ABA SUBCOMMITTEE ON PRIVATE INVESTMENT ENTITIES

Investment Advisers Act of 1940:
Section 203(b)(3) and Rule 203(b)(3)-1 and 203(b)(3)-2

ABA Subcommittee on Private Investment Entities

December 8, 2005

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Dear Messrs. Lang and Roth:

In 2004, the Commission adopted rule 203(b)(3)-2 and related rule amendments that require advisers to certain private funds (hedge funds) to register under the Advisers Act.1 Your letter of June 23, 2005 requests our views on various interpretive issues regarding the rule and related rule amendments. Below, we are responding to many of the issues you have raised in your letter. In some instances, the facts presented in your June 23, 2005 letter have been supplemented through telephone discussions with you that provided further explanations, and at times we have included the results of those discussions in our explanation of the issue or in our response. With respect to some of the issues you raise, including suggestions for future rulemaking by the Commission, the staff is not in a position to provide you with a response at this time, or would require further facts in order to fully formulate a response.

The statements in this letter represent the views of the Division of Investment Management. This letter is not a rule, regulation, or statement of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved its content. The references to "we," "our," and "us" are to the Division of Investment Management. To the extent that we indicate in this letter that we would not recommend enforcement action to the Commission based on any facts and circumstances presented in your letter, our response expresses the Division's position on enforcement only and does not purport to express any legal conclusion on the issue presented. Because any such position is based on the facts and representations in your letter, you should note that any different facts and circumstances may require a different conclusion.

QUESTIONS AND ANSWERS

I. The Rules

A. Definition of "Private Fund" — Redemption

Amended rule 203(b)(3)-l(d) generally defines a "private fund" as a company: (1) that would be an investment company under section 3(a) of the Investment Company Act of 1940 (the "Investment Company Act") but for the exception provided from that definition by either section 3(c)(1) or section 3(c)(7); (2) that permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and (3) interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.

Question 1: Redemptions Within Two Years. You essentially ask whether an owner will have redeemed his ownership interest in the fund "within two years of the purchase of such interest" if he purchases an interest in the fund on January 1, 2007 and redeems that interest as of December 31,

2008.

Answer: Yes. If an owner is permitted to redeem before the second anniversary of the date of investment, then under rule 203(b)(3)-1(d) the owner is permitted to redeem his ownership interest "within two years of the purchase of such interest" and will cause the fund to be a "private fund" under the rule. For example, if an owner purchases an ownership interest in a fund on January 1, 2007, and redeems that interest on December 31, 2008, he will have redeemed his interest within two years of the purchase of such interest. However, he can be permitted to redeem the interest on January 1, 2009 without causing the fund to be a private fund under rule 203(b)(3)-1(d). This conclusion follows from the plain wording of the rule. Under that wording, January 1, 2009 is the first day outside the two-year redemption period for the owner in our example to redeem his ownership interest without causing the fund to be a private fund under rule 203(b)(3)-1(d).

Question 2: Redemptions by the Advisory Firm, General Partner and Knowledgeable Employees. You suggest that advisers, general partners and knowledgeable employees be permitted to redeem their ownership interests in a fund within two years of the purchase of such interests without causing the fund to be a "private fund" under rule 203(b)(3)-1(d). Under rule 203(b)(3)-1(d), a company is a "private fund" if, among other things, it permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests. You argue that advisers, general partners and knowledgeable employees should not be considered "owners" and should therefore be able to redeem their ownership interests in a fund at any time without causing the fund to be a "private fund." You assert that "owner" is undefined for purposes of rule 203(b)(3)-1(d), that we should look to the definition of "owner" in rule 203(b)(3)-2, and that rule 203(b)(3)-2 excludes the adviser and knowledgeable employees from the definition of "owner." You also argue that a general partner that is under common control with, and a related person of, the adviser should not be treated as an "owner."

Answer: We disagree. Under rule 203(b)(3)-1, "owner" is defined for purposes of the rule, including rule 203(b)(3)-1(d), in paragraph (a)(2)(i) of the rule. Under this definition, "owners" are "shareholders, partners, limited partners, members, or beneficiaries." This includes anyone who owns an interest in a pooled investment vehicle, including the adviser, the general partner, and the knowledgeable employees. This definition applies throughout the rule, including paragraph (d). Therefore, advisers, general partners and knowledgeable employees are "owners" under rule 203(b)(3)-1(d), and the two-year redemption period applies to advisers, general partners, knowledgeable employees as well as to other owners of the fund.2 The Commission did not adopt an exclusion for "insiders" in rule 203(b)(3)-1(d). Such an exclusion would have encouraged insiders to take for themselves preferential liquidity terms that they do not extend to the investors to whom the insiders owe a fiduciary duty, and would not further the rules' objective of investor protection.

Question 3: Withdrawals of Incentive Fees and Incentive Allocations. You state that an onshore fund typically makes an "incentive allocation" to the capital account of the adviser or the adviser's affiliated general partner. An incentive allocation is an allocation to the capital account of the adviser or the general partner that may not be in proportion to the adviser or general partner's interest in the fund but rather is intended as performance compensation. The performance compensation for an onshore fund is often structured as an allocation rather than as a fee for tax reasons.3 An offshore fund typically provides its adviser with performance compensation through an "incentive fee;" in some cases, the incentive fee may be paid out to the adviser but in other cases the adviser may defer its receipt of the incentive fee, which is then allocated to the adviser's capital account, thus remaining an obligation of the fund. You repeat your argument that an adviser or general partner is not an "owner" of the fund and you also request clarification whether an adviser or its affiliated general partner may withdraw its deferred incentive fees or accrued incentive allocations deposited in its capital account with the fund within two years of the date of deferral or accrual without causing the fund to be a "private fund."

