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July 27, 2007

Mr. Robert E. Plaze
Associate Director, Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: *Exemptive Relief for Certain Principal Transactions*

Dear Mr. Plaze:

Following up on our recent meeting with you and your colleagues, the Financial Planning Association¹ ("FPA") hereby offers its thoughts regarding the Securities and Exchange Commission's ("SEC" or "Commission") granting additional exemptive relief from the principal trading restrictions found in Section 206(3) of the Investment Advisers Act of 1940 ("Advisers Act").

As explained below, FPA believes that the issue of principal trading relief should be treated separately from interim guidance to brokerage firms that are in the process of dismantling fee-based brokerage programs.² Long before the advent of fee-based brokerage programs, the brokerage industry had sought relief from Section 206(3). Moreover, recent history suggests that even though the securities markets have become more transparent over time, the inherent conflicts of interest and risks involving principal trades have not changed.

Recall that only a few years ago some of the firms that today are the loudest proponents of fee-based brokerage were the same ones fined \$875 million for conflicted analyst research.³ The

¹ The Financial Planning Association is the largest organization in the United States representing financial planners and affiliated firms. Most of FPA's 28,000 members are affiliated with investment adviser firms registered with the Securities and Exchange Commission, state securities administrators, or both. FPA is incorporated in Washington, D.C. where it maintains an advocacy office, with headquarters in Denver, Colorado.

² See June 27, 2007, Order of the U.S. Court of Appeals for the District of Columbia Circuit, in *Financial Planning Association v. Securities and Exchange Commission*. See also Rule 202(a)(11)-1, "Certain Broker-Dealers Deemed Not to be Investment Advisers" ("Rule 202").

³ See April 28, 2003, NASD News Release, "Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking," at http://www.nasd.com/PressRoom/NewsReleases/2003NewsReleases/NASDW_002909.

result of these conflicted 'buy' recommendations no doubt led to significant investor losses as a result of extensive principal trading in fee-based and other retail brokerage accounts. With this past experience in mind, we believe that any changes to Section 206(3) should be made with great care and stringent conditions. Additionally, such relief should be granted on a temporary basis, with a clear deadline for reassessing whether the revised framework for principal trading is working, i.e., whether it affords advisory clients reasonable protection against the types of potential harm Section 206(3) was originally designed to address.

Background

Section 206(3) forbids a registered investment adviser from knowingly selling any security to or purchasing any security from an advisory client on a principal basis without disclosing this capacity to the client in writing before the completion of the transaction and obtaining the client's consent.⁴ This restriction applies both to dually-registered broker-dealer/investment advisers and to advisers who trade with affiliated broker-dealers on behalf of managed accounts.⁵

By its terms, Section 206(3) is transaction-specific; its restrictions do not apply unless the broker-dealer is also acting as an investment adviser to the client *with regard to that transaction*. Furthermore, by virtue of Advisers Act Rule 206(3)-1, Section 206(3) does not apply in connection with any transaction for which the broker-dealer is acting as an investment adviser only in one or more of the following ways: (1) by means of publicly distributed written materials or publicly made oral statements;⁶ (2) by means of written materials or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts; or (3) through the issuance of statistical information containing no expressions of opinion as to the investment merits of a particular security. The availability of this exemption is conditioned on the firm's disclosing that if the purchaser of the advisory communication uses the adviser's services in connection with a purchase or sale of a security that is the subject of such communication, the adviser may act as principal for its own account or as agent for another person. This disclosure is in addition to any other disclosure that may be required under Section 206(1) or (2), the Advisers Act's general antifraud provisions.

Where Section 206(3) does apply, the written disclosure relating to principal trades must be given and client consent must be obtained on a case-by-case basis. The exact content of the required disclosure depends on facts and circumstances, including the degree of the client's trust and confidence in and reliance on the investment adviser with respect to the transaction.⁷ Among the types of information that may need to be disclosed, depending on their materiality to a particular transaction, are the cost to the adviser of any security to be sold to a client or the known resale

⁴ This section also imposes disclosure and consent requirements on an adviser who engages in agency-cross trades involving client accounts.

