SIFMA
Securities Industry and
Financial Markets Association

November 30, 2007

**VIA ELECTRONIC MAIL**

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 "F" Street, N.E.
Washington, D.C. 20549

Re: Temporary Rule Regarding Principal Trades with Certain Advisory Clients
Release No. IA.-2653; File No. S7-23-07

Dear Ms. Morris:

The Securities Industry and Financial Markets Association ("SIFMA")[1] is pleased to have the opportunity to comment on Temporary Rule 206(3)-3T (the "Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The Rule represents an important step by the Securities and Exchange Commission (the "SEC") to address investor needs in light of the recent decision of the Court of Appeals for the District of Columbia Circuit in *Fin. Planning Ass'n v. SEC,* 482 F.3d 481 (D.C. Cir. 2007). We commend the SEC for working diligently over the short time provided between issuance and effectiveness of the court order to develop the Rule and, thereby, accommodate the interests of large numbers of fee-based brokerage clients and certain other advisory clients to enjoy the benefits of accounts that combine asset-based fees with access to the securities inventory of a broker-dealer.[2]

As the SEC has recognized, a registered broker-dealer that is also registered as an investment adviser (sometimes called a "dual registrant") or that is affiliated with an investment adviser can provide important benefits to consumers, including access to instruments traded only on a principal basis, greater choice in the types of instruments available and the method of execution and the potential for beneficial pricing and greater liquidity.[3] Advisory clients benefit from being able to trade in and out of positions

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[1] SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Market Association, is based in Hong Kong. More information about SIFMA is available on its website at *www.sifma.org.*

[2] *See* Temporary Rule Regarding Principal Trades with Certain Advisory Clients (the "Adopting Release"), 72 Fed. Reg. 55022-01, 55023 (Sept. 28, 2007) (to be codified at 17 C.F.R. pt. 275) ("…firms that offered fee-based brokerage accounts informed us that, unless the Commission acts before October 1, 2007, one group of fee-based brokerage customers is particularly likely to be harmed by the consequences of the FPA decision: customers who depend both on access to principal transactions with their brokerage firms and on the protections associated with a fee-based (rather than transaction-based) compensation structure.")

[3] Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Investment Advisers Release No. 1732 (July 17, 1998) at 3 ("We are concerned that unless we clarify these issues, advisers will unnecessarily avoid engaging in principal … transactions that may serve their clients' best interests."). *See also* Certain Broker-Dealers Deemed Not to Be

more quickly as a result of having the flexibility to trade directly with their dual registrant adviser or a dually registered affiliate. These benefits may, for example, allow an advisory client to transition portfolio holdings in a timely fashion from more volatile instruments to relatively more stable ones, such as U.S. government bonds, in the face of a market downturn. Trading with a dual registrant may also provide certain execution efficiencies, such as facilitating smoother settlements since the securities being traded do not need to flow through different clearing and executing firms. The ability to engage in principal trading may also allow advisory clients to participate in electronic order routing systems sponsored by dual registrant advisers or their dual registrant affiliates.

The streamlined disclosure and consent procedures under the Rule enhance the ability of dual registrants to provide these benefits to their non-discretionary, advisory clients. In addition, the ability to provide oral consent granted by the Rule allows dual registrants to provide clients with the flexibility needed to take advantage of market windows to carry out principal trades quickly.[4] The Rule attains a workable balance between providing flexibility to advisory clients and addressing conflict of interest concerns that underlie Section 206(3) of the Advisers Act.

