SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

Release No. IA-3118; File No. S7-23-07

RIN 3235-AJ96

Temporary Rule Regarding Principal Trades with Certain Advisory Clients

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is proposing to amend rule 206(3)-3T under the Investment Advisers Act of 1940, a temporary rule that establishes an alternative means for investment advisers who are registered with the Commission as broker-dealers to meet the requirements of section 206(3) of the Investment Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients. The amendment would extend the date on which rule 206(3)-3T will sunset from December 31, 2010 to December 31, 2012.

DATES: Comments must be received on or before December 20, 2010.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-23-07 on the subject line; or

- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-23-07. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Brian M. Johnson, Attorney-Adviser, Devin F. Sullivan, Senior Counsel, Matthew N. Goldin, Branch Chief, or Sarah A. Bessin, Assistant Director, at (202) 551-6787 or *IArules@sec.gov*, Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5041.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is proposing an amendment to temporary rule 206(3)-3T [17 CFR 275.206(3)-3T] under the

Investment Advisers Act of 1940 [15 U.S.C. 80b] that would extend the date on which the rule will sunset from December 31, 2010 to December 31, 2012.

I. BACKGROUND

On September 24, 2007, we adopted, on an interim final basis, rule 206(3)-3T, a temporary rule under the Investment Advisers Act of 1940 (the "Advisers Act") that provides an alternative means for investment advisers who are registered with us as broker-dealers to meet the requirements of section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients.[1] The purpose of the rule was to permit broker-dealers to sell to their advisory clients, in the wake of *Financial Planning Association v. SEC* (the "FPA Decision"),[2] certain securities held in the proprietary accounts of their firms that might not be available on an agency basis — or might be available on an agency basis only on less attractive terms[3] — while protecting clients from conflicts of interest as a result of such transactions.[4]

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1 Rule 206(3)-3T [17 CFR 275.206(3)-3T]. All references to rule 206(3)-3T and the various sections thereof in this release are to 17 CFR 275.206(3)-3T and its corresponding sections. *See also Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2653 (Sep. 24, 2007) [72 FR 55022 (Sep. 28, 2007)] ("2007 Principal Trade Rule Release").

2 482 F.3d 481 (D.C. Cir. 2007). In the FPA Decision, handed down on March 30, 2007, the Court of Appeals for the D.C. Circuit vacated (subject to a subsequent stay until October 1, 2007) rule 202(a)(11)-1 under the Advisers Act. Rule 202(a)(11)-1 provided, among other things, that fee-based brokerage accounts were not advisory accounts and were thus not subject to the Advisers Act. For further discussion of fee-based brokerage accounts, see 2007 Principal Trade Rule Release, Section I.

3 *See* 2007 Principal Trade Rule Release at nn.19-20 and Section VI.C.

4 As a consequence of the FPA Decision, broker-dealers offering fee-based brokerage accounts with an advisory component became subject to the Advisers Act with respect to those accounts, and the client relationship became fully subject to the Advisers Act. These broker-dealers — to the extent they wanted to continue to offer fee-based accounts and met the requirements for registration — had to: register as investment advisers, if they had not done so already; act as fiduciaries with respect to those clients; disclose all material conflicts of interest; and otherwise fully comply with the Advisers Act,

As initially adopted on an interim final basis, rule 206(3)-3T was set to expire on December 31, 2009. In December 2009, however, we adopted rule 206(3)-3T as a final rule in the same form in which it was adopted on an interim final basis in 2007, except that we extended the rule's sunset period by one year to December 31, 2010.[5] We deferred final action on rule 206(3)-3T in December 2009 because we needed additional time to understand how, and in what situations, the rule was being used.[6]

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[7] Under section 913 of the Dodd-Frank Act, we are required to conduct a study, and provide a report to Congress, concerning the obligations of broker-dealers and investment advisers, including the standards of care applicable to those intermediaries and their associated persons.[8] We intend to deliver the report concerning this study, as required by the Dodd-Frank Act, no later than January 21, 2011.[9]

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including the restrictions on principal trading contained in section 206(3) of the Act. *See* 2007 Principal Trade Rule Release, Section I.

