AGENCY CROSS TRANSACTIONS FOR ADVISORY CLIENTS

SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISORS ACT OF 1940
Release No. 589

SECURITIES EXCHANGE ACT OF 1934
Release No. 13583

File No. S7-662

June 1, 1977

TEXT:

AGENCY: Securities and Exchange Commission.

ACTION: Final Rule.

SUMMARY: This rule provides a nonexclusive method for compliance with the Investment Advisers Act of 1940 in connection with an agency cross transaction for an advisory client by persons who otherwise might be considered to be acting in a conflict of interest in violation of their fiduciary duties to the client. It requires that the transaction be effected pursuant to a written consent for a period not to exceed one year and executed by the advisory client after full written disclosure that the investment adviser and/or an affiliated broker-dealer are acting as agent for and receiving commissions for both parties and, accordingly, have a conflicting division of loyalties and responsibilities.

EFFECTIVE DATE: Immediately.

FOR FURTHER INFORMATION CONTACT: Lee B. Spencer, Chief Counsel, Division of Investment Management, Securities and Exchange Commission, Washington, D.C. 20549 (202-376-8056)

SUPPLEMENTARY INFORMATION: On December 2, 1976, the Securities and Exchange Commission published notice (Advisers Act Release No. 557, 41 FR 53808, December 9, 1976) that it had under consideration the adoption of Rule 206(3)-2 (17 CFR 275.206(3)-2) under the Investment Advisers Act of 1940 ("Advisers Act") (15 U.S.C. 80b-1 et seq.). The notice invited all interested persons to comment on the proposed rule. The Commission has considered all the comments and suggestions received and has determined to adopt Rule 206(3)-2, with certain modifications, in the form set below.

Section 206(3) of the Advisers Act makes it unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, knowingly to effect a securities transaction (a) with a client while acting as principal or (b) for a client while acting as broker for a person other than such client, without disclosing in writing to such client before the completion of the transaction the capacity in which he is acting and obtaining the consent of the client to the transaction. That prohibition does not apply to any transaction with a customer of a broker or dealer if the broker or dealer is not acting as an investment adviser in relation to such transaction. n1

In Advisers Act Release No. 40, dated February 5, 1945, 11 FR 10997 (September 27, 1946) (Release No. 40"), the staff stated its opinion that an investment adviser who, as principal or as agent for another, effects a transaction with or for a client is required to obtain the client's consent in accordance with Section 206(3) of the Advisers Act on the basis of full disclosure of any adverse interest of the investment adviser. In the staff's opinion, as stated in that Release and modified in Investment Advisers Act Release No. 470, dated August 20, 1975 (40 FR 38158, August 27, 1975), it may be necessary that such disclosure include: the capacity in which the investment adviser proposes to act; the cost of the security to the investment adviser where he proposes to sell as principal; the price he expects to receive

on resale where the investment adviser proposes to buy from his client, or the total commission to the investment adviser where he proposes to act as an agent for another; and the best price at which the transaction could be effected by or for the client elsewhere if such price is more advantageous. n2 Moreover, according to Release No. 40, except where no advice is rendered as to the particular transaction, the Advisers Act requires that the disclosure of capacity (although not the other disclosures) be given in writing and the client's consent be obtained before the completion of each separate transaction.

Section 211(a) of the advisers Act (15 U.S.C. 80b-11(a)) authorizes the Commission to issue such rules as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission in the Advisers Act, including rules defining accounting, technical and trade terms used in the Advisers Act.

As originally proposed, Section 275.206(3)-2 could have been used only by a person who was dually registered as an investment adviser and as a broker-dealer. Thus, it was pointed out, although Section 206(3) of the Advisers Act would be applicable to a cross transaction by an investment adviser who was not dually registered and/or an affiliated broker-dealer, neither the investment adviser nor the affiliated broker-dealer n3 could make use of the procedures specified in the proposed rule. This was not the intended result, and the rule was modified throughout to make its provisions available to any registered investment adviser n4 and any affiliated broker-dealer.