## I. Enhancements to the Rule

Although the Rule improves in a meaningful way the investment and execution alternatives available to non-discretionary, advisory clients, we believe that the benefits would be further augmented, in a manner consistent with investor protection, by expanding the list of underwritten securities eligible for principal transactions under the Rule to include (i) preferred stock, (ii) convertible debt, (iii) certificates of deposit, (iv) municipal bonds, (v) unit investment trusts, (vi) government agency bonds, and (vii) all securities that qualify as exempted securities under Section 3(a)(12)(A) of the Securities Exchange Act of 1934. We also ask that the Rule be revised to change the definition of "investment grade debt" to include all securities, whether or not considered to be a debt security, rated investment grade by at least one (1) nationally recognized statistical rating organization ("NRSRO") rather than two.[5]

Preferred stock and convertible debt, depending upon their structure, often trade based on the issuer's credit, in a similar manner to straight, non-convertible debt. Many of these instruments are attractive to retail, advisory clients because they can offer higher yields but with a lower risk of loss than investments such as common equity. Unit investment trusts have the benefit of regulation under the Investment Company Act of 1940. Similarly, securities that are "exempted securities" under the

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Investment Advisors, SEC Rel. No. 34-51523, at 72 (April 12, 2005), *available at* http://www.sec.gov/rules/final/34-51523.pdf. ("Securities markets will also benefit because the rule would preserve the ability of broker-dealers to engage in principal transactions with these fee-based brokerage customers. Principal transactions are an important part of market liquidity in some sectors.")

[4] As the SEC noted in the Adopting Release, practical difficulties faced by firms in complying with the trade-by-trade written disclosure and consent requirements under Section 206(3) of the Advisers Act led most firms to refrain from engaging in principal trading with their advisory clients altogether.

[5] Section (c) of the Rule limits investment grade instruments covered by the exception to "debt" that is rated in one of the four highest rating categories by at least two nationally recognized statistical rating organizations.

Securities Exchange Act of 1934, such as certificates of deposit, municipal bonds and government agency securities, are conservative investment vehicles even though they may not be rated. We believe that inclusion of all these instruments under the Rule would benefit a number of advisory clients.

We believe that the exception in the Rule should be broadened to include all investment-grade rated securities issued by entities other than dual registrant or its affiliates. We see no reason to distinguish these securities from investment grade debt or to limit client choice and access to these instruments. Expanding the type of securities covered by the Rule benefits clients by permitting them to hold these investments in one advisory account which is subject to the fiduciary obligations under the Advisers Act, rather than having to bifurcate their holdings into advisory and brokerage accounts simply to access the products they want.

There are a variety of investment grade debt securities that do not qualify under the Rule because they are rated by only one NRSRO, rather than by two, as the Rule requires. We note that for purposes of defining eligible money market securities under Rule 2a-7 of the Investment Company Act of 1940, it is sufficient for the instrument to have been given a rating by any one NRSRO. If a single rating is sufficient for those purposes, we do not understand why a single rating would not also be sufficient to define "investment grade" under the Rule. Investment grade securities that are currently trading in the marketplace and that have been rated by only one NRSRO include debt issued by U.S. government agencies, such as the Federal Farm Credit Bank and the Federal Home Loan Bank, and senior notes issued by corporations such as General Electric Credit Corporation, JP Morgan Chase & Co. and Toyota Motor Credit.[6]

In addition to broadening the universe of securities eligible under the Rule, we also ask that the SEC clarify two points that we think are clearly intended to be within the scope of the Rule but were not expressly addressed. First, we believe that the intention of the Rule was to encompass principal trading by a dually-registered broker-dealer where it or a registered investment adviser affiliate serves as investment adviser to an account. We do not read the Rule to require that the affiliate providing advice on the transaction must itself be a dual registrant. This reading is consistent with the stated intent of the Rule to provide flexibility and consistency to transitioning fee-based brokerage customers.

