SUPPORTING STATEMENT
Rule 206(3)-3T

A. JUSTIFICATION

1. Necessity of Information Collection

The Securities and Exchange Commission (the "Commission") is proposing to amend rule 206(3)-3T (17 CFR 275.206(3)-3T) under the Investment Advisers Act of 1940 ("Advisers Act") to modify the definition of "investment grade debt security." This amendment is part of the Commission's initiative to address concerns regarding the reference to nationally recognized statistical rating organization ("NRSRO") ratings in Commission rules.

Section 206(3) of the Advisers Act makes it unlawful for any investment adviser, directly or indirectly "acting as principal for his own account, knowingly to sell any security to or purchase any security from a client …, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction."[1] Rule 206(3)-3T establishes a temporary alternative means for investment advisers who 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 certain of their advisory clients.[2]

An adviser generally may not rely on the rule for principal trades of securities if the investment adviser or a person who controls, is controlled by, or is under common control with the adviser ("control person") is the issuer or is an underwriter of the

[1] 15 U.S.C. 80b-6(3).

[2] Rule 206(3)-3T [17 CFR 275.206(3)-3T]. *See also* Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 2653 (Sept. 24, 2007) [72 FR 55022 (Sept. 28, 2007)].

security.[3] The rule contains an exception to this "underwritten securities" exclusion for trades in which the adviser or a control person is an underwriter of non-convertible *investment-grade* debt securities.[4] The rule defines an "investment grade debt security" 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 NRSROs.[5] Absent further Commission action the temporary rule will expire and no longer be effective on December 31, 2009.

The proposed amendment to rule 206(3)-3(T) would modify the definition of "investment grade security," thereby eliminating an adviser's ability to rely exclusively on NRSRO ratings to determine whether a security is investment grade for purposes of the rule. Instead, the adviser would have to make its own assessment taking into account specified criteria, including that the security: (i) has no greater than moderate credit risk; and (ii) is sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time.[6] This amended definition gives rise to a single new collection of information requirement. Pursuant to its obligations under rule 206(4)-7 under the Advisers Act, an adviser seeking to rely on rule 206(3)-3T must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. As the rule is proposed to be amended, an adviser seeking to rely on

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[3] Rule 206(3)-3T(a)(2).

[4] *Id.* There is no exception if the adviser or a control person is the issuer of the securities.

[5] Rule 206(3)-3T(c).

[6] Proposed rule 206(3)-3T(c). *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28327 (July 1, 2008). Although the proposed amendment would no longer require a security underwritten by an adviser or its control person to be rated by NRSROs to be eligible under the rule, investment advisers could reference ratings, reports, analyses, and other assessments issued by NRSROs and other persons, for the purpose of evaluating credit risk and liquidity

the exception to the "underwritten securities" exclusion must have policies and procedures that address the adviser's methodology for determining whether a security is investment grade quality pursuant to the definition. These policies and procedures – a collection of information – are needed to minimize the incentives associated with underwriting securities that may bias the advice being provided or may lead the adviser to exert undue influence on its client's decision to invest in the offering or the terms of that investment.

2. Purpose of the Information Collection

The amendment to rule 206(3)-3T contemplates an information collection requirement that provides important protections to investors when advisers engage in principal trades in securities they or a control person underwrote. Specifically, the amendment would eliminate an adviser's ability to rely exclusively on NRSRO ratings to determine whether a security is investment grade for purposes of an exception to the rule for principal trading of securities underwritten by the investment adviser or its control person. Instead, the adviser would have to make its own assessment taking into account specified criteria, including that the security: (i) has no greater than moderate credit risk; and (ii) is sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time.

The additional collection contemplated by the proposed rule would entail, for adviser's seeking to rely on the exception, policies and procedures that address the adviser's methodology for determining whether a security is investment grade quality pursuant to the revised definition. This collection of information provides investor protection by ensuring that advisers have established and verifiable methodology for

making that determination. Although the rule does not call for any of the information collected to be provided to us, to the extent advisers include any of the information in a filing, such as Form ADV, the information would not be kept confidential.