The proposed rule, in paragraph (a)(1), would have required that the client, prior to giving consent to agency cross transactions, be given full written disclosure of the nature of such transactions and the effect of the adviser or affiliated broker-dealer acting as broker for both parties to the transaction. There was some concern over what would constitute adequate disclosure to satisfy that requirement. Therefore, that paragraph was modified to specify more precisely the disclosure to be made.

Paragraph (a)(2) of Section 275.206(3)-2 requires that any person relying on the rules send to the client a written confirmation which includes: a statement of the nature of the transaction (i.e., that the broker also is acting as broker for a person on the other side of the transaction); the date the transaction took place; and an offer to furnish upon request the time when the transaction took place. Moreover, such confirmation must state the source and amount of any commission and other remuneration received or to be received in connection with the transaction by the investment adviser and any other person relying on the rule; except that in the case of purchase in which neither the investment adviser nor any other person relying on this rule was participating in a distribution or a sale in which no such person was participating in a tender offer, the written confirmation may state whether any other remuneration has been or will be received and that the source and amount will be furnished upon written request of such customer. As the rule was originally proposed, the time of the transaction and the source and amount of commission or other remuneration regarding any agency cross transaction had to be shown on the confirmation in all cases.

Because the rule requires the identification of the transaction date on each confirmation and source of all compensation in connection with an agency cross transaction as requested by the advisory client, paragraph (a)(2) of the rule was modified to require only that the total number of such transactions and the total compensation in connection therewith for the period covered by the statement be disclosed.

Apparently, there was some concern over how to comply with the requirement in paragraph (a)(4) that the disclosure statements and confirmations bear a "prominent legend" of revocability. It was intended that the client be reminded he may revoke at any time his consent to agency cross transactions, and that such reminder be conspicuous so as not to go unnoticed. In this regard, since the term "conspicuous" is a defined term in the Uniform Commercial Code, n5 the phrase "a prominent legend clearly stating" has been changed to "a conspicuous statement."

Paragraph (a)(5) would have denied the use of the rule for any transaction where any seller and any purchaser "are advised in relation to such transaction by the same investment adviser." It appears that the language could be interpreted to include each casual impersonal advice, which was not intended. n6 Accordingly, the paragraph was modified to exclude only a transaction where "the same investment

adviser, or an investment adviser and any person controlling, controlled by or under common control with such investment adviser, recommended the transaction to both any seller and any purchaser." (This provision also reflects a change made throughout the rule to encompass the affiliated broker-dealer, as discussed earlier.)

The terms "advisory account" and "advisory client" were used interchangeably in the proposed rule. To be consistent, the term "advisory account" has been changed throughout to "advisory client."

Additionally, the Note to the rule as originally proposed has been incorporated, with a minor modification of its language, as paragraph (c) of the rule. This language is not intended to define the requirements as to best price and execution, but merely to remind the persons relying on the rule that the rule does not relieve them of whatever obligations they may have to clients in this regard. n7 The language of the rule has been changed to read "fulfilling the duty with respect to best price and execution."

Because the rule provides a nonexclusive method for compliance with Section 206(3), it is made immediately effective.

* * *

Commission Action: Part 275 of Chapter II of Title 17 of the Code of Federal Regulations is amended by adding a new section 275.206(3)-2 reading as follows:

§ 275.206(3)-2 Agency cross transactions for advisory clients. (a)(1) An investment adviser registered under Section 203 of the Act (15 U.S.C. 80b-3), or (2) a person registered as a broker-dealer under Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) and controlling, controlled by or under common control with an investment adviser registered under Section 203 of the Act, shall be deemed in compliance with the provisions of Section 206(3) of the Act (15 U.S.C. 80b-6(3)) in effecting an agency cross transaction for an advisory client, if:

(i) the advisory client has executed a written consent prospectively authorizing for a period not to exceed one year the investment adviser, or any other person relying on this rule, to effect agency cross transactions for such advisory client, provided that such written consent is obtained after full written disclosure that with respect to agency cross transactions the investment adviser or such other person will act as broker for, receive commissions from, and have a potentially conflicting division of loyalties and responsibilities regarding, both parties to such transactions;