Answer: As discussed above, we disagree with your argument that the adviser and its affiliated general partner are not "owners" of the fund under rule 203(b)(3)-1(d). However, we would not recommend enforcement action to the Commission under section 203(a) of the Advisers Act against an adviser that failed to register solely because it did not treat the adviser's or its affiliated general partner's withdrawal of deferred incentive fees or accrued incentive allocations within two years of the date of deferral or accrual as redemptions for purposes of the definition of "private fund." For regulatory purposes, we would view the deferred incentive fees and accrued incentive allocations to be compensation for services

provided by the adviser and the general partner. The two-year redemption period under rule 203(b)(3)-1(d) was intended to apply to contributions of capital, not distributions made to the adviser or general partner as compensation for services provided by the adviser and the general partner.

Question 4: Transfers Among Classes of a Fund. An owner of a fund may seek, or be required, to transfer his interest in the fund from one class to another class issued by the same fund due, for example, to a change in the owner's legal status or residence. You ask whether under such circumstances, an owner may exchange his interests in one fund class for interests in another fund class that has "substantially similar investment objectives, risk portfolio compositions, risk/return characteristics and liquidity" without the transaction involving a redemption that would implicate the definition of private fund under rule 203(b)(3)-1(d). You also ask whether the two-year redemption period provision in rule 203(b)(3)-1(d) would apply to the investment in the new fund class.

Answer: Where the classes have only "substantially similar" investment objectives and the other characteristics you listed, we believe the transaction may involve a redemption under rule 203(b)(3)-1(d). The answer in any given situation will depend on the particular facts. However, in the staff's opinion, a transfer from one class of a fund to another class of the fund would not be considered a redemption under the rule where the two classes share the same underlying portfolio of investment securities and provide investors with the same redemption rights.4 We also believe that no redemption would be involved where an investor moves from one feeder fund that invests all of its assets solely in a master fund to another feeder fund that also invests all of its assets solely in the same master fund and offers its investors the same redemption rights. In our opinion, to the extent these transactions would not be considered redemptions, the two-year holding period for the investment would also run from the date of the purchase of the old interest in the original class.

We note that under rule 203(b)(3)-1(d)(2)(i), a fund may allow its owners to redeem their interests within two years of purchase in the case of an extraordinary event without triggering the definition of "private fund." There may be some situations under which an owner would be required to transfer between classes that have only substantially similar investment objectives and other characteristics that would involve "extraordinary" events. Whether an event is "extraordinary" depends on its facts and circumstances. If the situation does involve an extraordinary event, the owner could redeem his investment in the original fund class without causing the fund to be a "private fund," and immediately transfer the proceeds to the second class. We would not recommend enforcement action to the Commission under section 203(a) of the Advisers Act against an adviser that subsequently permitted such an owner to redeem its interest in the second class within two years of the date of transfer without treating the fund as a "private fund" by reason of that redemption, so long as the investor's combined holding periods for the first and second classes meet the two-year redemption period criteria in rule 203(b)(3)-1(d).

Question 5: Transfers of Ownership Interests Among Master Funds in a Captive Structure. You state that an adviser may establish a "captive" master-feeder structure consisting of multiple master and multiple feeder funds. That is, the same adviser would (a) purchase and sell investment securities only at the master funds level and (b) reallocate, from time to time, the feeder funds' assets exclusively among the master funds. Only the feeder funds would be permitted to invest in the master funds. The reallocations would affect only the composition of the portfolio of the feeder fund, and not the ownership interests of investors in the feeder fund. You state that the feeder funds do not permit their owners to redeem their ownership interests within two years after the purchase of such interests, and that reallocations of the interests of the feeder funds among the master funds are initiated only by the adviser in its sole discretion and not by the owners of the feeder funds. You question whether, if the adviser from time to time reallocates the interests of the feeder funds among the master funds to meet the feeder funds' investment objective and these reallocations occur within two years after a feeder fund's initial allocations and subsequent reallocations, the reallocation among master funds should be treated as a redemption for purposes of the definition of "private fund" in rule 203(b)(3)(1)(d).

Answer: Under the limited circumstances you have described, we would interpret the captive master-feeder structure as operating as an integrated structure, such that the adviser could look only to whether the investors in the feeder funds are permitted to redeem any portion of their interests in the feeder funds within two years of their purchase for purposes of the definition of "private fund" in rule 203(b)(3)(1)(d).

B. Definition of a Private Fund — Extraordinary Events

Amended rule 203(b)(3)-l(d)(2)(i) provides that a fund will not be deemed a "private fund" if the fund permits investors to redeem their interests within two years of the purchase of such interests in the case of events that the adviser finds after reasonable inquiry to be extraordinary.

Question 1: Dissolution of an Owner. You asked whether the dissolution or liquidation of an owner that is organized as a partnership, limited liability company, corporation or other type of entity ("entity owner") constitutes an "extraordinary" event. You argue that a dissolution or a liquidation of an entity owner certified by the entity owner to be for a bona fide purpose (that is, not for the purpose of avoiding the two-year redemption period) is similar to a natural person investor dying or becoming totally disabled (each of which is described as an extraordinary event in the Adopting Release).5

Answer: In the staff's opinion, the dissolution or liquidation of an owner may be considered an extraordinary event where the entity ceases to operate and the adviser has a reasonable basis to believe that the entity owner's dissolution or liquidation is bona fide and not designed to avoid the two-year redemption period. While having the entity owner certify that the dissolution or liquidation is bona fide is one factor that an adviser may use to establish a reasonable basis, advisers should make reasonable inquiry as required by rule 203(b)(3)-1(d)(2)(i). You also note in your letter that many partnership agreements provide that it is an event of withdrawal if an entity limited partner declares bankruptcy. In the staff's opinion, bankruptcy of an owner, whether an individual or an entity, is also an extraordinary event.

Question 2: Significant Withdrawals of Capital by the Adviser. You ask whether a significant withdrawal of proprietary investments by an adviser (without an intention to reinvest) may be viewed as an "extraordinary" event so that other owners may withdraw their interests in the fund without causing the fund to be a "private fund." You argue that a significant withdrawal of the proprietary investments of the adviser or its personnel is analogous to key personnel at the adviser dying, becoming incapacitated or ceasing to be involved in the management of the fund, and that investors often negotiate for redemption rights that are triggered in the event of a significant withdrawal by the adviser or its personnel. You suggest that the amount of reduction in the adviser's ownership, or the ownership of its personnel, that would constitute an "extraordinary" event be set through negotiation with investors, so long as the terms of the investors' redemption rights are set forth in an agreement between the investor and the fund at the time of the investor's investment.