5 *See Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2965 (Dec. 23, 2009) [74 FR 69009 (Dec. 30, 2009)] ("Extension Release") and *Temporary Rule Regarding Principal Trades With Certain Advisory Clients*, Investment Advisers Act Release No. 2965A (Dec. 31, 2009) [75 FR 742 (Jan. 6, 2010)] (making a technical correction to the Extension Release).

6 *See* Extension Release, Section II.c.

7 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

8 *See generally* section 913 of the Dodd-Frank Act and *Study Regarding Obligations of Brokers, Dealers, and Investment Advisers*, Investment Advisers Act Release No. 3058 (July 27, 2010) [75 FR 44996 (July 30, 2010)].

9 *See* section 913(d)(1) of the Dodd-Frank Act (requiring us to submit the study to Congress no later than six months after the date of enactment of the Dodd-Frank Act).

Our staff has observed the use of the rule by entities that are investment advisers also registered with us as broker-dealers.[10] Of the firms contacted by our staff, some firms indicated that they were relying on the rule. As discussed more fully below, our staff observed several compliance issues. The staff is pursuing those matters where appropriate, including referrals to the Division of Enforcement.

II. DISCUSSION

We are proposing to amend rule 206(3)-3T only to extend the rule's expiration date by two additional years. If the rule is amended, absent further action by the Commission, the rule will expire on December 31, 2012.

As noted above, under section 913 of the Dodd-Frank Act, we are required to conduct a study and provide a report to Congress concerning the obligations of broker-dealers and investment advisers, including the standard of care applicable to those intermediaries.[11] We are required to deliver the report concerning this study no later than six months after the enactment of the Dodd-Frank Act, in January 2011.[12]

Section 913 of the Dodd-Frank Act also authorizes us to promulgate rules concerning, among other things, the legal or regulatory standards of care for broker-dealers, investment advisers, and persons associated with these intermediaries for providing personalized investment advice about securities to retail customers. In enacting any rules pursuant to this authority, we are required to consider the findings, conclusions, and recommendations of the mandated study. The study and our

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10 Rule 206(3)-3T is available only to an investment adviser that is a broker-dealer registered under section 15 of the Securities Exchange Act of 1934 [15 U.S.C. 78o]. Rule 206(3)-3T(a)(7).

11 *See supra* note 8 and accompanying text.

12 *See supra* note 9 and accompanying text.

consideration of the need for further rulemaking pursuant to this authority are part of our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers in connection with the Dodd-Frank Act.[13]

As part of this study and any rulemaking that may follow, we expect to consider the issues raised by principal trading, including the restrictions in section 206(3) of the Advisers Act and our experiences with, and observations regarding, the operation of rule 206(3)-3T. We will not, however, complete our consideration of these issues before December 31, 2010, rule 206(3)-3T's current expiration date.

We believe that firms' compliance with the substantive provisions of rule 206(3)-3T as currently in effect provides sufficient protections to advisory clients to warrant the rule's continued operation for an additional limited period of time while we conduct the study mandated by the Dodd-Frank Act and consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers.[14]

If we permit rule 206(3)-3T to expire on December 31, 2010, after that date investment advisers also registered as broker-dealers who currently rely on rule 206(3)-3T would be required to comply with section 206(3)'s transaction-by-transaction written disclosure and consent requirements without the benefit of the alternative means of complying with these requirements currently provided by rule 206(3)-3T. This could

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[13] The study mandated by section 913 of the Dodd-Frank Act is one of several studies and other actions relevant to the regulation of broker-dealers and investment advisers mandated by that Act. *See, e.g.*, section 914 of the Dodd-Frank Act (requiring the Commission to review and analyze the need for enhanced examination and enforcement resources for investment advisers); section 919 of the Dodd-Frank Act (authorizing the Commission to issue rules designating documents or information that shall be provided by a broker or dealer to a retail investor before the purchase of an investment product or service by the retail investor).

[14] For a discussion of some of the benefits underlying rule 206(3)-3T, see 2007 Principal Trade Rule Release, Section VI.C.

limit the access of non-discretionary advisory clients of advisory firms that are also registered as broker-dealers to certain securities.[15] In addition, certain of these firms have informed us that, if rule 206(3)-3T were to expire on December 31, 2010, they would be required to make substantial changes to their disclosure documents, client agreements, procedures, and systems.