(ii) the investment adviser, or any other person relying on this rule, sends to each such client a written confirmation at or before the completion of each such transaction, which confirmation includes (A) a statement of the nature of such transaction, (B) the date such transaction took place, (C) an offer to furnish upon request, the time when such transaction took place, and (D) the source and amount of any other remuneration received or to be received by the investment adviser and any other person relying on this rule in connection with the transaction, provided, however, that if, in the case of a purchase, neither the investment adviser nor any other person relying on this rule was participating in a distribution, or in the case of sale, neither the investment adviser nor any other person relying on this rule was participating in a tender offer, the written confirmation may state whether any other remuneration has been or will be received and that the source and amount of such other remuneration will be furnished upon written request of such customer;

(iii) the investment adviser, or any other person relying on this rule, sends to each such client, within thirty days prior to the expiration of the written consent referred to in subparagraph (i) and with or as part of any written statement or summary of such account from the investment adviser or such other person, a written disclosure statement identifying the total number of such transactions during the period since the date of the written consent or during the period covered by any other written statement or summary, and the total amount of all commissions or other remuneration received or to be received by the investment adviser and any other person relying on this rule in connection with such transactions during such period;

(iv) each written disclosure and confirmation required by this rule includes a conspicuous statement that the written consent referred to in subparagraph (i) may be revoked at any time by written notice to the investment adviser, or to any other person relying on this rule, from the advisory client; and (v) no such transaction is effected in which the same investment adviser or an investment adviser and any person controlling, controlled by or under common control with such investment adviser recommended the transaction to both any seller and any purchaser.

(b) For purposes of this rule the term "agency cross transaction for an advisory client" shall mean a transaction in which a person acts as an investment adviser in relation to a transaction in which such investment adviser, or any person controlling, controlled by or under common control with such investment adviser, acts as broker for both such advisory client and for another person on the other side of the transaction.

(c) This rule shall be construed as relieving in any way the investment adviser or another person relying on this rule from acting in the best interests of the advisory client, including fulfilling the duty with respect to the best price and execution for the particular transaction for the advisory client; nor shall it relieve such person or persons from any disclosure obligation which may be imposed by subparagraphs (1) or (2) of Section 206 of the Act or Act or by other applicable provisions of the federal securities laws.

* * *

Section 275.206(3)-2 is adopted pursuant to the authority granted to the Commission in Section 211(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-11(a)).

By the Commission.

ENDNOTES

n1 However, the staff has taken the position that Section 206(3) of the Advisers Act is applicable even where an affiliated investment adviser has recommended the transaction

n2 Whether particular disclosures are required in connection with transactions effected in reliance upon Rule 206(3)-2 will depend on the materiality of the facts in each situation, as well as the degree of trust and confidence in and the reliance upon the person seeking to comply with the rule by the client. (See Advisers Act Release No. 470.) For example, in such agency transactions the disclosures relating to principal transactions would not be applicable.

n3 The term "affiliated broker-dealer" is used throughout this release to designate a person registered under the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. 78, et seq.] and who controls, is controlling or under common control with the investment adviser who recommended the agency cross transaction.

n4 Investment advisers who effect brokerage transactions for their advisory clients should be aware of the registration requirements of Section 15 of the Exchange Act [15 U.S.C. 78o] for persons within the definition of "broker" in Section 3(a)(4) of the act [15 U.S.C. 78C(a)(4)].

n5 Section 1-201(10) of the Uniform Commercial Code defines "conspicuous" as follows:

A term or clause is conspicuous when it is so written that a reasonable person against whom it is to operate ought to have noticed it. A printed heading in capitals (as: NON-NEGOTIABLE BILL OF LADING) is conspicuous" if it is in larger or other contrasting type or color. But in a telegram any stated term is "conspicuous". Whether a term or clause is "conspicuous" or not is for decision by the court.

n6 See, Rule 206(3)-1, 17 CFR 275.206(3)-1 (1976).

n7 It was stated in Advisers Act Release No. 40, dated February 5, 1945, that the disclosures in connection with Section 206(3) transactions include "the best price at which the transaction could be effected by or for the client elsewhere if . . . more advantageous to the client than the actual purchase or sale price."