3. Role of Improved Information Technology

The proposed amendment would not require the reporting of any information or the filing of any documents with the Commission, but rather it would require investment advisers to maintain written policies and procedures regarding advisers' methodology for determining whether a security is investment grade quality. The Commission permits advisers to maintain these records through electronic media.[7]

4. Efforts to Identify Duplication

There are no rules that duplicate or conflict with rule 206(3)-3T, even as it is proposed to be amended.

5. Effect on Small Entities

Small entities registered with the Commission as investment advisers seeking to rely on the rule would be subject to the same requirements as larger entities. In developing the amendment, the Commission considered the extent to which it would have a significant impact on a substantial number of small entities. It would defeat the purpose of the rule to exempt small entities from the rule.

6. Consequences of Less Frequent Collection

Although an adviser would be obligated to review and update its policies and procedures relating to the methodology for determining that a security is investment grade for purposes of the proposed amendment, it would need to initially develop and implement such policies and procedures only once, upon choosing to rely on the

[7] See Rule 204-2(g) [17 CFR 275.204(g)].

exception to the rule's prohibition on principal trading in securities underwritten by the adviser or its control person. Those advisers choosing not to rely on the exception would not need to engage in the collection. Less frequent information collection would be incompatible with the objectives of the rule and could hinder the Commission's oversight and examination program for investment advisers and thereby reduce protection of investors.

7. Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)

The collection requirements under the proposed amendment, pursuant to rule 204-2 under the Advisers Act, would generally require advisers to maintain documents for five years, and in some cases longer. The current retention period would not be affected. Although this period exceeds the three-year guideline for most kinds of records under 5 CFR 1320.5(d)(2)(iv), OMB has previously approved collections with this retention period. The retention period is warranted because the recordkeeping requirements under the Advisers Act are designed to contribute to the protection of investors and the effectiveness of the Commission's examination and inspection program. Because the period between examinations may be as long as five years, it is important that the Commission have access to records that cover the entire period between examinations.

8. Consultation Outside the Agency

In its release proposing amendments to rule 206(3)-3T and related rules, the Commission requests public comment on the effect of information collections under these amendments. In addition, the Commission and the staff of the Division of Investment Management participate in an ongoing dialogue with representatives of the investment adviser industry through public conferences, meetings and informal

exchanges. These various forums provide the Commission and the staff with a means of ascertaining and acting upon paperwork burdens confronting the industry.

9. Payment or Gift to Respondents

Not applicable.

10. Assurance of Confidentiality

Although the rule does not call for any of the information collected to be provided to us, to the extent advisers include any of the information required by the rule in a filing, such as Form ADV, the information will not be kept confidential. If information collected pursuant to the proposed amendment to the rule is reviewed by the Commission's examination staff, it will be accorded the same level of confidentiality accorded to other responses provided to the Commission in the context of its examination and oversight program.[8]

11. Sensitive Questions

Not applicable.

12. Estimate of Hour Burden

The Commission's estimate of the burden of the additional collection of information that would be implemented were the proposed amendment adopted reflects the expectation that a relatively small number of advisers would rely on the exception to the "underwritten securities" exclusion. The Commission's estimate of the burden hours that will be imposed by the collection of information contemplated by the proposed amendment to rule 206(3)-3T is set forth below.

a. Estimated Number of Advisers Relying on Amended Exception: 185*
b. Estimated Hours Burden Per Adviser: 10†

[8] *See* section 210(b) of the Advisers Act [15 U.S.C. 10(b)]

c. Total Estimated Hour Burden: 1,850[†]

* As of June 1, 2008, there were 639 advisers that were eligible to rely on the temporary rule (*i.e.*, also registered as broker-dealers), 409 of which indicate that they have non-discretionary advisory accounts.[9] We estimate that 90% of those 409 advisers, or a total of 368 of those advisers, rely on the rule.[10] Of those, we estimate that only 50% would seek to engage in principal trades with clients of securities they or a control person underwrote. Thus, we estimate that the total number of advisers who would rely on the non-convertible investment grade debt exception to the "underwritten securities" exclusion under the rule would be approximately 185.

