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Invested in America

November 13, 2012

Via E-Mail to: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F. Street N.E.
Washington D.C. 20549
Attn: Elizabeth M. Murphy, Secretary

Re: Release No. IA-3483; File No. S7-23-07
Temporary Rule Regarding Principal Trades with Certain Advisory Clients

Dear Ms. Murphy:

The Private Client Legal Committee of the Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the proposal by the Securities and Exchange Commission (the "Commission" or the "SEC") to amend Rule 206(3)-3T (the "Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") to extend the Rule's sunset date by two years from December 31, 2012 to December 31, 2014 (the "Rule Proposal").[2] For the reasons discussed below, SIFMA strongly supports extending the Rule, but also recommends that the Commission consider extending the Rule for a longer period of time of up to five years in order to give the Commission adequate time to consider broader rulemaking regarding the applicable standard of care for broker-dealers and investment advisers under Section 913 of the Dodd-Frank Act, as well as time to adopt and implement more permanent regulation of principal trading and prevent uncertainty caused by the need for additional extensions in the future.

I. Support for Extension of the Rule

The Rule was adopted to permit firms offering fee-based brokerage accounts (which are now subject to the requirements of the Advisers Act) to sell securities held in their proprietary accounts to their advisory customers in compliance with Section 206(3) of the Advisers Act

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 3483 (Oct. 9, 2012).

without requiring transaction-by-transaction, written disclosure and consent. Since the adoption of the Rule over five years ago, numerous firms have relied on the Rule's alternative means of complying with Section 206(3) in order to sell customers securities from their proprietary accounts that the firms would otherwise have been unable to offer or would only have been able to offer at a higher cost. During this time period, the staff of the Commission "has not identified instances where an adviser has used the temporary rule to 'dump' unmarketable securities or securities that the adviser believes may decline in value into an advisory account."[3] If the Rule were allowed to expire, firms would, at a great cost to investors, be required to eliminate or greatly reduce their offering of principal trades through advisory accounts. Moreover, the Commission is currently considering how best to implement a uniform fiduciary standard for broker-dealers and investment advisers. If the Rule were allowed to expire and the Commission then implements rulemaking following the study on investment advisers and broker-dealers required by Section 913 of the Dodd-Frank Act,[4] firms would be required to restructure their operations and incur significant costs for a second time.

As we explain in greater detail below, there is a compelling case for extending the Rule's sunset date for another two years, if not longer. Many of the reasons for extending the Rule have been articulated by the Commission in the Rule Proposal, with which we generally agree. SIFMA would like to supplement the rationale offered in the Rule Proposal with the following analysis as well as data from a survey that SIFMA recently conducted of members of its Private Client Committee regarding principal trading practices at firms that offer non-discretionary advisory accounts.[5]

A. The Benefits to Investors of Principal Trades

When the Commission initially adopted the Rule in 2007, the Commission recognized that principal trades give investors access to securities that may not be available on the open market or are only available on an agency basis at higher prices. For example, the Commission noted that principal trades provide "access to a broader range of investment opportunities, better trade execution, and more favorable transaction prices for the securities being bought or sold than would otherwise be available."[6] SIFMA agrees with the Commission's observations and believes that allowing firms to offer investors a greater variety of securities from firm

[3] Rule Proposal at 14.

[4] *Study on Investment Advisers and Broker-Dealers* (Jan. 21, 2011), available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[5] In this survey, which we conducted in June and July 2012, SIFMA received responses from seven dual-registrants that, in the aggregate, manage over $325 billion of assets in over 1.1 million non-discretionary advisory accounts.

[6] *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2653 (Sep. 24, 2007) ("2007 Principal Trade Rule Release") at 10-11 (quoting letter from Financial Planning Association).

inventories,[7] execute trades in such securities more quickly and offer customers better prices is a laudable goal when coupled with appropriate protections.

