SEC ADOPTS TEMPORARY RULE REGARDING PRINCIPAL TRADES AND PROPOSES A RECODIFICATION OF INTERPRETIVE RULE

At an open meeting held on September 19, 2007 (the "Open Meeting"), the Securities and Exchange Commission ("SEC") voted to adopt a temporary rule (Rule 206(3)-3T) under the Investment Advisers Act of 1940 (the "Act") that temporarily provides relief with respect to certain principal trading restrictions that, absent the temporary rule, would apply to certain fee-based accounts beginning on October 1, 2007. The SEC today published the temporary rule and the accompanying release.[1] During the Open Meeting, the SEC also proposed a new rule to recodify certain interpretive provisions regarding the definition of "investment adviser" as it relates to broker-dealers, which the SEC published yesterday for comment.[2]

On March 30, 2007, the U.S. Court of Appeals for the District of Columbia Circuit in *Financial Planning Association v. SEC* granted a petition to vacate Rule 202(a)(11)-1 under the Act (the "Vacated Rule"). The Vacated Rule had expanded on the Act's exceptions from the definition of "investment adviser" to permit broker-dealers to operate fee-based brokerage accounts under certain circumstances without being subject to the Act. The Court of Appeals concluded that the SEC lacked the authority to expand the broker-dealer exception in this manner and, effective October 1, 2007, vacated the rule. As a result, absent the temporary rule, a broker-dealer's fee-based, non-discretionary accounts would become subject to, among other things, the prohibitions set out in Section 206(3) of the Act relating to principal transactions. The SEC has requested that comments on the recodification of the interpretive provisions be submitted by November 2, 2007, and that comments on the temporary rule be submitted by November 30, 2007.

In adopting Rule 206(3)-3T, which becomes effective on September 30, 2007 and expires on December 31, 2009, the SEC will permit an adviser that is a registered broker-dealer to comply with Section 206(3) of the Act with respect to non-discretionary advisory accounts if the adviser, among other things:

- provides written disclosure regarding the conflicts arising from principal trades and how the investment adviser addresses these conflicts;
- obtains written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions;

---

1 Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 2653 (September 25, 2007).

2 Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, Investment Advisers Act Release No. 2652 (September 24, 2007).

- makes certain disclosures either orally or in writing and obtains the client's consent (which may be oral consent) before *each* principal transaction;
- sends to the client confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction; and
- delivers to the client an annual statement listing the principal transactions and the date and price of the transactions.

The relief provided under the temporary rule applies only to a nondiscretionary brokerage account that is managed by a dually registered investment adviser and broker-dealer. The relief will not be available with respect to principal trades of securities issued or underwritten by the investment adviser or its affiliates, except in the case of investment-grade debt securities. These dually registered firms will still be held to the standards set out in Sections 206(1) and 206(2) of the Act.

At the Open Meeting, the SEC also voted to propose rule amendments to recodify certain guidance, which had been provided under the Vacated Rule, that clarifies the application of the Act to certain activities of broker-dealers. The SEC, on the basis of its authority under Section 206A of the Act, would reinstate the interpretive guidance pertaining to the definitions of "solely incidental to" and "special compensation" set out in Section 202(a)(11)(C) of the Act, which excepts from the definition of "investment adviser" any broker or dealer that provides investment advice that is solely incidental to the conduct of its business as a broker or dealer and that receives no special compensation for such advice. The proposed interpretive provisions are as follows:

Separate fee or separate contract

The existence of a separate fee charged by a broker-dealer to a client for advisory services will be deemed to show that the services to the client are not solely incidental to the broker-dealer's brokerage services. A separate contract with a client for the provision of advisory services will similarly be deemed to be an arrangement in which the broker-dealer's advice to the client is not solely incidental to the firm's business as a broker-dealer.

Investment discretion

The exercise by a broker-dealer of investment discretion with respect to a client's account, except certain limited or temporary discretion granted by the client, would not be solely incidental to the broker-dealer's brokerage business.

Discount brokerage

A broker-dealer will not be considered to receive special compensation solely because the broker-dealer charges a commission, mark-up, mark-down or similar fee for brokerage services, such as to a discount brokerage account, that is greater than or less than the fee that it charges another customer, such as one with a full-service account.

Unlike the Vacated Rule, the proposed rule amendments do not include express provisions relating to financial planning services. At the Open Meeting, representatives of the SEC's Division of Investment Management did not provide a specific reason for omitting this part of the Vacated Rule from the recodified guidance and did not indicate whether interpretive guidance would be forthcoming with respect to whether financial planning services may be deemed to be "solely incidental to" a brokerage business.

* * * * * * * * * * * * * * *

If you have any questions regarding this memorandum, please contact Larry E. Bergmann (202-303-1103, lbergmann@willkie.com), Jesse P. Kanach (202-303-1276, jkanach@willkie.com), Matthew B. Comstock (202-303-1257, mcomstock@willkie.com), Jane H. Kim (202-303-1242, jkim@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, D.C. 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, D.C. telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

September 25, 2007