

CAHILL GORDON & REINDEL LLP
EIGHTY PINE STREET
NEW YORK, NEW YORK 10005-1702
TELEPHONE: (212) 701-3000
FACSIMILE: (212) 269-5420

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SEC Adopts Temporary Rule on Principal Trades With Certain Advisory Clients

On September 19, 2007, the Securities and Exchange Commission (the “Commission”) adopted, on an “interim final basis,” Temporary Rule 206(3)-3T (the “Temporary Rule”) under the Investment Advisers Act of 1940, as amended (the “Advisers Act”).¹ The Temporary Rule creates an alternative for investment advisers who are also registered as broker-dealers with the Commission to meet the requirements of Section 206(3) of the Advisers Act when they engage in principal trading with non-discretionary advisory clients. Section 206(3) permits such transactions only when advisers properly inform clients of the conflicts of interest inherent in principal trades and obtain, prior to the execution of a principal trade, written consent from such clients on a transaction-by-transaction basis. As a practical matter, these requirements act as a bar to investment advisers engaging in principal trades with their clients.

The Temporary Rule was adopted in response to the decision by the U.S. Court of Appeals for the District of Columbia Circuit in *Financial Planning Association v. SEC*, which vacated Rule 202(a)(11)-1 under the Advisers Act effective October 1, 2007.² Rule 202(a)(11)-1 provided relief from the requirements of Section 206(3) to broker-dealers that offered fee-based brokerage accounts by deeming so called “wrap accounts” not to be advisory accounts. By vacating Rule 202(a)(11)-1, the decision in *FPA* meant that broker-dealers offering such accounts would be deemed, by virtue of such product offerings, investment advisers subject to registration under the Advisers Act. Therefore, among other things, principal transactions between brokers and their clients effected through wrap accounts would be subject to the requirements of Section 206(3).

As a result of the Court’s mandate in *FPA*, broker-dealers offering fee-based brokerage accounts are faced with two alternatives: (a) register as investment advisers under the Advisers Act thus subjecting any principal trades they effect with clients to the trade-by-trade prior written consent requirements of Section 206(3), or (b) convert their wrap accounts to commission-based brokerage accounts — effectively eliminating their wrap account products. The Temporary Rule provides some relief from

¹ Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Release No. IA-2653; File No. S7-23-07 (Sept. 24, 2007) available at <http://www.sec.gov/rules/final/2007/ia-2653.pdf> (the “Adopting Release”).

² 482 F.3d 481 (D.C. Cir. 2007), hereafter referred to as “*FPA*.”

the effects of the *FPA* decision, at least for broker-dealers that are also already registered as investment advisers under the Advisers Act.³ The relief afforded by the Temporary Rule is in the form of easing some of the more onerous provisions of Section 206(3) provided certain disclosure requirements are met.

Perhaps the most significant element of the Temporary Rule is that a client's *written* consent to principal trades may be given prospectively. While client consent will still be required on a trade-by-trade basis, such consent may be given *orally* provided the requisite written consent has previously been obtained. This feature of the Temporary Rule removes what has perhaps been the most significant barrier to utilizing the procedures required by Section 206(3) since the steps needed to obtain client prior written consent on a trade-by-trade basis are most often viewed as impractical in the context of the execution of a trade under circumstances when time may be of the essence.

The Temporary Rule will be effective on September 30, 2007 and will expire on December 31, 2009. A brief summary of the Temporary Rule follows.

I. Temporary Rule 206(3)-3T

The Temporary Rule deems an investment adviser desiring to engage in a principal trade with a client to be in compliance with Section 206(3) of the Advisers Act when the adviser, or a person controlling, controlled by or under common control with the investment adviser, acting as principal for its own account, sells to or purchases from an advisory client any security, as long as the adviser:

- Is registered as a broker-dealer under Section 15 of the Exchange Act.
- Each account for which the adviser relies on the Temporary Rule is a brokerage account that is subject to the Exchange Act and the rules of the self-regulatory organization(s) of which the adviser is a member.⁴
- Provides its client, at the outset of the relationship, with written disclosure regarding: (1) the circumstances under which the investment adviser may engage in principal transactions with the client; (2) the nature and significance of the conflicts arising from principal trades; and (3) how the adviser addresses those conflicts.⁵
- Obtains written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions.⁶

³ The Temporary Rule is also available to investment advisers that are registered as broker-dealers under the Securities Exchange Act of 1934, as amended (the "Exchange Act").

⁴ Temporary Rule 206(3)-3T(a)(7).

⁵ Temporary Rule 206(3)-3T(a)(3).

⁶ *Id.*

- Makes, prior to each transaction, disclosures, either orally or in writing, that the adviser may act in a principal capacity with respect to the transaction and obtain the client's consent for that transaction.⁷
- Sends a confirmation statement to the client, at or before completion of the transaction, disclosing, in addition to the information required by Rule 10b-10 of the Exchange Act: (1) the capacity in which the adviser acted; (2) that the adviser informed the client that it may act in a principal capacity; and (3) that the client authorized the transaction.⁸
- Delivers an annual report to the client, listing each principal transaction during the preceding year and the date and price of each such transaction.⁹
- Provides a conspicuous, plain English statement that the prospective consent may be revoked at anytime, which is included with each written disclosure, confirmation, and request for written prospective consent.¹⁰

II. Eligible Securities

The Temporary Rule applies to any principal trade with a non-discretionary client except where the investment adviser is the issuer or underwriter (or control person of the issuer or underwriter) of the security. The Commission believes that an investment adviser who is also an issuer or underwriter of a security has too great a conflict of interest and thus should not obtain the benefit of the relief offered by the Temporary Rule. An exception to the limitation on eligible securities is provided in the case of an adviser acting as an underwriter of non-convertible investment-grade debt securities.

III. SEC Rationale for the Temporary Rule

In adopting the Temporary Rule the Commission noted that it believed that there may be substantial benefits to many of the investors holding an estimated \$300 billion in approximately one million fee-based brokerage accounts if their accounts are converted to advisory accounts instead of traditional brokerage accounts. Those investors will continue to be able to avoid transaction-based compensation and the incentives such a compensation arrangement creates for a broker-dealer, a reason they may have initially opened fee-based brokerage accounts. They also will enjoy, as the Court pointed out in the *FPA* decision, the protections of the “federal fiduciary standard [that] govern[s] the conduct of investment advisers.”

⁷ Temporary Rule 206(3)-3T(a)(4).

⁸ Temporary Rule 206(3)-3T(a)(5).

⁹ Temporary Rule 206(3)-3T(a)(6).

¹⁰ Temporary Rule 206(3)-3T(a)(8).

The Commission believes that the “temporary rule will allow fee-based brokerage customers to maintain their existing relationships with, and receive roughly the same services from, their broker-dealers.”¹¹

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jon Mark at (212) 701-3100 or jmark@cahill.com.

¹¹ Adopting Release at 11-12.