B. Extensive Reliance on the Rule by Investors and Dual Registrants

A significant number of advisers that are dual registrants and investors currently rely on the Rule in order to engage in principal trades. The Commission previously estimated that, as of May 2007, customers of broker-dealers held $300 billion in 1 million fee-based brokerage accounts that were eligible to engage in principal trading without providing written disclosure before each transaction under Section 206(3).[8]

According to the survey recently conducted by SIFMA, there is evidence that reliance on the Rule is extensive. In this survey, we received responses from seven dual-registrant firms that, in the aggregate, manage over $325 billion of assets in over 1.1 million non-discretionary advisory accounts. These firms indicated in their responses to the survey that 459,507 of these accounts, which contain aggregate assets of over $125 billion, are eligible to engage in principal trading pursuant to the Rule. These firms also indicated that, during the previous two years, they have engaged in principal trades in reliance on the Rule with 106,682 of these accounts and have executed an average of 12,009 principal trades per month in reliance on the Rule. This data alone indicates that the Rule helps a significant number of investors execute a significant volume of trades. However, since the respondents to SIFMA's survey represent only a small portion of dual registrants that manage non-discretionary advisory accounts or engage in principal trading with clients, the total number of investors that rely on the Rule and the total number of trades that are executed in reliance on the Rule are likely much higher. According to our analysis of the Form ADV, Part 1 data for all registered investment advisers that is available on the Commission's website,[9] there are a total of 125 registered investment advisers that engage in a broker-dealer business[10] and engage in principal trading with their advisory clients. These firms manage, in the aggregate, over $812 billion of non-discretionary assets in over 3.5 million non-discretionary accounts. Although this data does not directly indicate the number of advisory firms that rely on the Rule in order to engage in principal trading, it does indicate that the respondents to SIFMA's survey represent only a small number of the advisers that maintain non-discretionary accounts and engage in principal trading. This suggests that reliance on the Rule may be much more prevalent than our survey indicates.

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[7] According to the survey recently conducted by SIFMA, advisory firms currently rely on the Rule in order to trade a wide variety of securities, including fixed income securities, preferred shares and eligible syndicate securities.

[8] 2007 Principal Trade Rule Release at 4.

[9] We analyzed the spreadsheet containing the responses of every registered investment adviser to the questions in Form ADV, Part 1, which is available at http://www.sec.gov/foia/docs/invafoia.htm. The spreadsheet that we analyzed was dated as of October 1, 2012.

[10] Item 6A(1) of Form ADV, Part 1 asks advisers whether they are actively engaged in business as a broker-dealer (either registered or unregistered), so we are unable to calculate the number of dual registrants that engage in principal trading. We would surmise, however, that most advisers who are actively engaged in business as a broker-dealer are registered.

C. Current Unfeasibility of Complying with Section 206(3)

The Commission noted when adopting the Rule that compliance with Section 206(3) of the Advisers Act, which requires providing written disclosure and obtaining consent from customers before the completion of each transaction, is generally not feasible for the principal trades typically executed by advisory firms.[11] Because of the high volume of principal trades executed by many firms, compliance with Section 206(3) for an appreciable volume of trades would only be possible through use of automated systems capable of delivering written disclosure for such trades. According to SIFMA's survey, firms currently do not have such automated systems in place. Of the seven advisory firm that responded to the survey, two firms indicated that they would be completely unable to elicit customer consent in accordance with Section 206(3), and the other five firms indicated that they would be able to elicit customer consent in accordance with Section 206(3), but that the requirements of Section 206(3) are so cumbersome that they would have to significantly limit their volume of principal trading. The survey respondents estimated that they would require time periods ranging from several months to over one year to implement the changes to the technological systems, procedures and disclosure documents necessary to offer principal trades in compliance with Section 206(3), and even then only on a more limited basis.

As a result of these operational obstacles to compliance with Section 206(3), the expiration of the Rule would cause firms to stop offering or greatly limit their offering of principal trades to advisory accounts for a significant period of time. Investors would lose access to the securities currently offered through principal trades, receive much less favorable pricing on such securities, or be forced to buy such securities through brokerage accounts.

