SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

Release No. IA-3483; 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 that 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, 2012 to December 31, 2014.

DATES: Comments must be received on or before November 13, 2012.

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 email 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 email 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 a.m. and 3:00 p.m. 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: Melissa S. Gainor, Attorney-Adviser, Vanessa M. Meeks, Attorney-Adviser, Sarah A. Buescher, Branch Chief, or Daniel S. Kahl, 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 20549-8549.

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, 2012 to December 31, 2014.

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

As initially adopted on an interim final basis, rule 206(3)-3T was set to sunset 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 date 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]

In December 2010, we further extended the rule's sunset date by two years to December 31, 2012.[7] We deferred final action on rule 206(3)-3T at that time in order to complete a study required by section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[8] and to consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers, including

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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)] ("2009 Extension Release"); *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 2009 Extension Release).

6 *See* 2009 Extension Release, Section II.c.

7 *See Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 3118 (Dec. 1, 2010) [75 FR 75650 (Dec. 6, 2010)] (proposing a two-year extension of rule 206(3)-3T's sunset provision) ("2010 Extension Proposing Release"); *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 3128 (Dec. 28, 2010) [75 FR 82236 (Dec. 30, 2010)] ("2010 Extension Release").

8 Public Law 111-203, 124 Stat. 1376 (2010). Under section 913 of the Dodd-Frank Act, we were required to conduct a study and provide a report to Congress concerning the obligations of broker-dealers and investment advisers, including standards of care applicable to those intermediaries and their associated persons. Section 913 also authorizes us to promulgate rules concerning 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, taking into account the findings, conclusions, and recommendations of the study.

whether rule 206(3)-3T should be substantively modified, supplanted, or permitted to sunset.[9]

The study mandated by section 913 of the Dodd-Frank Act was prepared by the staff and delivered to Congress on January 21, 2011.[10] Since that time, we have considered the findings, conclusions, and recommendations of the 913 Study in order to determine whether to promulgate rules concerning the legal or regulatory standards of care for broker-dealers and investment advisers. In addition, since issuing the 913 Study, Commissioners and the staff have held numerous meetings with interested parties on the study and related matters.[11]

II. Discussion

We are proposing to amend rule 206(3)-3T only to extend the rule's sunset date by two additional years.[12] Absent further action by the Commission, the rule will sunset

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9 *See* 2010 Extension Release, Section II.

10 *See Study on Investment Advisers and Broker-Dealers* ("913 Study") (Jan. 21, 2011), available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf. For a discussion regarding principal trading, *see* section IV.C.1.(b) of the 913 Study. *See also* Commissioners Kathleen L. Casey and Troy A. Paredes, *Statement by SEC Commissioners: Statement Regarding Study on Investment Advisers and Broker-Dealers* (Jan. 21, 2011), available at http://www.sec.gov/news/speech/2011/spch012211klctap.htm.

11 *See Comments on Study Regarding Obligations of Brokers, Dealers, and Investment Advisers*, File No. 4-606, available at http://sec.gov/comments/4-606/4-606.shtml.

12 The rule includes a reference to an "investment grade debt security," which is defined as "a non-convertible debt security that, at the time of sale, is rated in one of the four highest rating categories of at least two nationally recognized statistical rating organizations (as defined in section 3(a)(62) of the Exchange Act)." Rule 206(3)-3T(a)(2) and (c). Section 939A of the Dodd-Frank Act requires that we "review any regulation issued by [us] that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and any references to or requirements in such regulations regarding credit ratings." Once we have completed that review, the statute provides that we modify any regulations identified in our review to "remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness" as we determine to be appropriate. We believe that the credit rating requirement in the temporary rule would be better addressed after the Commission

on December 31, 2012. We are proposing this extension because we continue to believe that 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, should be considered as 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 discussed in the 2010 Extension Release, section 913 of the Dodd-Frank Act 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 when providing personalized investment advice about securities to retail customers. Since the completion of the 913 Study in 2011, we have been

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completes its review of the regulatory standards of care that apply to broker-dealers and investment advisers. Therefore, we are not proposing any substantive amendments to the rule at this time. *See generally Report on Review of Reliance on Credit Ratings* (July 21, 2011), available at http://www.sec.gov/news/studies/2011/939astudy.pdf (staff study reviewing the use of credit ratings in Commission regulations).

