

Fund Democracy  
Consumer Federation of America

November 30, 2007

BY EMAIL AND US MAIL

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

RE: File No. S7-23-07

Dear Secretary Morris:

We write on behalf of Fund Democracy and the Consumer Federation of America to comment on the Commission's interim exemption ("Interim Rule") from principal trading restrictions under the Investment Advisers Act ("Act"). We recognize that this rule was put forward to ease the transition in the wake of the court decision overturning the fee-based brokerage account rule. We believe, however, that changes in the market justify a broader look at reforming the rule. While we agree that the Act's principal trading restrictions may be relaxed consistent with the protection of investors, and we appreciate the efforts the commission has undertaken to create a strong disclosure and consent regime, we are concerned that the Interim Rule reflects an over-reliance on disclosure and fails to incorporate adequate measures to prevent principal trading abuses.

The Rule relies primarily on four types of disclosure: prospective, written blanket disclosure and consent; pre-execution, oral, transaction-by-transaction disclosure and consent; confirmation disclosure; and annual disclosure. It also substantively limits principal trades by: (1) prohibiting almost all trades in securities of which the adviser or an affiliate is the issuer or an underwriter, (2) prohibiting trades in discretionary accounts, and (3) requiring broker-dealer registration. None of these provisions adequately addresses the ultimate goal of regulating principal transactions, which is to prevent trades that are disadvantageous to clients.

For this reason, we believe that it is imperative that the Rule expressly require firms to develop policies and procedures that are specifically designed to detect, deter and prevent disadvantageous principal transactions. In keeping with that approach, the Commission should provide guidance regarding specific situations in which it may be prohibitively

difficult to ensure that clients are not disadvantaged and discuss different ways in which advisers could address these situations. In addition, the Commission should amend provision (b) of the Rule to clarify that the Rule's disclosure requirements are not exclusive and that additional, transaction-by-transaction disclosure may be required under applicable anti-fraud and fiduciary principles. Here again, the Commission should provide examples of situations in which additional disclosure may be necessary, such as when there is no readily available market price with which to evaluate the fairness of a principal trade. Such an approach would be responsive to recent calls for more principles-based regulation, as it outlines the investor protection outcome market participants are responsible for achieving but provides them with flexibility in determining how best to achieve that outcome.

If the Commission were to adopt the more protective approach we advocate below, but only in that case, it might be possible to further relax some requirements of the rule consistent with the protection of investors. It might be possible, for example, to permit principal trading under the Rule within discretionary accounts and for advisers who are not registered as broker-dealers. Before adopting such an approach, however, the Commission should take steps to determine that investors are not unintentionally left without appropriate protection.

## BACKGROUND

Section 206(3) of the Act requires that investment advisers obtain written notice and consent from their clients prior to completion of the transaction in which the adviser acts in a principal capacity. As noted by the Commission, one purpose of this provision is to prevent advisers from dumping securities in client accounts. While this might have been the primary potential abuse that principal trading created in simpler times, the potential for abuse arising from principal trades today is far broader and more varied than mere dumping. Advances in technology, speedier transactions, increased market volatility, more diverse trading platforms and other factors have brought benefits to the markets while also presenting more, and more complex, opportunities for principal trading abuses.

These concerns are magnified for unsophisticated investors. The increasing scope and complexity of principal trading abuses have made it even less likely that unsophisticated investors can give truly informed consent to their advisers to act as principals. In contrast, many sophisticated institutional investors have developed metrics to measure the quality of execution provided by their advisers. These metrics have been designed to keep pace with the complexities of modern markets.

The regulation of principal trading, however, has not kept pace with the increased potential for principal trading abuses. Requiring prior written consent on a transaction-by-transaction basis serves the purpose of alerting investors to the greater potential for abuse presented by principal trades, but this requirement does not scale to the scope or complexity of the potential abuses. As the potential for abuse has grown in scope and complexity, the prior notice and consent requirement has provided less meaningful protection. This requirement also has become less practically relevant as the speed of

transactions has made it impracticable to engage in principal transactions with advisory clients under a notice and consent model. Firms may choose not to offer the advantages of principal trading rather than attempt to comply with Section 206(3).