Answer: You argue that a significant withdrawal of the proprietary investments of the adviser is analogous to key personnel at the adviser dying, becoming incapacitated or ceasing to be involved in the management of the fund for an extended period of time. We disagree. Unlike the death or incapacity of key personnel at the adviser, a significant withdrawal of investment by an adviser is an event within the adviser's discretion that we do not view as analogous to the examples provided in your letter and in the Adopting Release.6 In our view, a fund with investors that have negotiated for redemption rights that would be triggered in the event of a significant withdrawal by the adviser or its personnel would meet the definition of "private fund," and the adviser would be required to register with the Commission.7

C. Definition of a Private Fund — Interests Acquired through Reinvestment of Distributed Capital Gains or Income

Question 1: Allocated Gains or Income. You have suggested that, for purposes of the two-year redemption period provision in rule 203(b)(3)-1(d), gains or income allocated to an investor's capital account, and any subsequent appreciation thereon, be assigned the date of the investor's original investment to which those allocated gains or income are attributable. Thus, following the passage of two years from the date of the original investment, the investor would be able to redeem not only his original investment but also any gains or income and subsequent appreciation on those gains or income, without triggering the definition of "private fund." You ask for the staff's concurrence in your view.

Answer: We agree.

D. Definition of a Private Fund — Transfers of Interests

Question 1: Attribution of Holding Period. The Commission stated in footnote 241 of the Adopting Release that an investor's transfer of an interest in a fund to, for example, a new limited partner in a secondary market transaction will not be considered a redemption for purposes of the definition of "private fund." You have asked whether the transferor's acquisition date can be attributed to the acquired interest for purposes of the two-year holding period.

Answer: In our view, the original purchase date may be attributed to the interest transferred in a secondary market transaction, including interests transferred without consideration (i.e., gifts), provided that there has been no arrangement between the fund and either investor to circumvent the two-year redemption provision in the definition of "private fund."8 We caution, however, that if the secondary market transaction is arranged or initiated by the adviser or fund manager, section 208(d) of the Advisers Act may be implicated.

E. and F. Definition of a Private Fund — Subadvisers; Offshore Advisers

Question 1: Registration of Subadvisers to "Private Funds." You have asked that some subadvisers to private funds, including discretionary asset managers, be exempted from registration if the adviser to the private fund is registered. You have suggested that a subadviser should not be required to register if: (1) it is not named in the offering memorandum and manages 15 percent or less of the fund's assets at the time it is initially hired; (2) it is not controlled by or under common control with the registered adviser; and (3) it is not otherwise required to register. You suggest that the subadviser would be hired and fired by the registered adviser. You have suggested that these subadvisers are not managing the private fund, but are merely providing their specialized skills to the registered adviser. In your Question F.1, you present substantially the same facts but argue that there are additional policy considerations in the case of subadvisers located offshore.

Answer: We are unable to provide the relief that you seek with respect to subadvisers located in the United States, but as we describe in detail below, we are taking a different approach with respect to subadvisers located offshore.9 Footnote 243 of the Commission's Adopting Release clarifies that, if the fund is a private fund, all of its advisers, including subadvisers that may not be named in the fund's offering materials, must look through it for purposes of the private adviser exemption. This footnote makes it clear that if a fund is a "private fund," it is a "private fund" with respect to all, not merely some, of its advisers. The purposes articulated in the Adopting Release, including without limitation the collection of basic information on managers of private funds, and the Commission's ability to examine those managers, would be defeated if advisers could delegate management to unregistered firms. In our view, a subadviser that manages a portion of the private fund's assets, with or without investment discretion, is managing the fund and is not merely providing its specialized skills to the fund's primary adviser.10

However, you have suggested that different policy considerations may be presented when the rule is applied to subadvisers located offshore. You have suggested that an adviser to a private fund may delegate management of some portion of the fund's assets to an offshore subadviser that has particular access to non-U.S. markets, and that requiring the subadviser to register when it has no other connections to the United States may cause it to decline to manage the fund's assets and therefore limit U.S. investors' access to offshore investment opportunities.

We appreciate these policy considerations. The Commission, in its Adopting Release, considered issues raised by the extraterritorial application of the rule, and in adopting the rule and rule amendments, the Commission took significant steps designed to limit the extraterritorial burdens of the rule.11 Consistent with that approach, we would not recommend enforcement action to the Commission under section 203(a) against an offshore subadviser that did not register with the Commission as an investment adviser solely because it advises a private fund, provided: (1) the subadviser is hired (and subject to being discharged) by the private fund's adviser that is registered with the Commission ("primary adviser"); (2) the subadviser is not otherwise required to register with the Commission; (3) the subadviser does not control, is not controlled by, or is not under common control with the fund's primary adviser;12 (4) the written materials provided to the fund's investors clearly disclose that a portion of the fund's assets may be managed by one or more offshore subadvisers not registered with the Commission; and (5) at the time the subadviser is hired, and at the time any additional assets of the

fund are allocated to the subadviser for management, the unregistered offshore subadviser does not manage more than 10 percent of the fund's total assets.13 The first three of these five conditions are suggested by your letter. The fourth condition will alert investors to the possibility that unregistered offshore firms may be managing some of the fund's portfolio; investors may find that information important, particularly if, as you suggest, the subadvisers are not identified in the offering memorandum. The fifth condition stems from your suggestion that any relief include a stated threshold; we disagree, however, that the threshold can be used as a materiality safe harbor for whether the offering memorandum is required to identify and discuss the subadviser. We note, moreover, that if the registered primary adviser has custody of the fund's assets, we do not believe that its delegation of management of those assets to the unregistered subadviser would divest it of custody under rule 206(4)-2; therefore in our view the primary adviser would remain responsible for ensuring that those assets are maintained in accordance with the requirements of rule 206(4)-2.