As noted above, our staff has observed the use of the rule by entities that are investment advisers and are also registered as broker-dealers.[16] Of the firms contacted by our staff, some indicated that they were relying on the rule. Significantly, among those advisers, our staff did not identify instances of "dumping," a particular concern underlying section 206(3) of the Advisers Act.[17] However, our staff did observe certain compliance issues, including but not limited to instances in which firms:

- did not comply with section 206(3) or rule 206(3)-3T for certain transactions that were executed on a principal basis;[18]

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15 *See id.*

16 The Office of Compliance Inspections and Examinations conducted examinations regarding compliance with rule 206(3)-3T. The staff's observations discussed in this release are from these examinations.

17 Congress intended section 206(3) to address concerns that an adviser might engage in principal transactions to benefit itself or its affiliates, rather than the client. In particular, Congress was concerned that advisers might use advisory accounts to "dump" unmarketable securities or those the advisers fear may decline in value. *See* Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. of the Comm. on Banking and Currency, 76th Cong., 3d Sess. 320, 322 (1940) ("[i]f a fellow feels he has a sour issue and finds a client to whom he can sell it, then that is not right. . . .") (statement of David Schenker, Chief Counsel, Securities and Exchange Commission Investment Trust Study).

18 For example, the staff observed instances in which transactions in underwritten securities were not identified as being executed in a principal capacity, even when these securities passed through a firm's inventory. In addition, the staff observed instances in which firms executed principal transactions in reliance on rule 206(3)-3T in securities that were ineligible for trading pursuant to the rule.

- demonstrated weaknesses relating to compliance monitoring of electronic systems to identify principal trades and to validate compliance with rule 206(3)-3T's disclosure and consent provisions;[19]
- failed to test periodically the adequacy of their compliance programs;
- had inadequate policies and procedures concerning rule 206(3)-3T;[20]
- did not provide disclosures or provided disclosures that appeared to be potentially confusing, misleading, or incomplete;[21]
- failed to obtain transaction-by-transaction consent;
- provided written confirmations that appeared to be potentially confusing or incomplete;[22] and
- maintained books and records in a manner that did not enable the staff meaningfully to assess compliance with rule 206(3)-3T.[23]

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19 For example, in some instances, automated compliance systems erroneously permitted advisory client transactions to be executed on a principal basis for clients that had not authorized such transactions.

20 *See* 2007 Principal Trade Rule Release, Section II.B.8 (". . . an adviser relying on rule 206(3)-3T as an alternative means of complying with section 206(3) must have adopted and implemented written policies and procedures reasonably designed to comply with the requirements of the rule."); Rule 206(4)-7(a) [17 CFR 275.206(4)-7(a)] (requiring an investment adviser registered with us to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act (and the rules thereunder) by the adviser or any of its supervised persons).

21 Such observations were made with respect to prospective written disclosures, transaction-by-transaction disclosures, and client annual reports. For example, the staff observed instances in which firms placed limitations on clients' ability to revoke their permission to execute transactions on a principal basis. The staff also observed instances in which annual summary reports were not sent to clients or were incomplete.

22 For example, the staff observed instances in which confirmations did not clearly state that the client's consent was given *prior to execution.*

23 For example, in some instances, the staff was unable to verify whether oral transaction-by-transaction disclosures were, in fact, provided. The staff also observed instances in

We find it important that the staff found no instances of "dumping" by advisers the staff observed were relying on rule 206(3)-3T.[24] However, we remain concerned about the compliance issues observed by the staff. As noted above, the staff is pursuing those matters where appropriate, including referrals to the Division of Enforcement. If the rule is extended, the staff will monitor compliance and continue to take appropriate action to help ensure that firms are complying with the rule's conditions, including referring firms to the Division of Enforcement if warranted. We further encourage all firms that rely on rule 206(3)-3T to evaluate whether they have any of the compliance issues discussed in this Release, and if so, to take steps to address them.

