THE AYCO COMPANY, L.P.

Investment Advisors Act of 1940 -- Section 205(a)(3)

December 14, 1995

TOTAL NUMBER OF LETTERS: 2
SEC-REPLY-1:
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

December 14, 1995

Our Ref. No. 95-426-CC
The Ayco Company, L.P.
File No. 801-48238

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter dated October 25, 1995 requests our assurance that we would not recommend enforcement action to the Commission under Section 205(a)(3) of the Investment Advisers Act of 1940 ("Advisers Act") if The Ayco Company, L.P. ("Ayco"), a registered investment adviser, does not include in its advisory contracts a provision obligating it to notify its clients when limited partners withdraw from or new limited partners are admitted to Ayco.

Ayco is a limited partnership organized under Delaware law, and currently has more than 10,000 advisory clients. Ayco has one general partner, Hambre, Inc. ("Hambre"), and 61 limited partners. The sole shareholders of Hambre, John J. Breyo and Barry Hammerling, also are limited partners of Ayco and own in the aggregate 35% of Ayco. All of the other limited partners are employees of Hambre who are leased to Ayco. Ayco's partnership agreement allows for additional limited partners to be admitted prior to December 9, 1996.

Section 205(a)(3) of the Advisers Act provides that it is unlawful for an investment adviser to enter into, extend, or renew any investment advisory contract, or in any way perform any investment advisory contract, if such contract fails to provide that the investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of the partnership within a reasonable time after such change. n1 You assert that, notwithstanding this provision, an investment adviser organized as a limited partnership should not be required to include a provision in its advisory contracts requiring client notification each time a limited partner withdraws from or is admitted to the limited partnership.

In support of your argument, you contend that limited partners are passive investors and therefore are in a comparable position to corporate shareholders with respect to their right to affect the entity's management. n2 You note that the Advisers Act does not require an adviser organized as a corporation to include a provision in its advisory contracts providing for notice of changes in share ownership, notwithstanding that, in 1940, numerous advisers were organized as corporations. n3 Given the similarity between the status of limited partners and that of shareholders, you maintain that advisers organized as limited partnerships also should not be required to notify clients of changes in the identity of limited partners. n4

The Commission acknowledged that limited partners and shareholders are similarly situated in a rule that equalizes their treatment for purposes of the definition of affiliated person under the Investment Company Act of 1940 ("1940 Act"). n5 Although this rule was considered in a context outside of the Advisers Act, the staff subsequently applied similar reasoning in issuing a no-action letter under Advisers

Act Rule 204-2(a)(12) to an adviser organized as a limited partnership. W.R. Huff Asset Management Co., L.P. (pub. avail. Aug. 10 1994) ("Huff"). Rule 204-2(a)(12) requires that advisers keep such records for their "advisory representatives," a term defined to include any "partner" (but not any shareholder) of the adviser. In Huff, the adviser argued that it should not have to maintain records of limited partners' securities transactions if those limited partners owned less than 5% of the adviser's outstanding limited partnership interests and had no other relationship with the adviser.

As illustrated by the foregoing, we believe that, generally, is appropriate to treat limited partners comparably to corporate shareholders because of the essentially passive nature of a limited partnership interest. Therefore, we conclude that, for purposes of Section 205(a)(3), an investment adviser organized as a limited partnership need not notify clients of changes in its limited partners. n6 This position applies to all limited partners, including Messrs. Breyo and Hammerling, who are also the sole shareholders of Hambre, Ayco's general partner. Of course, client consent would be required under Section 205(a)(2) if disposition of the limited partnership interests of these two individuals (or disposition of their interests in Hambre) were to result in the assignment of Ayco's advisory contracts.n7

We note, nonetheless, that Section 206 of the Advisers Act, which requires advisers to disclose all material facts to their clients, might require advisers to notify their clients of material changes in advisory personnel. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

Accordingly, we would not recommend enforcement action to the Commission under Section 205(a)(3) if Ayco does not include in its advisory contracts a provision obligating it to notify its clients whenever there is a change in the identity of Ayco's limited partners. n8 Because this position is based on the facts and representations made in your letter, you should note that any different facts or circumstances might require a different conclusion.

