August 14, 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:

In our recent August 3, 2007 meeting with Director Donahue, the National Association of Personal Financial Advisors (NAPFA)[i] expressed its strong reservations regarding the possible grant of principal trading relief to broker-dealer firms in the context of fiduciary investment advisory relationships. This correspondence sets forth our concerns regarding this issue in more detail, which are summarized as follows:

A. **Even though the securities markets have become more transparent over time, the inherent conflicts of interest and risks to individual investors involving principal trades have not changed.**

B. **Loosening principal trading rules lessens fiduciary duties – which should be preserved as the highest standard under the law. This erosion of the fiduciary standard hurts not only consumers but also the investment advisory professional.**

C. **State common law fiduciary duties applicable to investment advisers would still require detailed disclosures and informed consent even if principal trading rules are relaxed under the Advisers Act.**

D. **The real reason behind principal trading relief is to preserve the profits of Wall Street firms at the expense of individual investors. The Commission should not serve as a tool of broker-dealer firms to prevent disintermediation and stop progress in securing for individual investors a greater share of the returns the capital markets have to offer.**

NAPFA urges the Commission to move slowly and deliberately, considering comments from many sources and only following an objective economic impact study of all of a proposed rule's consequences, prior to permitting all-important

fiduciary standards of conduct to be eroded – to the detriment of consumers and fiduciary advisers alike.

A. Even though the securities markets have become more transparent over time, the inherent conflicts of interest and risks to individual investors involving principal trades have not changed.

The National Association of Personal Financial Advisors (NAPFA) notes that the complexities of the capital markets have increased in recent years. This is evident in the deluge of new types of securities, thousands and thousands of new product offerings each year, and the increased appetite by Wall Street firms to assume, and then seek to cast off, various risks. While the securities markets have become more transparent, the rise of large wirehouse firms with their many affiliates has increased the number and severity of conflicts of interest which arise in Wall Street, to the detriment of the consumer.

It should be noted that principal trading by investment advisers involves an inherent conflict of interest. Principal trading is at odds with the long-standing historical "no-profit rule"[ii] applicable to fiduciaries. Investment advisers that, as dealers in securities, engage in principal trading may easily violate their fiduciary obligations to their clients by:

- manipulating prices;
- dumping unwanted securities into client accounts; and
- otherwise, not in the best interests of the client, but in the advisor's (or its affiliate's) interest.[iii]

Transparency has not lessened these conflicts of interest. Advance disclosures of specific information relating to principal trades, in order to seek out informed consent, is more important than ever before. Increased transparency is not a valid reason for removal of a strictly mandated advance and specific disclosure in writing of all of the material facts relating to any proposed principal trade.

Indeed, the increased complexity of the securities markets have made it more difficult for individual investors to understand and provide informed consent to transactions involving conflicts of interest. It must be questioned whether "informed consent" is even possible, given the substantial obstacles to same which individual investors, in this highly specialized society of the 21st Century, possess.[iv]

B. Loosening principal trading rules lessens fiduciary duties – which should be preserved as the highest standard under the law. This erosion of the fiduciary standard hurts not only consumers but also the investment advisory professional.

Section 206(3) is designed to preserve basic fiduciary duties which clients possess a right to expect from their trusted advisers. "The purpose of the rule is to ensure that the adviser serves the interests of his client with undivided loyalty."[v] This duty of loyalty is one of the triad of fiduciary duties (the others being utmost good faith and due care) which arise under the Advisers Act.[vi]

Judge Cardozo, in his opinion in *Meinhard v Salmon*, 164 N.E. at 548 (N.Y.1928), described in modern terms the standard to which fiduciaries will be held:

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct fiduciaries been kept at a level higher than that trodden by the crowd.