In light of these and other considerations discussed in this Release, we believe that it would be premature to require these firms to restructure their operations and client relationships before we complete our study and our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers. To the extent our consideration of these issues leads to new rules concerning principal trading, these firms would again be required to restructure their operations and client relationships, potentially at substantial expense.

As part of our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers, we intend to carefully consider principal trading by advisers, including whether rule 206(3)-3T should be substantively modified, supplanted, or permitted to expire. In making these determinations, we expect to consider, among other things, the results of the study required by section 913 of the

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which it was unable to establish whether certain transactions were, in fact, subject to section 206(3).

24 *See supra* note 17.

Dodd-Frank Act, relevant comments received in connection with the study and any potential rulemaking that may follow, the results of our staff's evaluation of the operation of rule 206(3)-3T, any relevant comments we receive in connection with this proposal, and comments we received in response to the 2007 Principal Trade Rule Release.

We expect to revisit the relief provided in rule 206(3)-3T following the completion of our study. Although we anticipate that will occur prior to the proposed amended expiration date for the temporary rule, we want to ensure that we have sufficient time to complete any potential rulemaking process prior to the rule's expiration.

III. REQUEST FOR COMMENT

We request comment on our proposal to extend rule 206(3)-3T for two additional years.

- Is it appropriate to extend rule 206(3)-3T for a limited period of time in its current form while we complete our study and our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers? Or should we allow the rule to expire?
- Given the compliance issues observed, is extending the rule appropriate?
- Is two years an appropriate period of time to extend the rule? Or should we extend the rule for a different period of time? If so, for how long?

IV. PAPERWORK REDUCTION ACT

Rule 206(3)-3T contains "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[25] The Office of Management and Budget ("OMB") approved the burden estimates presented in the 2007 Principal Trade

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[25] 44 U.S.C. 3501 *et seq.*

Rule Release,[26] first on an emergency basis and subsequently on a regular basis. OMB approved the collection of information with an expiration date of March 31, 2011. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The title for the collection of information is: "Temporary rule for principal trades with certain advisory clients, rule 206(3)-3T" and the OMB control number for the collection of information is 3235-0630. As noted in the Extension Release, the 2007 Principal Trade Rule Release solicited comments on our PRA estimates, but we did not receive comment on them.[27]

The amendment to the rule we are proposing today — to extend rule 206(3)-3T for two years — does not affect the burden estimates contained in the 2007 Principal Trade Rule Release. Therefore, as was the case when we extended rule 206(3)-3T in December 2009, we are not revising our Paperwork Reduction Act burden and cost estimates submitted to OMB.

We request comment on whether the estimates and underlying assumptions that are more fully described in the 2007 Principal Trade Rule Release continue to be reasonable.[28] Have circumstances changed since that time such that these estimates should be modified or revised? Persons submitting comments should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Elizabeth M. Murphy, Secretary,

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26 *See* 2007 Principal Trade Rule Release, Section V.B&C.

27 *See* Extension Release, Section IV.

28 *See* 2007 Principal Trade Rule Release, Section V.

Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with referece to File No. S7-23-07.

V. COST-BENEFIT ANALYSIS

Other than proposing to extend rule 206(3)-3T's sunset period for two years, we are not otherwise proposing to modify the rule from the form in which we initially adopted it on an interim final basis in September 2007 or as final in December 2009. We discussed the benefits provided by rule 206(3)-3T in both the 2007 Principal Trade Rule Release and the Extension Release.

In summary, as explained in the 2007 Principal Trade Rule Release and the Extension Release,[29] we believe the principal benefit of rule 206(3)-3T is that it maintains investor choice and protects the interests of investors who formerly held an estimated $300 billion in fee-based brokerage accounts. A resulting second benefit of the rule is that non-discretionary advisory clients of advisory firms that are also registered as broker-dealers have easier access to a wider range of securities which, in turn, should continue to lead to increased liquidity in the markets for these securities and promote capital formation in these areas. A third benefit of the rule is that it provides the protections of the sales practice rules of the Securities Exchange Act of 1934 ("Exchange Act")[30] and the relevant self-regulatory organizations because an adviser relying on the rule must also be a registered broker-dealer. Another benefit of rule 206(3)-3T is that it provides a lower cost alternative for an adviser to engage in principal transactions. We did not receive comments directly addressing with supporting data the cost-benefit

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[29] *See id.*, Section VI; Extension Release, Section V.

