National Association of Personal Financial Advisors

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Via Electronic Filing

December 20, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: **File No. S7-23-07: Release No. IA-3118, "Temporary Rule Regarding Principal Trades with Certain Advisory Clients"**

Re: **File No. 4-606: Study Regarding Obligations of Brokers, Dealers, and Investment Advisers**

Dear Ms. Murphy:

The National Association of Personal Financial Advisors (NAPFA)[1] is pleased to offer its views as the U.S. Securities and Exchange Commission considers whether to extend the Temporary Rule regarding principal trades with certain clients of investment advisers.[2] While NAPFA appreciates the Commission's efforts to protect the interests of investors, we believe that the Temporary Rule reflects an over-reliance upon disclosure as a means of meeting a fiduciary's legal obligations to its clients, that the benefits of the Temporary Rule are largely illusory, and that the risks to consumers posed by the continuation of the Temporary Rule remain substantial.

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[1] The National Association of Personal Financial Advisors is the nation's leading organization of Fee-Only comprehensive financial planning professionals. Since 1983, NAPFA's members have operated under a strict Code of Ethics, with each member adopting a Fiduciary Oath and adhering to our widely recognized definition of Fee-Only compensation. NAPFA members are trusted, objective financial advisors for consumers and institutions alike. NAPFA's over 1,400 NAPFA-Registered Financial Advisors are nearly all representatives of registered investment advisory firms. Each member of NAPFA believes that bona fide fiduciary standard of conduct is vital to ensuring that the best interests of the client remains paramount at all times during the course of the advisor-client relationship.

[2] SEC Release No. IA-3118, located at http://sec.gov/rules/proposed/2010/ia-3118.pdf, proposes to amend rule 206(3)-3T under the Investment Advisers Act of 1940, a temporary rule that establishes an alternative means for investment advisers who are registered with the Commission as broker-dealers to meet the requirements of section 206(3) of the Investment Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients. The Proposed Rule would extend the date for sunset of the rule for an additional two years, from Dec. 31, 2010 to Dec. 31, 2012. Rule 206(3)-3T was originally adopted in September 2007, with the understanding that it would sunset at the end of 2008. *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Release No. IA-2653 (Sep. 24, 2007) (Sep. 28, 2007)] ("2007 Principal Trade Rule Release").

<u>NAPFA's Recommendations.</u> NAPFA questions whether the Temporary Rule – which was designed to permit a *limited* expansion of principal trading by dual registrant firms as to their investment advisory clients – has been utilized instead as a means to engender substantial profits for broker-dealer firms, to the detriment of the clients of dual registrants. Accordingly, NAPFA recommends to the Commission the following:

1. ***<u>Don't Extend the Temporary Rule.</u>*** In response to the question posed in Release IA-3118, as to the appropriateness of extending, rule 206(3)-3T yet again, well beyond the original trial period (Sept. 2007 thru Dec. 2009), NAPFA opines that there is no substantial evidence that the Temporary Rule actually benefits clients of investment advisers. Given the substantial risks present to clients due to the major conflicts of interest posed in connection with principal trading, NAPFA recommends that rule 206(3)-3T should be permitted to expire. Additionally, NAPFA recommends to the Commission's Division of Investment Management that it deny all individual applications for exemptive orders that would provide for similar alternative means for compliance with Section 206(3), should rule 206(3)-3T be permitted to expire.

2. ***<u>If the Rule is Extended, Require Broker-Dealer/RIA Firms Who Rely Upon the Temporary Rule to Adopt Better Policies and Procedures, Including Chinese Walls, and Extend the Rule for Only One Year.</u>*** Should the Commission choose to extend the Temporary Rule:

    a. NAPFA recommends that the Commission's Division of Investment Management should require dual registrant firms to adopt better policies and procedures, not later than January 31, 2011, including the establishment of a solid Chinese Wall, in order to better ensure that the fiduciary obligation to maintain the client's interests paramount at all times is better applied.

    b. NAPFA further suggests a mid-2011 sweep examination of dually registered firms be undertaken by the Commission's Office of Compliance, Inspections, and Enforcement (OCIE), to ensure that strict observance occurs with respect to a fiduciary's obligations to its clients with respect to all principal trades to investment advisory clients.

    c. NAPFA suggests the OCIE also examine, in connection with that sweep examination, whether dual registrants are attempting to avoid the requirements of Section 206(3) of the Advisers Act, and the requirements of rule 206(3)-3T, by improperly characterizing many accounts as "brokerage accounts" rather than "investment advisory accounts" in situations where it is apparent that the investment advice provided is more than "merely incidental" or "solely incidental" to sales transactions.

    d. Additionally, NAPFA suggests that a true fiduciary investment adviser would not usurp the opportunity presented in aggregating trades of its clients and effecting such trades on an agency basis, in order to obtain better pricing for them by means of greater purchasing power. NAPFA recommends that the Commission explore whether dual registrants who possess sizeable volume in bond purchases have adequately fulfilled their fiduciary duties, in this regard.

Principal Trading and the Advisers Act, Generally.

By the SEC's own admission,[3] "transaction-by-transaction … written disclosure and consent" by the client is required under Section 206(3) of the Advisers Act.[4] A long history of interpretation of Section 206(3) by the SEC indicates that blanket disclosures and consent are inadequate.[5]

The "ultimate goal" of Section 206(3) is to "prevent trades which are disadvantageous to clients of fiduciary advisors."[6] As NAPFA has previously opined[7] to the Commission its view, derived from the practical knowledge of thousands of financial advisors engaged with clients every day as well as a substantial body of academic evidence,[8] in today's much more complex financial world in which there exists a substantial and ever-growing knowledge gap between securities industry representatives and consumers,[9] and that financial literacy efforts[10] and disclosures[11] have largely proven ineffective to protect consumer interests.