Jana M. Cayne
Attorney

Footnotes

n1 You state that Ayco's contract provides that Ayco will notify clients of any changes in its limited partners "to the extent required by applicable law." While we question whether this language technically complies with Section 205(a)(3), the position we take herein obviates the need to address this issue further.

n2 Under Delaware law, a limited partner is not personally liable for the obligations of the partnership unless, in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business. Section 17-303(a) of the Delaware Revised Uniform Limited Partnership Act. You state that Ayco's partnership agreement provides that the limited partners shall not participate in the management and control of the partnership.

n3 See SEC Supplemental Report on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services (August 17, 1939), p. 7. The legislative history of the Advisers Act offers no guidance with respect to the purposes underlying Section 205(a)(3).

n4 We reject your argument that the application of Section 205(a)(3) to limited partnership interests is superfluous because advisers are required to amend Part II of Form ADV to reflect certain material changes in advisory personnel (see Rule 204-1(b)(1) under the Advisers Act and item 6 of Part II of Form ADV). First, this argument is not supported by the statutory language or the legislative history. Second, while Part II of Form ADV is required to be delivered to clients at the inception of the advisory relationship, it only need be offered to existing clients annually. Section 205(a)(3) requires that clients be notified of certain information without requesting it.

n5 Rule 2a3-1 under the 1940 Act excepts limited partners from the definition of affiliated person under Section 2(a)(3)(D) of that Act, which includes any "partner" of another person, provided that the person's status as a limited partner is the sole reason for the affiliation. Investment Company Act Rel. No. 19658 (Aug. 25, 1993).

n6 Our position is unaffected by the fact that all of Ayco's limited partners also are its employees. There is nothing in the express language of Section 205(a)(3) or in the legislative history to indicate that Section 205(a)(3) was intended to require client notification of changes in a partnership's advisory personnel. Moreover, if Congress had intended that Section 205(a)(3) apply to personnel changes, it seems unlikely that it would have singled out advisers that are organized as partnerships, as opposed to some other organizational structure.

n7 Section 205(a)(2) of the Advisers Act requires that advisory contracts provide that the adviser will not assign the contract without the client's consent. Section 202(a)(1) of the Advisers Act includes in the definition of assignment any transfer of a controlling block of an adviser's outstanding voting securities. Section 202(a)(1) also provides that if the investment adviser is a partnership, no assignment of an advisory contract shall be deemed to result from the withdrawal or admission of a minority of the members having only a minority interest in the adviser. You represent that Ayco will not rely on this less restrictive provision of Section 202(a)(1) addressing the assignment of a partnership's advisory contracts in connection with the transfer of minority limited partnerships interests, and, instead, Ayco will obtain client consent to the assignment of its advisory contracts whenever a change in Ayco's limited partners is significant enough to result in a change of control.

n8 Our position applies only to notification of changes in the identity of limited partners. An adviser organized as a limited partnership continues to be required to include in its contracts a notification provision with respect to changes in its general partners.

INQUIRY-1:

SHEREFF, FRIEDMAN, HOFFMAN & GOODMAN, LLP
919 THIRD AVENUE
NEW YORK, N.Y. 10022-9998
TELEPHONE (212) 758-9500
FACSIMILE (212) 758-9526
TELEX 237328
DIRECT DIAL NUMBER
(212) 891-9228

October 25, 1995

Jack W. Murphy, Esq.
Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: The Ayco Company, L.P.
Investment Advisers Act of 1940, as amended, Section 205(a)(3)

Dear Mr. Murphy:

The Ayco Company, L.P. ("Ayco") is an investment adviser registered under the Investment Advisers Act of 1940, as amended (the "IAA"). Ayco is a limited partnership that was established on October 6, 1994

under the Delaware Revised Uniform Limited Partnership Act (the "Delaware Act"). It has one general partner, Hambre, Inc., a New York corporation (the "General Partner"), and currently has 61 limited partners. Ayco's Partnership Agreement (as hereinafter defined) allows for additional limited partners to be admitted prior to December 9, 1996, and additional limited partners are scheduled to be admitted in December 1995. It is likely that additional limited partners will be admitted prior to December 9, 1996. Ayco currently has over 10,000 advisory clients. As required by Section 205(a)(3) of the IAA, the advisory contract with each client provides, in substance, that Ayco will notify the client of any change in its membership within a reasonable time after such change. We hereby seek the assurance of the Staff of the Securities and Exchange Commission (the "Commission") that it will not recommend enforcement action under the IAA against Ayco if, as set forth below, Ayco does not include in its contracts with clients the provision required by Section 205(a)(3) with respect to notice of changes in limited partners.