This may be especially true for retail investors. The prior written notice and consent requirement is necessarily more burdensome with respect to investors who are difficult to contact, and it will generally be more difficult to contact retail investors than institutional investors. During business hours, institutional investors will often have many employees available to provide consent on short notice, whereas retail investors will often be unavailable.

Thus, Section 206(3) may be more impracticable for unsophisticated retail investors while also providing less protection for such investors from the potential abuses presented by principal trading. This is not to say that prior notice and consent should be abandoned for such investors, but rather that prior notice and consent cannot be sufficient (and perhaps not even cost-effective) as a meaningful form of protection against principal trading abuses for those likely to need it most. Public enforcement tools (*i.e.*, examinations and enforcement actions) may be a far more cost-effective tool, in addition to the deterrent effect of anti-fraud and fiduciary standards and effective policies and procedures to ensure that such standards are met. We therefore have focused on requirements other than notice and consent in the analysis provided below.

## ANALYSIS

### Overriding Anti-Fraud and Fiduciary Principles

As the Commission has stated in the adopting release, investment advisers that are subject to Section 206(3) are subject to the “federal fiduciary standard [that] govern[s] the conduct of investment advisers.”<sup>1</sup> We are concerned, however, that the Commission has not made it sufficiently clear that compliance with the Rule (or Section 206(3) for that matter) does not necessarily satisfy disclosure required under general anti-fraud and fiduciary principles. Indeed, in some places in the Release, the Commission seems to imply that the Rule *would* fully satisfy such requirements.<sup>2</sup> We assume that the Commission agrees that the particular circumstances of a principal transaction (or any transaction) may require disclosure beyond that which is required by the Rule, Section 206(3), or other rule under or provision of the federal securities laws.

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<sup>1</sup> Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 2653 at 12 (Sep. 24, 2017) (quoting *FPA v. SEC*, 482 F.3d 481, 490 (*citing Transamerica Mortgage Advisors Inc. v. Lewis*, 444 U.S. 11, 17 (1979))) (“Release”).

<sup>2</sup> *See, e.g.*, Release at 25 (“Given the frequency and speed of trading in some advisory accounts as well as the increasing complexity of securities products available in the marketplace, trade-by-trade disclosure and consent, even if oral, might be a more effective protection against misunderstanding by advisory clients of the nature of a transaction and the conflicts inherent in it **as well as a meaningful safeguard for investment advisers seeking to comply with their fiduciary obligations.**” (emphasis added)).

For this reason, it is critical that the Commission include a provision in the Rule that expressly requires that additional disclosure be provided to the extent that material conflicts of interest created by a particular principal transaction necessitate such disclosure.<sup>3</sup> The Release's statement that compliance with the Rule does not necessarily satisfy independent disclosure requirements mandated under anti-fraud and fiduciary principles is not sufficient. In 2000, the Commission argued in *Press v. Quick* that compliance with the confirmation rule (Rule 10b-10) was not determinative of whether a broker-dealer's disclosure obligations under the anti-fraud provisions of the federal securities laws had been satisfied. Notwithstanding that this position is stated in the preliminary note to Rule 10b-10, the court rejected the SEC's argument in holding that satisfying the requirements of the Rule necessarily satisfied the broker's disclosure obligations in that case.<sup>4</sup> The lesson of *Press* is that the Commission must tread carefully to ensure that the Interim Rule's disclosure requirements do not inadvertently relieve advisers of their overriding disclosure obligations for anti-fraud and fiduciary purposes. In addition to including a provision in the rule confirming these overriding disclosure obligations, the Commission should provide nonexclusive examples of particular instances in which additional disclosure would be necessary. For example, additional disclosure would be necessary to the extent that the market prices for the securities traded were readily available and that the client was more likely to have received a disadvantageous price in the transaction.