[30] 15 U.S.C. 78 *et seq*.

analysis we presented in the 2007 Principal Trade Rule Release and we continue to believe those benefits apply today.

In addition to the general benefits described in those releases, there also are benefits to extending the rule for an additional two years. If we do not extend the rule in its current form, firms currently relying on the rule would be required to restructure their operations and client relationships on or before the rule's current expiration date — potentially only to have to do so again shortly thereafter (first when the rule expires or is modified, and again if we adopt a new approach after the study mandated by the Dodd-Frank Act, discussed above, is complete). By extending the rule for two years, non-discretionary advisory clients who have had access to certain securities because of their advisers' reliance on the rule to trade on a principal basis would continue to have access to those securities without disruption. Firms relying on the rule would continue to be able to offer clients and prospective clients access to certain securities on a principal basis as well and would not need during this two-year period to incur the cost of adjusting to a new set of rules or abandoning the systems established to comply with the current rule. In other words, extension would avoid disruption to clients and firms during the period while we complete the study mandated by section 913 of the Dodd-Frank Act and our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers.

We also described the costs associated with rule 206(3)-3T, including the operational costs associated with complying with the rule, in the 2007 Principal Trade Rule Release and the Extension Release. We presented estimates of the costs of each of the rule's disclosure elements, including: prospective disclosure and consent; transaction-by-transaction disclosure and consent; transaction-by-transaction confirmations; and the annual report of principal transactions. We also provided estimates for the following related costs of compliance with rule 206(3)-3T: (i) the initial distribution of prospective disclosure and collection of consents; (ii) systems programming costs to ensure that trade confirmations contain all of the information required by the rule; and (iii) systems programming costs to aggregate already-collected information to generate compliant principal transactions reports. We did not receive comments directly addressing with supporting data the cost-benefit analysis we presented in the 2007 Principal Trade Rule Release and we believe the amendments we are proposing today would not materially affect those costs.[31]

We recognize that if today's amendment is adopted, firms relying on the rule would incur the costs associated with complying with the rule for two additional years.

We request comment on all aspects of the cost-benefit analysis, including the accuracy of the potential costs and benefits identified and assessed in this Release, the 2007 Principal Trade Rule Release and the Extension Release, as well as any other costs or benefits that may result from the proposal.

VI. PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION

Section 202(c) of the Advisers Act mandates that the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, consider, in addition to the protection of

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31 In the 2007 Principal Trade Rule Release, we estimated the total overall costs, including estimated costs for all eligible advisers and eligible accounts, relating to compliance with rule 206(3)-3T to be $37,205,569. *See* 2007 Principal Trade Rule Release, Section VI.D.

investors, whether the action will promote efficiency, competition, and capital formation.[32]

We explained in the 2007 Principal Trade Rule Release and the Extension Release the manner in which rule 206(3)-3T, in general, would promote these aims. We continue to believe that this analysis generally applies today.

As noted in the Extension Release, we received comments on the 2007 Principal Trade Rule Release from commenters who opposed the limitation of the temporary rule to investment advisers that are also registered as broker-dealers, as well as to accounts that are subject to both the Advisers Act and Exchange Act as providing a competitive advantage to investment advisers that are also registered broker-dealers.[33] Based on our experience with the rule to date, just as we noted in the Extension Release, we have no reason to believe that broker-dealers (or affiliated but separate investment advisers and broker-dealers) are put at a competitive disadvantage to advisers that are themselves also registered as broker-dealers;[34] however we intend to continue to evaluate the effects of the rule on efficiency, competition and capital formation as we complete the study mandated by section 913 of the Dodd-Frank Act and our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers.

We anticipate no new effects on efficiency, competition and capital formation would result from the two-year extension. However, during that time, we would continue to assess the rule's operation and impact along with intervening developments.

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[32] 15 U.S.C. 80b-2(c).

[33] *See* Extension Release, Section VI; Comment Letter of the Financial Planning Association (Nov. 30, 2007).

