



Consumer Federation of America

September 17, 2014

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

Re: File Number 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 (CFA)¹ to oppose the current proposal to extend for another two years a “temporary” rule that provides broker-dealers that operate non-discretionary fee-based accounts with an alternate means of complying with the Investment Advisers Act’s principal trading rules. As we have previously stated, CFA believes it is possible to relax the Act’s principal trading restrictions in a way that is consistent with the protection of investors.² Indeed, the Advisers Act rules have in our view been rendered obsolete by changes in the market and are themselves in need of review and revision. However, as we noted when this rule was first issued as an interim final rule in 2007, we are not convinced that the current regulatory approach provides adequate protection against abusive principal trades.³ The primary question that ought to concern the Commission is whether the rule prevents principal trades that are disadvantageous to investors. But that is a question that the Commission appears never to have fully considered in its ongoing reliance on a temporary rule adopted in haste without adequate opportunity for public input.

Since first adopting this rule as an interim final rule, the Commission has justified maintaining its initial regulatory approach on the grounds that it was engaged in a broader consideration of the regulatory requirements for broker-dealers and investment advisers and would address the principal trading restrictions in that context. In 2010, we were persuaded that the Commission was poised to initiate fiduciary duty rulemaking that would address the issue, so we set aside our earlier objections to the Commission’s highly questionable procedural approach

¹ CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1967 to represent the consumer interest through research, advocacy and education.

² See November 30, 2007 letter from Mercer Bullard, Founder and President of Fund Democracy, and Barbara Roper, Director of Investor Protection of Consumer Federation of America, to Securities and Exchange Commission Secretary Nancy M. Morris, regarding File No. S7-23-07.

³ Ibid.

and agreed that it would be reasonable to extend the temporary rule “if, as we hope, more extensive revisions to the principal trading requirements are just around the corner.”⁴ As it turned out, however, rulemaking was not “just around the corner,” and it appears no closer to completion today. With no active rulemaking underway or even promised, it is simply not reasonable to continue to rely on vague and unspecified ongoing consideration of regulatory requirements for broker-dealers and investment advisers to justify yet another extension of this temporary rule without any consideration of its potentially harmful impact on investors or of alternative approaches that might be more effective.

The inadequacy of the Commission’s justification for extending the temporary rule is even more apparent when one considers how little the Commission appears to have done in the intervening years to assess the issue. The proposing release for this latest extension offers no evidence that the Commission has gained, or even sought, the information that would permit a thoughtful evaluation of its current regulatory approach. Or, if the Commission has done so, it has not shared that information with the public as part of the comment process. Instead, we are asked to accept on faith unsupported assertions by the Commission that investors and the markets would benefit from extension of the temporary rule.

1. The Commission has not adequately assessed whether the rule is effective in preventing principal trading abuses.

In its original 2007 release, the Commission stated that “the temporary nature of the rule will give us an opportunity to observe how firms comply with their obligations, and whether, when they conduct principal trades with their clients, they put their clients’ interests first.” In repeatedly proposing to extend the temporary rule, however, the only statement the Commission has made with regard to the appropriateness of broker-dealer recommendations when engaging in principal transactions is that “the staff has not identified instances where an adviser has used the temporary rule to ‘dump’ unmarketable securities or securities that the adviser believes may decline in value into an advisory account.” This statement was first included in the 2010 release. That release listed a variety of compliance failures identified by the Office of Compliance Inspections and Examinations (OCIE) as part of a special review it had conducted, but it failed to provide any information about the extent of those compliance failures or their impact on the quality of recommendations. Subsequent releases have repeated the statement, citing to the 2010 review. This failure to update the 2010 discussion suggests that the Commission may be operating on stale data in analyzing the impact of the rule.

Moreover, as we noted in our original comment letter, “While [dumping] might have been the primary potential abuse that principal trading created in simpler times, the potential for abuse arising from principal trades today is far broader and more varied than mere dumping. Advances in technology, speedier transactions, increased market volatility, more diverse trading platforms and other factors have brought benefits to the markets while also presenting more, and more complex, opportunities for principal trading abuses.”⁵ The Commission must update its understanding of the risks to investors associated with principal trading to reflect this new market

⁴ See December 20, 2010 letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Elizabeth M. Murphy regarding File No. S7-23-07.

⁵ Fund Democracy/CFA 2007 comment letter.

reality and assess the effectiveness of its proposed regulatory approach accordingly. There is no evidence in the proposing release that it has done so.

