DAVIS POLK & WARDWELL

450 LEXINGTON AVENUE
NEW YORK, NY 10017
212 450 4000
FAX 212 450 3800

MENLO PARK
WASHINGTON, D.C.
LONDON
PARIS
FRANKFURT
MADRID
TOKYO
BEIJING
HONG KONG

Electronic Filing

December 4, 2007

Re: **File No. S7-23-07**

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Dear Ms. Morris:

We are writing in response to the Commission's request for comments on interim final temporary rule 206(3)-3T under the Investment Advisers Act of 1940 (the "**Advisers Act**").[1] The Temporary Rule provides an alternative means for investment advisers who are also registered broker-dealers to comply with Section 206(3) of the Advisers Act when they act as principal in transactions with their non-discretionary advisory accounts.[2] Under the Temporary Rule an adviser, with respect to a non-discretionary advisory account, may comply with Section 206(3) of the Advisers Act if the adviser, among other things, (i) provides written prospective disclosure to its clients concerning the conflicts arising from principal transactions, (ii) obtains written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions, (iii) prior to the execution of each principal transaction, informs the client, either orally or in writing, of the capacity in which it may act with respect to such transaction and receives the client's consent, either orally or in writing, to act in such capacity, (iv) at or before completion of the transaction, sends to the client written confirmation statements disclosing the capacity in which the adviser has acted and the client's authorization of the transaction and (v) at least annually, delivers to

[1] TEMPORARY RULE REGARDING PRINCIPAL TRADES WITH CERTAIN ADVISORY CLIENTS, Securities and Exchange Commission Release No. IA-2653, released September 24, 2007 (hereinafter referred to as the "**Temporary Rule**"). Page references to the Temporary Rule herein are to the Temporary Rule as released in Commission Release IA-2653.

[2] Temporary Rule at 12-18.

the client a report itemizing the transactions executed in reliance on rule 206(3)-3T, including the date and price of such transactions.[3]

We appreciate the opportunity to comment on the Temporary Rule.[4] We support the Commission's efforts to assist broker-dealers and investors by providing an alternative means of complying with the requirements of Sections 206(3). The Temporary Rule will make it easier for broker-dealers to retain their fee-based brokerage accounts while allowing their customers to continue to have access to certain securities held in the principal accounts of certain advisory firms. Accordingly, we support the Commission's Temporary Rule and believe that it should continue after its proposed expiration date. However, we feel that the Commission should also provide more relief from the restrictions of Section 206(3) of the Advisers Act. Specifically, we propose that the Commission allow investors affirmatively to waive the transaction-by-transaction consent requirement of the Temporary Rule if the principal transaction involves readily marketable securities or financially sophisticated investors. If the Commission does not grant this additional relief then, in the alternative, we respectfully suggest that negative consent be sufficient to satisfy the trade-by-trade consent requirement of the Temporary Rule.

I. Recommended Exemptions under Section 206(3)

We recommend that the Commission grant further relief from the principal trading restrictions contained in Section 206(3) of the Advisers Act. In particular, we believe that the per-transaction consent requirement unnecessarily hinders the ability of investment advisers to trade on behalf of their clients. The high number of advisory accounts, combined with the critical need for timely execution of trades, has rendered the trade-by-trade consent requirements impractical in many markets in which investment advisers trade. As a result, advisory clients may forego valuable trading opportunities and incur significant trading costs. However, advances in technology have made price information more readily available to market participants and enabled greater surveillance of investment advisers, thus decreasing the risks of adviser self-dealing. Consequently, we propose that investors be allowed to waive the transaction-by-transaction consent requirement of paragraph (a)(4) of the Temporary Rule if the principal transaction involves readily marketable securities or if the advisory client is a financially sophisticated investor.

Investors who have fee-based brokerage accounts subject to the Temporary Rule, but who elect to waive the trade-by-trade consent requirements of paragraph (a)(4), will be able to shield themselves against overreaching while expanding their own control over transactions in their accounts. Under our proposal, as under the Temporary Rule, before any principal trading may occur, the adviser must obtain written, revocable prospective general consent from the

[3] *Id.* at 14-29.

[4] The opinions expressed herein represent those of the undersigned and not necessarily those of our clients.

client for principal transactions between the client and the adviser or its affiliates. In addition, the adviser must provide substantial disclosures about the nature and conflicts of principal transactions, send clients trade-by-trade confirmation statements that disclose the capacity in which the adviser acted and, at least annually, deliver an itemized report to its clients that detail the transactions executed on the client's account in reliance on the Temporary Rule. Under our proposal the only part of the Temporary Rule that would not be required is the requirement to obtain consent before execution of each trade. Trade-by-trade confirmation statements, however, would provide investors the transparency to see every transaction and revocable consent would give investors the power to change the client-adviser relationship at any time. As this proposal would only apply to readily marketable securities, prices should be easily ascertained and verified. In addition, advisers are required to maintain books and records of these transactions[5] which can be reviewed by the Commission at any time, ensuring that investors receive fair prices on principal transactions. These safeguards provide significant protection against overreaching and self-dealing to investors who determine that trade-by-trade consent requirements are too impractical for their fee-based account preferences.[6]

A. Readily Marketable Securities

We propose that the trade-by-trade consent requirements of Section 206(3) not apply to principal transactions involving "readily marketable" securities. Readily marketable securities generally would include highly liquid securities in which ascertainable prices and other information is readily accessible by the parties to the transaction. Consequently, advisers and their affiliates would have little incentive to engage in self-dealing or "dumping" with respect to such securities. In addition, it would not be difficult to ascertain at a later date whether an appropriate price was used in their sale. Given the large potential universe of "readily marketable securities," we propose the following categories of securities that we would consider readily marketable.

