SEC Adopts Interim Rule Regarding Adviser Principal Trades and Proposes Rule Interpreting the Broker-Dealer Exclusion from the Advisers Act

On September 24, 2007, the SEC published its release adopting Temporary Rule 206(3)-3T (“Interim Rule”)1 under the Advisers Act to afford investment advisers that are dually registered as broker-dealers (“Dual Registrants”) limited relief from the principal trading restrictions under Section 206(3) of the Advisers Act. In a companion release, the SEC proposed a rule to clarify the scope of “solely incidental” and “special compensation” for purposes of the broker-dealer exclusion from the definition of investment adviser in Section 202(a)(11)(C).2 The SEC’s actions were taken in anticipation of the October 1, 2007 effective date of a recent DC Circuit Court ruling that vacated Advisers Act Rule 202(a)(11)-1, which had permitted broker-dealers to receive fee-based compensation without registering as investment advisers.3

The following is a high level summary of significant issues addressed in the SEC’s Releases, which are attached. We expect to follow this with a more detailed analysis in the near future. In the meantime, do not hesitate to call the contact persons listed below with any questions.

The Interim Rule

Currently, Dual Registrants that offer fee-based non-discretionary accounts are required under Section 206(3) of the Advisers Act, among other things, to give written notice and obtain client consent on a transaction-by-transaction basis when trading as a principal with these accounts.4 The Interim Rule provides the following relief:

Blanket Written Notice and Consent. The Interim Rule allows Dual Registrants to give clients blanket written prospective notice and obtain clients’ blanket written revocable prospective consent with respect to principal transactions with non-discretionary advisory accounts, provided the Dual Registrar gives oral notice and obtains the client’s oral consent to the Dual Registrar’s capacity as principal on a transaction-by-transaction basis.

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1 Temporary Rule Regarding Principal Trades with Certain Advisory Clients (Release No. IA-2653) (September 24, 2007).
4 Section 206(3) provides that:

[i]t shall be unlawful for any investment adviser. . . acting as principal for his own account, knowingly to sell any security to or purchase any security from a client . . . without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.
The written notice must include disclosures about the circumstances under which the Dual Registrant may engage in principal transactions and conflicts of interest related to principal trading, including how the firm addresses such conflicts. The Interim Rule does not relieve any adviser of its fiduciary obligations imposed by the Advisers Act or other applicable provisions of federal law.

**Eligible Securities.** The relief is available for principal transactions in securities other than (i) securities issued by the Dual Registrant or its affiliates, or (ii) securities underwritten by the Dual Registrant or its affiliates, with the exception of certain investment-grade debt securities, which for this purpose, are non-convertible debt securities that, at the time of the sale, are rated in one of the four highest rating categories of at least two nationally recognized statistical rating organizations.

**Confirmations.** The Dual Registrant must send the client a confirmation at or before completion of the transaction that includes the information required under Exchange Act Rule 10b-10, and in plain English, disclose that it informed the client that it may act in a principal capacity, that the client authorized the transaction, and that the Dual Registrant sold the security to, or bought the security from, the client for its own account.

**Annual Report of Principal Transactions.** Dual Registrants must provide clients with an annual report of principal trades effected in their account for the year, including the date and price of such transactions.

**Brokerage Account.** The Interim Rule requires that each account for which a Dual Registrant relies on the Interim Rule be a brokerage account. Dual Registrants may rely on the Interim Rule with respect to all non-discretionary advisory accounts, not just those that were originally established as fee-based accounts, provided the Dual Registrant meets the other conditions of the Interim Rule.

**Effective Dates.** The Interim Rule is effective September 30, 2007 and will sunset on December 31, 2009, unless extended by the SEC.

**Grace Period.** Dual Registrants may rely on the Interim Rule with respect to existing fee-based accounts that convert to non-discretionary advisory accounts, provided the Dual Registrant provides the required written notification to such clients before engaging in any principal transactions, obtains the written consents from such clients by January 1, 2008, and otherwise complies with the Interim Rule. Dual Registrants similarly have a grace period until January 1, 2008 for delivery of the information required to be disclosed in Part II of Form ADV to existing fee-based accounts that convert to non-discretionary advisory accounts.

The SEC invited comments on the Interim Rule to be submitted by November 30, 2007.

**Proposed Rule**

The SEC also proposed Advisers Act Rule 202(a)(11)-1 to reinstate certain interpretative positions that address the broker-dealer exclusion from the definition of an “investment adviser” in Section 202(a)(11)(C) under the Advisers Act, which was left in doubt following the DC Circuit Court decision that vacated the earlier iteration of this rule. Specifically, a broker-dealer is not deemed to be an investment adviser under Section 202(a)(11)(C) of the Advisers Act if the broker-dealer’s advisory services are “solely incidental” to the brokerage services and the broker-dealer receives no “special compensation” for such services. The proposed rule revisions address these aspects of the definition of investment adviser as described below. Comments are due on the rule proposal by November 2, 2007.

Proposed Rule 202(a)(11)-1 would provide the following:

**Separate Fee or Contract.** When a broker-dealer enters into a separate contract with a client for advisory services or charges a separate fee for advisory services, such advisory services would not be considered “solely incidental” to the firm’s brokerage services and would be subject to the Advisers Act.

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Discretionary Accounts. The exercise of investment discretion (except in limited cases) over an account would not be deemed “solely incidental” to brokerage services, irrespective of the form of the broker-dealer’s compensation.

Varying Fee Schedules. Brokerage firms would not be considered to be receiving “special compensation” simply because they charge a commission, mark-up, markdown or similar fee for brokerage services solely because such fee is greater for some customers than for others. Similarly, firms that offer different fee schedules, such as one for discount brokerage and a higher fee schedule for full service brokerage, would not be considered to be receiving “special compensation” solely because of the price differential.

Account-by-Account Determination. Dual Registrants would be considered investment advisers with respect only to those accounts for which they provide advisory services or receive compensation that subject the firm to the Advisers Act.

The SEC is not currently addressing the financial planning aspect of its prior interpretations. Instead, the SEC will consider this as part of the Rand Corporation study of broker-dealer and investment adviser regulatory protections, thus leaving open issues regarding broker-dealers’ financial planning activities.

For more information, please contact one of the professionals listed below.

Washington, D.C.
Diane E. Ambler diane.ambler@klgates.com +1.202.778.9886
C. Dirk Peterson dirk.peterson@klgates.com +1.202.778.9324
Melissa A. Roverts melissa.roverts@klgates.com +1.202.778.9058

San Francisco
Elaine A. Lindenmayer elaine.lindenmayer@klgates.com +1.415.249.1042
David Mishel david.mishel@klgates.com +1.415.249.1015

New York
David Dickstein david.dickstein@klgates.com +1.212.536.3978