Among the investments most commonly sold to investors on a principal basis are corporate and municipal securities. Members of the Commission have recently raised concerns about this fixed income market, including with regard to what appear to be excessively high trading costs for retail investors who invest in municipal bonds.⁶ While not providing conclusive evidence, the pricing of municipal securities to retail investors at least suggests that the current principal trading rules may not be effective in ensuring that principal trades are executed in the best interest of investors. What, if anything, is the Commission doing to explore this question? The proposing release offers no hints. Unless and until it explores this issue, on what basis can the Commission reasonably claim that extending the rule benefits investors by preserving their access to securities sold on a principal basis in fee-based brokerage accounts? After all, those benefits only fully accrue to investors if the securities are sold to them on beneficial terms.

2. The proposal fails to consider evidence that has emerged since the rule was adopted which calls the rule's effectiveness into question.

There are additional serious gaps in the Commission's analysis in support of a rule extension. For example, the original extension of the rule was justified on the grounds that the Commission "needed additional time to understand how, and in what situations, the rule was being used." None of the subsequent releases have answered that question. The Section 913 staff study released in January 2011 did note that many retail investors maintain multiple accounts with broker-dealers for reasons that include "using the brokerage account to access products and services offered by a firm on a principal basis."⁷ One question that the Commission should answer is whether broker-dealers are using this multiple account structure to evade the principal trading restrictions for fee-based accounts and what, if any, impact that is having on investors.

Both the Advisers Act notice and consent approach, and the more flexible alternative approach incorporated in the temporary rule, are premised on the notion that investors can make an informed choice about engaging in principal transactions if they are provided with prior notice. In our original 2007 comment letter, we expressed concern that the proposed approach "reflects an over-reliance on disclosure and fails to incorporate adequate measures to prevent principal trading abuses."⁸ In particular, we stated: "If the Commission should decide to rely heavily on a disclosure and consent model of regulation, we strongly urge that it do so only after having assured through testing that such an approach would provide effective investor protections." Findings of the Commission's 2012 financial literacy study, which demonstrate that many investors are unable to determine the capacity in which a broker has acted based on

⁶ See, for example, remarks of Commissioner Michael S. Piwowar at the 2014 Municipal Finance Conference presented by *The Bond Buyer* and Brandeis International Business School, Aug. 1, 2014. Also, Harris, Lawrence E. and Piwowar, Michael S., "Secondary Trading Costs in the Municipal Bond Market," *The Journal of Finance* (Vol. LXI, NO. 3), June 2006.

⁷ SEC staff, *Study on Investment Advisers and Broker-Dealers: As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, January 2011, at p. 13.

⁸ Fund Democracy/CFA 2007.

confirmation disclosures, add urgency to that recommendation.⁹ Moreover, this and other research has documented the difficulty investors have in assessing the potential impact of conflicts of interest.¹⁰ Nonetheless, the subsequent releases reflect no such analysis of the effectiveness of the required disclosures in promoting informed consent by investors with regard to principal transactions.

As noted above, the 2010 rule release did provide evidence of significant compliance failures among firms that have chosen to rely on the rule. The release failed to make clear the extent of those abuses or their effect on the quality of recommendations to investors. It does not require much of a leap, however, to assume that a firm that failed to provide mandated disclosures or to adopt appropriate compliance programs might also be willing to recommend principal trades that placed the firm's interests ahead of those of their clients. In our 2010 comment, we noted that continued monitoring of compliance was essential, and we warned that "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." Subsequent releases, which simply cite to the 2010 reviews, suggest that the Commission has failed to take that warning to heart.

3. The proposal to further extend a long-pending and hastily adopted temporary rule continues the procedural abuses that led to the initial hasty rulemaking.

The current proposal is the direct result of an earlier decision by the Commission to forego normal rulemaking procedures and to act without regard either to the requirements of the Administrative Procedures Act or to the underlying statutory language its rules were intended to interpret. We are referring, of course, to the Commission's 1999 decision to allow its fee-based brokerage account rule proposal to take effect through a "no action" position without formal approval by the Commission. That "temporary" action lasted until 2005, when a lawsuit by the Financial Planning Association finally prompted the Commission to vote to finalize a rule. However, as we had repeatedly warned the Commission over the six years in which it relied on its no action position, the regulatory approach adopted by the Commission in that rule was clearly inconsistent with the statutory language of the Investment Advisers Act. In 2007, the U.S. Court of Appeals for the District of Columbia Circuit reached the same conclusion and vacated the rule.