[†]We estimate that the burden for drafting the required policies and procedures for each eligible adviser that chooses to rely on the rule in connection with underwritten securities in particular, would be approximately 10 hours on average. Further, we expect the drafting burden would be uniform with respect to each eligible adviser regardless of how many individual non-discretionary advisory accounts that adviser maintains or seeks to engage with in principal trading. We therefore estimate that the total burden will be 1,850 hours (10 hours per adviser x 185 eligible advisers that will rely on the rule = 1,850 total hours).

The Commission estimates that the following costs correspond with the hour burdens described above.

d. Dollar Cost Estimate Per Adviser Corresponding to Hour Burden: $620[#]
e. Total Dollar Cost Estimate $114,700[#]

[#]We estimate that the internal preparation function will most likely be performed by a compliance clerk at $62 per hour. $62 per hour x 10 hours = $620 on average per adviser of internal costs for preparation of the policies and procedures. Assuming there are 185 eligible advisers that would prepare relevant policies and procedures, we estimate that the total costs would be $114,700.

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9 IARD data as of June 1, 2008, for Items 6.A(1) and 5.F(2)(e) of Part 1A of Form ADV.

10 We anticipate that most investment advisers that are dually registered as broker-dealers will make use of the rule to engage in, at a minimum, riskless principal transactions to limit the need for these advisers to process trades for their advisory clients with other broker-dealers. We estimate that 10% of these advisers will determine that the costs involved to comply with the rule are too significant in relation to the benefits that the adviser, and their clients, will enjoy.

13. Estimate of Total Cost Burden

The Commission estimates that there is an additional cost burden for the proposed amendment, excluding any cost of the burden hours as identified in Item 12 above.

Professional fees for preparation of disclosure statement

i. Advisers relying on the rule	185
ii. Cost burden per adviser	$1,200*
iii. Initial cost burden	**$222,000**

*We estimate an average one-time cost, for approximately three hours of outside legal counsel time (at approximately $400 per hour) in connection with the preparation of the policies and procedures, of $1,200 per eligible adviser on average. As explained in Item 12 above, we estimate that a total of approximately 185 advisers will seek to rely on the exception affected by the amendment. 185 x $1,200 = $222,000.

14. Estimate of Cost to the Federal Government

There are no costs to the federal government directly attributable to Rule 206(3)-3T.

15. Explanation of Changes in Burden

The change in the burden stems from a proposed amendment to rule 206(3)-3T which is part of the Commission's broader project to address the reference to and use of NRSRO ratings in Commission rules. The proposed amendment to rule 206(3)-3(T) would modify the definition of "investment grade security," thereby eliminating an adviser's ability to rely exclusively on NRSRO ratings to determine whether a security is investment grade for purposes of the rule. Instead, the adviser would have to make its own assessment taking into account specified criteria, including that the security: (i) has no greater than moderate credit risk; and (ii) is sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time.

This amended definition gives rise to a single new collection burden that is in addition to the burdens currently approved for the rule. Pursuant to its obligations under

rule 206(4)-7 under the Advisers Act, an adviser seeking to rely on rule 206(3)-3T must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. As the rule is proposed to be amended, an adviser seeking to rely on the exception to the "underwritten securities" exclusion must have policies and procedures that address the adviser's methodology for determining whether a security is investment grade quality pursuant to the definition. These policies and procedures – a collection of information – are intended to permit underwritten principal trades under the proposed amendment for investment grade securities, which may be less risky and less likely to be "dumped" in client accounts and it may be easier for clients to identify whether the price of the security is fair based upon comparability in this sector of the market.

As described above, we expect only a relatively small proportion of advisers – which, to rely on the rule, must also be registered as broker-dealers – to rely on the exception to the "underwritten securities" exclusion. The policies and procedures they will promulgate in order to be able to determine whether relevant securities are "investment grade" is the basis of the increase in the burden. As noted above, we believe that this requirement provides investor protection by ensuring that advisers have established and verifiable methodology for making that determination.

16. Information Collection Planned for Statistical Purposes

Not applicable.

17. Approval to not Display Expiration Date

Not applicable.

18. Exceptions to Certification Statement

Not applicable.

B. COLLECTIONS OF INFORMATION EMPLOYING STATISTICAL METHODS

Not applicable.