The Commission should undertake the same stance as a protector of the fiduciary standard and its duty of loyalty to the client. For it is the U.S. Securities and Exchange Commission, in describing its mission, which states: "As more and more first-time investors turn to the markets to help secure their futures, pay for homes, and send children to college, our investor protection mission is more compelling than ever."[vii]

In today's increasingly complex financial world, individual investors seek out, and need, the assistance of true fiduciary advisers, who eschew compensation other than that paid directly by the client. Yet the investment advisory profession is in jeopardy – by those who seek to diminish the high standards of conduct which apply to investment advisers. The delicate fiduciary nature of an investment advisory relationship should not be put at risk. No profession can retain the respect of its clients if scandals continue to erupt, as will certainly occur as broker-dealer firms fail to act in the best interests of their clients due to the ever-present allure of profits from principal trades.

Indeed, relief from principal trading restrictions presents another challenge to individual investor's faith in our capital markets system. When the reputation of investment advisers is diminished by the inevitable future "principal trading" scandal, who can investors turn to for truly objective advice? Once fiduciaries let them down, investors will lose confidence in our system of financial intermediaries, and many will not participate in the capital markets at all. Those that do will be less likely to utilize fiduciary advisers – which is a crime where the system that is designed to protect the consumer has instead protected the brokerage industry. Fiduciary advisers who avoid conflicts of interests wherever possible (instead of asking for permission to engage in transactions involving inherent conflicts of interest) can truly add true value to his or her clients.

Why proceed down this slippery slope of eroded consumer protection? Proposals to relax principal trading rules involve a real and dangerous threat to fiduciary law. Fiduciaries are essential to our modern society as specialization occurs in the face of greater and greater complexity. Indeed, the dangers posed by loosening fiduciary protections extend far beyond Wall Street and its consumers.

C. <u>State common law fiduciary duties applicable to investment advisors would still require detailed disclosures and informed consent even if principal trading rules are relaxed under the Advisors Act.</u>

"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). <u>Blanket disclosure and consent, rather than transaction-by-transaction consent, generally will not suffice because of the potential for self-dealing that can be associated with each principal transaction</u>. The Commission has instituted enforcement actions against investment advisers that violated Section 206(3) when they entered into principal transactions with their clients using prior blanket disclosures and consents. *See In the Matter of Stephens, Inc.*, Investment Advisers Act Release No. 1666 (Sept. 16, 1997); *In the Matter of Clariden Asset Management (New York) Inc*., Investment Advisers Act Release No. 1504 (July 10, 1995). In those cases, the principals acted as market makers and had the opportunity to profit when the market price of a security sold to a client out of its inventory was higher than the average cost of that security held in its inventory." <u>[Emphasis added.]</u>[viii]

As noted above, the Commission has long taken the position that blanket consent to principal trading is insufficient. It must be recognized that blanket consent fails not only the requirements of the Advisers Act, but also would run afoul of the fiduciary duties imposed upon investment advisers by state common law. Several cases (and there are many more) illustrate this concept:

> Informed consent is only present where the investor (client) is competent, has **<u>full knowledge</u>** of the relevant facts, knows his or her legal rights, and his or her consent is not induced by any other improper conduct of the trustee. *See Lambos v. Lambos*, 9 Ill.App.3d 530, 535, 292 N.E.2d 587 (1973).

> "[A]uthorization to engage in self-dealing must be **<u>clear and explicit</u>**. **<u>Full and complete disclosure is essential</u>** …." *Equ. Invest. v. Opportunity Equity*, 427 F.Supp.2d 491 (S.D.N.Y., 2006).

> "One of the most **<u>stringent precepts in the law</u>** 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 **<u>inevitably a conflict of interest</u>**: 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." *Birnbaum v. Birnbaum*, 117 A.D.2d 409, 503 N.Y.S.2d 451 (N.Y.A.D. 4 Dept., 1986).

Indeed, the very concept of advance consent of a blanket nature – without full disclosure of transaction-specific facts – is foreign to the concept of the duty of loyalty and the nature of informed consent (the only exception to the no-profit rule).