Question 2: Separate Redemption Provisions for an Offshore Fund's U.S. Investors. You have asked whether an offshore fund advised by an offshore adviser may provide that U.S. investors may not redeem their interests within two years of purchase, but allow non-U.S. investors to redeem their interests sooner without causing the fund to fall within the definition of a "private fund."

Answer: In our view, a fund that allows non-U.S. investors to redeem their ownership interests within two years of purchase would fall within the definition of a private fund. The Commission stated in footnote 233 of the Adopting Release that if a fund uses side letters to provide some, but not all, investors the opportunity to redeem shares within two years, the fund would meet the definition of a private fund. In the staff's opinion, interpreting the rule to include, as a private fund, a fund that allowed non-U.S. investors to redeem their ownership interests within two years of purchase would be consistent with this footnote; under the rule, if a fund permits any owner to redeem its interest within two years of purchase, the fund meets that portion of the definition of "private fund."

G. Registration of Related Persons

Question 1: Registration of the Adviser and the General Partner or Managing Member. You state that the investment adviser to a private fund often establishes a special purpose vehicle ("SPV") to act as the private fund's general partner or managing member. You state that the SPV's formation documents designate the investment adviser to manage the private fund's assets, and that the SPV has no employees or other persons acting on its behalf other than officers, directors, partners or employees of the adviser. You essentially ask whether it would be sufficient for the investment adviser to the private fund to register with the Commission under section 203(a) of the Advisers Act and for the SPV to remain unregistered.

Answer: The staff would not recommend enforcement action to the Commission under sections 203(a) or 208(d) of the Advisers Act against a registered investment adviser and an SPV if the SPV does not register as an investment adviser with the Commission, provided that all of the investment advisory activities of the SPV are subject to the Advisers Act and the rules thereunder, and the SPV is subject to examination by the Commission.14 In particular, the registered investment adviser would subject the SPV, its employees and persons acting on its behalf to the adviser's supervision and control.15 Thus, the SPV, all of its employees and the persons acting on its behalf would be "persons associated with" the registered investment adviser (as that term is defined in section 202(a)(17) of the Advisers Act) so that the Commission could enforce the requirements of the Advisers Act against the SPV, those persons, and the registered investment adviser.16 In addition, the SPV would look to and essentially rely upon the investment adviser's registration with the Commission in not registering itself. 17

Question 2: Registration of Affiliated Entities. You request guidance concerning the applicability of the registration requirements of the Advisers Act to a registered investment adviser's foreign affiliates.18 In particular, you state that a registered adviser may establish advisory affiliates in non-U.S. jurisdictions to take advantage of investment opportunities in those jurisdictions. You state that each foreign affiliate typically would have at least one portfolio manager, as well as analysts and support personnel, and that a portfolio manager would have the authority to manage some portion of a private fund's assets.

You essentially request our assurance that we would not recommend enforcement action to the

Commission under section 203(a) of the Advisers Act against a registered adviser's foreign affiliate that does not register as an investment adviser. As you note in your letter, we previously have provided similar no-action assurances to registered advisers' foreign affiliates that share personnel with, and provide certain services through, the registered advisers (the "Letters").19 In the Letters, we generally referred to the foreign affiliates as "participating affiliates." Our assurances in the Letters were based on representations made by the participating affiliates and the registered investment advisers that were designed to ensure that the advisory activities of the participating affiliates, which affect U.S. clients or markets, were subject to the Advisers Act and the rules thereunder and the Commission's regulatory oversight.

Answer: We believe that the foreign affiliates and the registered advisers that you describe in your letter may rely on the relief provided in the Letters to the extent that their facts and circumstances are substantially similar to those described in the Letters.20 Please note that the ability to rely on the Letters is not dependent on whether or not the registered adviser has a principal office and place of business located in the United States.21

In addition, we recognize that certain representations that we relied upon in providing no-action assurances in the Letters relate to provisions of rules under the Advisers Act that were subsequently amended by the Commission (e.g., representation 12 in RBC refers to "advisory representatives" as defined in rule 204-2(a)(12)(A) when the rule no longer contains such a definition), and also may implicate new rules adopted by the Commission (e.g., rule 204A-1 under the Advisers Act). We encourage registered advisers and participating affiliates that wish to rely on the Letters to contact the staff if they have questions in light of recent changes to the rules.

H. Family Offices and Family Funds

Question 1: Treatment of Family Funds as "Private Funds." You have asked for our interpretation whether an investment vehicle composed solely of family members described in section 2(a)(51)(A)(ii) of the Investment Company Act,22 where the adviser is a family member or an entity organized and controlled primarily by family members, should be excluded from the definition of a "private fund."

Answer: Having considered comments urging such an exemption,23 the Commission chose not to adopt a provision excepting family investment funds from the definition of "private fund." As you acknowledged, the Commission did recognize in the Adopting Release that some family investment funds may not be offered based on the expertise of the adviser.24 If interests in a family investment fund are not offered based on the investment advisory skills, ability or expertise of the adviser, the fund is not a private fund under the definition in rule 203(b)(3)-1(d). Whether a fund is offered based on its adviser's expertise is determined by the facts and circumstances of that particular fund. Neither the fact that the fund is offered only to family members, nor the fact that a family member controls the adviser, necessarily determines whether the investors are committing their capital to the fund based on the adviser's expertise.

Question 2: Treatment of Non-Family Members as Clients. You have asked whether an adviser to a family investment fund should be required to count only non-family investors in the fund as its clients for purposes of determining its registration obligations.

Answer: All owners, including family members, must be counted under rule 203(b)(3)-2(a). While family members must be counted, the Commission reminded advisers that certain family members sharing the same principal residence could be counted together as a single client.25 Under rule 203(b)(3)-1(a)(1)(iv), trusts of which those family members are the only primary beneficiaries may also be grouped into the "single client" count. While we disagree with your request, we would like to take this opportunity to clarify the staff's interpretation of one point under rule 203(b)(3)-1(a)(1)(iv); your letter suggests that under the relief you requested, you would count, as non-family members, trustees of family trusts where the trustees themselves are not family members. Rule 203(b)(3)-1(a)(1)(iv) does not address whether, for client counting purposes, a family member must also serve as trustee; in our view, a trust may be included in the single client count so long as the family members referred to in the rule are the only primary beneficiaries, whether or not a family member also serves as trustee.

