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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

Release No. IA-3522; File No. S7-23-07

RIN 3235-AL28

Temporary Rule Regarding Principal Trades With Certain Advisory Clients

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is amending 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 extends the date on which rule 206(3)-3T will sunset from December 31, 2012 to December 31, 2014.

DATES: The amendments in this document are effective December 28, 2012 and the expiration date for 17 CFR 275.206(3)-3T is extended to December 31, 2014.

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SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is adopting 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 extends the date on which the rule will sunset from December 31, 2012 to December 31, 2014. Note that previous related releases used RIN 3235-AJ96. (See *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2653 (Sep. 24, 2007) [72 FR 55022 (Sep. 28, 2007)]; *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2965 (Dec. 23, 2009) [74 FR 69009 (Dec. 30, 2009)]; *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 2965A (Dec. 31, 2009) [75 FR 742 (Jan. 6, 2010)]; *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 3118 (Dec. 1, 2010) [75 FR 75650 (Dec. 6, 2010)]; *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 3128 (Dec. 28, 2010) [75 FR 82236 (Dec. 30, 2010)]; *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 3483 (October 9, 2012), [77 FR 62185 (October 12, 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 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 In December 2009, we extended the rule’s sunset date by one year to December 31, 2010.² In December 2010, we further extended the rule’s sunset date by two years to December 31, 2012.³ 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”)⁴ and to consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers, including whether rule 206(3)-3T should be substantively modified, supplanted, or permitted to sunset.⁵

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 *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).

³ *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 date) (“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”).

⁴ 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 provides that we may commence a rulemaking 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.

⁵ *See* 2010 Extension Release, Section II.

The study mandated by section 913 of the Dodd-Frank Act was prepared by the staff and delivered to Congress on January 21, 2011.⁶ 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.⁷

On October 9, 2012, we proposed to extend the date on which rule 206(3)-3T will sunset for a limited amount of time, from December 31, 2012 to December 31, 2014.⁸ We received five comment letters addressing our proposal.⁹ Four of these commenters generally supported extending rule 206(3)-3T for at least two years,¹⁰ and one opposed a two-year extension.¹¹ The comments we received on our proposal are discussed below.

⁶ 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>.

⁷ 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>.

⁸ See *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Investment Advisers Act Release No. 3483 (October 9, 2012), [77 FR 62185 (October 12, 2012)] (“Proposing Release”).

⁹ See Comment Letter of Chris Barnard (Oct. 26, 2012) (“Barnard Letter”); Comment Letter of fi360, Inc. (Nov. 13, 2012) (“fi360 Letter”); Comment Letter of the Financial Services Institute (Nov. 5, 2012) (“FSI Letter”); Comment Letter of the Securities Industry and Financial Markets Association (Nov. 13, 2012) (“SIFMA Letter”); Comment Letter of Wells Fargo Advisors (Nov. 13, 2012) (“Wells Fargo Letter”).

¹⁰ See Barnard Letter; FSI Letter; SIFMA Letter; Wells Fargo Letter.

¹¹ See fi360 Letter.

After considering each of the comments, we are extending the rule's sunset date by two years to December 31, 2014, as proposed.

II. Discussion

We are amending rule 206(3)-3T only to extend the rule's sunset date by two additional years.¹² We are not adopting any substantive amendments to the rule at this time. Absent further action by the Commission, the rule would sunset on December 31, 2012. We are adopting this extension because, as we discussed in the Proposing Release, 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

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 appropriate. We believe that the credit rating requirement in the temporary rule would be better addressed after the Commission completes its review of the regulatory standards of care that apply to broker-dealers and investment advisers. One commenter addressed credit ratings and agreed with us that the issue would be better addressed after the Commission completes its review. *See* SIFMA Letter. We are not adopting 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 *See* Proposing Release, Section II. 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

Section 913 of the Dodd-Frank Act provides that we may commence a rulemaking 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 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.

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 a self-regulatory organization to oversee private funds).

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>.

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 would be required to make substantial changes to their disclosure documents, client agreements, procedures, and systems.

As noted above, four commenters generally supported our proposal to amend rule 206(3)-3T to extend it,¹⁶ and one commenter opposed the two-year extension.¹⁷ Commenters who supported the extension cited the disruption to investors that would occur if the rule expired at this time, asserting that investors would lose access to the securities currently offered through principal trades, receive less favorable pricing on such securities, or be forced to buy such securities through brokerage accounts.¹⁸ These commenters further explained that, if the rule were allowed to expire, firms relying on the rule would be required to make considerable changes to their operations, client relationships, systems, policies and procedures at substantial expense, without substantial

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

¹⁶ *See* Barnard Letter; FSI Letter; SIFMA Letter; Wells Fargo Letter.