#### Compliance Procedures

We believe that no exemptive relief from Section 206(3) should be granted without at least a discussion of the Commission's (1) expectations regarding the internal compliance policies and procedures necessary to prevent principal trading abuses and (2) intentions regarding the enforcement of such policies and procedures. Rule 206(4)-7 under the Act requires that advisers adopt and implement policies and procedures that are reasonably designed to prevent violations of the Act and designate a chief compliance officer who is responsible for administering the policies and procedures. In the releases accompanying the promulgation of Rule 206(4)-7, the Commission described its expectations in specific areas of compliance. We believe that the Commission should do the same in connection with any final action on the Interim Rule. Such guidance should recognize the scope and complexity of principal trading abuses in the context of modern markets and require that advisers adopt policies and procedures that identify all such abuses and include objective metrics for determining whether such abuses are occurring. The Commission should indicate that these policies and procedures will be a special focus of

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<sup>3</sup> We note that paragraph (b) does not accomplish this because it refers only to substantive obligations (best price and execution), and general obligations under the anti-fraud provisions of the Act and other applicable provisions of the federal securities laws. The reference to these obligations without any specific reference to overriding *disclosure* obligations could even be read as suggesting that the Interim Rule has occupied the field as to required disclosure. The discussion of paragraph (b) in the Release does nothing to contradict this interpretation. See Release at 29-30.

<sup>4</sup> See *Press v. Quick*, 218 F.3d 121, 131-32 (2d Cir. 2000). But see *Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 835 F.2d 1031, 1036 (3d Cir. 1987).

the Office of Compliance Inspections and Examinations. The foregoing should apply regardless of whether the regulated entity relies on the Interim Rule, because the potential for principal trading abuses also exists when advisers comply with Section 206(3).

We believe that a critical element of principal trading policies and procedures will be the manner in which the fairness of prices is evaluated. There are certainly many securities that are traded in highly liquid markets for which the fairness of the price at which a principal trade was executed can be reasonably verified. Advisers should be required to document such prices and to do so on multiple exchanges, as applicable. There are other securities, however, that are thinly traded and for which an objective measure of price is not available. The market's current difficulty in valuing CDOs that previously were considered relatively liquid and easily valued illustrates the potential risk. Securities that are difficult to value often are more likely to be securities that an adviser may be attempting to dump on its clients, so the potential for abuse rises with the difficulty of determining whether the transaction was fair.

If an adviser cannot reasonably certify the objectivity of a security's price, the adviser should not be allowed to rely on the Rule, and the Commission should add that an adviser relying on Section 206(3) would still be subject to a fiduciary obligation to make additional, transaction-specific disclosure of any uncertainty of the security's price in connection with obtaining consent to the transaction.<sup>5</sup> In other contexts, the Commission has required that advisory clients receive the best price in principal trades,<sup>6</sup> and it should consider whether and discuss under what circumstances advisers should be expected to satisfy a best-price standard. In summary, our support for the Rule is contingent on principal trades' being permitted only when the adviser can demonstrate through objective, verifiable metrics that the client has not been disadvantaged.

#### Transaction-Specific, Prior Notice and Consent

The essential difference between the Interim Rule and Section 206(3) is that the Rule requires *oral* notice and consent prior to *execution* of the transaction, whereas the Act requires *written* notice and consent prior to *completion* of the transaction. The Rule's requirement that notice and consent occur prior to execution would seem to improve investor protection. Section 206(3) permits notice and consent to be obtained after the adviser has already committed to (executed) the transaction, when there is additional pressure on the client to grant (and on the adviser to obtain) consent so as not to saddle the adviser with the trade. The Rule removes this pressure by requiring pre-execution

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<sup>5</sup> We note, in this respect, that price tests that rely on obtaining hypothetical bids from other dealers – which the Commission has inadvisedly allowed in other contexts – is wholly inadequate to ensure the fairness of the price. See, e.g., *In the Matter of Goldman Sachs Trust*, Investment Company Act Release Nos. 24834 (Jan. 23, 2001) (notice) & 24877 (Feb. 21, 2001) (order); see also Mercer Bullard, *Another Chink in the Wall: SEC Grants Self-Dealing Exemption to Goldman Funds*, TheStreet.com (Mar. 1, 2001) at <http://www.thestreet.com/funds/mercerbullard/1325120.html>.

<sup>6</sup> See Investment Company Act Rule 17a-9 (requiring adviser's purchase of ineligible security from money market fund to be effected at higher of amortized cost or market price).

notice and consent. Section 206(3)'s requirement for written disclosure is arguably more protective, however, because a writing is more likely to draw the client's attention to the matter and easier to evaluate for compliance purposes. But oral consent on a transaction-by-transaction basis also is likely to draw the client's attention to the adviser's principal capacity, and we assume that the Commission will expect advisers to keep an internal record of orally obtained consent.