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[3] SEC Rel. IA-3118, p. 6. "Section 206(3) requires, among other things, transaction-by-transaction disclosure to, and consent by, the client prior to the completion of each principal transaction …." *See* Opinion of Director of Trading and Exchange Division, Investment Advisers Act Release No. 40 (Feb. 5, 1945).

[4] Section 206 of the Advisers Act provides in pertinent part: "It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly— (3) **acting as principal for his own account**, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client **in writing** **before the completion of such transaction** the capacity in which he is acting and **obtaining the consent of the client to such transaction**. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction …."

[5] *See Commission Interpretation of Section 206(3) of the Investment Advisers Act of 1940*, SEC Release No. IA-1732 (July 17, 1998) ("[A]n adviser may comply with Section 206(3) either by obtaining client consent prior to execution of a principal or agency transaction, or after execution but prior to settlement of the transaction."). *See also* Release No. No. IA-40 (Jan. 5, 1945) ("[T]he requirements of written disclosure and of consent contained in this clause must be satisfied before the completion of each separate transaction. A blanket disclosure and consent in a general agreement between investment adviser and client would not suffice.").

[6] Comment letter of Mercer Bullard, Founder and President, Fund Democracy, and Barbara Roper, Director of Investor Protection, Consumer Federation of America, Nov. 30, 2007, available at http://sec.gov/comments/s7-23-07/s72307-18.pdf, at p.1.

[7] Comment Letter of William T. Baldwin, CFP®, 2009-10 Chair of NAPFA, Ellen Turf, CEO of NAPFA, and Susan MacMichael John, CFP®, Chair of NAPFA's Industry Issues Committee (and 2010-1 Chair of NAPFA), regarding the Section 913 Study, dated August 30, 2010 (and located at http://sec.gov/comments/4-606/4606-2514.pdf) (hereafter "NAPFA Aug. 30, 2010 Comment Letter").

[8] *See* the many citations found in the NAPFA Aug. 30, 2010 Comment Letter.

[9] *See* NAPFA Aug. 30, 2010 Comment Letter at pp.9-11.

[10] *See* NAPFA Aug. 30, 2010 Comment Letter at pp.12-13.

[11] *See* NAPFA Aug. 30, 2010 Comment Letter at pp.14-17, and stating in part: "The SEC's emphasis on disclosure, drawn from the focus of the 1933 and 1934 Securities Acts on enhanced disclosures, results from the myth that investors carefully peruse the details of disclosure documents that regulation delivers. However, under the

To overcome the effectiveness of disclosures and for substantial reasons of public policy,[12] the fiduciary principle requires much more than just disclosure. Rather, it requires proper observance to the fiduciary's duty of due care, as well as the fiduciary's duties of loyalty and utmost good faith, to ensure that the client's interests are well represented and protected. The fiduciary principle requires the investment adviser "to adopt the [client's] goals, objectives, or ends"[13] as the adviser's own.

When engaging in principal trades, the dual registrant is wearing two hats – in itself a violation of the fiduciary principle that should not be encouraged by relaxation of the very limited exception provided by Section 206(3) of the Advisers Act. Indeed, very early decisions applying the Advisers Act illustrate the fiduciary principle and highlight the requirements of fiduciary requirements when a fiduciary acts with respect to its own account:

> It is well settled that a fiduciary, as, for example, an agent, who sells his own property to his principal must disclose his cost to the principal so that the principal will know what profits the fiduciary will realize by effecting the transaction.[14]
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> [An agent must disclose not only that he] is acting on his own account, but also all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction from the viewpoint of the principal [including] the price paid by the agent for the property which he sells to the principal . . . and the price he receives for the property he buys from the principal.[15]
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> Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients.[16]

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scrutinizing lens of stark reality, this picture gives way to an image of a vast majority of investors who are unable, due to behavioral biases and lack of knowledge of our complicated financial markets, to comprehend the disclosures provided yet alone to undertake sound investment decision-making." [Citations omitted.]

[12] These public policy reasons include, but are not limited to, the reduction of transaction costs where monitoring costs are high through shifting of such certain oversight costs to agencies of the government, reliance upon market forces for monitoring are largely ineffective, the encouragement of specialization in today's modern society, the promotion of trust in our capital markets system, the importance to Americans and to America itself of ensuring proper financial and investment decision-making, and the encouragement of individuals to engage in a profession under the fiduciary principle. See NAPFA Aug. 30, 2010 Comment Letter at pp.17-23.

[13] Laby, Arthur B., "The Fiduciary Obligation as the Adoption of Ends," Buffalo L. Rev 99, 103 (2008), available at available at: http://ssrn.com/abstract=1124722.

[14] *Arleen W. Hughes*, 27 S.E.C. 629, 635 (1948), *aff'd sub nom*., *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949). In *Arleen W. Hughes* the Commission found that a registered broker-dealer who was also a registered investment adviser violated the antifraud provisions of the securities laws by executing principal trades with her customers without disclosing fully the nature and extent of her adverse interest. Although the registrant had disclosed her principal status in her written agreement with her customers, the SEC determined that such disclosure was inadequate to alert the customers to the potential conflict of interest. The Commission stated: "[I]f registrant chooses to assume a role in which she is motivated by conflicting interests …. she may do so if, but only if, she obtains her client's consent after disclosure not only that she proposes to deal with them for her own account but also of all other facts which may be material to the formulation of an independent opinion by the client as to the advisability of entering into the transaction." *Hughes*, 27 S.E.C. at 637.