13 The 913 Study is one of several studies relevant to the regulation of broker-dealers and investment advisers mandated by the Dodd-Frank Act. *See, e.g.*, *Study on Enhancing Investment Adviser Examinations* (Jan. 19, 2011), available at http://sec.gov/news/studies/2011/914studyfinal.pdf (staff study required by section 914 of the Dodd-Frank Act, which directed the Commission to review and analyze the need for enhanced examination and enforcement resources for investment advisers); Commissioner Elisse B. Walter, *Statement on Study Enhancing Investment Adviser Examinations (Required by Section 914 of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act)* (Jan. 19, 2011), available at http://sec.gov/news/speech/2011/spch011911ebw.pdf. *See also Study and Recommendations on Improved Investor Access to Registration Information About Investment Advisers and Broker-Dealers* (Jan. 26, 2011), available at http://sec.gov/news/studies/2011/919bstudy.pdf (staff study required by section 919B of the Dodd-Frank Act, that directed the Commission to complete a study, including recommendations (some of which have been implemented) of ways to improve investor access to registration information about investment advisers and broker dealers, and their associated persons); *United States Government Accountability Office Report to Congressional Committees on Private Fund Advisers* (July 11, 2011), available at http://www.gao.gov/new.items/d11623.pdf (study required by section 416 of the Dodd-Frank Act, which directed the Comptroller General of the United States to study the feasibility of forming an self-regulatory organization to oversee private funds).

considering the findings, conclusions, and recommendations of the study and the comments we have received from interested parties.[14] In addition, our staff has been working to obtain data and economic analysis related to standards of conduct and enhanced regulatory harmonization of broker-dealers and investment advisers to inform the Commission as it considers any future rulemaking. At this time, our consideration of the regulatory requirements applicable to broker-dealers and investment advisers and the recommendations from the 913 Study is ongoing. We will not complete our consideration of these issues before December 31, 2012, the current sunset date for rule 206(3)-3T.

If we permit rule 206(3)-3T to sunset on December 31, 2012, after that date investment advisers registered with us as broker-dealers that 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 limit the access of non-discretionary advisory clients of advisory firms that are registered with us as broker-dealers to certain securities.[15] In addition, firms may be required to make substantial changes to their disclosure documents, client agreements, procedures, and systems.

We believe that the requirements of rule 206(3)-3T, coupled with regulatory oversight, will adequately protect advisory clients for an additional limited period of time

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[14] Section 913(f) of the Dodd-Frank Act requires us to consider the 913 Study in any rulemaking authorized by that section of the Dodd-Frank Act. *See also Comments on Study Regarding Obligations of Brokers, Dealers, and Investment Advisers*, File No. 4-606, available at http://sec.gov/comments/4-606/4-606.shtml.

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

while we consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers.[16] In the 2010 Extension Proposing Release, we discussed certain compliance issues identified by the Office of Compliance, Inspections and Examinations.[17] One matter identified in the staff's review resulted in a settlement of an enforcement proceeding and other matters continue to be reviewed by the staff.[18] Since 2010 and throughout the period of the proposed extension, the staff has and would continue to examine firms that engage in principal transactions and will take appropriate action to help ensure that firms are complying with section 206(3) or rule 206(3)-3T (as applicable), including possible enforcement action.

In light of these considerations, we believe that it would be premature to require firms currently relying on the rule to restructure their operations and client relationships before we complete our consideration of the standards of conduct and 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 be required to restructure their operations and client relationships, potentially at substantial expense.

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16 In addition, rule 206(3)-3T(b) provides that the rule does not relieve an investment adviser from acting in the best interests of its clients, or from any obligation that may be imposed by sections 206(1) or (2) of the Advisers Act or any other applicable provisions of the federal securities laws.

17 *See* 2010 Extension Proposing Release, Section II (discussing certain compliance issues identified by the Office of Compliance Inspections and Examinations with respect to the requirements of section 206(3) or rule 206(3)-3T and noting that the staff did not identify any instances of "dumping" as part of its review).

18 *See In the Matter of Feltl & Company, Inc.*, Investment Advisers Act Release No. 3325 (Nov. 28, 2011) (settled order finding, among other things, violations of section 206(3) of the Advisers Act for certain principal transactions and section 206(4) of the Advisers Act and rule 206(4)-7 thereunder for failure to adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules).