¹⁷ *See* fi360 Letter.

¹⁸ *See* FSI Letter; SIFMA Letter (noting that of seven advisory firms that responded to a recent SIFMA survey, two firms indicated that they would not be able to elicit customer consent in accordance with section 206(3) of the Advisers Act, and the other five firms indicated that although they would be able to elicit customer consent in accordance with section 206(3), they would nonetheless significantly limit their volume of principal trading); Wells Fargo Letter.

benefits to investors.¹⁹ One commenter described a recent survey it conducted that indicated reliance on rule 206(3)-3T by dual registrants in order to engage in principal trades.²⁰ In addition, two commenters specifically addressed Commission consideration of requests for exemptive orders as an alternative means of compliance with section 206(3). Both commenters strongly supported the two-year extension instead of Commission consideration of requests for exemptive orders.²¹ One commenter expressed concern about the potential inefficiency and uncertainty created by the need to submit individual requests for exemptive relief.²² Commenters supporting the extension agreed that extending the rule while the Commission conducted its review of the obligations of broker-dealers and investment advisers, as mandated by the Dodd-Frank Act, would be the least disruptive option.²³

One commenter opposed extending the rule for more than a limited period of time (no more than six months) and questioned maintaining investor choice as a rationale for extending rule 206(3)-3T.²⁴ This commenter also noted that although instances of “dumping” have not been discovered, the staff has observed related compliance problems

¹⁹ See FSI Letter; SIFMA Letter; Wells Fargo Letter.

²⁰ See SIFMA Letter (SIFMA noted responses from seven dual-registrant firms that, in the aggregate, manage over \$325 billion of assets in over 1.1 million non-discretionary advisory accounts. The firms indicated that 459,507 of these accounts with aggregate assets of over \$125 billion are eligible to engage in principal trading in reliance on rule 206(3)-3T. These firms also indicated that, during the previous two years, they engaged in principal trades in reliance on rule 206(3)-3T with 106,682 accounts and executed an average of 12,009 principal trades per month in reliance on the rule.)

²¹ See SIFMA Letter; Wells Fargo Letter.

²² See SIFMA Letter.

²³ See Barnard Letter; SIFMA Letter; Wells Fargo Letter.

²⁴ See fi360 Letter. This commenter also raised concerns regarding the effectiveness of disclosure generally, including the disclosures required by the temporary rule. Such concerns are beyond the scope of this rulemaking.

in the past. The commenter asserted that a more detailed analysis of principal trades executed in reliance on rule 206(3)-3T, including spreads paid by investors and investment returns, be conducted and suggested that the Commission extend rule 206(3)-3T for no more than six months to conduct such an assessment.²⁵ The commenter also expressed concern about the open-ended nature of extending this temporary rule.²⁶

On balance, and after careful consideration of these comments, we conclude that extending the rule for two years is the most appropriate course of action at this time. First, with respect to investors, we agree with commenters that permitting the rule to sunset before we complete our consideration of the regulatory requirements applicable to broker-dealers and investment advisers could produce substantial disruption for investors with advisory accounts serviced by firms relying on the rule.²⁷ These investors might lose access to securities available through principal transactions and be forced to convert their accounts in the interim, only to face the possibility of future change — and the costs and uncertainty such additional change may entail.²⁸ We believe that the rule benefits investors because it provides them with greater access to a wider range of securities and includes provisions designed to protect them.

Second, with respect to firms, the letters submitted by three commenters demonstrate that firms in fact do rely on the rule, and that those firms will be faced with

²⁵ See fi360 Letter.

²⁶ *Id.*

²⁷ See Barnard Letter; SIFMA Letter; Wells Fargo Letter.

²⁸ As discussed in each of the 2007 Principal Trade Rule Release, 2009 Extension Release and 2010 Extension Release, firms have explained that they may refrain from engaging in principal trading with their advisory clients in the absence of the rule given the practical difficulties of complying with section 206(3), and thus may not offer principal trades through advisory accounts. See 2007 Principal Trade Rule Release, Section I.B; 2009 Extension Release, Section I; 2010 Extension Release, Section II. See also SIFMA Letter.

uncertainty and disruption of operations should the rule expire just as the Commission is engaging in a comprehensive review process that may ultimately produce different regulatory requirements.²⁹ One commenter that represents securities firms provided data showing that a substantial number of accounts and volume of trades would be affected by a change in the rule.³⁰ This disruption will be avoided if the rule remains available while we engage in our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers.

