



GlobalNote

SEC ISSUES NO-ACTION LETTER RESPONSE TO ABA LETTER REQUESTING CLARIFICATION OF *GOLDSTEIN* DECISION¹

To: Clients and Friends of Tannenbaum Helpern Syracuse &
Hirschtritt LLP

Date: August 2006

I. Introduction

On August 10, 2006, the Division of Investment Management (the “Division”) of the Securities and Exchange Commission (the “SEC”) published a No-Action Letter (the “No-Action Letter”)² responding to a letter dated July 31, 2006 (the “ABA Letter”) from the ABA Subcommittee on Private Investment Entities (the “ABA Subcommittee”). Ricardo Davidovich, a partner in the firm’s Financial Services Department, is a member of the ABA Subcommittee. In the ABA Letter, the ABA Subcommittee requested clarification on various interpretative issues regarding matters affecting investment advisers of certain private investment funds as a result of the decision of the United States Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC* (the “*Goldstein* decision”)³. The No-Action Letter provides relief to registered investment advisers that remain registered with the SEC as well as to investment advisers that withdraw their registration from the SEC by February 1, 2007. This memorandum summarizes the response of the Division. Note that the Division emphasizes that their response to the

¹ This memorandum provides general information on the subject matter described, and it should not be relied on for legal advice on any matter, which may turn on specific facts. You should seek specific legal advice before acting with regard to the subjects discussed herein. For further information see the firm’s website: www.thshlaw.com.

² See ABA Subcommittee on Private Investment Entities, SEC No-Action Letter (pub. avail. August 10, 2006).

³ *Goldstein v. Securities and Exchange Commission*, No. 04-1434, 2006 (D.C. Cir. June 23, 2006).

ABA Letter is not a rule, regulation, or statement of the SEC, and solely expresses the Division's views.

II. Background

In the *Goldstein* decision, the Court of Appeals vacated Rule 203(b)(3)-2 (the "Registration Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") as well as other rule related amendments adopted by the SEC in Release No. IA-2333 (Dec. 2, 2004) (the "Adopting Release"). The Registration Rule required hedge fund managers to look through "private funds" and count investors in such funds as their clients. As a result, most hedge fund managers had to register with the SEC under the Advisers Act. In the *Goldstein* decision, the court held that the SEC lacked the authority to adopt rules requiring hedge fund advisers to count investors in private funds as clients for purposes of the Advisers Act. The issues presented in the ABA Letter arise because the *Goldstein* decision appears to vacate all of the Registration Rule, as well as other rules, interpretations, and transitional provisions contained in the Adopting Release designed to facilitate the ability of newly registered hedge fund advisers to conduct their operations in accordance with the Advisers Act and SEC rules. In testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs on July 25, 2006, Chairman Cox stated that he had directed the staff of the SEC to take action to ensure that transitional and exemptive rules in the Adopting Release are restored to their full legal effect.

III. Investment Advisers that Remain Registered

Offshore Investment Advisers to Offshore Funds

The Adopting Release stated that although offshore advisers (advisers having a principal office and place of business outside the U.S.) would have to include U.S. residents for client counting purposes, as long as the offshore adviser was only advising offshore funds (a private fund organized or incorporated under the laws of a country other than the U.S.), it would be exempt from the bulk of the substantive provisions of the Advisers Act. Notwithstanding the *Goldstein* decision, the Division agrees with the ABA Subcommittee that the substantive provisions of the Advisers Act still do not apply to offshore advisers with respect to such offshore advisers' dealings with offshore funds and other offshore clients. In adopting Rule 203(b)(3)-2(c), the SEC made clear that an offshore adviser advising an offshore fund, would not be subject to the substantive provisions of the Advisers Act with respect to the offshore fund, but only to the client-counting and anti-fraud provisions of the Advisers Act. The Division has indicated that the "compliance lite" concepts contained in the Adopting Release will continue to be applicable. With respect to any U.S. clients (*i.e.* a private fund organized or incorporated under the laws of the U.S.), registered offshore advisers must comply with all of the rules of the Advisers Act.

Records Supporting Performance Information

In the Adopting Release, the SEC amended the rule requiring a registered investment adviser to maintain certain specified records that form the basis for or demonstrate the calculation of performance information used by the adviser in advertising and similar materials. The rule was amended to create a limited transition exception for investment advisers to private funds who registered as a result of the Registration Rule. This transition exception was intended to facilitate the ability of an investment adviser to continue to use performance information for periods prior to its SEC registration despite lacking all of the records necessary to comply with the Advisers Act for its pre-registration period. Such investment advisers would not be required to maintain books and records pertaining to the investment performance of any private fund or other account for any period prior to February 10, 2005. This relief was to be given provided that the investment adviser was not registered with the SEC as an investment adviser prior to February 10, 2005 and that the investment adviser continued to preserve any books and records in its possession pertaining to investment performance during that period.

The Division states that it would not recommend enforcement action if an investment adviser that registered as a result of the Registration Rule does not maintain the books or records required for performance information for periods before they were registered.

Performance-Based Compensation Arrangements

The Division responds to the ABA Subcommittee's concern that investment advisers who registered as a result of the Registration Rule and relied on the Adopting Release that amended Rule 205-3 to "grandfather" existing compensation arrangements may now be prohibited from receiving performance-based fees from certain investors. The Advisers Act does not permit investment advisers to receive performance-based compensation. Rule 205-3 of the Advisers Act provides an exemption from this prohibition with respect to persons that are "qualified clients." In the Adopting Release, the SEC amended Rule 205-3 to allow investment advisers that registered as a result of the Registration Rule to continue receiving performance-based compensation from private funds with investors who are not "qualified clients" if such investors became equity investors in the private fund before February 10, 2005. The Division states that it would not recommend enforcement action if an investment adviser that registered as a result of the Registration Rule receives performance-based compensation from any persons that are not "qualified clients" provided that the arrangements with any such persons (with respect to the investment subject to performance-based compensation) that are not "qualified clients" were in effect prior to February 10, 2005.