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 sunset. In making these determinations, we will consider, among other things, the 913 Study, relevant comments received in connection with the 913 Study and any rulemaking that may follow, the results of our staff's evaluation of the operation of rule 206(3)-3T, and comments we receive on rule 206(3)-3T in connection with this proposed extension.

III. Request for Comment

We request comment on our proposal to extend rule 206(3)-3T's sunset date for two additional years.

- Should we allow the rule to sunset?
- If so, what costs would advisers that currently rely on the rule incur? What would be the impact on their clients?
- If we allow the rule to sunset, should we consider requests from investment advisers that are registered with us as broker-dealers for exemptive orders providing an alternative means of compliance with section 206(3)?
- If we extend the rule's sunset date, is two years an appropriate period of time to extend the sunset date? Or should we extend the rule's sunset date for a different period of time? If so, for how long?
- Is it appropriate to extend rule 206(3)-3T's sunset date for a limited period of time in its current form while we complete our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers?

- Should we consider changing the requirements for adviser disclosures to have registered advisers provide more information to us and their clients about whether they are relying on the rule? For example, should we amend Part 1A of Form ADV to require advisers to disclose whether they rely on rule 206(3)-3T for certain principal transactions? Should we amend Part 2A of Form ADV to require advisers who rely on rule 206(3)-3T to provide a description to clients of the policies and procedures they have adopted to ensure compliance with the rule?
- Why do advisers eligible to rely on the temporary rule not rely on it?

IV. Paperwork Reduction Act

Rule 206(3)-3T contains "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[19] The Office of Management and Budget ("OMB") last approved the collection of information with an expiration date of May 31, 2014. 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.

The amendment to the rule we are proposing today – to extend rule 206(3)-3T's sunset date for two years – does not affect the current annual aggregate estimated hour burden of 378,992 hours.[20] Therefore, we are not revising the Paperwork Reduction Act burden and cost estimates submitted to OMB as a result of this proposed amendment.

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19 44 U.S.C. 3501 *et seq.*

20 *See Proposed Collection; Comment Request,* 75 FR 82416 (Dec. 30, 2010); *Submission for OMB Review; Comment Request*, 76 FR 13002 (Mar. 9, 2011).

We request comment on whether the estimates continue to be reasonable. Have circumstances changed such that these estimates (or the underlying assumptions embedded in 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, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-23-07.

V. Economic Analysis

A. Introduction

The Commission is sensitive to the costs and benefits of its rules. The discussion below addresses the costs and benefits of extending rule 206(3)-3T's sunset date for two years, as well as the effect of the proposed extension on the promotion of efficiency, competition, and capital formation as required by section 202(c) of the Advisers Act.[21]

Rule 206(3)-3T provides an alternative means for investment advisers that are registered with the Commission 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 their non-discretionary advisory clients. Other than proposing to extend rule 206(3)-3T's sunset date for two years, we are not otherwise proposing to modify the rule from its current form. We previously considered and discussed the economic analysis of rule

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[21] 15 U.S.C. 80b-2(c). 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 investors, whether the action will promote efficiency, competition, and capital formation.

206(3)-3T in its current form in the 2007 Principal Trade Rule Release, the 2009 Extension Release, and the 2010 Extension Release.[22]

The baseline for the following analysis of the benefits and costs of the proposed rule is the situation in existence today, in which investment advisers that are registered with us as broker-dealers can choose to use rule 206(3)-3T as an alternative means to comply with section 206(3) of the Advisers Act when engaging in principal transactions with their non-discretionary advisory clients. The proposed amendment, which will extend rule 206(3)-3T's sunset date by an additional two years, will affect investment advisers that are registered with us as broker-dealers and engage in, or may consider engaging in, principal transactions with non-discretionary advisory clients, as well as the non-discretionary advisory clients of these firms that engage in, or may consider engaging in, principal transactions. The extent to which firms currently rely on the rule is unknown.[23] Past comment letters have indicated that since its implementation in 2007, both large and small advisers have relied upon the rule.[24]

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22 *See* 2007 Principal Trade Rule Release, Sections VI-VII; 2009 Extension Release, Sections V-VI; 2010 Extension Release, Sections V-VI.