D. The Rule's Successful Protection of Investors Over the Past Five Years

SIFMA agrees with Commission's assessment that the Rule, which has been in effect for over five years, has provided sufficient protection to investors and will continue to adequately protect investors if its sunset date is extended.[12] Although some commenters to previous extensions of the Rule voiced concerns that advisory firms would use the Rule to facilitate "dumping" (the practice of an adviser using advisory accounts to dump unmarketable securities or securities that the adviser fears may decline in value), the Commission itself notes that the staff has not identified any instances of this practice actually occurring during the period of over five years that the Rule has been effective. Although the SEC previously identified potential

[11] *See* 2007 Principal Trade Rule Release at 4 ("The combination of rapid electronic trading systems and the limited availability of many of the securities traded in principal markets means that an adviser may be unable to provide written disclosure and obtain consent in sufficient time to obtain such securities at the best price or, in some cases, at all.").

[12] *See* Rule Proposal at 7-8 ("We believe that the requirements of rule 206(3)-3T, coupled with regulatory oversight, will adequately protect advisory clients for an additional limited period of time."); *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 3118 (Dec. 1, 2010) ("2010 Extension Release") at 6 ("We believe that firms' compliance with the substantive provisions of rule 206(3)-3T as currently in effect provides sufficient protections to advisory clients to warrant the rule's continued operation for an additional limited period.").

issues with some firms' compliance with the Rule,[13] SIFMA does not believe that these compliance issues should affect the extension of the Rule and supports the Commission's continued diligent enforcement of the Rule's requirements.

E. Disruption Caused By Allowing the Rule to Expire

If the Rule were allowed to expire at the end of 2012, advisory firms would need to incur substantial costs in order to offer principal trading to clients and even then the offering might be far more limited. If the Commission were to also adopt new rules concerning principal trading following its consideration of the standards of conduct and regulatory requirements applicable to broker-dealers and investment advisers, firms would be required to restructure their operations and client relationships for a second time, potentially at substantial expense. SIFMA is supportive of the Commission's efforts to update the standards of conduct and regulatory requirements applicable to broker-dealers and investment advisers. We would also support a more permanent solution to the regulation of principal trading by investment advisers through the adoption of a new rule or modified version of Rule 206(3)-3T that provides greater flexibility to dual registrants while still providing robust investor protections. We strongly agree with the Commission that it would be premature to require firms currently relying on the Rule to restructure their operations before the Commission completes any broader rulemaking applicable to broker-dealers and investment advisers.

II. Comments to Specific Questions and Issues Raised by the Commission

In addition to expressing our general support of extending the Rule, SIFMA would like to also respond to some of the specific questions and issues raised by the Commission in the Rule Proposal:

- *Should we allow the rule to sunset? If so, what costs would advisers that currently rely on the rule incur? What would be the impact on their clients?*

For the reasons previously discussed in this letter, SIFMA strongly supports extending the Rule rather than allowing it to sunset. If the Rule were allowed to sunset, advisers would be forced to incur significant costs over a period of several months to over a year to implement the changes to the technological systems, procedures and disclosure documents necessary to offer principal trades in compliance with Section 206(3) even on a limited basis. Further, until advisers made these changes, their clients would either lose access to the securities currently offered through principal trades or be forced to pay higher prices for these securities.

- *If we allow the rule to sunset, should we consider requests from investment advisers that are registered with us as broker-dealers for exemptive orders providing an alternative means of compliance with section 206(3)?*

SIFMA strongly prefers that the Commission extend the Rule. There is considerable efficiency for both the Commission staff and registrants in dealing universally with the issues the

[13] 2010 Extension Release at 7-8.

Rule is intended to address. If the Rule were allowed to sunset, SIFMA believes it would be necessary for the Commission to consider a request for class exemptive relief as an alternative means of compliance with Section 206(3). An exemptive relief process that would entertain a request for a class exemption would be preferable to customers losing access to securities currently offered through principal trades because of advisers' inability to comply with Section 206(3). In contrast, an approach that would require submitting, considering, and deciding potentially dozens of separate, individual requests for exemptive relief would be inefficient and time consuming and ultimately could leave some firms and their clients with considerable uncertainty.