It must be noted that neither the 1934 Act nor the Advisers Act pre-empt state common law. In other words, the federal securities acts do not in any way disturb or interfere with the development of fiduciary principles under state law nor with their application. Hence, in the absence of federal or state legislation which preempts state common law fiduciary duties and their prohibitions against self-dealing absent transactional-specific informed consent following full disclosure of all material facts, any attempt to engage in principal trades via "blanket consent" provisions would expose investment advisers to state law claims for breach of their fiduciary duty of loyalty.

Investment advisers should not be put at jeopardy of civil suits which will inevitably arise from principal trades which occur without full advance written disclosure of the terms of the principal trade. Such civil suits will arise as state common law fiduciary duty claims, notwithstanding any relief the Commission may have desired to grant. The Commission should not deviate from uniformity in the law, especially when relaxation of federal standards does not result in a relaxation of state standards, and where both standards apply to investment advisers.

D. The real reason behind principal trading relief is to preserve the profits of Wall Street firms at the expense of individual investors. The Commission should not serve as a tool of broker-dealer firms to prevent disintermediation and stop progress in securing for individual investors a greater share of the returns the capital markets have to offer.

As agency transactions become more and more competitive (to the benefit of individual investors), broker-dealer firms seek to move toward principal trading in order to preserve their profits. As noted in studies by the IBM Institute for Business Value, in 2004 there was "essentially was a 50-50 split between the revenue contributions of agency trading ('riskfree') and principal trading (risk-incurring activities) for sell-side firms. By 2015, that split likely will be 70 percent for principal activities and 30 percent for agency."[ix]

Disintermediation is a powerful force. It has affected many, many industries. Often when industries face the impact of technology, education and a changing market place which provides consumers direct access to products and services, industry leaders attempt to preserve their profits by seeking intervention by regulators. Regulations relaxing principal trading rules is but one more attempt by the securities industry to preserve its profits at the expense of individual investors. True fiduciary advisers act as representatives of the client, to secure the returns of the capital markets for the client, not divert such returns into the hands of affiliated firms.

In summary, we again urge the Commission to proceed slowly and deliberately prior to relaxation of any fiduciary standard of conduct. There is no compelling reason to enact temporary or emergency relief in this area. Given the substantial harm which can result to individual investors and to the profession of the investment adviser, substantial study should be undertaken of all of the potential impacts of any proposed rule which might seek to relax principal trading restrictions.

Our Board of Directors and various committee members, who have carefully considered these issues, would be pleased to discuss these issues with you further. If you would like to follow up with us, please contact our CEO, Ellen Turf, at 847-483-5400.

Very truly yours,

Richard L Bellmer

Richard Bellmer
Chair, NAPFA

Ellen Turf

Ellen Turf
CEO, NAPFA

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
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[i] NAPFA is the nation's leading organization of Fee-Only® comprehensive financial planning professionals. All NAPFA members adhere to a fiduciary oath to exercise their best efforts to act in good faith and in the best interests of their clients. NAPFA-Registered Financial Advisors adhere to the three basic principles – comprehensive planning, professional competency, and Fee-Only® compensation. Approximately one-half of NAPFA's Financial Advisers are with investment advisory firms which are SEC-registered. Since 1982 NAPFA members have sought to protect the interests of investment consumers through their advocacy programs and service.

[ii] "Historically, the prohibitions go back to common law times and middle ages, the agent never deals with a principal. A principal never deals with his agent in establishing a price. It's not an arm's length price so how do you create a price." Robert E. Plaze, Roundtable On Investment Adviser Regulatory Issues (2001) (transcript). It must be emphasized that the fiduciary duty is the highest standard of care imposed at either equity or law. Accordingly, a fiduciary is expected to be extremely loyal to the person to whom they owe the duty (the "principal"): they must not put their personal interests before the duty, and must not profit from their position as a fiduciary, unless the principal provides informed consent thereto. Under the "no-profit" rule, a fiduciary must not profit from the fiduciary position. This includes any benefits or profits which, although unrelated to the fiduciary position, came about because of an opportunity that the fiduciary position afforded. It is unnecessary that the principal would have been unable to make the profit; if the fiduciary makes a profit, by virtue of their role as fiduciary for the principal, then the fiduciary must report the profit to the principal. If the principal consents then the fiduciary may keep the benefit. If this requirement is not met then the property is deemed by the court to be held by the fiduciary on constructive trust for the principal.