Custody Rule

In the Adopting Release, the SEC amended Rule 206(4)-2 of the Advisers Act regarding procedures applicable to registered investment advisers of fund of funds deemed

to have custody of client funds or securities. Rule 206(4)-2 requires, among other things, that a registered investment adviser which has custody of a client's assets or securities: (i) have a qualified custodian send investors quarterly account statements identifying the amount of funds and of each security in their account and setting forth all transactions in such account; or (ii) itself send a similar quarterly account statement provided that the investment adviser is subject to a surprise audit by an independent public accountant on an annual basis to verify all client funds and securities. There is an exemption from these account statement requirements for limited partnerships and other pooled investment vehicles if there is an annual audit of such vehicles' financial statements prepared in accordance with generally accepted accounting principles and such financial statements are distributed to all limited partners (or members or other beneficial owners) within 120 days following the relevant limited partnership's or investment pool's fiscal year end (the "annual audit exception"). For investment advisers to fund of funds, the Adopting Release amended Rule 206(4)-2 to extend the deadline of delivery of audited financial statements from 120 days to 180 days for such fund of funds (this extended deadline to the annual audit exception only applies to fund of funds). A "fund of funds" was defined in Rule 206(4)-2 to mean a limited partnership, limited liability company or other type of pooled investment vehicle that invests 10% or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a "related person" as defined in Form ADV, of the limited partnership or other pooled vehicle, its general partners or its adviser. This extended period for the annual audit exception was made available to all registered investment advisers of fund of funds and not just to investment advisers that registered as a result of the Registration Rule. The ABA Subcommittee expressed concern that fund of fund advisers would no longer be able to rely on 180 day deadline.

The Division states that it would not recommend enforcement against an adviser to a fund of funds relying on the annual audit exception if the audited financial statements of the fund of funds are distributed to investors in the fund of funds within 180 days of the fund of fund's fiscal year end.

IV. Investment Advisers that Withdraw Their Registrations

Effect of Existing Regulations on Withdrawing Hedge Fund Advisers

The Division states that an investment adviser that registered as a result of the Registration Rule and that withdraws its registration with the SEC by no later than February 1, 2007 may rely on the exemption from registration provided by Section 203(b)(3) without regard to whether the adviser (i) held itself out generally to the public while it was registered, and/or (ii) had more than fourteen clients while it was registered (counting each private fund as a single client). Section 203(b)(3) provides an exemption from the registration requirement of the Advisers Act to any investment adviser who during the course of the preceding twelve months had fewer than fifteen clients and who neither held itself out generally to the public as an investment adviser nor acted as an investment adviser to any registered investment company. The Division states that for the first twelve months following withdrawal from registration, the hedge fund adviser may,

for the purposes of assessing its eligibility for the 203(b)(3) exemption, determine the number of clients it had by reference to a period of time beginning on the date of withdrawal, rather than the number of clients it had for the preceding twelve months.

Form ADV-W Balance Sheet Requirement

Investment advisers that wish to withdraw their registration from the SEC must complete and submit Form ADV-W. Schedule W2 on Form ADV-W requires withdrawing investment advisers to include a balance sheet as of the end of the month prior to its filing of the Form ADV-W if: (i) the investment adviser or a related person of the adviser has “custody” over client cash or securities; (ii) the investment adviser has received advisory fees for investment advisory services or publications that it has not rendered or delivered or has borrowed money from clients that it has not repaid; or (iii) there are any unsatisfied judgments or liens against the investment adviser. The Division states that it is not necessary for investment advisers who are withdrawing their registration because they registered as a result of the Registration Rule to include a balance sheet as required by Item 7 of Form ADV-W. When completing Form ADV-W, the Division instructs investment advisers to enter “0” for all entries on Schedule W2 of Form ADV-W. This exemption from providing a balance sheet is not applicable if the requirement to file such information is due to unsatisfied judgments or liens or because money is owed to clients.

V. Other Matters Addressed In No-Action Letter

The SEC is in the process of making changes to Form ADV to reflect the *Goldstein* decision. Until these changes are made on the IARD system, the staff of the SEC will post additional guidance on how SEC-registered advisers should complete Form ADV at <http://www.sec.gov/divisions/investment/iard.shtml>.

Also, the Division notes that registered investment advisers cannot evade the requirement to make all records available for examination by holding records through any other person, including a related entity or private fund.

* * * * *

If you have any questions or comments regarding the SEC response to the ABA Letter, please feel free to contact:

Michael G. Tannenbaum
(212) 508-6701
tannenbaum@thshlaw.com

Ricardo W. Davidovich
(212) 508-6710
davidovich@thshlaw.com

Wayne Davis
(212) 508-6705
davis@thshlaw.com

Shelley J. Rosensweig
(212) 508-6774
rosensweig@thshlaw.com

Ella D. Cohen
(212) 508-6775
cohen@thshlaw.com

Barry E. Breen
(212) 508-6725
breen@thshlaw.com

Beth Smigel
(212) 702-3176
smigel@thshlaw.com

Mary L. McAnally
(212) 702-3162
mcanally@thshlaw.com

Adam R. Hopkins
(212) 508-6702
hopkins@thshlaw.com