures? Do customers ask any questions related to the disclosures?[23]

There appears to be little known about the operation of the temporary rule other than the fact that few firms are relying on it and are experiencing several compliance issues. Accordingly, we encourage the Commission to gather more information, expand its analysis of fiduciary obligations beyond disclosure, and to share its data and analysis with the public to the greatest extent possible.

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19 *See* 2010 Release, 75 Fed. Reg. at 75,651-75,652.

20 *See* 2009 Release, 74 Fed. Reg. at 69, 012.

21 *See* 2007 Release, 72 Fed. Reg. at 55,029.

22 *See* 2010 Release, 75 Fed. Reg. at 75,653; 2009 Release, 74 Fed. Reg. at 69,013; 2007 Release, 72 Fed. Reg. at 55,025.

23 We would also note that Section 912 of the Dodd-Frank Act authorizes and encourages the Commission to "gather information from and communicate with investors" and "engage in … temporary investor testing programs" for purposes of evaluating any rule. Given the compliance issues raised with the temporary rule, such information gathering and/or testing of investors could assist the Commission with better understanding the operation of the temporary rule and how effectively it protects investors.

Conclusion

In summary, in the absence of clear empirical analysis showing clear benefits for investors and in light of a history of disclosure and associated recordkeeping deficiencies, we do not believe that it is reasonable for the Commission to extend the rule for any additional period of time. If there are mitigating circumstances for an extension, we do not believe these have been clearly articulated in the proposing release. Moreover, we believe that any additional supporting data and analysis to justify the extension should be shared with the public to the extent possible. Even with such information, however, a two (2) year extension does not appear warranted. Rather, a six (6) month period should be adequate for the Commission to consider related policy issues under the Dodd-Frank Act and for firms to accordingly modify their compliance programs. We note, however, that we would only support such an extension if the Commission is able to provide further explanation and supporting evidence.

We truly appreciate the opportunity to provide our views on these important issues. Please do not hesitate to contact us if you have any questions or would like additional information.

Sincerely,

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CEO

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Senior Policy Analyst

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