[15] *William J. Stelmack Corporation*, 11 S.E.C. 601, 618 (1942).

[16] *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 194 (1963).

In the more recent case of *Geman vs. SEC*, the view of the SEC was set forth again:

> As the Commission has said here, 'when a firm has a fiduciary relationship with a customer, it may not execute principal trades with that customer absent full disclosure of its principal capacity, as well as all other information that bears on the desirability of the transaction from the customer's perspective' … Other authorities are in agreement. For example, the general rule is that an agent charged by his principal with buying or selling an asset may not effect the transaction on his own account without full disclosure which 'must include not only the fact that the agent is acting on his own account, but also all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction, from the viewpoint of the principal.'[17]

Additionally, the requirements of fiduciary law and Section 206(3) are informed not only by the Commission's prior decisions, but also by state common law.[18] Fundamentally, a principal trade is "self-dealing" – a form of conflict of interest where the fiduciary attempts to wear two hats – one in which it represents the dealer's interest and determines whether to purchase or sell a security to/from the dealer's inventory, and the other in which it attempts to represent the client's interest. The high degree of caution which must be employed in such situations was highlighted by one state court:

> One of the most stringent precepts in the law is that a fiduciary shall not engage in self-dealing and when he is so charged, his actions will be scrutinized most carefully. When a fiduciary engages in self-dealing, there is inevitably a conflict of interest: as fiduciary he is bound to secure the greatest advantage for the beneficiaries; yet to do so might work to his personal disadvantage. Because of the conflict inherent in such transaction, it is voidable by the beneficiaries unless they have consented. Even then, it is voidable if the fiduciary fails to disclose material facts which he knew or should have known, if he used the influence of his position to induce the consent or if the transaction was not in all respects fair and reasonable.[19]

The 2007 Adoption of the "Temporary" Rule. Upon this strict legal foundation the Temporary Rule was adopted in September 2007. The limited "purpose of the rule was to permit broker-dealers to sell to their advisory clients … certain securities held in the proprietary accounts of their firms that might not be available on an agency basis — or might be available on an agency basis only on less attractive terms — while protecting clients from conflicts of interest as a result of such transactions."[20]

It should be noted that Rule 206(3)-3T did not exist prior to 2007, nor was there any need for the rule for nearly six decades - from 1940 until the late 1990's, when fee-based brokerage accounts appeared. There exists no evidence that the markets have changed which would warrant the

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[17] Geman v. SEC, 334 F.3d 1183, 1189 (2004).

[18] *See U.S. v. Brennan*, 938 F.Supp. 1111 (E.D.N.Y., 1996) ("Other spheres in which the existence and scope of a fiduciary duty are matters of federal concern are ERISA and § 523(a)(4) of the Bankruptcy code. The analysis under each of these statutes continues to be informed by state and common law.")

[19] *Birnbaum v. Birnbaum*, 117 A.D.2d 409, 503 N.Y.S.2d 451 (N.Y.A.D. 4 Dept., 1986).

[20] SEC Release IA-3118, at p.3.

adoption of the new rule. In fact, the only thing that has changed is the increased appetite of broker-dealer firms to engage in principal trading, and the higher profits which generally result from such principal trading activities when contrasted with agency trading.[21] Hence, from all accounts the primary motivation behind broker-dealer firms' seeking "annual blanket consent"[22] from clients to principal trading is the increased profits of the firms, at the expense of their investment advisory clients.

Rule 206(3)-3T relaxes the limited circumstances, based upon established precedent, in which principal trading was permitted between a dual registrant, occupying a fiduciary position, and its clients. Perhaps the most significant element of the Temporary Rule is that a client's written consent to principal trades may be given prospectively. While client consent will still be required on a trade-by-trade basis, such consent may be given orally provided the requisite written consent has previously been obtained.

Moreover, the Commission's rationale for relaxation of the requirements of Section 206(3) were in large part the result of the transition then occurring from fee-based brokerage accounts to investment advisory accounts,[23] and broker-dealer's worries regarding the effects of such transition – a dynamic, one-time transitional situation which no longer exists.

The Illusory Benefits of Rule 206(3)-3T.

NAPFA believes that the Commission's argument for expansion of relief from the principal trading restrictions of the Advisers Act is fundamentally at odds with the Commission's mandates to protect the interests of consumers and to preserve the integrity of the capital markets.

One alleged "benefit" of the Temporary Rule is that it provides the "protections of the sales practice rules of the Securities Exchange Act of 1934 … and the relevant self-regulatory organizations." Yet, *the Commission does not possess any mandate to preserve conflict-ridden sales practices, nor to preserve any business model which has become outmoded through the process of time*. The Investment Advisers Act of 1940 The Commission should not seek to protect a broker-dealer firm's ability to generate profits at the expense of their customers, especially where that customer is in a relationship of trust and confidence with a firm possessing status as a fiduciary.

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21 As NAPFA stated in its comment letter to the SEC on this issue, dated Nov. 20, 2007, "We remain concerned that the real reason behind calls for principal trading relief is to preserve the profits of Wall Street firms at the expense of individual investors."

22 While the Temporary Rule still requires transaction-by-transaction consent, albeit verbal consent would be permitted, many broker-dealer firms appear to have misinterpreted the Rule as one permitting "annual blanket disclosure." This terminology was utilized in a recent article exploring the Commission's current proposal. Bingham newsletter, Dec. 6, 2010, "SEC Proposes Extension of Rule 206(3)-3T Blanket Consents for Principal Trades in Non-Discretionary Advisory Accounts," available at http://binghamstrategicadvisors.com/Media.aspx?MediaID=11614.