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 while we consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers.³¹ In the 2010 Extension Proposing Release, we discussed certain compliance issues identified by the Office of Compliance, Inspections and Examinations.³² 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.³³ We are sensitive to the concerns regarding compliance issues with respect to rule

²⁹ See FSI Letter; SIFMA Letter; Wells Fargo Letter.

³⁰ See SIFMA Letter.

³¹ 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.

³² 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).

³³ 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).

206(3)-3T raised by one commenter.³⁴ Since 2010 and throughout the period of the extension, the staff has and will 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.

We received four comment letters specifically addressing the duration of our proposed extension of rule 206(3)-3T.³⁵ Three of these commenters expressed support for extending the rule for an additional two years, although two of these commenters suggested that an extension of five years would be more appropriate.³⁶ One commenter opposed extending the rule for more than a six-month period, during which the rule's effectiveness could be further assessed.³⁷

As we noted in the Proposing Release, we believe that the rule's sunset date should be extended only for a limited amount of time.³⁸ That period of time, however, must be long enough to permit us to engage in any rulemaking prompted by our broader review of regulatory requirements applicable to investment advisers and broker-dealers. We do not believe that six months is long enough to engage in this process, and we do not believe that it is appropriate at this time to extend the temporary rule for an additional five years. We are sensitive to comments regarding the duration of the extension and the uncertainty caused by extending a temporary rule, but we believe that a two-year extension is necessary to provide investors uninterrupted access to securities available

³⁴ See fi360 Letter.

³⁵ See fi360 Letter; FSI Letter; SIFMA Letter; Wells Fargo Letter.

³⁶ See FSI Letter; SIFMA Letter; Wells Fargo Letter. Two of these commenters also recommended that the rule should ultimately be made permanent. See FSI Letter; SIFMA Letter.

³⁷ See fi360 Letter.

³⁸ See Proposing Release, Section II.

through principal trades and to provide us adequate time to engage in any rulemaking or other process.

Three commenters addressed the question of whether we should 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 rule 206(3)-3T.³⁹ Each of these commenters asserted that additional requirements for adviser disclosures are unnecessary, noting that certain additional disclosures may be redundant, and that current disclosures appear to be adequate.⁴⁰ We are not adopting amendments requiring additional adviser disclosures at this time, but will consider the need for such disclosures in future rulemakings or other processes as necessary.⁴¹

As noted above, one commenter suggested that there be a more detailed analysis of data, including spreads paid and investor returns.⁴² These factors are relevant to principal trades in general, and are not specific to rule 206(3)-3T. This commenter also raised the concern that the Commission may ultimately apply a “uniform” fiduciary standard to broker-dealers and investment advisers in two different ways.⁴³ These comments pertain to our broader consideration of the regulatory requirements applicable

³⁹ See FSI Letter; SIFMA Letter; Wells Fargo Letter. See also Proposing Release, Section III (requesting comment on whether we should consider changing the requirements in Form ADV for adviser disclosures to have registered advisers provide more information to us and their clients about whether they are relying on the rule).

⁴⁰ See FSI Letter; SIFMA Letter; Wells Fargo Letter.

⁴¹ See *supra* note 25.

⁴² See fi360 Letter.

⁴³ See fi360 Letter. We note that the standard of care to which advisers are subject and the duties they owe clients are in no way diminished by their reliance on rule 206(3)-3T. See *supra* note 30.

to broker-dealers and investment advisers, and we will consider these comments in conducting this broader review.

III. Certain Administrative Law Matters

The amendment to rule 206(3)-3T is effective on December 28, 2012. The Administrative Procedure Act generally requires that an agency publish a final rule in the Federal Register not less than 30 days before its effective date.⁴⁴ However, this requirement does not apply if the rule is a substantive rule which grants or recognizes an exemption or relieves a restriction, or if the rule is interpretive.⁴⁵ Rule 206(3)-3T is a rule that recognizes an exemption and relieves a restriction and in part has interpretive aspects.

IV. Paperwork Reduction Act

Rule 206(3)-3T contains “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995.⁴⁶ 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 Proposing Release solicited comments on our PRA estimates, but we did not receive comment on them.⁴⁷

⁴⁴ 5 U.S.C. 553(d).

⁴⁵ *Id.*

⁴⁶ 44 U.S.C. 3501 et seq.

⁴⁷ *See* Proposing Release, Section IV.

The amendment to the rule we are adopting 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.⁴⁸ Therefore, we are not revising the Paperwork Reduction Act burden and cost estimates submitted to OMB as a result of this amendment.