That decision, or more accurately the Commission's procedural and policy abuses that led to that decision, forced a disruptive transition for fee-based brokerage accounts. These accounts, which had previously been regulated exclusively as brokerage accounts, were suddenly

⁹See, Siegel & Gale, LLC, Investor Research Report, Submitted to the Securities and Exchange Commission on July 26, 2012. (Part of the SEC's financial literacy study) When asked to read and respond to questions based on a sample stock trade confirmation, just over half of survey respondents (55.9 percent) were able to correctly identify that the firm acted as an agent in the transaction. Even fewer correctly answered a similar question based on a sample confirmation of a mutual fund trade in which the broker-dealer acted as a dual agent.

¹⁰ See, for example, Chater, Nick; Huck, Steffen; Inderst, Roman; and Goethe, Johann Wolfgang, *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective*, November 2010. (Coordinated by Decision Technology Ltd with participation by Online Interactive Research Ltd.). Also, Cain, Daylian M.; Loewenstein, George; and Moore, Don A., "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest," *Journal of Legal Studies*, vol. 34 (January 2005).

subject to the full regulatory requirements of the Investment Advisers Act, including the principal trading restrictions. With firms threatening to discontinue the accounts unless the Commission took steps to provide them with an exemption, the Commission quickly adopted its temporary rule on an interim final basis without providing an opportunity for prior public comment. Since then, it has finalized the rule and extended the sunset deadline two times, all without ever analyzing the rule's effectiveness in protecting investors or considering alternative regulatory approaches.

The economic analysis that the Commission has produced to justify this approach is a travesty. It is replete with vague, speculative statements about the benefits of the rule for which it offers no factual support. Indeed, six years after suggesting that the Commission would use the year before finalizing the interim final rule to determine how and to what extent the rule was being relied on by industry, the latest release reiterates that "the extent to which firms rely on the rule is unknown." How is it possible for the Commission to justify extending this temporary rule if it can't even answer the most basic questions about the extent to which firms are relying on the rule and under what circumstances, let alone whether the recommendations they make in reliance on the rule are in the best interests of the investor? And, without that knowledge, how can the Commission confidently assert that "non-discretionary advisory client access to a wider range of securities is beneficial" or, even more speculatively, that "greater access to a wider range of securities may allow non-discretionary advisory clients to more efficiently allocate capital and, in the long term, the more efficient allocation of capital may lead to an increase in capital formation"? With no apparent sense of irony, the Commission dismisses a similarly speculative statement from a commenter about the potential harmful consequences of the rule on the grounds that the commenter "did not provide any specific data, analysis, or other information in support of its comment."

Conclusion

When Congress adopted the Investment Advisers Act, it imposed tight restrictions on principal trading that reflected its deep concern that investors could be harmed by advisers who put their own interests ahead of those of their clients in effecting such transactions. As the Commission noted in its 2007 release, "Congress's concerns were and continue to be significant. Self-dealing by investment advisers involves serious conflicts of interest and a substantial risk that the proprietary interests of the adviser will prevail over those of its clients." Although the Commission has justified each prior extension on the grounds that it was conducting a broader review of the regulatory requirements for broker-dealers and investment advisers, the release offers no evidence that the Commission has engaged in any serious evaluation of the current regulatory approach in the years since the interim final rule was first adopted. That is particularly troubling since this regulatory approach was adopted without any prior opportunity for public comment and without any consideration of alternative regulatory approaches.

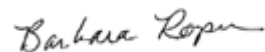
While we agree in theory that the principal trading rules would best be considered in the context of a broader review of the regulatory requirements for broker-dealers and investment advisers, the Commission offers no evidence that a broader assessment of alternative regulatory approaches is in fact underway. With no active rulemaking having been undertaken or even promised, the Commission cannot justify further delaying a formal consideration of principal

trading rules for fee-based accounts on this basis. Moreover, absent evidence that principal trades made subject to these rules are being conducted in investors' best interests, the Commission cannot justify maintaining its current regulatory approach on the grounds that it benefits investors and the markets.

For these reasons, we oppose the current proposal to extend the deadline for the current temporary rule for another two years. Instead, we urge the Commission to begin formal rulemaking to review and revise principal trading rules. In order to ensure that its rules promote the best interests of investors, that rulemaking must both analyze the effectiveness of the existing regulatory approach and give full and fair consideration to alternative regulatory approaches with the potential to better protect investors from principal trading abuses.

Thank you for your consideration of our views.

Respectfully submitted,



Barbara Roper
Director of Investor Protection

cc: The Honorable Mary Jo White, Chairman
The Honorable Luis Aguilar, Commissioner
The Honorable Daniel Gallagher, Commissioner
The Honorable Michael Piwowar, Commissioner
The Honorable Kara Stein, Commissioner