Another difference is that Section 206(3) requires notice that the adviser "is acting" as principal, whereas the Rule requires disclosure of the capacity in which the adviser "may" act. It is possible that the less conclusive posture of the notice under the Rule will make clients less attentive to the issue, or it might make no difference. This is one of many areas of the rule that would benefit from the kind of testing of disclosure effectiveness that the Commission conducted in evaluating the effectiveness of the disclosures required under the fee-based brokerage account rule. If the Commission should decide to rely heavily on a disclosure and consent model of regulation, we strongly urge that it do so only after having assured through testing that such an approach would provide effective investor protections.

Another concern might be that advisers would provide notice that the adviser "may" act as principal prior to execution of every transaction. In other words, the same, presumably standardized communication in which the adviser obtains the client's consent to the trade (the Rule being available only for nondiscretionary accounts) would include an equally standardized statement that the adviser may act as principal. Such routine disclosure probably would not draw the client's attention to the principal capacity issue as successfully as Section 206(3)'s specific notice that the adviser "is acting" as principal, because only principal trades would include such disclosure. Also, Section 206(3)'s requirement of a writing, when consent to the trade can be obtained orally, increases the likelihood that the client would receive an independent communication. Of course, if the impracticability of complying with Section 206(3) leads advisers simply to forego principal trades, then the relevant comparison arguably would be between a world in which there were no principal trades to one in which clients received notice and granted consent under circumstances that were not ideally suited to drawing the client's attention to the principal trading issue. (As discussed further below, neither would the Rule's blanket consent requirement draw clients' attention to the issue.)

We agree that it would be appropriate to permit oral notice and consent as an alternative to Section 206(3)'s requirements, provided that the risks attendant upon principal trades are adequately addressed in other ways. First, our position is contingent on policies and procedures similar to those describe above being required of advisers that rely on the Rule. Second, blanket consent must actually alert the client to the potential for principal trading abuses (as discussed further below). Finally, as discussed above, the Commission must clarify that the Rule does not necessarily exhaust an adviser's disclosure obligations under general antifraud and fiduciary principles and that these obligations may require disclosure beyond that which satisfies the four corners of the Rule.

## Blanket Consent and Disclosure

The Rule requires that advisers obtain written, prospective consent to engage in principal transactions, and the Commission suggests that advisers could satisfy this requirement by including applicable disclosures in the account-opening agreement. We strongly believe that this disclosure will not provide meaningful notice or produce informed consent unless it is set forth in a separately executed, independent document. The Commission repeatedly notes the importance of alerting clients to the particular conflicts of interest raised by principal trades, yet the current Rule would allow advisers to bury the blanket consent and disclosure among pages of legalese and minutiae. Failure to strengthen this requirement would make the Rule's promise of informed consent meaningless.

## Confirmation Disclosure

The Interim Rule requires that the transaction confirmation include a conspicuous statement that the adviser previously disclosed that it might act as principal, and that it did act as principal. While we appreciate the SEC's desire to draw the client's attention to principal capacity in which the adviser acted, we doubt that the benefits of the Rule's confirmation disclosure would outweigh the cost of revising and further burdening the confirmation. We believe these protections could be better provided through the more protective approach to prior consent we have outlined above. Disclosing to the client that the possibility of the adviser's principal capacity was previously disclosed and that adviser actually did act as principal, after the transaction has been completed, probably provides little additional benefit, if separate written blanket consent and oral transaction-by-transaction consent has been obtained, and an annual summary is delivered.

## Discretionary Accounts

The Rule is generally unavailable for discretionary accounts on the ground that:

the risk of relaxing the procedural requirements of section 206(3) of the Advisers Act when a client has ceded substantial, if not complete, control over the account raises significant risks that the client will not be, or is not in a position to be, sufficiently involved in the management of the account to protect himself or herself from overreaching by the adviser.

Release at 17. We agree that discretionary accounts present greater risk of abuse as a general matter, and we appreciate the steps of the Commission has taken here to provide extra protections for those accounts. However, if the Rule required separate, independently executed, prospective blanket consent; an annual summary; **and** policies and procedures designed to deter, detect and prevent principal trades that are disadvantageous to clients, it might be appropriate to consider allowing principal trading in discretionary accounts under the Rule. Such an approach would minimize the risk that the Rule's disparate treatment for discretionary accounts will distort advisers' incentives when deciding whether to offer discretionary or non-discretionary services and encourage

gamesmanship by advisers to fit their discretionary accounts within the “temporary” and “limited” exceptions (which we believe are highly susceptible to abuse).