Second on the exclusion in Section (a)(1) of the Rule for transactions "with respect to … [an] account" over which the investment adviser exercises investment discretion (other than discretion on a temporary or limited basis), we think it would be helpful to clarify that all non-discretionary advisory transactions would qualify under the Rule regardless of whether the investment adviser had exercised investment discretion on other transactions in the account for which it is not relying on the Rule. Thus, if a client engaged a firm to act as his or her discretionary adviser but elected, from time to time, to direct trades through the account on a non-discretionary basis or the adviser elected to obtain the client's

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[6] Single rated cusips include the following: EHO902922 (S&P AAAe rated bonds of the Federal Farm Credit Bank); EG5942776 (S&P AAAe rated bonds of the Federal Home Loan Bank); EC8711953 (Moody's Aaa rated Euro notes of General Electric Capital Corporation); EG9875931 (Moody's Aa2 rated notes of JP Morgan Chase & Co.) and EG4808408 (Moody's Aaa rated notes of Toyota Motor Credit Corp.)

consent, those transactions should be covered by the Rule (assuming that all of the other conditions under the Rule are met).

## II. Additional Items Relating to the Rule.

The Adopting Release poses several questions on client and account eligibility under the Rule. We agree that the Rule should not be restricted in scope to "wealthy" or "qualified investor" clients. Section 206(3), as originally adopted, does not make any such distinction nor is one necessary in the interest of investor protection. In our view, all non-discretionary, advisory clients should be able to benefit from greater investment choices, potentially enhanced executions and the availability of an additional source of liquidity provided by the Rule. We also note that many firms already require reasonable account minimums with advisory accounts. As a result, our expectation would be that the average non-discretionary advisory client would be sufficiently sophisticated to make an informed consent and to be able to appropriately evaluate potential execution choices. We do not believe there is any need for the SEC to restrict client eligibility under the Rule.

In addition, we agree that the Rule should apply broadly to all non-discretionary clients and not be limited in its application to accounts that were previously fee-based brokerage accounts. It would be operationally complex – if not impossible – to limit the non-discretionary advisory accounts that may take advantage of the Rule to those that, prior to October 1, 2007, were fee-based brokerage accounts. There is no reason to distinguish between types of non-discretionary advisory clients. Furthermore, we do not think that investment advisers should be placed in a situation in which they must treat non-discretionary advisory clients differently simply due to the predecessor account the client carried with the firm.

In our view, the Rule provides a balanced approach to investor disclosure. By focusing on the investor's decision-making process, the Rule ensures that the investor has the necessary information to provide an informed consent to principal trades when the investment decision is made. Moreover, the investor may revoke his or her general consent at any time and may elect not to consent to a particular principal trade. As a result, it is not necessary to provide for a periodic renewal of the general, written consent required by the Rule.

The Adopting Release asks whether the Rule should be amended to prohibit advisers from making consent to principal trading a condition to participation in a non-discretionary advisory program. We believe this is unnecessary and would be inappropriate. Participation in a non-discretionary advisory program – whether consent is a condition or not – is voluntary, and there are many program or account alternatives for investors to choose from. Moreover, the Rule includes numerous protections for investors through the upfront and trade-by-trade consent procedures, as well as the clear right of the client to revoke his or her consent at any time.

The Adopting Release asks for comments on the two-year sunset provision built into the Rule. We agree with Investment Management Director Donahue's analysis that the 27-month period should

provide the Staff an opportunity to study the implementation and impact of the Rule.[7] As Commissioners Atkins and Casey noted, we also urge the SEC to use this time period effectively to evaluate the Rule and develop appropriate principal trading reforms, including permanent principal trading relief, drawing on the lessons learned from the Rule as well as valuable insights obtained through the Rand Corporation Study.[8] We believe that the SEC's study of broker and adviser regulation being conducted by the Rand Corporation is an opportune time to re-consider the disclosure and consent requirements of Section 206(3), particularly in light of changed market structure.

## III. Conclusion.

We appreciate your giving us the opportunity to comment. We support the Rule and believe that it is an important step towards providing advisory clients greater choice of investment alternatives and broader market access in a manner that ensures that investor protections are in place. We believe that the Rule appropriately recognizes that dramatic changes have occurred in our securities markets since Section 206(3) was enacted that provide transparency in prices and allow investors to make more informed decisions on investment and execution choices. We also believe that the Rule takes into account the protections already available to investors under the Advisers Act, such as the general anti-fraud provisions to which advisers are subject under Section 206, the state law fiduciary standards applicable to advisers and the robust system of regulation, oversight and examination applicable to dual registrants.