23 In April 2005, the SEC had adopted Rule 202(a)(11)-1 under the Advisers Act, which, subject to several conditions, exempted from regulation under the Advisers Act (including the principal trading restrictions thereunder) broker-dealers that provide incidental investment advisory services and receive fee-based compensation. However, the U.S. Court of Appeals for the District of Columbia Circuit vacated Rule 202(a)(11)-1 in *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. Mar. 30, 2007).

Another stated "benefit" of the rule is that non-discretionary advisory clients of advisory firms that are also registered as broker-dealers have easier access to a wider range of securities which, in turn, should continue to lead to increased liquidity in the markets for these securities. However, there is no credible evidence that this situation exists. The only "evidence" that has been supplied are the non-academic and conflicted assertions by the very broker-dealer firms that would benefit from the relaxation of the requirements of Section 206(3).[24] Rather, it is logical that broker-dealer firms would not have argued so extensively for a relaxation of the requirements of Section 206(3) unless such broker-dealer firms would have substantially benefitted, themselves, in their ability to secure greater profits, by a relaxation of the statute's long-standing requirement of written consent.

Another alleged "benefit" of rule 206(3)-3T include that it "maintains investor choice." Yet, there has been no credible, evidence submitted by any organization that the requirement of written consent (a requirement which existed for nearly seven decades) has impeded investor choice. A movement toward "blanket consent" should not occur with such reckless abandonment of the fiduciary principle of *informed consent*. Indeed, absent from the Commission's Temporary Rule was the emphasis, as would have been expected, that clients must nevertheless be informed of *all material facts* regarding the proposed principal transaction. Moreover, "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."[25]

The Commission opines that the Temporary Rule will "promote capital formation." Yet, in reality, the promotion of capital formation is impeded with each relaxation by the Commission of the requirements of fiduciary law, as more numerous and more severe violations occur of the trust placed by individual investors in their trusted investment adviser. Breaches of trust and the fiduciary duty of advisers, so likely to result from principal trades in which a serious

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[24] "[F]irms informed our staff that the written disclosure and the client consent requirements of section 206(3) act as an operational barrier to their ability to engage in principal trades with their clients. Firms that are registered both as broker-dealers and investment advisers generally do not offer principal trading to current advisory clients (or do so on a very limited basis), and the rule vacated in the FPA decision had allowed broker-dealers to offer fee-based accounts without complying with the Advisers Act, including the requirements of section 206(3). Most informed us that they plan to discontinue fee-based brokerage accounts as a result of the FPA decision because of the application of the Advisers Act. They also informed us of their view that, unless they are provided an exemption from, or an alternative means of complying with, section 206(3) of the Advisers Act, they would be unable to provide the same range of services to those fee-based brokerage customers who elect to become advisory clients and would expect few to elect to do so." SEC Rel. No. IA-2653 (Sept. 24, 2007), at p.7.

[25] Comment letter of Fund Democracy and Consumer Federation of America, *supra* n.__, at p.2. ["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 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."] *Id.* at pp.2-3.

conflict of interest both exists and is highly likely to be capable of proper management, "shakes people's faith in the market and their ability to rely upon investment advisors."[26]

<u>The Apparent Substantial Non-Compliance by Firms with the Temporary Rule – A Cause for Great Concern.</u>

The Commission opined that it "believe[s] 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 of time …."[27]

Yet, as the Commission also noted, it is clear that firms are <u>not</u> complying with their fiduciary obligations to their investment advisory clients:

A. The Office of Compliance Inspections and Examinations "observed instances in which transactions in underwritten securities were not identified as being executed in a principal capacity, even when these securities passed through a firm's inventory."[28] This would be a gross violation of the fundamental obligation of disclosure, which arises when a conflict of interest is present and all material facts regarding the conflict of interest and its potential ramifications to the client are not disclosed to the client of a fiduciary in a timely manner, in advance of the transaction.

B. The Office of Compliance Inspections and Examinations also uncovered that various firms "did not provide disclosures or provided disclosures that appeared to be potentially confusing, misleading, or incomplete."[29] Again, not providing disclosures required of firms in connection with principal trading would negate any possibility of informed consent, thereby leading to a breach of the firm's fiduciary duty. Moreover, providing confusing, misleading and incomplete disclosures appear to indicate a loose culture of compliance within firms seeking to rely upon the Temporary Rule.

C. The Office of Compliance Inspections and Examinations "observed instances in which firms executed principal transactions in reliance on rule 206(3)-3T in securities that were ineligible for trading pursuant to the rule."[30] The fact that systems were

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[26] *See DeRance, Inc. v. PaineWebber Inc.*, 872 F.2d 1312, 1328 (C.A.7 (Wis.), 1989) ("The conduct at issue here, breach of fiduciary duty and fraud both by omission and commission, not to mention defendant's violation of both the law and their own policies governing such accounts, is very serious indeed. Such activity shakes people's faith in the market and their ability to rely upon investment advisors, and demands heavy punishment.")

[27] SEC Rel. IA-3118, p.6.

[28] SEC Rel. IA-3118, fn.18, at p.7

[29] As noted in SEC Rel. IA-3118, fn. 21, on p. 8: "Such observations were made with respect to prospective written disclosures, transaction-by-transaction disclosures, and client annual reports. For example, the staff observed instances in which firms placed limitations on clients' ability to revoke their permission to execute transactions on a principal basis. The staff also observed instances in which annual summary reports were not sent to clients or were incomplete."

[30] SEC Rel. IA-3118, fn. 18, at p.7.

not established, as has been common in broker-dealer firms for decades, to prevent ineligible principal transactions, and contrary to express instructions from the Commission, should be a cause for great alarm.

