

SEC Adopts Temporary Rule Regarding Principal Trades with Certain Advisory Clients

On September 24, 2007, the Securities and Exchange Commission (“SEC”) adopted Temporary Rule 206(3)-3T (“Temporary Rule”) under the Investment Advisers Act of 1940 (“Advisers Act”). The Temporary Rule is effective from September 30, 2007 to December 31, 2009.

The Temporary Rule provides an alternative method for investment advisers that are also registered with the Commission as broker-dealers (“Dual Registrants”) under the Securities Exchange Act of 1934 (“Exchange Act”) to comply with Section 206(3) of the Advisers Act in instances where a Dual Registrant executes a principal transaction with an advisory client. Under Section 206(3), as interpreted by the SEC, principal trades include all trades in which an adviser or one of its affiliated entities trades with a client from its own account, including riskless principal transactions. Section 206(3) requires written disclosure to the client and written consent from the client prior to the settlement of each principal trade; so-called blanket consents have been interpreted by the SEC as insufficient to comply with Section 206(3). Although the Temporary Rule applies only to Dual Registrants, a principal trade executed between the client of a broker-dealer/adviser and one of its affiliated entities can rely on the Temporary Rule. The converse situation, however, is not covered by the Temporary Rule – an adviser that is not also a registered broker-dealer cannot rely upon the Temporary Rule in executing a principal trade through an affiliated broker-dealer/adviser.

The Commission adopted the Temporary Rule as part of its response to the decision in *Financial Planning Association v. SEC* (“FPA Decision”), which invalidated Rule 202(a)(11)-1 under the Advisers Act (“Fee-Based Rule”). The Fee-Based Rule provided, among other things, that certain brokerage accounts that were charged asset-based fees, rather than transaction-based fees, were not subject to the Advisers Act. As a result of the FPA Decision, broker-dealers offering clients certain fee-based brokerage accounts were required to comply with the provisions of the Advisers Act, including Section 206(3).

In adopting the Temporary Rule, the Commission sought to address a perceived industry concern that compliance with Section 206(3) – trade-by-trade disclosure and written client consent – is impractical while, at the same time, limiting client trading to agency only trading is also impractical. The Temporary Rule liberalizes the requirements of Section 206(3) by permitting oral client consent on a trade-by-trade basis, rather than the written client consent that had previously been required. Because a broker-dealer/adviser may not be certain in advance whether a trade will be executed on a principal, rather than an agency, basis, the Temporary Rule permits the oral disclosure to state that the trade may be executed on a principal basis.

The Temporary Rule is perceived by the brokerage industry as having several limitations.

First, there are several potentially burdensome conditions to compliance with the Temporary Rule, including the conditions set forth below.

- a. At the time of the principal trade, neither the broker-dealer/adviser nor any of its affiliates can be acting as an underwriter of the security, unless the underwritten security is “investment grade debt” as defined in the Temporary Rule. For example, the Temporary Rule is unavailable for a nondiscretionary principal trade in “a proprietary structured product, such as a structured note.”

- b. The client must execute a written, revocable prospective consent accompanied by a disclosure explaining the circumstances under which the broker-dealer/adviser may engage in principal transactions, the conflicts created by such transactions, and how the broker-dealer/adviser will address these conflicts.
- c. Confirmations for all principal transactions must contain a plain English statement that the broker-dealer/adviser disclosed to the client prior to the execution of the transaction that it would trade with the client on a principal basis and identify the trade as a principal trade. (As the SEC noted, confirmations cannot be used to satisfy the requirements of Section 206(3) because confirmations need only be sent when the trade is completed, whereas Section 206(3) requires that disclosure be delivered by the time the trade is completed.)
- d. The broker-dealer/adviser must send the client, at least annually, a list of all principal trades executed in reliance on the Temporary Rule and the date and price of each such transaction.
- e. Each written disclosure required by the Temporary Rule – which includes the initial authorization, the trade-by-trade confirmations, and the annual statements – must include a plain English statement that the client may revoke authorization for the arrangement at any time and without penalty.

Second, the Temporary Rule only applies to nondiscretionary accounts, except accounts where discretion is exercised on a “temporary or limited basis.” Fully discretionary accounts cannot rely on the Temporary Rule. Examples of “temporary and limited discretion” include discretion: “(i) as to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security; (ii) on an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time not to exceed a few months; (iii) as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent; (iv) to purchase or sell securities to satisfy margin requirements; (v) to sell specific bonds and purchase similar bonds in order to permit a customer to take a tax loss on the original position; (vi) to purchase a bond with a specified credit rating and maturity; and (vii) to purchase or sell a security or type of security limited by specific parameters established by the customer.”

Third, the Temporary Rule still requires trade-by-trade disclosure and client consent; blanket consents are not permitted. Although the Temporary Rule for the first time permits oral consent to principal trades, there can be questions of proof in verifying that the required oral disclosure and client consent has been obtained. This risk can be lessened by taping conversations with the client, although taping can be a burdensome and potentially unreliable process.

Fourth, since the Temporary Rule will expire on December 31, 2009, it cannot be relied upon to plan long-term business initiatives.

The SEC noted that compliance with the Temporary Rule would not relieve a broker-dealer/adviser from its fiduciary duties imposed by the Advisers Act or other federal law to seek best execution of client transactions, to provide full and fair disclosure about material conflicts of interest, and to act in the best interests of its clients.

Contact Information

Richard Marshall

212-596-9006

richard.marshall@ropesgray.com