⁵ As used in this letter, the terms "broker-dealer" and "adviser" refer both to dual registrants and to affiliates.

⁶ For purposes of this rule, "publicly distributed" materials are those distributed to 35 or more paying clients. "Publicly made" statements are those made simultaneously to 35 or more paying clients.

⁷ IA Release No. 557 (December 2, 1976), 41 Fed. Reg. 53808; IA Release No. 470 (August 20, 1975), 40 Fed. Reg. 38158.

value of any security to be bought from a client and the best price at which the transaction could be effected by or for the client elsewhere, if such price is more advantageous to the client.⁸

Additional Exemptive Relief for Principal Trades

Depending on the circumstances, clients may benefit from principal trades, but only in the context of a fiduciary relationship with the best interests of the client being paramount. In favorable circumstances, advisers may obtain access to a broader range of investment opportunities, better trade execution, and more favorable transaction prices for the securities being bought or sold than would otherwise be available. However, principal trading also poses unique risks for advisory clients, since advisers who trade on a principal basis may be in a position to violate their fiduciary obligations by manipulating prices and dumping unwanted securities into client accounts. As a result, the trade-by-trade notice and consent requirements of Section 206(3) make it impractical for investment advisers and financial planners holding discretion over client accounts to engage in principal transactions. Nonetheless, if the Commission does propose modifications that would tend to benefit primarily the large firms with investment banking affiliates or proprietary mutual funds, we urge you not to lose sight of the commensurately broader range of conflicts that could erode the basic fiduciary protections Section 206(3) was designed to preserve.

At a minimum, this means that any additional relief from the Advisers Act's principal trading restrictions⁹ should be conditioned on the adviser's adopting and implementing written policies and procedures that are reasonably designed to ensure that any principal trades effected for managed accounts are in the clients' best interests. These procedures must include how the adviser addresses material conflicts that may arise between its interests and those of its clients, with particular attention to avoiding price manipulation and dumping unwanted securities.¹⁰ In accordance with Rule 206(4)-7, the adviser would be obligated, at least annually, to review the sufficiency of these policies and procedures and the effectiveness of their implementation.

Furthermore, an adviser wishing to engage in principal trading with its managed and nondiscretionary accounts should be required to obtain written consent from the clients prospectively authorizing the adviser (or its affiliate, if applicable) to engage in such transactions. Before obtaining such consent, the adviser should furnish each client with a written disclosure briefly describing (i) the circumstances under which the adviser may buy securities from or sell securities to the client's account; (ii) the potential for conflicts between the client's interests and those of the adviser; and (iii) the policies and procedures the adviser has adopted to address those

⁸ IA Release No. 1732 (July 17, 1998), 63 Fed. Reg. 39505, note 9, quoting IA Release No. 40 (January 5, 1945), 11 Fed. Reg. 10997.

⁹ In crafting such relief, the Commission might take the opportunity to discuss the types of trading that is subject to Section 206(3). For example, the Commission might determine that same-price riskless principal trades should be treated as agency trades rather than principal trades because they do not pose the risk of dumping and price manipulation that Section 206(3) was designed to address.

¹⁰ Such procedures might include, for example, a requirement to obtain and document other dealers' contemporaneous bid/ask prices in the subject securities.

conflicts. The adviser should also inform the client that the client may terminate the principal trading authorization, at any time and without penalty, by sending the adviser a written notice to that effect.

In addition to this initial information, an adviser engaging in principal trades should be obligated to provide the client with certain information on an ongoing basis. This includes, at the client's option, either (a) a confirmation of each securities transaction executed under the exemption, indicating the nature of the trade, the price of the security and the markup, markdown, commission equivalent or other fee paid by the managed account for executing the transaction, or (b) quarterly reports containing the same information that would have been disclosed on such confirmations.