- *If we extend the rule's sunset date, is two years an appropriate period of time to extend the sunset date? Or should we extend the rule's sunset date for a different period of time? If so, for how long?*

SIFMA recommends that the Commission extend the Rule's sunset date for a period of five years rather than just two years. As the Commission noted in the Rule Proposal, a temporary rule creates uncertainty that may result in a reduced ability of firms to plan future business activities.[14] We note that the Rule has been temporary for over five years and is currently being considered for its third extension. SIFMA is concerned that it may take longer than two years for the Commission to adopt permanent regulation of principal trading in the context of its broader regulation of broker-dealers and investment advisers and that another extension of the Rule may be required. We believe that a five-year extension would give the Commission ample time to formulate more permanent regulation and give certainty and comfort to both investors and advisory firms. If the Commission were to move forward with broader regulatory changes in this area in less than five years, the Commission of course could amend or abrogate the temporary rule at that time.

- *Is it appropriate to extend rule 206(3)–3T's sunset date for a limited period of time in its current form while we complete our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers?*

As discussed in more detail above, SIFMA strongly supports extending the Rule until the Commission has completed its consideration of the regulatory requirements applicable to broker-dealers and investment advisers. We agree with the Commission that allowing the Rule to expire before the Commission adopts any broader changes to the regulation of broker-dealers and investment advisers could result in unnecessary costs by requiring advisory firms to restructure their operations relating to principal trades twice within a short time period.

- *Should we consider changing the requirements for adviser disclosures to have registered advisers provide more information to us and their clients about whether they are relying on the rule? For example, should we amend Part 1A of Form ADV to require advisers to disclose whether they rely on rule 206(3)–3T for certain principal transactions? Should we amend Part 2A of Form ADV to require advisers who rely on rule 206(3)-3T to*

[14] Rule Proposal at 16-17.

provide a description to clients of the policies and procedures they have adopted to ensure compliance with the rule?

Given the additional disclosure and reporting obligations in the Rule itself, it is not necessary to amend Part 1A or Part 2A of Form ADV to duplicate those protections.

- *Why do advisers eligible to rely on the temporary rule not rely on it?*

Although advisers may have different reasons for not relying on the Rule, many firms do not rely on the Rule because the requirements of (i) distributing and collecting the initial disclosure and consent forms, (ii) soliciting trade-by-trade consent, (iii) preparing confirmations that comply with the Rule and (iv) generating annual reports of principal transactions, are still too costly or burdensome for these advisers to comply with.

- *Modification of the definition of investment grade security.*

SIFMA supports the goal of eliminating regulatory reliance on credit ratings issued by nationally recognized statistical rating organizations, but agrees with the Commission that modification of the definition of investment grade security in the Rule would be better addressed after the Commission has completed its review of the regulatory standards of care applicable broker-dealers and investment advisers.

III. Conclusion

SIFMA agrees with the Commission's conclusion that the Rule benefits investors and, therefore, should be extended. The available evidence indicates that the Rule has allowed investors to maintain access to the securities available through principal trading without exposing such investors to abusive trading practices such as the dumping of unmarketable securities. Allowing the Rule to expire would substantially limit the availability of securities offered through principal trades and force advisory firms to either incur significant costs in order to comply with Section 206(3) or stop offering principal trades. We agree with the Commission that any expiration or modification of the Rule should be delayed until after the Commission has completed its review of the regulatory standards of care that apply to broker-dealers and investment advisers. Although SIFMA would support the Commission's proposal of extending the Rule for another two years, we respectfully urge the Commission to consider extending the Rule for a longer period of time of up to five years.

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Thank you for giving SIFMA's Private Client Legal Committee the opportunity to comment on the foregoing. If you have any questions regarding this letter, please contact the undersigned at [redacted]).

Sincerely,

Kevin M. Carroll
Managing Director and
Associate General Counsel

cc: The Hon. Mary L. Schapiro, Chairman
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
The Hon. Daniel M. Gallagher, Commissioner
Robert W. Cook, Director, Division of Trading and Markets
Norman B. Champ III, Director, Division of Investment Management
Craig M. Lewis, Chief Economist and Director, Division of Risk, Strategy and Financial Innovation