Other violations were also detected.[31]

While we share the Commission's concerns about the compliance issues observed by the Office of Compliance Inspections and Examinations, NAPFA's reaction is not one in which "continued monitoring" is recommended, but rather one of shock and dismay. If these violations are systemic or broad, which appears to be the case as referrals have been made to the Commission's Division of Enforcement, the mere existence of these violations provides more than ample reason to not extend the Temporary Rule.

It is difficult to assess, without better disclosure by the Commission, the extent of these breaches of fiduciary duties in connection with principal trades in which firms relied upon the Temporary Rule. Hence, we call upon the Commission to publicly release the full results of the Office of Compliance Inspections and Examinations' findings, as to broker-dealer firms' compliance with the provisions of law in connection with principal trades. Increased transparency has been a central theme of securities regulatory reform efforts over the past year, and such transparency should serve to illuminate the particular problems OCIE has detected and permit commentators to more fully respond to the Commission with regard to its proposals.

While the Commission recites the January 2011 date for completion of the study, it is highly unlikely that the need for further extensions of the "Temporary" Rule will not be required. Given the substantial non-compliance by broker-dealer firms with their fiduciary obligations in connection with principal trades arising under the Temporary Rule, NAPFA believes the time is now to terminate this ill-advised experiment, and restore to investors the protections afforded by written transaction-by-transaction notice of principal trades.

Generally, The Inherent Dangers of Principal Trades.

The specific potential problems with principal trades include (but are not limited to):

1. dumping securities no longer desired to be held by the broker into clients' accounts;
2. achieving a fair price for the principal transaction, especially when other similar investments may be less costly; and
3. engaging in principal trades with a client leads to erosion of trust in the relationship between the firm and its client.

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[31] *See* SEC Rel. IA-3118, at pp.7-8.

Dumping – Difficult to Detect. "Dumping" is one of the particular concerns underlying section 206(3) of the Advisers Act. As the Commission stated, the 1940 "Congress was concerned that advisers might use advisory accounts to 'dump' unmarketable securities or those the advisers fear may decline in value."[32]

While the Commission's examiners have not found any evidence of dumping,[33] this could be because the practice of dumping securities is extremely difficult to detect – especially if a Chinese Wall and/or other policies and procedures sufficient to protect investors have not been put in place. Fundamentally, a dealer who maintains an inventory does so with a profit motive – the dealer seeks to hold securities which it believes may be underpriced, and it seeks to sell securities which it believes are overpriced, or where it believes the price may fall. Without a wholesale review of all of the records of the dealer, as to why it has undertaken decisions to sell a security (which decisions are rarely recorded, and even if they were recorded such records could easily be written to list false reasons for decisions made), there is no way to detect dumping which may be going on. NAPFA does not believe that the Commission should place undue emphasis on not detecting dumping, given the difficulty of detecting same, and especially given serious violations by broker-dealers of other aspects of their fiduciary obligations.

Establishing a Fair Price in the Principal Trade – Nearly Impossible, In Most Instances. It is also apparent that the Temporary Rule's assumption that a dealer can determine a fair price is no longer valid, at least with respect to many of the securities in which principal trading is permitted by the Temporary Rule.

The Temporary Rule assumes that securities such as municipal bonds are easy to price. Since the adoption of the Temporary Rule in September 2007, the secondary market for municipal bonds, in particular, has dramatically changed. Pricing may have been relatively easy when most municipal bonds were backed by insurance from insurers with substantial capital. Yet, following the financial crisis, it is widely known among investment advisers that bond insurers lack the capital to meet their many obligations. Moreover, few investment advisers now rely upon the ratings of municipal bond issuers provided by credit rating agencies, given their recent dismal record of evaluating the worthiness of securities.

Instead, a much greater amount of due diligence is required of the investment adviser who engages in advising clients on purchases of individual municipal bonds. Such due diligence will often include the investment adviser's own assessment of the financial stability of the issuer.

Before the financial crisis, "AAA-rated, insured municipal bonds" were largely able to be contrasted with each other, in terms of price, despite the fact that many of the issues traded very infrequently. As exists both then and now, it is not uncommon to see municipal bond issues

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[32] SEC Rel. IA-3118, fn.17, at p.7.

[33] SEC Rel. IA-3118, p.7.

that trade only once every few months, or even less often. The ability to accurately determine a fair price assumes a liquid market, or some other device, such as the ability to compare bonds of similar maturity and the same credit quality.

Yet, now, in the absence of meaningful protections afforded to investors in municipal bonds by muni bond insurers, determine the fair pricing of municipal notes and bonds – even when contrasted with securities of identical maturity – has become much more complex. In essence, determining a "fair price" in this highly illiquid market, where the financial strength of issuers varies widely and changes frequently, is no longer possible. As a result, one of the underlying assumptions behind the Temporary Rule no longer exists.

The Erosion of Trust by Particular Exceptions. The fiduciary principle is based upon trust. A fiduciary requests the client to repose trust in the fiduciary throughout the term of the relationship. This trust has several components:

First, the client is to trust the fiduciary as an expert. In the context of trading securities as the representative of the purchaser, this means that the client expects of the fiduciary investment adviser that the adviser will scrutinize the quality of the security, through a due diligence process in which independent and knowledgeable analysis is undertaken, prior to recommending same. Failure to undertake such due diligence would constitute a breach of the investment adviser's duty of due care.