V. Economic Analysis

A. Introduction

We are sensitive to the costs and benefits of our 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 extension on the promotion of efficiency, competition, and capital formation as required by section 202(c) of the Advisers Act.⁴⁹

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 extending the rule’s sunset date for two additional years, we are not modifying the rule from its current form. We previously considered and discussed the economic analysis of rule 206(3)-3T in its current form in the 2007 Principal Trade Rule Release, the 2009 Extension Release, and the 2010 Extension Release.⁵⁰

⁴⁸ See *Proposed Collection; Comment Request*, 75 FR 82416 (Dec. 30, 2010); *Submission for OMB Review; Comment Request*, 76 FR 13002 (Mar. 9, 2011).

⁴⁹ 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.

⁵⁰ See 2007 Principal Trade Rule Release, Sections VI-VII; 2009 Extension Release, Sections V-VI; 2010 Extension Release, Sections V-VI.

The baseline for the following analysis of the benefits and costs of the amendment 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 amendment, which will extend rule 206(3)-3T's sunset date by two additional 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.⁵¹ Past comment letters have indicated that since its implementation in 2007, both large and small advisers have relied upon the rule.⁵² A recent letter submitted by one commenter describes survey results of several of its members that rely on the rule.⁵³

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 among different types of accounts and protects the interests of investors. Rule 206(3)-3T also provides a lower cost and more efficient alternative for an adviser that is registered with us as a broker-dealer to comply with the

⁵¹ As of November 1, 2012, we estimate that there are 491 registered investment advisers that also are registered broker-dealers. Based on IARD data as of November 1, 2012, we estimate that there are approximately 100 registered advisers that also are registered as broker-dealers that have non-discretionary advisory accounts and that engage in principal transactions.

⁵² 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”).

⁵³ See *supra* notes 18, 20.

requirements of section 206(3) of the Advisers Act. This, in turn, may provide non-discretionary advisory clients greater access to a wider range of securities. Non-discretionary advisory clients also benefit from the protections of the sales practice rules of the Securities Exchange Act of 1934 (the “Exchange Act”) and the relevant self-regulatory organization(s) and the fiduciary duties and other obligations imposed by the Advisers Act. Greater access to a wider range of securities may also allow non-discretionary advisory clients to better allocate capital. In the long term, the more efficient allocation of capital may lead to an increase in capital formation.

We received one comment on our economic analysis.⁵⁴ The commenter questioned the importance of investor choice as the principal benefit of rule 206(3)-3T.⁵⁵ We continue to believe that providing non-discretionary advisory clients with greater access to a wider range of securities is beneficial. As we have previously stated, many clients wish to access the securities inventory of a diversified broker-dealer through their non-discretionary advisory accounts.⁵⁶ We believe that it is appropriate to preserve investors’ access to the securities available through principal transactions made in reliance on rule 206(3)-3T while consideration of the regulatory requirements applicable to broker-dealers and investment advisers is ongoing.

Also, in connection with the 2010 extension of the rule, one commenter had disagreed with a number of the benefits of rule 206(3)-3T described above, but did not

⁵⁴ See fi360 Letter.

⁵⁵ *Id.*

⁵⁶ See 2007 Principal Trade Rule Release, Section I.B.

provide any specific data, analysis, or other information in support of its comment.⁵⁷

That commenter 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.”⁵⁸ While we understand the view that numerous and severe violations of trust could impede capital formation, we have not 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.⁵⁹ No commenter provided any substantive or specific evidence to contradict our previous conclusion that the rule benefits investors, and we continue to believe that the rule provides those benefits.⁶⁰

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

⁵⁷ 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).

⁵⁸ See *id.*

⁵⁹ See *supra* note 32.

⁶⁰ See 2007 Principal Trade Rule Release, Section VI.C; 2009 Extension Release, Section V; 2010 Extension Release, Section V.

advisers that are registered with us as broker-dealers.⁶¹ 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.⁶² Commenters on the Proposing Release did not address this specific issue, but 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.

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.⁶³ 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. Although one commenter noted that the Commission's cost analysis had remained unchanged, we do not believe the extension we are adopting

⁶¹ 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.

⁶² See 2009 Extension Release, Section VI; 2010 Extension Release, Section VI.

⁶³ See *supra* note 50.

today materially affects the cost estimates associated with the rule.⁶⁴ The commenter did not provide supporting data discrediting the cost analysis we presented in the 2007 Principal Trade Rule Release.⁶⁵

C. Benefits and Costs of the 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. The temporary extension of rule 206(3)-3T will have the benefit of providing the Commission with additional time to consider principal trading as part of the broader 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 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 did 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

⁶⁴ See 2007 Principal Trade Rule Release, Section VI.D. 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.