(i) Fixed Income Securities: Money Market Instruments

Readily marketable securities should include money market instruments (with a maximum maturity of two years) because they present limited credit risk, are highly liquid and trade in a narrow price range due to the competitiveness of the market.[7] Money market instruments offer substantial safety of principal as

[5] Rule 204-2(a)(3) of the Advisers Act.

[6] Notably, the above safeguards are similar to (or arguably more protective than) the requirements of Rule 206(3)-2 which permits agency-cross transactions without per-transaction client consent.

[7] Money market instruments would include the following: Municipal notes; bank money market instruments (including negotiable certificates of deposit and bankers' acceptances); commercial paper rated in one of the top two grades by an NRSRO; bank notes; repurchase agreements; and medium-term notes issued by industrial companies, utilities, banks and finance companies having a long-term rating from at least one NRSRO in one of the two highest long-term rating categories for debt obligations.

they are generally issued only by obligors of the highest credit rating. In addition, because of their short maturities, these securities have only a relatively small risk of principal loss due to interest rate fluctuations. Their high level of liquidity eliminates any incentive for advisers to dump these securities into unwilling advisory accounts.[8] Nearly all of the trading in money market instruments takes place in highly competitive over-the-counter markets consisting of groups of dealer firms composed primarily of major securities firms or large banks.

(ii) Fixed Income Securities: U.S. Government Securities

Government securities, as defined in Section 2(a)(16) of the Investment Company Act, should also be considered readily marketable.[9] These securities include Treasuries and obligations issued or guaranteed by federal government agencies. Treasuries carry the highest credit ratings and are considered to be extremely liquid. They also have readily accessible historical market prices that enable investors to confirm the fairness of any principal trades.

(iii) Fixed Income Securities: Investment Grade Municipal and Corporate Securities

Readily marketable securities should include investment grade municipal or corporate fixed income securities. The size of the U.S. municipal and the corporate fixed income markets provides a high degree of liquidity for a large number of debt issues. Third-party pricing information is available for many fixed income securities, but prices can also be reliably determined by obtaining price quotes from two independent dealers, assuring that clients receive a fair price. Investment grade municipal and corporate debt securities generally are highly liquid, present a limited credit risk, have extensive pricing coverage and offer historical pricing information.

(iv) Large Cap U.S.-Exchange Listed Equity Securities

Readily marketable securities should include any large cap equity security listed on a U.S. exchange (or having unlisted trading privileges on a U.S. exchange). Listed securities have readily available market quotations and exchanges maintain historical pricing information. Moreover, large cap securities generally have a high level of liquidity. In addition, Rule 204-2(a)(3) of the Advisers Act requires advisers to maintain a memorandum of every order for the purchase and sale of any security, which ensures that principal trades are executed at a fair price.

---

[8] For example, the U.S. commercial paper market had outstanding issues of $1.899 trillion as of October 31, 2007. This figure is based on information provided by the Federal Reserve System on the *Federal Reserve Bulletin*, November 21, 2007.

[9] Under Section 2(a)(16) of the Investment Company Act, "government securities" are "any securities issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to the authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing."

(v) Certain Non-U.S. Equity Securities

Readily marketable securities should also include any equity securities of a foreign issuer that are listed on the FTSE All-World Index.[10] These securities are generally recognized as having a "ready market" for purposes of the SEC's net capital rule.[11] In addition, the Commission recently approved an NASD rule change exempting these securities from the Three Quote Rule, subject to certain conditions.[12] The liquidity and readily available price information of these securities will deter advisers from dumping these securities in advisory accounts.

(vi) Riskless Principal Transactions

Principal transactions should be permitted for any security involved in a riskless principal transaction, provided that the adviser receives independent quotations from at least two sources. Riskless principal transactions involve transactions whereby the dealer executes the transaction but does not hold the securities in its preexisting inventory. Because the dealer does not hold the securities in its own account, there is no risk that the adviser will dump securities into advisory accounts. In addition, the independent quotations ensure that clients receive a fair price in the transaction.[13]

Again, the protections afforded by the Temporary Rule, particularly the requirements that advisers obtain written, revocable prospective consent and send clients trade-by-trade confirmation statements, along with the highly liquid and transparent nature of readily marketable securities, will provide ample protection to investors who wish to waive the trade-by-trade consent requirement for principal transactions.[14]

---

[10] The FTSE All-World Index is owned and operated by the Financial Times and the London Stock Exchange. *See* http://www.ftse.com/About_Us/index.jsp. In November 1999, the FT/S&P Actuaries World Index was acquired by FTSE and renamed the FTSE World Index, which is currently a subset index of the FTSE All-World Index. *See* SEC Release No. 34-54650 (October 25, 2006), 71 FR 63812 at n.5 (October 31, 2006) (approved in SEC Release No. 34-56004 (July 2, 2007), 72 FR 37285 (July 9, 2007).