Second, the client is to trust the fiduciary to act in the client's interest, not the interest of the adviser. Yet, in the instance of principal trading, the adviser as seller establishes the price, and the adviser as purchaser's representative accepts the price – a fundamental wearing of "two hats" resulting in a most serious conflict of interest. The existence of such a conflict of interest should not be encouraged by the Commission's relaxation of the requirements long ago applied under Section 206(3). This is especially true given the existence of academic research revealing that maintaining conflicts of interest results in biased advice which is nearly always poor advice, and that disclosures are ineffective to both negate the bias of the advisor or to enable the client to protect himself or herself. Without full and complete disclosure of all material facts prior to the execution of the transaction in a manner which would ensure understanding of the aspects of the transaction by the client, and without the *informed* consent of the client, the fiduciary adviser cannot proceed with a principal trade. To do otherwise would be a clear violation of the investment adviser's duty of loyalty.

Third, the client expects honesty from the fiduciary at all times. Complete candor, and with regard to principal trades wherein a conflict of interest is necessarily present, complete disclosure of *all material facts* is required. Such facts include, but are not limited to: (1) the profit, if any, made by the broker-dealer in connection with the trade; (2) the results of the due diligence conducted by the investment adviser, such as with respect to credit quality of a municipal bond; (3) the recent trades which occurred in the security, and the prices of such trades; (4) how a fair price was established by the broker dealer; and (5) whether there exists any motivation, of any kind, the fiduciary possesses to either sell the security to the client or purchase the security from the client, and the details as to that motivation. Prior decisions of the Commission and prior case law can be reviewed by Commission staff which will reveal other material facts which are required to be disclosed. The failure to disclosure all material facts, and any negative ramifications of the principal trade upon the client, would be a violation of the investment adviser's fiduciary duty of utmost good faith.

There is no profession more dependent upon trust than that of the investment adviser. As fiduciaries, investment advisers are stewards of their clients' life savings – a major responsibility which should not be taken lightly – by either the investment adviser or by the Commission. This is especially true given the much more complex financial world of today, and the erosion of trust between the American public and the securities industry which occurred in large part due to principal trading by investment banks and broker/dealer firms.

NAPFA is concerned that the Commission, in its 2007 adoption of the Temporary Rule, and since then, did not adequately stress to firms all of the requirements imposed by law in connection with principal trading, which requirements arise out of the fiduciary relationship. Moreover, throughout the last decade or two, the Commission has apparently pursued a course in which it refused to apply the requirements of fiduciary law upon relationships based upon trust and confidence, permitted the use of titles denoting relationships of trust and confidence while permitting broker-dealer firms to deny that fiduciary obligations existed, and has sought through rule-making to provide particular exceptions to fiduciary obligations (as it does by the proposed extension of this Temporary Rule).

Where will this end up? Should the Commission continue down this path, in which fiduciary standards of conduct are minimized or eroded, or redefined by the Commission as a much lesser standard of conduct requiring only casual disclosure of the existence of a conflict of interest, the ramifications for investment advisers, for all Americans, for America itself, and for the Commission, are quite severe:

(1) Fiduciary law will suffer across many different contexts. As the late Justice Benjamin Cardoza warned in *Meinhard v. Salmon* over eight decades ago, neither fiduciary law nor the Advisers Act's fiduciary standard should be undermined by the "disintegrating erosion of particular exceptions."

(2) Investment advisers will no longer be entrusted by clients. As more and more conflicts of interest are permitted, and as "casual disclosure" replaces timely and full disclosure of all material facts in a manner designed to ensure full understanding (and with the client's informed consent secured), clients will not turn to investment advisers for guidance, and the profession will diminish.

(3) Clients of all investment advisers will suffer. Not knowing whom they can trust, but requiring of financial and investment advice, they will seek to avoid all purveyors of advice. Given individual's own lack of expert knowledge of the capital markets, and

their own behavioral biases, they will fall prey to poor decisions, thereby jeopardizing their own financial futures.

(4) If Americans seek out trusted advisers, and then have their trust betrayed (as has already occurred, by the numerous violations already observed by OCIE in connection with principal trading – even if clients remain unaware of the transgressions), Americans will become skeptics – not only of investment adviser, but the entire capital markets system. This will (and already has, to a substantial degree) result in flight of capital away from productive uses in the capital markets and into depository accounts. Academic studies of other countries have demonstrated that when trust in the capital markets is low, and capital formation is accordingly very low, the economies of those countries possess lower economic growth. Capital formation will decline if the trust of Americans is not maintained in financial intermediaries. Each time trust is reasonably expected, as in investment advisory relationships, but then betrayed, consumers retreat further from participation in the capital markets. In turn, this increases the cost of capital and stagnation in terms of economic growth. "Providing liquidity" to investors becomes meaningless, if individual investors loose trust in the capital markets system due to ongoing failures by those in advisory relationships with their clients to strictly adhere to the requirements of fiduciary law.

(5) America itself will falter. If Americans fail, with the aid of trusted advisors, make correct decisions regarding their savings and investments, then America itself will be called upon to provide more to meet individual Americans' financial needs – precisely at a time when America cannot afford to do such.

(6) The U.S. Securities and Commission would falter, in its essential missions to both protect the American consumer of financial and investment advice, and in promoting capital formation.

NAPFA is concerned that the Commission's action in proposing this extension of the Temporary Rule, especially in light of the substantial non-compliance by broker-dealer firms with their fiduciary obligations, portends a direction in which law is adopted to meet the business models of Wall Street firms, rather than requiring Wall Street's broker-dealer firms to adapt their business practices to meet the requirements of fiduciary law.

NAPFA is concerned that the Commission may, by this extension of the Temporary Rule, be seeking to protect the profits of broker-dealer firms – profits which have again arisen to such a level which far exceeds the value of financial services to our society. The Commission may, by adopting the positions of Wall Street firms again and again, often without supporting credible independent evidence substantiating their positions, and contrary to academic evidence illuminating the real dangers of conflicts of interests and the failures of disclosures to mitigate same, risks so ignoring the interests of consumers and the need for prudent, long-term capital formation, that the Commission itself will never again assume its mantel it once held as one of the most respected of our government agencies.