At least once a year, the adviser should also furnish the client with a summary report identifying, for the reporting period, (x) the total number of principal transactions effected, (y) the total amount of all markups, markdowns, commission equivalents or other fees the account paid to the adviser in connection with such transactions, and (z) any material changes to the adviser's written policies and procedures regarding principal trading. The annual report also should remind the client of its right to terminate the principal trading authorization at any time, without penalty.

To the extent that the initial disclosures, client authorizations, confirmations, annual reports and other principal trading records are not already covered by Advisers Act Rule 204-2,¹¹ this rule should be modified to ensure that the adviser maintains appropriate records relating to the activities it conducts pursuant to the exemptive relief. This will permit the Commission's examination staff to determine whether advisers engaging in principal transactions with their managed accounts are satisfying their fiduciary obligations, including their duty of best execution.

In addition to these basic client protections, the Commission should limit such relief to a narrow range of investment and fixed-income options. For example, the Commission should restrict principal trading to listed securities and other securities where market prices are readily available. With respect to bonds held in inventory, the Commission should consider limiting sales to high-quality bonds. The Commission should also limit blanket principal trading authorizations only to institutional clients or natural persons who are deemed to be "qualified clients" for purposes of Advisers Act Rule 205-3.

FPA does not believe principal trading relief should be extended to proprietary mutual funds of an investment adviser or adviser affiliate. Nor should the Commission afford principal trading relief to an investment adviser who holds an interest of more than 5 percent in another firm that offers mutual funds or managed accounts to the public.¹² We further note that similar investor

¹¹ It appears that each of these documents would be covered by Rule 204-2(a)(7), which concerns written communications relating to the placing or execution of any order to purchase or sell any security, and/or Rule 204-2(a)(3), which relates to memoranda of orders for the purchase or sale of securities for client accounts.

¹² For example, we note the recent sale of Merrill Lynch & Company's proprietary funds to BlackRock Inc., in which Merrill Lynch retains a 49 percent ownership interest. According to anecdotal evidence, many of BlackRock managed funds are beginning to show up as significant positions in the accounts of Merrill Lynch's financial advisors. Such funds where the advisory firm holds more than 5 percent

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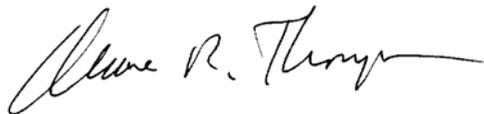
protection concerns were expressed by Congress in the Pension Protection Act of 2006 ("PPA") with respect to fiduciary advisers. In an effort to discourage incentives that would tend to steer plan participants to proprietary investments of the investment adviser, the fiduciary adviser's compensation under such arrangements is required to be 'level' no matter the recommendation.

Finally, if the Commission decides to grant additional exemptive relief under Section 206(3), we believe that implementation of the rule and subsequent principal trading activity should be vigorously monitored and studied over a period of 12 to 24 months. After such time, we believe that SEC staff should recommend to the Commission whether such relief should be continued. If systemic problems have been found, such rules should undergo significant modification to further restrict principal trading relief, or else be repealed.

In summary, the FPA respectfully asks that the Commission grant only temporary relief, and then carefully assess, after a reasonable period of time, whether such relief should be made permanent. No matter what conditions for Section 203 relief are ultimately attached, investment advisers should not be absolved from their obligation to act in the best interests of their clients, including the obligation to seek to obtain best execution on client trades.

We would be happy to discuss these issues with you further. If you would like to follow up with us, please contact me at 202-449-6341.

Very truly yours,



Duane Thompson
Managing Director, Washington Office

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Kathleen L. Casey, Commissioner
The Honorable Annette L. Nazareth, Commissioner
Brian G. Cartwright, General Counsel
Andrew Donohue, Division of Investment Management
Eric R. Sirri, Director, Division of Market Regulation
Linda C. Thomsen, Director, Division of Enforcement
Lori A. Richards, Director, Office of Compliance Inspections and Examinations

ownership, in our view, create material conflicts of interest and should be subject to Section 206(3) trading restrictions.