I. Compliance Dates

Question 1: Effective Date of Registration. The Commission has established February 1, 2006 as the date by which advisers to "private funds" must have their SEC registration effective. Under the Advisers Act, the Commission declares adviser registrations effective within 45 days of the date of filing the Form ADV.26 You have asked that we deem the new registrants to have met the February 1, 2006 date, and that their registration statements be deemed effective as of that date, provided they file their Form ADV with the Commission by January 13, 2006 and that Form ADV is complete in all material respects.

Answer: The Commission established a compliance period of over one year for the new rules in order to give advisers sufficient time to prepare and submit registration material to the Commission. Advisers that will be required to register as a result of the new rules are urged to submit their applications no later than December 15, 2005 (to be sure that there are at least 45 days before the compliance date of February 1, 2006). Form ADV must be filed through the Investment Adviser Registration Depository (IARD), a secured system that requires advisers to mail in entitlement forms and receive system entitlement before they can make any filings. Advisers can find entitlement forms and form processing information at www.iard.com. You correctly note that in many cases, we are in a position to declare an adviser's registration effective before expiration of the 45-day period.27 Once an application for registration is filed, advisers can log onto the IARD system to check the status of their application.28

We recognize, however, that many private fund advisers and their counsel will be reviewing these staff responses in assessing their registration and regulatory obligations. Accordingly, if an adviser required to register as a result of the Commission's adoption of rule 203(b)(3)-2 files its initial application for registration as an investment adviser on Form ADV with the Commission no later than January 9, 2006, the staff will endeavor to act upon the application by February 1, 2006.

We expect that most of the new registrants have a fiscal year ending December 31. The submission of a registration application close to, but before the end of, the applicant's fiscal year end could raise a question of when its first annual updating amendment will be due. Each adviser, once its registration is effective, must file an annual updating amendment within 90 days after the close of its fiscal year. In order to ensure that new registrants' first annual updating amendment is due by March 31, 2007, rather than March 31, 2006, Form ADV filings made on or after November 20, 2005 will not be declared effective before January 3, 2006 absent filer requests to the contrary. Filers can request earlier approval either on Schedule D, or by calling the SEC IARD Filing Status phone number listed on the Commission's Web site at http://www.sec.gov/divisions/investment**/iard/iardhelp.shtml.**

II. Related Issues

You have also requested our views on various issues arising under the Advisers Act that you suggest are unique to hedge fund managers; while we believe other registered investment advisers have faced many of these issues and resolved them, we agree that they may have increased significance now that many private fund advisers are required to register with the Commission.

A. Trading Issues –Principal Transactions and Rebalancing

Question 1: Determination of the Status of an Unregistered Pool for Principal Transaction Purposes. You state that an adviser may manage multiple unregistered pooled investment vehicles with the same investment strategy, and that the adviser may seek to rebalance the portfolios of the pools on a monthly or quarterly basis to reflect contributions and redemptions that are disproportionate among the pools. You state that when rebalancing, the adviser may sell securities from one or more unregistered pools and purchase the securities for one or more of the other unregistered pools in a simultaneous transaction (i.e., a cross transaction) so that each pool maintains the same pro rata ownership of each securities position. You state that one or more of the unregistered pools may contain proprietary assets of that adviser and its personnel. You are concerned that such unregistered pools could be viewed as a principal account of the investment adviser and that any trade, including a rebalancing transaction, involving such pools could be viewed as a principal transaction. You ask whether these rebalancing transactions among an adviser's unregistered pools would be viewed as principal transactions subject to the notice and consent requirements of section 206(3) of the Advisers Act. Alternatively, you ask for guidance as to the threshold percentage of an unregistered pool that must be owned by the fund's investment adviser and the adviser's personnel before the pool must be viewed

as a principal account of the adviser for purposes of section 206(3).

Answer: Whether section 206(3) of the Advisers Act applies to the periodic rebalancing transactions described in your letter, or to transactions between an adviser's client and an unregistered pooled investment vehicle in which the adviser and/or its personnel have an ownership interest, depends upon all of the facts and circumstances.29 In our view, significant factors include the extent of the ownership interest of the adviser and/or its personnel in the unregistered pool, as well as the relationship of the personnel to the adviser. The Commission has instituted enforcement actions based on claims of violations of section 206(3) against advisers and their principals when the advisers effected transactions between their advisory clients and accounts in which the principals of the advisers held significant ownership interests.30

We also note that sections 206(1) and (2) of the Advisers Act impose a fiduciary duty on advisers with respect to their clients and a duty of full and fair disclosure of all material facts.31 Those provisions may require an adviser to disclose information about rebalancing transactions and transactions effected by the adviser involving an unregistered pooled investment vehicle in which the adviser and/or its personnel have an ownership interest, regardless of whether section 206(3) also applies.32 We suggest that advisers monitor the ownership interests of the adviser, and its personnel, in unregistered pooled investment vehicles advised by the adviser as part of their compliance procedures under rule 206(4)-7 under the Advisers Act to assure themselves that they satisfy their obligations under sections 206(1), (2), and (3) (as applicable) with respect to these transactions.

B. Form ADV

Question 2: Schedule D, Section 7.B. You have asked whether an adviser that advises both a master fund and feeder funds that invest in that master fund is required to complete Section 7.B of Schedule D only for each feeder fund, and not for the master fund, provided that the only investors in the master fund are the feeder funds, and, for each feeder fund, to report those assets of the master fund that are attributable to the respective feeder fund.

Answer: If both the master fund and the feeder funds are investment-related limited partnerships or limited liability companies having the adviser or a related person as their general partner or managing member, or are other private funds advised by the adviser, then Section 7.B of Schedule D of Form ADV requires the adviser to report both the feeder funds and the master fund, and to identify the current value of the total assets in each. The adviser may wish to state, in the field that calls for the name of the feeder, that this is a feeder fund invested solely in a master fund, and provide the name of the master fund.