<u>In Conclusion, NAPFA's Primary Recommendation: Don't Extend the Temporary Rule.</u> In response to the question posed in Release IA-3118, as to the appropriateness of extending, rule 206(3)-3T yet again, well beyond the original trial period (Sept. 2007 thru Dec. 2009), NAPFA opines that there is no substantial evidence that the Temporary Rule actually benefits clients of investment advisers. The perceived benefits are largely illusory, and the dangers to capital formation, and to individual clients of dual registrants, are both real and substantial.

The Commission's 2007 decision to abandon a long history of precedent in requiring written consent, and the Commission's failure to highlight the need for full disclosure of all material facts of any principal trade, were troubling enough at the time. The changed market environment, in which establishing the pricing of individual fixed income securities in the secondary market, has become much more challenging, only heightens our concerns.

Moreover, the evidence has already been accumulated, by OCIE, that the Temporary Rule has spawned serious and apparently widespread violations of dual registrants' fiduciary obligations, sufficient to warrant numerous referrals to the SEC's Division of Enforcement. As such, another extension of the Temporary Rule appears most unwarranted.

NAPFA believes that the Temporary Rule fails any reasonable cost-benefit analysis, given the evidence present. Given the substantial risks present to clients due to the major conflicts of interest posed in connection with principal trading, NAPFA recommends that rule 206(3)-3T should be permitted to expire.

<u>NAPFA'S Alternate Recommendation - If the Rule is Extended, Require Broker-Dealer/RIA Firms Who Rely Upon the Temporary Rule to Adopt Better Policies and Procedures, Including Chinese Walls, and Extend the Rule for Only One Year.</u>

While NAPFA favors the Commission permitting the Temporary Rule to lapse, should the Commission choose to extend the Temporary Rule, NAPFA believes that the Commission should undertake actions to ensure that the clients of dual registrant firms, acting in a fiduciary capacity, are better protected. In particular:

(A) *Better Policies and Procedures – Due Diligence, Fair Pricing Establishment, and Chinese Walls.* NAPFA recommends that the Commission's Division of Investment Management should require dual registrant firms to adopt better policies and procedures,[34] not later than January 31, 2011, for principal trades with clients. These should include:

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[34] SEC Release IA-2653 requires that "an adviser relying on rule 206(3)-3T as an alternative means of complying with section 206(3) must have adopted and implemented written policies and procedures reasonably designed to comply with the requirements of the rule." Additionally, Rule 206(4)-7(a) under the Advisers Acts requires an investment adviser registered with the Commission to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder by the investment adviser or any of its

(1) Fundamentally, the due diligence of the investment adviser should be documented, both in selecting the security and in determining that the price offered by the dealer is fair. Such due diligence procedures might include an independent (of the dual registrant firm) evaluation of the creditworthiness of a bond issuer. No fixed income security, other than debt possessing the full faith and credit of the U.S. government, should be purchased on the recommendation of a fiduciary advisor, without strict adherence by the investment adviser to its fiduciary obligation of due care.

(2) A fair price for the security must be capable of being established. If bond issues with very similar credit quality and maturities cannot be contrasted, and documented, and if the bond issue does not trade frequently enough to establish a range of market prices, then any attempt to engage in a principal transaction with respect to that issue should be foreclosed. If a principal transaction does occur, all of the discussions and analysis regarding establishment of a fair price for the security should be maintained in a file which is easily inspected by securities examiners. Moreover, it would not be unreasonable to require, in instances in which trades in the security have recently occurred, for sales of individual bonds to occur out of dealer's inventory within 1% of the lowest price trade for that security, and for purchases from clients to occur within 1% of the highest price trade for that security, as a means of ensuring a fair price for the client.

(3) Moreover, given the substantial possibility of harm that exists arising from the inherent conflict of interest present in principal trading, it would not be inappropriate for the Division of Investment Management, or OCIE, to require that dual registrants prove, through adequate documentation, that clients actually benefit from principal trading, either: (a) by obtaining a better price for a security; or (b) by the client's ability to access a security from the dealer's inventory at a price which can be fairly established, in those circumstances where a similar security which would meet the client's needs is not available on an agency basis.

(4) OCIE should examine whether there has occurred timely (advance) disclosures of all material facts regarding a transaction to the client, including how pricing was established and the amount of compensation which results to the dealer. A complete record of the conveyance of all material facts regarding the transaction, following all of the dictates of establish precedent, should be maintained by the dual registrant.

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supervised persons. However, the Temporary Rule does not expressly require firms to develop policies and procedures that are specifically designed to detect, deter and prevent disadvantageous principal transactions, in order to effect the over-riding purpose of Section 206(3) of the Advisers Act. Nor does the Temporary Rule require that firms adopt policies and procedures which would identify those situations in which additional disclosures of material facts to clients would be required, such as "when there is no readily available market price with which to evaluate the fairness of a principal trade."

(5) Additionally, it would not be unreasonable for the Division of Investment Management to require, of dually registered firms engaging in principal trades with investment adviser clients, that any verbal consents obtained from the client to be recorded and time-stamped in some manner. For example, a simple recordation of the conversation in an e-mail, delivered routinely to a supervisor, would provide the necessary evidence to prove that the client's consent was actually obtained.

(6) In connection with such due diligence and fair pricing establishment processes, it would be unreasonable for a fiduciary to rely upon the judgment of the dealer's representatives, who are recommending to their firm that the security be sold from the dealer's inventory. Instead, firms should establish a solid Chinese Wall,[35] in which analysis of the security occurs independent of dealer's representatives, in order to better ensure that the fiduciary obligation to maintain the client's interests paramount at all times is better applied.