[34] *See* Extension Release, Section VI.

We request comment on whether the proposal, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data to support their views.

VII. INITIAL REGULATORY FLEXIBILITY ACT ANALYSIS

The Commission has prepared the following Initial Regulatory Flexibility Analysis ("IRFA") regarding the proposed amendment to rule 206(3)-3T in accordance with section 3(a) of the Regulatory Flexibility Act.[35]

A. Reasons for Proposed Action

We are proposing to extend rule 206(3)-3T for two years in its current form because we believe that it would be premature to require firms relying on the rule to restructure their operations and client relationships before we complete our study and our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers.

B. Objectives and Legal Basis

The objective of the proposed amendment to rule 206(3)-3T, as discussed above, is to permit firms currently relying on rule 206(3)-3T to limit the need to modify their operations and relationships on multiple occasions, both before and potentially after we complete our study and any related rulemaking.

We are proposing to amend rule 206(3)-3T pursuant to sections 206A and 211(a) of the Advisers Act [15 U.S.C. 80b-6a and 15 U.S.C. 80b-11(a)].

C. Small Entities Subject to the Rule

[35] 5 U.S.C. 603(a).

Rule 206(3)-3T is an alternative method of complying with Advisers Act section 206(3) and is available to all investment advisers that: (i) are registered as broker-dealers under the Exchange Act; and (ii) effect trades with clients directly or indirectly through a broker-dealer controlling, controlled by or under common control with the investment adviser, including small entities. Under Advisers Act rule 0-7, for purposes of the Regulatory Flexibility Act an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year.[36]

We estimate that as of November 1, 2010, 680 SEC-registered investment advisers were small entities.[37] As discussed in the 2007 Principal Trade Rule Release, we opted not to make the relief provided by rule 206(3)-3T available to all investment advisers, and instead have restricted it to investment advisers that also are registered as broker-dealers under the Exchange Act.[38] We therefore estimate for purposes of this IRFA that 38 of these small entities (those that are both investment advisers and broker-dealers) could rely on rule 206(3)-3T.[39]

D. Reporting, Recordkeeping, and other Compliance Requirements

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36 *See* 17 CFR 275.0-7.

37 IARD data as of November 1, 2010.

38 *See* 2007 Principal Trade Rule Release, Section VIII.B.

39 IARD data as of November 1, 2010.

The provisions of rule 206(3)-3T impose certain reporting or recordkeeping requirements, and our proposal, if adopted, would extend the imposition of these requirements for an additional two years. We do not, however, expect that the proposed two-year extension would alter these requirements.

Rule 206(3)-3T is designed to provide an alternative means of compliance with the requirements of section 206(3) of the Advisers Act. Investment advisers taking advantage of the rule with respect to non-discretionary advisory accounts would be required to make certain disclosures to clients on a prospective, transaction-by-transaction and annual basis.

Specifically, rule 206(3)-3T permits an adviser, with respect to a non-discretionary advisory account, to comply with section 206(3) of the Advisers Act by, among other things: (i) making certain written disclosures; (ii) obtaining written, revocable consent from the client prospectively authorizing the adviser to enter into principal trades; (iii) making oral or written disclosure and obtaining the client's consent orally or in writing prior to the execution of each principal transaction; (iv) sending to the client confirmation statements for each principal trade that disclose the capacity in which the adviser has acted and indicating that the client consented to the transaction; and (v) delivering to the client an annual report itemizing the principal transactions. Advisers are already required to communicate the content of many of the disclosures pursuant to their fiduciary obligations to clients. Other disclosures are already required by rules applicable to broker-dealers.

Our proposed amendment, if adopted, only would extend the rule for two years in its current form. Advisers currently relying on the rule already should be making the disclosures described above.

E. Duplicative, Overlapping, or Conflicting Federal Rules

We believe that there are no rules that duplicate or conflict with rule 206(3)-3T, which presents an alternative means of compliance with the procedural requirements of section 206(3) of the Advisers Act that relate to principal transactions.