Discussion of Facts

Ayco provides, either directly or through subsidiaries, financial planning, financial education, benefit consulting, insurance agency and insurance brokerage as well as investment advisory services and ancillary sales of products. In particular, Ayco offers the following advisory services:

1. Individual Counseling Services. Incidental to Ayco's primary business of financial and tax counseling, Ayco makes recommendations as to investments suited to the overall personal objectives of the individual client. As of July 18, 1995, Ayco had 1,976 individual counseling clients and 196 corporate clients.
2. Asset Management Services. Ayco Asset Management, a division of Ayco, provides investment supervisory services. It manages equity, balanced and fixed income accounts for clients. As of July 18, 1995, Ayco had 540 asset management clients.
3. Money in Motion (R) Program. This program is an educational program that focuses on the fundamentals of financial planning for large groups of corporate employees. The service may include a workbook with a customized employee benefit supplement, RoadMap (R) software, newsletters, a toll-free answer line, a two-tape video set, and a half-day seminar. Fees range from $ 20 to $ 450 per participant, depending on the number of participants in a program and components selected. As of July 18, 1995, Ayco had 7,471 individual Money in Motion (R) clients.
4. Financial Related Services. Financial Related Services provides a broad spectrum of financial planning seminars. As of July 18, 1995, Ayco had 36 Financial Related Services clients. As of July 18, 1995, Ayco had a total of 10,219 clients.

Hambre, Inc. is Ayco's General Partner. John J. Breyo and Barry Hammerling are the sole shareholders of the General Partner, each owning a 50% interest therein. The Amended and Restated Agreement of Limited Partnership, dated as of December 9, 1994 (the "Partnership Agreement"), of Ayco, provides:

Except as otherwise expressly provided or limited by the provisions of this Agreement, the General Partner shall have full and complete authority to manage and control the business and affairs of the Partnership, to make all decisions affecting the business and affairs of the Partnership, and to take all such actions as it deems necessary or appropriate to accomplish the purposes of the Partnership it being understood that the Limited Partners shall not participate in the management and control of the Partnership. *(emphasis supplied)*

The General Partner owns, and will continue to own following admission of new limited partners, 1% of Ayco.

The Partnership Agreement provides for four classes of limited partners, although units of only two classes (Class A and Class B) are currently outstanding.

There are currently 59 Class A limited partners, all of whom are employees of the General Partner who are leased to Ayco. The number includes 29 employees who purchased Class A limited partnership units in an offering that was completed on June 19, 1995. Additional Class A limited partnership units may

subsequently be offered and sold to other employees from time to time. No Class A limited partner owns or, assuming the sale of Class A limited partnership units to additional employees, will own, 5% or more of Ayco. Ayco anticipates that any new limited partners who are subsequently admitted will, in the aggregate, own less than 20% of Ayco.

Messrs. Breyo and Hammerling are currently the only Class B limited partners and own in the aggregate 35% of Ayco. Following the admission of additional Class A limited partners as anticipated by the Partnership Agreement, the Class B limited partners will own in the aggregate 29% of Ayco.

The Partnership Agreement imposes restrictions on the ability of the Class A and B limited partners to withdraw from Ayco prior to its dissolution and prohibits the transfer or assignment of such limited partnership units without the prior written approval of the General Partner. If a limited partner terminates his employment with the General Partner, the limited partner's units will be purchased by Ayco.

The Travelers Inc. holds an option to acquire all of the Class C limited partnership units. The option is not exercisable until January 1, 1998. If the option is exercised in full, the Class C limited partnership units will represent a 13.02% interest in Ayco. The Partnership Agreement provides that Class C limited partners will be guaranteed distributions equal to a fixed minimum percentage of gross revenues and that the interests of Class C limited partners may not be diluted. The Partnership Agreement also imposes restrictions on transfer of Class C limited partnership units and grants certain rights of first refusal with respect thereto.