(B) *Recommended - Sweep Exam to be Conducted.* NAPFA further suggests a mid-2011 sweep examination of dually registered firms be undertaken by the Commission's Office of Compliance, Inspections, and Enforcement (OCIE), to ensure that strict observance occurs with respect to a fiduciary's obligations to its clients with respect to all principal trades to investment advisory clients. Particular attention should be paid to whether dual registrants, when acting as fiduciaries, are undertaking appropriate and independent due diligence prior to recommending securities to clients. Additionally, OCIE should require that dual registrants, when engaging in principal trades, possess substantial and conclusive documentation that a fair price for the client could be established, and that a better price for a similar security was not available at the time of the transaction.

NAPFA further suggests the OCIE also examine, in connection with such a sweep examination, whether dual registrants are attempting to avoid the requirements of Section 206(3) of the Advisers Act, and the requirements of rule 206(3)-3T, by improperly characterizing many accounts as "brokerage accounts" rather than "investment advisory accounts" in situations where it is apparent that the investment advice provided is more than "merely incidental" or "solely incidental" to sales

[35] "Many integrated firms have established 'Chinese Wall' arrangements and other controls to insulate analysts from investment banking personnel and activity. These arrangements and controls also assist firms in avoiding and managing conflicts of interest that could impair the independence of the research analyst and the impartiality of fixed income research." The Bond Market Association, "Guiding Principles to Promote the Integrity of Fixed Income Research: A Global Approach to Managing Potential Conflicts of Interest" (May 2004), available at http://www.sifma.net/assets/files/Guiding_Principles_for_Research.pdf.

transactions. In this regard, NAPFA suggests to the Commission that the term "solely incidental" should be afforded its plain meaning.[36]

(C) *OCIE Should Also Examine Whether Larger Firms are Fulfilling Their Fiduciary Obligations, by Aggregating Trades.* Lastly, NAPFA suggests that a true fiduciary investment adviser would not usurp the opportunity presented in aggregating trades of its clients and effecting such trades on an agency basis, in order to obtain better pricing for them by means of greater purchasing power.[37] It would be particularly troublesome if a firm engages in the practice of trade aggregation for securities permitted to be purchased by clients under the Temporary Rule, but the benefits of such aggregation were not extended to such clients. At a minimum, dual registrants who possess the means to aggregate trades, but who do not engage in such practice, face substantially greater disclosure obligations to their clients.[38] NAPFA recommends that the Commission explore whether dual registrants who possess sizeable volume in bond purchases have adequately fulfilled their fiduciary duties, in this regard.

[36] The "brokers' exclusion" found in Section 202(a)(11)(C) of the Advisers Act excludes from the definition of an investment adviser "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." The prior Commission's 2007 attempt to interpret this exclusion in such a broad fashion, in essence having the exclusion absorb the definition, is highly suspect. *See* Comment Letter of Barbara Roper, Director, Investor Protection, Consumer Federation of America, and Mercer Bullard, Founder and President, Fund Democracy, November 2, 2007, located at http://sec.gov/comments/s7-22-07/s72207-9.pdf, regarding the Commission's proposed interpretative rule (SEC Rel. No IA-2652, Sept. 24, 2007), found at http://sec.gov/rules/proposed/2007/ia-2652.pdf. *See also* NAPFA's comment letter of Nov. 2, 2007, from Tom Orecchio, 2007-8 Chair, and Ellen Turf, CEO, located at http://sec.gov/comments/s7-22-07/s72207-8.pdf (opining, in part, "The Advisers Act definition of "Investment Advisor" imposes fiduciary status upon a "person," not an account through the plain language of the Act. The Commission is seeking to have the Act apply to particular transactions or accounts instead of to persons and relationships as was originally intended. Congressional intent supports the broadened application of the Advisers Act and not the narrow interpretation by the Commission.")

[37] *See* Ron A. Rhoades, JD, CFP®, "How the Large Modern Financial Services Firm Can Better Compete as Financial Advisors and Clients Migrate to a Fiduciary Business Model" (Dec. 1, 2009), available at

http://www.fpcompliance.com/EmbraceFiduciaryBusinessModel20091201.pdf. ["A better solution is to utilize the aggregate purchasing power which a large financial services firm would possess to secure improvement in execution (price improvement) on behalf of its investment advisory clients. Aggregating orders into million-dollar bond purchases will substantially lower the transaction costs, especially in comparison with bond purchases of less than $100,000 denominations. Smaller registered investment adviser firms simply cannot compete against such a service offering, unless they band together with other firms to establish a joint fixed income trading desk (as some firms have done, but often at considerable cost to the adviser, and/or incremental cost to the clients thereby negating much of the purchasing power advantages otherwise secured)."]

[38] "Clients engaging an adviser can benefit when the adviser aggregates trades to obtain volume discounts on execution costs. Item 12 requires the adviser to describe whether and under what conditions it aggregates trades. If the adviser does not aggregate trades when it has the opportunity to do so, the adviser must explain in the brochure that clients may therefore pay higher brokerage costs ... aggregation practices may have a material effect on the quality of execution." SEC Rel. IA-3060 (July 28, 2010), regarding the new Form ADV, Part 2 disclosures, available at http://sec.gov/rules/final/2010/ia-3060.pdf.

The National Association of Personal Financial Advisors and its members have, for over a quarter of a century, provided leadership in the adoption of the fiduciary principle to the investment and financial advisory activities of its members. We stand ready to assist the Commission, at any time, as it considers these all-important issues.

Yours truly,

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