### Broker-Dealer Registration Requirement

The Interim Rule requires that the adviser be registered as a broker-dealer in order to rely on its provisions. While this may reflect the fact that the Rule was developed specifically to address the transition of fee-based brokerage accounts to advisory accounts, it implies that there are broker-dealer requirements that are applicable to principal trades to which an adviser would not otherwise be subject. We believe that this also improperly implies that there are gaps in the fiduciary requirement that advisers act solely in the best interests of their clients. If the Commission believes that registered broker-dealers are subject to specific obligations that would not be subsumed under this fiduciary standard – *i.e.*, that require that broker-dealers maintain a higher standard than acting solely in their client’s best interests – then it should identify them so that the Commission’s position can be openly debated. We note that the Commission cannot make the case simply by listing formal rules by which advisers are not technically bound. The Commission must identify practices in which an adviser could engage that would otherwise be impermissible for a registered broker-dealer. Indeed, creating formal rules to address conduct already covered by fiduciary standards can undermine those standards when acting in a client’s best interests requires a higher standard than that required by the Rule, or when conduct that satisfies the four corners of the Rule nonetheless violates an adviser’s fiduciary obligations. As the Commission is aware, financial services firms do not hesitate to defend against anti-fraud and fiduciary violations on the ground that an applicable rule has been satisfied.

### Other Matters

Regarding other aspects of the Interim Rule, we agree that the delivery of an annual summary would materially enhance investor protection. The annual summary will provide a record that separately identifies actual principal transactions in the aggregate and thereby represents a different and useful way to alert clients to the special conflicts that principal trades present.

We also agree that principal trades in securities issued or underwritten by the adviser or its affiliates should not be exempt from Section 206(3). Securities issuances and underwritings create the greatest risk of dumping securities, and the absence of a readily available market price for such securities further enhances this risk. We disagree, however, that nonconvertible investment grade debt securities should be excluded from this carve-out. It is simply counter-factual to assert that such securities present a materially lower risk of abuse. The 21<sup>st</sup> century has been rife with instances in which rating agencies have grossly miscalculated the risk presented by securities, and most recently debt instruments. It simply is not accurate that such securities are always easier to price, as this assumes a liquid market. The Commission seems to base its position on the nature of the market and the potential difficulties that clients otherwise may encounter

if the Rule is unavailable.<sup>7</sup> See Release 21. Yet it is precisely these market characteristics that increase the risk of principal trading abuses. The debt securities exclusion should be removed.

## Conclusion

We appreciate the practical problems created by Section 206(3)'s written notice and consent requirement and support the SEC's view that appropriate exemptive rule can be fashioned that is consistent with the protection of investors. The Interim Rule lacks important elements, however, that are necessary to prevent the principal trading abuses that Congress drafted Section 206(3) to address. We hope that the Commission will consider carefully whether the Rule as written will be effective at preventing such abuses, as opposed to simply making advisory clients aware that they may occur, and will adapt appropriate provisions as outlined above to strengthen its protections.

Respectfully submitted,

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Fund Democracy

Barbara Roper  
Director of Investor Protection  
Consumer Federation of America

cc: (U.S. Mail only)

The Honorable Christopher Cox  
The Honorable Paul S. Atkins  
The Honorable Kathleen L. Casey  
The Honorable Annette L. Nazareth  
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<sup>7</sup> We note that here, as in many places in the Release, the Commission blames the *FPA* decision for creating the need for exemptive relief. See Release at 21. For example, the Commission states that fee-based brokerage accounts became subject to the IAA “[a]s a consequence of the *FPA* decision.” Release at 4. This is inaccurate, inappropriate and self-serving. The *FPA* decision held that the broker rule exceeded the SEC's legal authority, which had the affect of making the Act applicable to fee-based accounts. Thus, it is the applicability of the Act to fee-based accounts that provides the impetus for the Interim Rule, not the *FPA* decision. Indeed, had the Commission correctly interpreted the Act in the first place, it could have promulgated principal trading relief years ago and thereby avoided the wrenching transitions that its ill-considered strategy has fostered.