Class D limited partnership units will be issued in exchange for Class A and B limited partnership units of certain limited partners who desire to withdraw from Ayco or terminate their employment with the General Partner, but whose interests are not redeemed by Ayco. Class D limited partners will receive a guaranteed distribution and will have priority to have their interests redeemed in full based on the chronological order in which they become Class D limited partners.

Each of Ayco's advisory contracts currently provides:

> The Ayco Company, L.P., a limited partnership, will notify you of any change in general partner and, to the extent required by applicable law, of any changes in its limited partners, in each case within a reasonable time of such change. n1

On May 24, 1995, Ayco notified its clients of the anticipated admission of 29 additional Class A limited partners, who were admitted as of June 19, 1995.

Given the large number of limited partners, the potential frequency of their admission and withdrawal, and the lack of any ability on the part of the limited partners to participate in Ayco's management, for the reasons discussed below, we hereby seek assurances from the Staff of the Commission that it will not recommend enforcement action against Ayco if it does not include the provision required pursuant to Section 205(a)(3) of the IAA with respect to the provision of notice to clients of changes in limited partners.

Legal Discussion

Section 205(a)(3) of the IAA provides, in pertinent part:

> No investment adviser, unless exempt from registration pursuant to section 203(b), shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to enter into, extend, or renew any investment advisory contract, or in any way to perform any investment advisory contract ..., if such contract ... fails to provide, in substance, that the

investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of such partnership within a reasonable time after such change.

As a limited partnership, Ayco is subject to the foregoing requirement, and its advisory contracts contain the requisite language.

We respectfully submit that the mere notice of changes in limited partners is not meaningful information to a client of Ayco. As described above, all current limited partners are employees of Ayco, and the offer and sale of Class A limited partnership units to an employee is similar to many corporate equity participation programs (such as stock option plans). If Ayco were organized as a corporation rather than as a limited partnership, it would not be obligated to notify clients each time there was a change in share ownership.

The fact that Ayco is organized as a limited partnership does not create for the limited partners (as investors in Ayco) any greater right to affect the management of Ayco's business than they would have as shareholders of an investment adviser organized as a corporation. As stated in the preceding section, the Partnership Agreement vests the right to manage and control the business of Ayco in the General Partner, and specifically provides that the limited partners shall not participate in such management and control. Indeed, under Delaware law it is in the interest of a limited partner not to participate in management of a limited partnership so as to insulate himself from liability to the creditors of the partnership. Section 17-303(a) of the Delaware Act provides:

A limited partner is not liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business...n2

Moreover, if a change in limited partners were significant enough to result in a change in control of Ayco, Ayco's contracts with its clients would be deemed to be assigned within the meaning of Section 202(a)(1) of the IAA. n3 Under such circumstances, clients would have to be notified and their consent to the assignment solicited.

We respectfully further submit that the requirement that Ayco notify its clients of any change in limited partners is superfluous in that any limited partner who is a principal executive officer of Ayco or a member of Ayco's investment committee that determines general investment advice to be given to clients must be disclosed in Part II of Ayco's Form ADV (and any written disclosure statement used in lieu thereof), which must be delivered to clients at inception of the advisory relationship and offered annually thereafter, subject to the requirements of Rule 204-3 under the IAA. Rule 204-1 under the IAA specifies when Form ADV must be amended to reflect changes in advisory personnel disclosed therein. In addition, Schedule B to Form ADV must be completed for any registered investment adviser organized as a partnership. Notably, the schedule does not require disclosure of every limited partner of a limited partnership; rather, only those limited partners who have contributed, directly or indirectly through intermediaries, 5% or more of the partnership's capital must be identified on Schedule B. The only limited partners currently reflected on Schedule B to Ayco's Form ADV are John J. Breyo and Barry Hammerling. Ayco's Schedule B would have to be amended pursuant to Rule 204-1 under the IAA to reflect the addition of any other limited partner owning 5% or more of Ayco's capital.