We believe that the SEC should take action at this time, along the lines we recommend in this letter, to further enhance and revise the Rule. Because the Rule is a temporary one, the SEC will be well positioned, over the coming months, to consider the benefits the Rule offers to investors as well as to evaluate what additional refinements may be desirable in a permanent rule. In particular, we urge the SEC to expand the range of securities that are eligible for trading on a principal basis under the Rule at this juncture, as we have discussed. In our view, this expansion will give the SEC an opportunity to better evaluate the impact of the Rule on the marketplace and the benefits offered to investors.

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[7] *See* Webcast of SEC Open Meeting, September 19, 2007, *available at* http://www.connectlive.com/events/secopenmeetings, 52:55 of the Webcast ("The rule contains a Sunset provision. Absent further action by the Commission, the temporary rule would expire on December 31, 2009, about 27 months from its effective date. This 27 month period provides an opportunity for the Staff to observe how firms comply with their disclosure obligations under the rule and whether when they conduct principal trades with their clients, they put their clients' interest first.")

[8] *Id.* at 1:03:48 (P. Atkins – "The two year sunset of the rule will allow us time to adopt permanent principal trading relief; once we have the benefit of comments on this rule. The Rand Study, to which Bob [Plaze] referred, which we expect to receive by the end of the year, will provide us with the raw data to consider more far-reaching changes to the manner in which we regulate broker-dealers and investment advisers.") and at 1:17:14 (K. Casey – "The [Rand] Study will hopefully be instructive as a basis for the Commission's future thinking on needed reforms which, from my perspective, may lead the Commission to conclude that legislation will be necessary. In light of this potential reality and while I support the temporary nature of the relief, [the sunset provision is necessary] in order to give the commission the ability to monitor the effectiveness of the interim final rule as well as consider the implications of the Rand Study findings.")

We recommend that the SEC use the occasion of the Rand Corporation Study to continue to evaluate the Rule together with other regulatory reforms that focus on maximizing investor choice and enhancing investor access to the broader investment market. In our view, principal trading offers advisory investors important benefits by providing access to a broad array of investment opportunities and the potential for enhanced executions and market access. Our strong hope would be that the SEC will make the Rule permanent at the end of the sunset provision in an appropriate form, together with modifications that consumers, market professionals and the regulators jointly recommend.

As the SEC reviews these issues and the future of Section 206(3) generally, we urge the SEC to consider how bond and debt markets have evolved and operate today, including the role of trading and order routing systems of firms that are subject to best execution obligations to mitigate the conflicts of interest discussed historically in connection with principal transactions. For example, in the corporate, municipal, and government agency bond markets, after an order is entered, it is a firm's trading system that typically determines execution of the order (whether as principal or agent), taking into account factors such as (i) speed and certainty of execution; (ii) price and size improvement; and (iii) overall execution quality. Those processes, coupled with the protections afforded to clients by Section 206(1) of the Advisers Act, support a more flexible approach to dealing with principal trading.

SIFMA, like the SEC, is currently engaged in an evaluation of ways that we, as an industry, can best position ourselves to enhance client services and address client needs. We look forward at the appropriate time in the coming months to working with the Staff to suggest refinements to our regulatory structure that best address evolving demographics and attendant customer needs, maximize our execution efficiencies within the changing marketplace and leverage innovative new tools and products.

Should you have any questions about our views, please feel free to contact the undersigned at 202-962-7373 or Mike Udoff at 212-313-1209.

Sincerely yours,

Ira D. Hammerman
Senior Managing Director and General Counsel

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Annette L. Nazareth, Commissioner
The Hon. Kathleen L. Casey, Commissioner
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