23 Based on IARD data as of August 1, 2012, we estimate that there are less than 100 registered advisers that are also registered as broker-dealers that have non-discretionary advisory accounts and that engage in principal transactions.

24 *See* Comment Letter of Securities Industry and Financial Markets Association (Dec. 20, 2010); Comment Letter of Winslow, Evans & Crocker (Dec. 8, 2009) ("Winslow, Evans & Crocker Letter"); Comment Letter of Bank of America Corporation (Dec. 20, 2010) ("Bank of America Letter").

B. Benefits and Costs of Rule 206(3)-3T

As stated in previous releases, we believe the principal benefit of rule 206(3)-3T is that it maintains investor choice and protects the interests of investors. Rule 206(3)-3T also provides non-discretionary advisory clients easier access to a wider range of securities by providing a lower cost and more efficient alternative for an adviser that is registered with us as a broker-dealer to comply with the requirements of section 206(3) of the Advisers Act. Non-discretionary advisory clients also benefit from the protections of the sales practice rules of the Exchange Act and the relevant self-regulatory organization(s), and the fiduciary duties and other obligations imposed by the Advisers Act. The rule also may promote a more efficient allocation of capital by increasing access of non-discretionary advisory clients to a wider range of securities. In the long term, the more efficient allocation of capital may lead to an increase in capital formation.

A commenter disagreed with a number of the benefits of rule 206(3)-3T described above in connection with the 2010 extension of the rule, but did not provide any specific data, analysis, or other information in support of its comment.[25] This commenter also argued that rule 206(3)-3T would impede, rather than promote, capital formation because it would lead to "more numerous and more severe violations…of the trust placed by individual investors in their trusted investment adviser."[26] While we understand the view that numerous and severe violations of trust could impede capital formation, we have not

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[25] *See* Comment Letter of the National Association of Personal Financial Advisors (Dec. 20, 2010) ("NAPFA Letter") (questioning the benefits of the rule in: (1) Providing protections of the sales practice rules of the Exchange Act and the relevant self-regulatory organizations; (2) allowing non-discretionary advisory clients of advisory firms that are also registered as broker-dealers to 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; (3) maintaining investor choice; and (4) promoting capital formation).

[26] *See id*.

seen any evidence that rule 206(3)-3T has caused this result. 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, a harm that section 206(3) and the conditions and limitations of rule 206(3)-3T are designed to redress.[27] No commenter provided any substantive or specific evidence to contradict the Commission's previous conclusion that the rule benefits investors, and the Commission continues to believe that the rule provides those benefits.[28]

We also received comments on the 2007 Principal Trade Rule Release from commenters who opposed the limitation of the temporary rule to investment advisers that are registered with us 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 registered with us as broker-dealers.[29] Based on our experience with the rule to date, and as we noted in previous releases, 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.[30] We intend to continue to evaluate the effects of the rule on efficiency, competition, and capital formation in connection with our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers.

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27 *See supra* n.17.

28 *See* 2007 Principal Trade Rule Release, Section VI.C; 2009 Extension Release, Section V; 2010 Extension Release, Section V.

29 *See* Comment Letter of the Financial Planning Association (Nov. 30, 2007); Comment Letter of the American Bar Association, section of Business Law's Committee on Federal Regulation of Securities (Apr. 18, 2008). *See also* 2009 Extension Release, Section VI.

30 *See* 2009 Extension Release, Section VI; 2010 Extension Release, Section VI.

As we discussed in previous releases, there are also several costs associated with rule 206(3)-3T, including the operational costs associated with complying with the rule.[31] In the 2007 Principal Trade Rule 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 analysis we presented in the 2007 Principal Trade Rule Release. We do not believe the extension we are proposing today would materially affect the cost estimates associated with the rule.[32] We request comment on whether the proposed extension would impact our previous estimates.

C. Benefits and Costs of the Proposed Extension

In addition to the benefits of rule 206(3)-3T described above and in previous releases, we believe there are benefits to extending the rule's sunset date for an additional two years. A temporary extension of rule 206(3)-3T would have the benefit of providing the Commission with additional time to consider principal trading as part of the broader

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31 *See supra* n. 22.

32 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.

consideration of the regulatory requirements applicable to broker-dealers and investment advisers without causing disruption to the firms and clients relying on the rule.