C. The Custody Rule

Rule 206(4)-2 under the Advisers Act (the "Custody Rule") provides that it is a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of section 206(4) of the Advisers Act for an investment adviser that is registered or required to be registered under section 203 of the Advisers Act to have "custody" of client funds or securities unless they are maintained in accordance with the requirements of the rule.33 The Custody Rule requires an investment adviser that has custody34 of client funds and securities to: maintain the funds and securities with a "qualified custodian;"35 provide its clients with certain information about their qualified custodian;36 and have a reasonable basis for believing that the qualified custodian is sending account statements on at least a quarterly basis directly to clients ("quarterly reporting requirement").37 An investment adviser to a pooled investment vehicle does not have to comply with the quarterly reporting requirement if, among other things, the pooled investment vehicle distributes financial statements audited in accordance with generally accepted accounting principles ("GAAP") within a prescribed time after the close of its fiscal year.38

Question 1: The Use of Offshore Prime Brokers. The Custody Rule defines qualified custodian to include "a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets."39 You explain that many investment advisers to pooled investment vehicles use the services of prime brokers located outside of the United States as custodians for the vehicle's

assets. You therefore seek a staff interpretation that such a prime broker would be a "qualified custodian" within the meaning of the Custody Rule, provided that an adviser using that prime broker discloses in the entity's offering memorandum and the adviser's Form ADV the specific risks inherent in the manner in which the prime broker holds the vehicle's assets.

Answer: A qualified custodian must segregate advisory client assets using one of two specified alternatives. The qualified custodian must either maintain a separate account for each advisory client under the client's name (rule 206(4)-2(a)(i)) or maintain a separate account for the assets of the adviser's clients under the adviser's name as agent or trustee for the clients (rule 206(4)-2(a)(ii)). As you note, the Custody Rule specifies that a foreign financial institution must also keep advisory clients' assets in customer accounts segregated from the institution's proprietary assets. So long as an offshore prime broker complies with these requirements, it would be eligible to act as a qualified custodian under that rule.

Question 2: Definition of Privately Offered Securities. Advisers are excepted from compliance with the requirements of the Custody Rule with respect to their custody of "privately offered securities," which are securities that are: (A) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (B) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and (C) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.40 You seek an interpretation that would broadly expand the types of securities that would be deemed to be privately offered securities under the rule to include any securities "where payment or transfer of a security is controlled by, or requires approval from, a third party," and that would permit advisers keeping such advisory client securities not to maintain written agreements evidencing a client's interest in such securities.41

Answer: Based on the information in your letter, we are unable to provide the interpretation that you seek. The Custody Rule excepts advisers from its requirements only with respect to certain types of privately offered securities that have clear impediments to transferability. While there may be circumstances in which securities that do not meet the description of "privately offered securities" under the Custody Rule have impediments to transferability that provide clients with protections equivalent to those offered under the Custody Rule, you have not provided us with information that would allow us to conclude that the securities that you describe do so. We would be willing to consider a request seeking our assurances that we would not recommend enforcement action to the Commission if an adviser treats a particular security or type of security as a privately offered security under the rule, provided that the request discusses any relevant precedent and contains the legal and factual analysis necessary to allow us to fully evaluate the request.42

Question 3: Amortization of a Fund's Start-Up Costs. The quarterly reporting requirement of the Custody Rule applies to any adviser registered or required to be registered under section 203 of the Advisers Act. Any such adviser that has custody of client assets must provide its clients, or must have a reasonable basis to believe that the qualified custodian provides the adviser's clients, with account statements, at least quarterly, providing the information specified in the rule.43 Advisers that maintain custody of a pooled investment vehicle's assets are excepted from this requirement if the pooled investment vehicle "is subject to audit ... at least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles ... within 120 days of the end of the fiscal year."44

You state that an unregistered pooled investment vehicle typically amortizes its start-up costs so that those costs are not borne solely by the initial investors. As a consequence, the audit opinion accompanying such a vehicle's financial statements typically is qualified to reflect such treatment, in which case the financial statements are not prepared in accordance with GAAP.45 Consequently, an adviser to such a pooled investment vehicle must provide investors with account statements, at least quarterly, under the Custody Rule. So that a pooled investment vehicle's adviser may avoid this requirement, you essentially seek an interpretation that a pooled investment vehicle's financial statements comply with the requirement that they be prepared in accordance with GAAP despite the fact that the audit opinion accompanying the financial statements is qualified to reflect that the vehicle amortizes its start-up costs.

Answer: In adopting the 2003 amendments to the Custody Rule, the Commission clearly indicated that

the exception to the quarterly reporting requirement is available only to advisers to pooled investment vehicles whose financial statements are fully GAAP compliant.46 Moreover, the interpretation that you seek is substantially similar to an approach suggested to the Commission by one of the commenters on the 2003 proposal to amend the Custody Rule.47 Following consideration of the commenter's proposal, however, the Commission determined to adopt the more narrow exception set forth in the rule.48

E. Record Retention

Question 1: Retention of Private Fund Records by a Fund Administrator. You essentially ask whether a registered investment adviser of a private fund may engage the services of a third-party administrator (an "Administrator") to maintain and preserve, on the adviser's behalf, the books and records required to be kept under rule 204-2 under the Advisers Act and still comply with paragraph (e) of that rule, which requires that a registered investment adviser maintain and preserve those records for the first two years in an appropriate office of the investment adviser (the "Appropriate Office Requirement").49 You maintain that the investment adviser would enter into a contract with the Administrator, and such contract may require the Administrator to (1) maintain and preserve the records as required under rule 204-2 on behalf of the investment adviser, and (2) provide those records to the adviser promptly upon request.