⁶⁵ See fi360 Letter.

applicable to broker-dealers and investment advisers).⁶⁶ As a result of the two-year extension of the rule's sunset date, firms relying on the rule will continue to be able to offer clients and prospective clients the same level of access to certain securities on a principal basis and will 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. The extension of the rule will also permit non-discretionary advisory clients who have had greater access to certain securities because of their advisers' reliance on the rule to trade on a principal basis to continue to have the same level of access to those securities without disruption.

Although we did not receive any comments on the rule's compliance costs, we recognize that, as a result of our amendment, firms relying on the rule will 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, which in turn, may result in a reduced ability of firms to coordinate and plan future business activities.⁶⁷ 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. We also considered extending the rule's sunset date for a period other than two years. Two commenters suggested an extension of five years, noting that this period of time would provide greater certainty for firms and more ample time for the Commission to consider its broader regulation of broker-dealers

⁶⁶ See 2010 Extension Release, Section V.

⁶⁷ One of the two commenters who argued that the rule should eventually be made permanent specifically noted the uncertainty caused by the need for additional extensions in the future. See SIFMA Letter. We also 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.

and investment advisers.⁶⁸ Another commenter stated that the rule should be extended for no more than six months.⁶⁹ We do not believe that six months is long enough to engage in a review of the regulatory obligations of broker-dealers and investment advisers, and we do not believe that it is appropriate at this time to extend the temporary rule for an additional five years. Should our consideration of the fiduciary obligations and other regulatory requirements applicable to broker-dealers and investment advisers extend beyond the sunset date of the temporary rule, a longer period may be appropriate. On balance, however, we continue to believe that the two-year extension of rule 206(3)-3T appropriately addresses the needs 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.

VI. Final Regulatory Flexibility Act Analysis

The Commission has prepared the following Final Regulatory Flexibility Analysis ("FRFA") regarding the amendment to rule 206(3)-3T in accordance with 5 U.S.C. 604. We prepared and included an Initial Regulatory Flexibility Analysis ("IRFA") in the Proposing Release.⁷⁰

A. Need for the Rule Amendment

We are adopting an amendment 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

⁶⁸ See SIFMA Letter; Wells Fargo Letter.

⁶⁹ See fi360 Letter.

⁷⁰ See Proposing Release, Section VII.

restructure their operations and client relationships before we complete our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers. The objective of the 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 before we complete our broader consideration of the regulatory requirements applicable to broker-dealers and investment advisers. Absent further action by the Commission, the rule will sunset on December 31, 2012.

We are amending 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)].

B. Significant Issues Raised by Public Comments

We did not receive any comment letters related to our IRFA.

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 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.⁷¹

As noted in the Proposing Release, we estimated that as of August 1, 2012, 547 SEC-registered investment advisers were small entities.⁷² 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.⁷³ We therefore estimated for purposes of the IRFA that 7 of these small entities (those that are both investment advisers and registered broker-dealers) could rely on rule 206(3)-3T.⁷⁴ We did not receive any comments on these estimates.

D. Projected Reporting, Recordkeeping, and other Compliance Requirements

The provisions of rule 206(3)-3T impose certain reporting or recordkeeping requirements and our amendment will extend the imposition of these requirements for an additional two years. The two-year extension will not 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 are required to

⁷¹ See 17 CFR 275.0-7.

⁷² IARD data as of August 1, 2012. As of November 1, 2012, based on IARD data, we estimate that 502 SEC-registered investment advisers were small entities.

⁷³ See 2007 Principal Trade Rule Release, Section VIII.B.

⁷⁴ IARD data as of August 1, 2012. As of November 1, 2012, based on IARD data, we estimate that 6 of these small entities could rely on rule 206(3)-3T.

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 amendment will only extend the rule's sunset date for two years in its current form. Advisers currently relying on the rule already should be making the disclosures described above.

E. Agency Action to Minimize Effect on Small Entities

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.⁷⁵ Alternatives in this category would include: (i) Establishing different compliance or reporting standards or timetables that take into account the resources

⁷⁵ See 5 U.S.C. 603(c).

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 our goal 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 our 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.⁷⁶ 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.

VII. Statutory Authority

The Commission is amending 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 RULE AMENDMENT

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is 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.

* * * * *

§275.206(3)-3T [Amended]

⁷⁶ 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)).

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: December 20, 2012