[11] *See Securities Industry Association*, 1993 SEC No-Act. LEXIS 967 (August 13, 1993) (foreign equity issues listed on the FT-Actuaries World Index satisfy the ready market provisions of Rule 15c3-1 of the Securities Exchange Act).

[12] *See* SEC Release No. 34-56004 (July 2, 2007), 72 FR 37285 (July 9, 2007).

[13] We note that in a recent no-action letter the staff permitted an investment adviser to engage in riskless principal transactions of certain OTC options on behalf of certain financially sophisticated investors without acquiring individual consents for each transaction, so long as the adviser and its affiliated OTC derivatives dealer adhered to certain enumerated conditions. *See Credit Suisse First Boston, LLC*, 2005 SEC No-Act. LEXIS 707 (August 31, 2005).

[14] Finally, we note that the Commission recently approved a change to NYSE Rule 92 that, among other things, expanded the consent provisions of the rule for members who trade alongside customer orders. *See* SEC Release No. 34-56753 (November 6, 2007), 72 FR 63948 (November 13, 2007). NYSE Rule 92 formerly required order-by-order consent but now allows members to utilize an affirmative blanket consent procedure to comply with the rule. *See id*.

B. Financially Sophisticated Investors

We believe that there are certain categories of investors that are sufficiently sophisticated to choose whether or not to give prospective, general consent for principal transactions on their accounts. Although such a category of investors may be difficult to classify, we propose that this relief be limited to "qualified purchasers" as defined in Section 2(a)(51) of the Investment Company Act of 1940 (the "**Investment Company Act**"). Advisory clients that are qualified purchasers are financially sophisticated and aware of the risks and benefits of principal transactions with affiliates. Furthermore, advisory clients that are qualified purchasers will likely have access to the same market information as their advisers or the adviser's affiliates, and consequently have less need for the self-dealing protections afforded by the Advisers Act. Congress recognized "qualified purchasers" as a limited category of investors that do not need the protections of the Investment Company Act.[15] We believe that the benefits of waiving the Section 206(3) requirements to these clients significantly outweigh the protections afforded to them and that these categories of clients should be free to decide whether or not to dispense with the Section 206(3) restrictions in seeking greater flexibility in investing.[16]

II. Negative Consent Should Satisfy the Trade-by-Trade Disclosure and Consent Requirement of Section 206(3)

We support the Commission's efforts to increase the flexibility of the Section 206(3) trade-by-trade consent requirements by allowing for oral consent and disclosure under the Temporary Rule. While we feel that the Commission should grant further relief for sophisticated investors and readily marketable securities, we respectfully suggest that, in the alternative, negative consent be sufficient to satisfy the transaction-by-transaction disclosure and consent requirements of Section 206(3). Negative consent would ensure that clients are notified in writing but would reduce the burden on certain clients who must locate and contact an authorized person to sign on behalf of the client on a timely basis. The negative consent would be sent along with the disclosure letter to the advisory client before every principal trade according to the requirements of the Temporary Rule.

As the Commission recognizes, in the wake of *Financial Planning Association v. SEC*,[17] there will be substantial and ongoing burdens for broker-dealers and investors whose fee-based brokerage accounts are subject to the Advisers Act.[18] Negative consent will help alleviate the burden associated with

[15] Similarly, such an exemption would be consistent with relief provided to this class of investors under other federal securities laws, *e.g.*, Rule 144A of the Securities Act of 1933 (the "**Securities Act**").

[16] It should be noted that none of these transactions would be effected with registered investment companies whose advisers are affiliated with the investment adviser, otherwise a separate exemption would be needed from Section 17(a) of the Investment Company Act.

[17] 482 F.3d 481 (D.C. Cir. 2007).

[18] Temporary Rule at 3-13.

managing the accounts of customers who depend on access to principal transactions while providing substantial safeguards of disclosure and consent to the advisory clients.

* * *

We appreciate the opportunity to respond to the Commission's request for comments and we hope that these comments and observations contribute to the important work of the Commission. If you have any questions with respect to the matters raised in this letter, please contact any of the undersigned.

Very truly yours,

Nora M. Jordan
212-450-4684
nora.jordan@dpw.com

Yukako Kawata
212-450-4896
yukako.kawata@dpw.com

Leor Landa
212-450-6260
leor.landa@dpw.com

Danforth Townley
212-450-4240
dan.townley@dpw.com

John G. Crowley
212-450-4550
john.crowley@dpw.com