Answer: We would not recommend enforcement action to the Commission under section 204 or rule 204-2 thereunder against an investment adviser and its Administrator with respect to the Appropriate Office Requirement, provided that: (i) the Administrator acts as a service provider to the adviser50 in maintaining, preparing, organizing and/or updating the adviser's records for the adviser's ongoing use in its business, and does not merely provide long-term storage of the records; and (ii) upon request of the Commission's staff, the records are produced promptly for the staff at the appropriate office of the adviser or an office of the Administrator.51

Question 2: Records of an Offshore Private Fund with an Independent Board of Directors. Under rule 204-2(l), if an adviser to a private fund, or a related person of that adviser, serves as the private fund's general partner, managing member, or in a comparable capacity, the books and records of the private fund are records of the adviser for purposes of section 204 of the Advisers Act.52 You have asked whether the records of an offshore private fund formed as a corporation would be considered records of the fund's adviser under rule 204-2(l) where a majority of the fund's directors are not affiliated with the adviser. You have stated that neither the adviser nor any of its related persons acts as general partner, managing member or in a similar capacity for the fund.

Answer: If neither the adviser nor any of its related persons acts as the private fund's general partner, managing member, or in a similar capacity, rule 204-2(l) does not cause the books and records of the private fund to be records of the adviser.

Sincerely,

Douglas Scheidt
Associate Director and Chief Counsel   Robert E. Plaze
Associate Director

Endnotes

1 Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) (the "Adopting Release").

2 We also disagree that advisers and knowledgeable employees are not "owners" under the definition in rule 203(b)(3)-2. As stated in the Adopting Release, supra note 1, rule 203(b)(3)-2 is solely designed to specify the methodology of counting clients that private fund advisers must use for purposes of applying the private adviser exemption. The plain wording in rule 203(b)(3)-2(a) includes advisers and their knowledgeable employees in the definition of "owner", but provides that they need not be counted for purposes of the private adviser exemption. See Adopting Release, supra note 1 at Section II. D.

3 You have explained this to us in telephone conversations.

4 If either class has any investments not shared, in the same proportion, by the other class, such as investments in side pockets, we would not view the two classes as sharing the same underlying portfolio.

5 See Adopting Release, supra note 1, at n.240.

6 Id.

7 The Adopting Release makes it clear, however, that advisers are required to apply the two-year redemption test only to investments made on or after February 1, 2006. Adopting Release, supra note 1, at Section III. Thus any agreements providing investors with redemption rights in the event of a significant withdrawal by the adviser or its personnel would not trigger the definition of "private fund" to the extent those agreements apply to investments made prior to February 1, 2006. Investments made under those agreements on or after February 1, 2006, however, would trigger the private fund definition.

8 Cf. Rule 144 under the Securities Act of 1933, which permits tacking the seller's holding period on to the purchaser's holding period for restricted securities when the seller and purchaser are not affiliated with the issuer. See Rule 144: Selling Restricted and Control Securities, available on www.sec.gov/investor/pubs/rule144.htm.

9 Under rules under the Advisers Act, the location of an investment adviser, including a subadviser, is determined by reference to the adviser's principal office and place of business. See, e.g., rule 203(b)(3)-1(b)(5), rule 203(b)(3)-2(c), Form ADV Part 1A Item 2.A(3).

10 We agree that in some limited circumstances, it may be appropriate for the other advisory firm to be viewed as not acting as an adviser to the private fund. Those limited circumstances, however, do not include situations where the other advisory firm is managing a portion of the private fund's assets, with or without discretion.

11 See Adopting Release, supra note 1, at Section II.D.4.

12 See also our response to question I.G.2., infra, for guidance regarding the registration obligations under the Advisers Act of foreign affiliates of registered investment advisers.

13 We believe this relief should not be contingent on whether the offshore subadviser is identified in the fund's offering materials or other disclosure to investors. Such a proviso could have the effect, which would not further the protection of investors, of discouraging fund advisers and general partners from informing investors of the name or other information about the offshore subadvisers.

14 For instance, any investment advisory fee, including a performance fee or any allocation of a fee, that the SPV receives from the private fund would have to be consistent with the Advisers Act (e.g., section 205). As another example, the SPV would make and keep the books and records required under the Advisers Act, and provide the Commission's staff with access to its books and records, as if those requirements applied directly to the SPV (we would not object, however, if the books and records of the SPV are maintained at the offices of the registered adviser rather than at offices of the SPV). These examples are non-exclusive. See also Glenwood Associates, Inc., SEC Staff Letter (Aug. 6, 1992) and Thomson Advisory Group L.P., SEC Staff Letter (Sept. 26, 1995).

15 For example, all of the employees of the SPV and persons acting on its behalf would be subject to the registered investment adviser's code of ethics (see rule 204A-1) and compliance procedures and practices (see rule 206(4)-7).

16 See, e.g., sections 203(e) and (f) of the Advisers Act.

17 For example, any disciplinary history that the SPV would have been required to disclose on Form ADV, had it registered as an investment adviser, would be disclosed on the registered investment adviser's Form ADV.

18 In your letter, you also appear to request such guidance concerning a registered investment adviser's U.S. affiliates, stating that: "In this scenario, a private fund (including a private fund organized in the United States) might be advised by entities located, for example, in the United States ...." Our response to this question I.G.2 does not address the registration requirements for a registered investment adviser's U.S. affiliates.

19 See, e.g., Uniao de Banco de Brasileiros S.A., SEC Staff Letter (July 28, 1992); Mercury Asset Management plc, SEC Staff Letter (Apr. 6, 1993) ("Mercury"); Kleinwort Benson Investment Management Limited, et al., SEC Staff Letter (Dec. 15, 1993); Murray Johnstone Holdings Limited, et al., SEC Staff Letter (Oct. 7, 1994); ABN AMRO Bank N.V., et al., SEC Staff Letter (July 1, 1997) ("ABN AMRO"); and Royal Bank of Canada, et al., SEC Staff Letter (June 3, 1998) ("RBC").

20 See Informal Guidance Program for Small Entities, Investment Company Act Release No. 22587 (Mar. 27, 1997) (explaining the policy of the Division of Investment Management concerning reliance by third parties on no-action letters issued to others).

21 See, e.g., ABN AMRO (providing no-action assurances to a registered adviser, which was incorporated under the laws of Delaware, and its participating entities and certain other affiliates). We believe that our position in ABN AMRO responds to your request for confirmation that a registered adviser, with a principal office and place of business that is located in the United States, can treat its foreign affiliates as participating affiliates.