We note, however, that rule 10b-10 under the Exchange Act is a separate confirmation rule that requires broker-dealers to provide certain information to their customers regarding the transactions they effect. Furthermore, FINRA rule 2230 requires broker-dealers that are members of FINRA to deliver a written notification containing certain information, including whether the member is acting as a broker for the customer or is working as a dealer for its own account. Brokers and dealers typically deliver this information in confirmations that fulfill the requirements of rule 10b-10 under the Exchange Act. Rule G-15 of the Municipal Securities Rulemaking Board also contains a separate confirmation rule that governs member transactions in municipal securities, including municipal fund securities. In addition, investment advisers that are qualified custodians for purposes of rule 206(4)-2 under the Advisers Act and that maintain custody of their advisory clients' assets must send quarterly account statements to their clients pursuant to rule 206(4)-2(a)(3) under the Advisers Act.

These rules overlap with certain elements of rule 206(3)-3T, but we designed the temporary rule to work efficiently together with existing rules by permitting firms to incorporate the required disclosure into one confirmation statement.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small entities.[40] Alternatives in this category would include: (i) establishing different compliance or reporting standards or timetables that take into account the resources available to small entities; (ii) clarifying, consolidating, or simplifying compliance requirements under the rule for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of the rule, or any part of the rule.

We believe that special compliance or reporting requirements or timetables for small entities, or an exemption from coverage for small entities, may create the risk that the investors who are advised by and effect securities transactions through such small entities would not receive adequate disclosure. Moreover, different disclosure requirements could create investor confusion if it creates the impression that small investment advisers have different conflicts of interest with their advisory clients in connection with principal trading than larger investment advisers. We believe, therefore, that it is important for the disclosure protections required by the rule to be provided to advisory clients by all advisers, not just those that are not considered small entities. Further consolidation or simplification of the proposals for investment advisers that are small entities would be inconsistent with the Commission's goals of fostering investor protection.

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[40] *See* 5 U.S.C. 603(c).

We have endeavored through rule 206(3)-3T to minimize the regulatory burden on all investment advisers eligible to rely on the rule, including small entities, while meeting our regulatory objectives. It was our goal to ensure that eligible small entities may benefit from the Commission's approach to the new rule to the same degree as other eligible advisers. The condition that advisers seeking to rely on the rule must also be registered as broker-dealers and that each account with respect to which an adviser seeks to rely on the rule must be a brokerage account subject to the Exchange Act, and the rules thereunder, and the rules of the self-regulatory organization(s) of which it is a member, reflect what we believe is an important element of our balancing between easing regulatory burdens (by affording advisers an alternative means of compliance with section 206(3) of the Act) and meeting our investor protection objectives.[41] Finally, we do not consider using performance rather than design standards to be consistent with our statutory mandate of investor protection in the present context.

G. Solicitation of Comments

We solicit written comments regarding our analysis. We request comment on whether the rule will have any effects that we have not discussed. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

Do small investment advisers believe an alternative means of compliance with section 206(3) of the Advisers Act should be available to more of them?

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41 *See* 2007 Principal Trade Rule Release, Section II.B.7 (noting commenters that objected to this condition as disadvantaging small broker-dealers (or affiliated but separate investment advisers and broker-dealers)).

VIII. CONSIDERATION OF IMPACT ON THE ECONOMY

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[42] we must advise OMB whether a proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results in or is likely to result in: (1) an annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effects on competition, investment or innovation.

We request comment on the potential impact of the proposed amendment on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

IX. STATUTORY AUTHORITY

The Commission is proposing to amend rule 206(3)-3T pursuant to sections 206A and 211(a) of the Advisers Act.

LIST OF SUBJECTS IN 17 CFR PART 275

Investment advisers, Reporting and recordkeeping requirements.

TEXT OF PROPOSED RULE AMENDMENT

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows.

PART 275 -- RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for Part 275 continues to read in part as follows:

Authority: 15 U.S.C. 80b-2(a)(11)(G), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a,

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[42] Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

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§275.206(3)-3T

2. In § 275.206(3)-3T, amend paragraph (d) by removing the words “December 31, 2010” and adding in their place “December 31, 2012.”

By the Commission.

Elizabeth M. Murphy
Secretary

Dated: December 1, 2010