Consumer Federation of America

December 20, 2010

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

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

Dear Secretary Murphy:

I am writing on behalf of the Consumer Federation of America in support of the Commission's proposal to extend for up to two additional years the temporary rule that establishes an alternative means for dual registrants to meet the Investment Advisers Act principal trading requirements. Although CFA has been critical of the temporary rule and has in the past urged the Commission to act expeditiously to replace it,[1] we believe that, at this point, revision of the rule is best achieved in conjunction with the Commission's broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers. Specifically, we believe that a revised principal trading rule that applies to advisers and brokers alike should accompany a new rule to impose a fiduciary duty on brokers when they give personalized investment advice to retail customers.

If, as we hope, more extensive revisions to the principal trading requirements are just around the corner, it would be unduly disruptive to abandon the existing system now absent evidence of significant harm to investors. Indeed, our one concern in supporting an extension of the temporary rule is the evidence of potentially significant compliance failures hinted at in the rule proposal. Unfortunately, the proposing document's discussion of these compliance failures is not robust enough to allow us to draw conclusions about the extent and seriousness of the problem or whether these compliance failures are resulting in transactions being conducted on terms that are not in investors' best interests. Absent a more thorough discussion of the issue, it is impossible to independently assess the Commission's statement that "firms' compliance with the substantive provisions of rule 206(3)-3T as currently in effect provides sufficient protections

[1] See the November 30, 2007 comment letter from Fund Democracy and CFA urging significant strengthening amendments to the temporary rule and the April 17, 2009 letter from Mercer Bullard and Barbara Roper to SEC Chairman Mary Schapiro urging the Commission to take immediate steps to adopt a final rule that addresses "significant investor protection concerns" with the temporary rule.

to advisory clients to warrant the rule's continued operation for an additional limited period of time." As a result, we are forced to take it on faith that this is the case.

1) The principal trading rule should be modernized.

As CFA and Fund Democracy described in more detail in our joint 2007 comment letter, the notice-and-consent approach to principal trading required under Section 206(3) of the Investment Advisers Act is no longer adequate to ensure that principal trades are conducted in investors' best interests. The rule was designed in a simpler time to protect primarily against "dumping" of securities. But advances in technology, increased transaction speed and market volatility, more diverse trading platforms and other factors present more, and more complex, opportunities for principal trading abuses in today's markets. Moreover, many if not most retail investors lack the sophistication either to determine whether a particular transaction is in their best interest or to give truly informed consent to their advisers to act as principals. That argues for an approach to principal trading requirements that focuses less on mechanical compliance with a notice-and-consent regime and more on ensuring that transactions are conducted in investors' best interests.

In order to achieve this objective, a revised principal trading rule should require firms to adopt policies and procedures specifically designed to detect, deter and prevent disadvantageous principal transactions. This more principles-based approach would clearly define the investor protection outcome firms would be responsible for achieving – ensuring that principal trades on conducted in investors' best interest – but provide them with greater flexibility in determining how best to achieve that outcome. For this approach to work, the policies and procedures that firms put in place would have to be adequate to allow both compliance officers within the firm and regulators to reach an independent judgment that the transaction in question meets the fiduciary standard. In developing such an approach, the Commission must look beyond narrow concerns about "dumping" to address the broader range of potential principal trading abuses. The Commission should also seek to identify situations in which it may be prohibitively difficult to ensure that clients are not disadvantaged and to provide guidance regarding different ways in which advisers could address these situations.

2) The Commission's evaluation of regulatory requirements for brokers and advisers provides an appropriate context in which to undertake these revisions.

The principal trading restrictions encompassed in Advisers Act Rule 206(3) have as their foundation Congress's recognition that these trades pose particularly severe conflicts of interest that could induce advisers to violate their fiduciary duty. Congress was particularly concerned that advisers might be tempted to unload securities that they were trying to move out of their own account by "dumping" them on their clients. As we have noted above, however, this is far from the only abuse potentially associated with principal trading. Among other things, those engaging in principal trades may have an incentive to charge excessive mark-ups and mark-downs or to overlook a better price available elsewhere in the market. Ensuring that these transactions are conducted in the clients' best interest is therefore a key component of ensuring compliance with a fiduciary duty.

Because of the prevalence of principal trading within the broker-dealer business model, the issue of principal trade requirements is one that must certainly be addressed if the Commission moves forward with a rule imposing a fiduciary duty on brokers when they give personalized investment advice. Moreover, since the goal of that policy is not simply to raise the standard that applies to brokers when they give advice, but also to harmonize the standards that apply to brokers and advisers when they perform the same functions, it makes sense for the Commission to seek to adopt a uniform approach to principal trade requirements as well. For these reasons, the fiduciary duty study currently being completed by the Commission and the rules that grow out of that study offer an ideal opportunity to simultaneously modernize and harmonize the principal trading requirements. Among other things, we urge the Commission to provide greater detail in the fiduciary study regarding practices related to principal trading, including for example the number of firms relying on the temporary rule and the prevalence of compliance failures at those firms.

3) A revised principal trading rule must address the compliance failures identified by the Commission in its rule proposal.

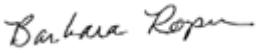
The rule proposal discusses the findings of examinations conducted by the Office of Compliance Inspections and Examinations regarding compliance with rule 206(3)-3T. Although the staff reportedly did not identify any instances of "dumping," it did identify a number of compliance failures that appear to reflect serious short-comings in firms' policies and procedures to implement the rule. It is impossible to tell from the rule release how frequent these compliance failures were, whether they were concentrated in a few firms or were more widespread, or whether they resulted in securities' being sold to investors on terms that were not in their best interests. However, it seems reasonable to assume that a firm that is not routinely or effectively complying with Rule 206(3)-3T's notice-and-consent requirements for principal trades, or is relying on the rule for trades in ineligible securities, may also be ignoring its obligation to ensure that the transactions are conducted in their customers' best interests. It is particularly disturbing that at least some firms did not have adequate policies and procedures concerning the rule, were not periodically testing the adequacy of their compliance programs, and did not maintain books and records in a manner that would enable the staff to conduct a meaningful assessment of their compliance. Will an occasional slip-up in application of the rule is understandable, this suggests a cavalier approach to compliance that cannot be tolerated.

The release indicates that the staff is pursuing compliance issues uncovered in its examinations, including making referrals to the Enforcement Division, and will continue to monitor compliance if the temporary rule is extended. This is continued monitoring is absolutely essential. But ensuring mere technical compliance with the rule's notice-and-consent requirements is not sufficient. The staff must also ensure that recommendations made are in the best interests of clients. And, in considering the best approach to take as it considers revising the principal trading rule, the Commission should ensure that it addresses weaknesses identified in the current approach and backs that rule with tough enforcement focused on the larger issue of the appropriateness of recommendations.

Conclusion

CFA supports extension of the temporary rule on principal trading, but only to accommodate a more thorough revision of the rule that seeks to modernize, strengthen and harmonize principal trading requirements for both brokers and advisers. Only in this way can the Commission justify the continued reliance on a temporary rule adopted more than three years ago without appropriate notice and public comment. If, however, the Commission adopts a strong new principals-based approach to principal trading requirements for brokers and advisers, and backs that new rule with tough enforcement that holds them accountable for compliance, investors will reap the benefits.

Respectfully submitted,



Barbara Roper
Director of Investor Protection

cc: The Honorable Mary Schapiro, Chairman
The Honorable Luis Aguilar, Commissioner
The Honorable Kathleen Casey, Commissioner
The Honorable Troy Paredes, Commissioner
The Honorable Elisse Walter, Commissioner