We have located nothing in the legislative history of the IAA specifically explaining the purpose of the requirement in Section 205(a)(3) relating to notification of changes in the membership of a partnership. We believe that it is logical to conclude, however, that this requirement was not intended to require notification of changes in the roster of limited partners. We base this conclusion on the following. First, there is no investor protection purpose to be served by applying such a requirement with regard to limited partners. Second, we believe that prior to enactment of the IAA in 1940, investment advisory firms were organized typically as either general partnerships or sole proprietorships, although there were several firms organized as corporations. Not only does this fact support the argument that the

subject requirement was not intended to reach passive, non-controlling investors like corporate shareholders or limited partners, it also explains the inconsistency of not treating corporate shareholders the same as limited partners (assuming no control in either case). That is, the framers of the IAA did not contemplate that investment advisers would be organized as limited partnerships and a fortiori they did not intend to require that advisory clients be bombarded with what in some cases might be hundreds of notices of changes in the identity of non-controlling holders of ownership interests in the adviser.

Further, the Staff of the Commission has given no-action advice that is consistent with our interpretation of the purpose of the notification requirement in Section 205(a)(3). That is, in W.R. Huff Asset Management Co., L.P. (pub. available August 10, 1994) ("WR Huff"), the Staff stated that it would not recommend enforcement action to the Commission under Rule 204-2(a)(12) if W.R. Huff Asset Management Co., L.P. ("WRH"), a Delaware limited partnership registered as an investment adviser, did not treat certain of its limited partners as advisory representatives for purposes of the recordkeeping requirements of Rule 204-2(a)(12) under the IAA. The limited partners in question were individuals, each of whom owned less than 5% of WRH's limited partnership interests and was a passive investor not involved in WRH's investment decisions. In granting the no-action assurance, the Staff apparently found persuasive two arguments made by WRH, which were repeated in the Staff's letter. The first argument was that these limited partners were "analogous to an incorporated investment adviser's non-controlling shareholders, who are not included in the definition of advisory representative unless they also have another relationship with the adviser that is specified in the rule." The second argument specifically cited by the Staff was the recent equalization of treatment by the Commission of limited partners and shareholders under the Investment Company Act of 1940, as amended (the "1940 Act"), recognizing that they are similarly situated:

Section 2(a)(3)(D) of the 1940 Act defines affiliated person to include any "partner" of another person.

The Commission recently adopted Rule 2a3-1 under the 1940 Act to except limited partners from this definition if the sole reason for the affiliation arises from being a limited partner investor. We are persuaded that the same reasoning underlying the adoption of Rule 2a3-1 applies in the circumstances you describe. (footnote omitted)

We believe that the reasoning that persuaded the Staff in WR Huff should also apply to Ayco's request. We do not believe that notice of every change in limited partners provides meaningful or necessary disclosure to Ayco's clients. Clients will be notified, and their consent sought, in the event of any change in control of Ayco that results in an assignment of advisory contracts. They will also be notified through revised disclosure in Part II of Ayco's Form ADV (or other written disclosure statement) of any material changes in advisory personnel. To subject Ayco to a more onerous notification requirement than would be the case if Ayco were organized as a corporation would not seem to produce any tangible benefits to clients.

Accordingly, we respectfully request the Staff to take the position that it will not recommend enforcement action against Ayco if it does not include in its advisory contracts a provision otherwise required by Section 205(a)(3) of the IAA with respect to notification of changes in its limited partners.

Please contact the undersigned at (212) 891-9228 with any questions you may have.

Very truly yours,

Margery K. Neale

Footnotes

n1 The language was drafted in anticipation of seeking the no-action assurance requested herein. In the event that such assurance is granted, Ayco will not in the future provide clients whose contracts contain

such provision with notice of changes in limited partners, since Section 205(a)(3) of the IAA requires a contractual provision, but does not itself require actual notice of changes in limited partners. In addition, Ayco will not include in future contracts any provision pursuant to Section 205(a)(3) of the IAA with respect to notice of changes in limited partners.

n2 Section 17-303(b) of the Delaware Act provides that a limited partner does not participate in the control of the business within the meaning of Section 17-303(a) by virtue of, among other things, being an employee of the limited partnership or its general partner.

n3 "Assignment" is defined in Section 202(a)(1) of the IAA to include "any direct or indirect transfer or hypothecation. . . of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but if the investment adviser is a partnership, no assignment of an investment advisory contract shall be deemed to result from the death or withdrawal of a minority of the members of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members who, after such admission, shall be only a minority of the members and shall have only a minority interest in the business."