22 Section 2(a)(51)(A)(ii) of the Investment Company Act refers to companies that are owned directly or indirectly by 2 or more natural persons who are related as siblings or spouses (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations or trusts established by or for the benefit of such persons.

23 See Adopting Release, supra note 1, at n.249 (citing letters of Skadden, Arps and American Bar Association Section of Business Law, among others).

24 Id.

25 See Adopting Release, supra note 1, at n.248 (explaining how rule 203(b)(3)-2 works in conjunction with rule 203(b)(3)-1(a)(1)).

26 See section 203(c)(2) of the Advisers Act. Alternatively, the Commission may institute proceedings to determine whether the registration should be denied. Id.

27 As you noted, the IARD does not accept filings during late December of each year. The shutdown in 2005 will commence December 21, 2005, and the IARD is scheduled to re-open for filings at 7 a.m. on January 2, 2006.

28 In addition, the IARD system now sends registrants an email notification the day after their registrations are declared effective (provided the registrant has authenticated (verified) its contact information through the system; see http://www.sec.gov/divisions/investment/iard.shtml).

29 Advisers seeking interpretive guidance concerning the applicability of section 206(3) to rebalancing and other transactions should provide us with specific factual information, and should explain how the transactions may implicate section 206(3) and whether they raise the concerns underlying that section (i.e., price manipulation and dumping). See, e.g., Gulf Coast Venture Forum, Inc., SEC Staff Letter (Aug. 21, 2002); Glenwood Investment Corp., SEC Staff Letter (Aug. 10, 1994).

30 See SEC v. Beacon Hill Asset Management, LLC, et al., Litigation Release No. 18950 (Oct. 28, 2004) (in a settled action, the Commission alleged violations of section 206(3) against an unregistered investment adviser and its four principals when the principals caused securities in an account in which three of the four principals were the only investors to be sold to, and purchased from, a hedge fund client of the adviser without disclosing the adviser's capacity in which it was acting and obtaining the

consent of the client to such transactions); Gintel Asset Management, et al., Investment Advisers Act Release No. 2079 (Nov. 8, 2002) (in a settled action, the Commission alleged that an investment adviser violated section 206(3), and Robert Gintel, the adviser's sole owner, aided and abetted and caused the adviser's section 206(3) violations, when Mr. Gintel effected certain cross transactions between a registered investment company, of which Mr. Gintel owned approximately 34%, and other accounts advised by the adviser without disclosing the adviser's capacity in which it was acting and obtaining the consent of the clients to such transactions).

31 See Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., et al. 375 U.S. 180 (1963).

32 See Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1732 (July 17, 1998) (stating that "Sections 206(1) and (2) may require the adviser to disclose information about agency transactions that are not subject to Section 206(3)").

33 The Commission comprehensively amended the Custody Rule in 2003. See Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176 (Sept. 25, 2003) ("Custody Rule Adopting Release").

34 See rule 206(4)-2(c)(1) (defining custody).

35 Rule 206(4)-2(a)(1).

36 Rule 206(4)-2(a)(2).

37 Rule 206(4)-2(a)(3).

38 Rule 206(4)-2(b)(3).

39 Rule 206(4)-2(c)(3)(iv).

40 Rule 206(4)-2(b)(2).

41 You refer to certain loans, privately negotiated derivatives and other instruments as examples of securities that may not be deemed to be privately offered securities as described in the Custody Rule, but that you believe should not be required to be maintained with a qualified custodian.

42 See Glenwood Investment Corp., SEC Staff Letter (Aug. 10, 1994) (providing guidance as to the information that should be provided when submitting no-action requests).

43 Rule 206(4)-2(a)(3).

44 Rule 206(4)-2(b)(3). The deadline is within 180 days of the end of the fiscal year in the case of a fund of funds.

45 See American Institute of Certified Public Accountants, Statements of Position 98-5 (discussing accounting treatment of start-up costs).

46 The Commission initially proposed a complete exemption from the Custody Rule for advisers to audited pooled investment vehicles, but ultimately determined only to adopt the narrow exception from the quarterly reporting requirement because it believed that the other requirements of the Custody Rule provide protections to investors for which an annual audit provides an insufficient substitute. See Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Release No. 2044 (July 18, 2002) (proposing release) and Custody Rule Adopting Release, supra note 33 at Section II.D.

47 Comment Letter of Dechert (Sept. 25, 2002) available at www.sec.gov/rules/proposed/s72802/dechert1.htm.

48 It is our understanding that pooled investment vehicles may be able to develop alternate methods

of sharing organizational costs with subsequent investors in the pool instead of amortizing organizational expenses in the pool's financial statements. We are exploring the possibility of alternatives that would allow pooled investment vehicles to effect these alternate cost-sharing methods while being able to prepare financial statements in accordance with GAAP.

49 See rule 204-2(l), which provides that if the adviser to a private fund or a related person of that adviser acts as the fund's general partner, managing member, or in a comparable capacity, the records of the private fund are records of the adviser for purposes of section 204 of the Act.

50 For purposes of our response, we would view the Administrator as acting as a service provider to the adviser regardless of whether the adviser engages the services of the Administrator through a contract with the adviser itself, the fund or with the fund's general partner.

51 See also First Call Corporation, SEC Staff Letter (Sept. 6, 1995) and rule 31a-3 under the Investment Company Act of 1940 (Records Prepared or Maintained by Other Than Person Required to Maintain and Preserve Them). But see National Regulatory Services, Inc., SEC Staff Letter (Dec. 2, 1992) ("NRS") (stating that, even though an investment adviser may delegate the responsibility of creating certain records required to be maintained under rule 204-2 to a wrap fee sponsor, maintenance of the records in the offices of the sponsor would not comply with the Appropriate Office Requirement). Our position in NRS is superseded in so far as it is inconsistent with this response.

52 Rule 204-2(l) incorporates the "related person" definition in Form ADV, under which a related person of the adviser includes any officer, partner or director of the adviser, and person controlling, controlled by or under common control with the adviser, and any employee of the adviser other than one performing only clerical, administrative or support functions.