One alternative to the proposed extension of the rule's sunset date would be to let the temporary rule sunset on its current sunset date, and so preclude investment advisers from engaging in principal transactions with their advisory clients unless in compliance with the requirements of section 206(3) of the Advisers Act. As explained in the 2010 Extension Release, if we do not extend rule 206(3)-3T's sunset date, 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 later (first when the rule sunsets or is modified, and again if we adopt a new approach in connection with our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers).[33] On the other hand, if the rule's sunset date is extended for two years, firms relying on the rule would continue to be able to offer clients and prospective clients access to certain securities on a principal basis and would not need to incur the cost of adjusting to a new set of rules or abandoning the systems established to comply with the current rule during this two-year period. An extension of the rule would also permit 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 to continue to have access to those securities without disruption.

We recognize that if this proposal is adopted, firms relying on the rule would continue to incur the costs associated with complying with the rule for two additional years. We also recognize that a temporary rule, by nature, creates long-term uncertainty,

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33 *See* 2010 Extension Release, Section V.

which in turn, may result in a reduced ability of firms to coordinate and plan future business activities.[34] However, we believe that it would be premature to allow the rule to sunset or to adopt the rule on a permanent basis while consideration of the regulatory requirements applicable to broker-dealers and investment advisers is ongoing. The Commission also considered extending the rule's sunset date for a period other than two years. Should our consideration of the fiduciary obligations and other regulatory requirements applicable to broker-dealers and investment advisers extend beyond the proposed sunset date of the temporary rule, a longer period may be appropriate. On balance, however, we believe that the proposed two-year extension of rule 206(3)-3T appropriately addresses the concerns of firms and clients relying on the rule while preserving the Commission's ability to address principal trading as part of its broader-consideration of the standards applicable to investment advisers and broker-dealers. We will continue to assess the rule's operation and impact along with intervening developments during the period of the extension.

D. Request for Comment

We request comment on all aspects of the economic analysis, including the accuracy of the potential costs and benefits identified and assessed in this Release and the prior releases, any other costs or benefits that may result from the proposal, and whether the proposal, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data to support their views.

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[34] We received several comments in connection with prior extensions of the rule urging us to make the rule permanent to avoid such uncertainty. *See e.g.*, Winslow, Evans & Crocker Letter; Bank of America Letter.

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's sunset date for two years 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 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 any regulatory actions stemming from the 913 Study.

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

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

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

Regulatory Flexibility Act an investment adviser generally is a small entity if it: (i) Has assets under management 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 total assets of $5 million or more on the last day of its most recent fiscal year.[36]

We estimate that as of August 1, 2012, 547 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 are registered as broker-dealers under the Exchange Act.[38] We therefore estimate for purposes of this IRFA that 7 of these small entities (those that are both investment advisers and registered broker-dealers) could rely on rule 206(3)-3T.[39]

D. Reporting, Recordkeeping, and other Compliance Requirements

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 of the rule's sunset date would alter these requirements.

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36 *See* 17 CFR 275.0-7.

37 IARD data as of August 1, 2012.

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

39 IARD data as of August 1, 2012.

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 a confirmation statement for each principal trade that discloses 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's sunset date for two years. 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, including whether the broker or dealer is acting as an agent or as a principal for its own account in a given transaction. Furthermore, FINRA rule 2232 requires broker-dealers that are members of FINRA to deliver a written notification in conformity with rule 10b-10 under the Exchange Act containing certain information. Rule G-15 of the Municipal Securities Rulemaking Board also contains a separate confirmation rule that governs transactions in municipal securities, and requires brokers, dealers and municipal securities dealers to disclose, among other things, the capacity in which the firm effected a transaction (*i.e.*, as an agent or principal). 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

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

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.

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 rule to the same degree as other eligible advisers. The condition that advisers seeking to rely on the rule must also be registered with us 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 the broker-dealer 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) should be available to more of them?

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;

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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)).

42 Public Law 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).

(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 [15 U.S.C. 80b-6a and 80b-11(a)].

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)(11)(H), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

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§275.206(3)-3T [Amended]

2. In § 275.206(3)-3T, amend paragraph (d) by removing the words “December 31, 2012” and adding in their place “December 31, 2014.”

By the Commission.

Elizabeth M. Murphy
Secretary

Dated: October 9, 2012