[iii] "Let's say you have a transaction that's fair, fair price, not dumping. But yet the transaction would not have occurred but for the need of the affiliate to remove those securities from books, the affiliate's." *Id.* An example might be the removal of subprime debt instruments from the books of the investment adviser, in order to shore up the investment adviser's reputation among investors, analysts or bond rating companies, and/or to actually reduce its risk exposure, even though a fair price for the transaction is achieved and even if the client is in a position to assume the risks of the debt or may not bear any reputational risk by reason of holding the security.

Achieving "best execution" does not solve all of the specific potential problems with principal trades, which include (but are not limited to): (1) dumping poorly performing stocks or bonds held by the broker into customer accounts; (2) marking the spread more than what is really suitable for the customer when other stocks or funds may be less costly; or (3) being paid higher incentives for pumping the new IPO to customers over other, more suitable investment options.

[iv] "Informed consent" by individual investors is highly unlikely to occur, for all of the reasons set forth in the memorandum attached as Appendix F to the Final Report of the FPA's Fiduciary Task Force (June 1, 2007), available at www.fpanet.org under "Government Relations' / "Professional Issues." As stated therein, "[I]ndividual consumers possess substantial barriers, resulting from behavioral biases, to the provision of informed consent, even after full disclosure. Moreover, "not only can marketers who are familiar with behavioral research manipulate consumers by taking advantage of weaknesses in human cognition, but .... competitive pressures almost guarantee that they will do so … To accept the premise, which broker-dealer firms often advance, that investors are responsible for understanding what they read and acting prudently thereafter, it is necessary to conclude that investors are not only armed with timely and adequate disclosure, but also that they possess an ability to understand the disclosures which have been provided to them, both intellectually and unhampered by behavioral biases. Consumer ability to understand is not only difficult due to the enormous knowledge base required to undertake decisions in dealing with a highly complex world, but also due to bounds upon human behavior that limit the extent to which people actually and effectively pursue utility maximization. Individuals possess substantial barriers, resulting from behavioral biases, to the provision of informed consent, even after full disclosure. *See* Prentice, "Whither Securities Regulation? Some Behavioral Observations Regarding Proposals For Its Future," 51 Duke L. J. 1397 (2002).

[v] *In the Matter of Certain Market Making on NASDAQ,* IA Rel. No. 1781 (Jan. 11, 1999).

[vi] Section 206 of the Advisers Act prohibits misstatements or misleading omissions of material facts and other fraudulent acts and practices in connection with the conduct of an investment advisory business. While fiduciary duties are not expressly mentioned by the Advisers Act, it is well-established that investment advisers do in fact bear such fiduciary duties to their clients, as Section 206 has been interpreted to impose such duties. "[T]he Committee Reports indicate a desire to preserve 'the personalized character of the services of investment advisers,' and to eliminate conflicts of interest between the investment adviser and the clients as safeguards both to 'unsophisticated investors' and to 'bona fide investment counsel.' The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser - consciously or unconsciously - to render advice which was not disinterested." *SEC vs. Capital Gains Research Bureau, Inc*., 375 U.S. 180 (1963), at 191-2.

[vii] SEC web site, "About Us" (August 2007).

[viii] No-Action Letter to Credit Suisse First Boston, LLC, August 31, 2005, from the Office of Chief Counsel, Division of Investment Management (August 31, 2005) (quotation from text and fn. 13).

[ix] IBM Global business Services, "Insights into the changing financial markets climate – What broker/dealers can do to stay out of the rain" (2006).