GARDNER RUSSO & GARDNER

Investment Advisers Act of 1940 - Section 206(3)

June 7, 2006

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT
Our Ref. No. 2005518927

Gardner Russo & Gardner

File No. 801-41357

Your letter dated May 3, 2005 (as supplemented by your letter dated June 6, 2006) requests that we concur with your view that, for purposes of section 206(3) of the Investment Advisers Act of 1940 (the "Advisers Act"), Gardner Russo & Gardner ("GRG"), an investment adviser, would not be acting as principal for its own account with respect to the transactions involving the Private Funds (as defined below).

BACKGROUND

You state that, pursuant to discretionary investment management agreements, GRG, a general partnership, acts as investment manager to various client accounts (the "Accounts"), including two private investment funds, Semper Vic Partners, L.P. ("Semper Vic") and Semper Vic Partners (QP), L.P. ("Semper Vic QP," together with Semper Vic, the "Private Funds"). A general partner (the "Partner") of GRG1 is the sole general partner and portfolio manager of each Private Fund. The Partner has a 6.237% ownership interest in Semper Vic and a 1.4405% ownership interest in Semper Vic QP. Neither GRG nor any employee of GRG (other than the Partner) has an ownership interest in the Private Funds.2

GRG from time to time finds that, due to timing of capital flows into and out of the Accounts, it is disposing of a particular security for one Account that it is acquiring for another. GRG would like to cross the trades of a Private Fund with another Account and/or Private Fund (the "Proposed Transactions") to, among other things, reduce transaction costs.3 You are generally concerned, however, that GRG, because of the Partner's ownership interest in each Private Fund, may be acting as principal for its own account, thereby subjecting the Proposed Transactions to the transaction by transaction notice and consent requirements of section 206(3) of the Advisers Act.

ANALYSIS

Section 206(3) of the Advisers Act, in relevant part, makes it unlawful for any investment adviser, directly or indirectly, acting as principal for its own account, knowingly to sell any security to, or purchase any security from, a client without disclosing to such client in writing, before the completion of the transaction, the capacity in which the adviser is acting and obtaining the client's consent to the transaction.4 Section 206(3) is intended to address the potential for self dealing that could arise when an investment adviser acts as principal in transactions with clients, such as through price manipulation or the dumping of unwanted securities into client accounts.5 To address this potential for self dealing, section 206(3) requires, among other things, transaction by transaction disclosure to, and consent by, the client prior to the completion of each principal transaction.6

You question whether section 206(3) would apply to the Proposed Transactions in light of the Partner's ownership interest in each Private Fund. You cite to an enforcement proceeding, in which the Commission alleged and found that an investment adviser of a registered investment company violated section 206(3) and that Robert Gintel, the adviser's sole owner, aided and abetted and caused the adviser's violation of section 206(3). The Commission found that Mr. Gintel effected certain cross transactions between the investment company, of which Mr. Gintel owned approximately 34%, and

other accounts advised by the adviser without disclosing the capacity in which the adviser was acting and obtaining the consent of the clients to such transactions.7 The Commission found that the investment adviser violated section 206(3) because of Mr. Gintel's "substantial ownership stake" in the fund and relationship to the adviser.

You generally contend, however, that the Partner's ownership interest in each Private Fund should not cause the Proposed Transactions to implicate section 206(3). You also suggest that a Proposed Transaction would not implicate section 206(3) unless the Partner owns 25% or more of a Private Fund. We assume that you are concerned about whether section 206(3) would apply if the Partner's ownership interests in the Private Funds increase.

Recently, we addressed the application of section 206(3) to certain transactions involving principal accounts in which investment advisers have interests in the Letter to the American Bar Association, dated December 8, 2005 (the "ABA Letter").8 As we stated in the ABA Letter, whether section 206(3) applies to transactions involving client accounts and accounts in which an investment adviser and/or its personnel have ownership interests depends upon all of the facts and circumstances. Significant factors include the relationship of the personnel to the investment adviser, as well as the extent of the ownership interest of the investment adviser and/or its personnel in the account.

You state that the Partner is a general partner of, and controls, GRG. For purposes of section 206(3), we would deem the ownership interest of a controlling person of an investment adviser to be the ownership interest of that adviser.9 Consequently, the investment adviser may be acting "as principal for his own account" for purposes of section 206(3) in effecting transactions involving the account, depending on the extent of the controlling person(s) and investment adviser's aggregate ownership interest in the account (as discussed below).

The extent of the ownership interest at issue is also relevant to whether the Proposed Transactions implicate section 206(3). We believe that section 206(3) would apply to a cross transaction between a client account and an account of which the investment adviser and/or a controlling person, in the aggregate, own(s) more than 25%.10 In contrast, we believe that section 206(3) would not apply to a cross transaction between a client account and an account of which the investment adviser and/or its controlling persons, in the aggregate, own 25% or less.11

We note that ownership interests of an investment adviser and/or its controlling persons of 25% or less of an account may present the opportunity for significant conflicts of interest between an investment adviser and its clients, creating incentives to overreach and treat unfairly the clients with which the account engages in transactions. Cross transactions involving such an account may implicate sections 206(1) and (2) of the Advisers Act, which were designed to address such conflicts of interest. These sections impose a federal fiduciary duty on an investment adviser with respect to its clients and a duty of full and fair disclosure of all material facts.12 Those provisions may require an investment adviser to disclose information about transactions effected by the adviser involving any account in which the adviser and/or its controlling persons have an ownership interest, regardless of whether section 206(3) also applies.13 An investment adviser, therefore, should consider monitoring the ownership interests of the adviser, and/or its controlling persons, in accounts advised by the adviser, and the terms of the transactions involving those accounts.14

In conclusion, you essentially contend that the Partner's 6.237% ownership interest in Semper Vic and 1.4405% ownership interest in Semper Vic QP should not cause the Proposed Transactions to implicate section 206(3). We agree. Our conclusion is based on the foregoing facts and representations, in particular the representation that neither GRG nor any employee of GRG (other than the Partner) has an ownership interest in the Private Funds. Any different facts or representations may require a different conclusion.15 Further, section 206(3) would apply to the Proposed Transactions if the Partner (who is a controlling person of GRG), along with GRG and any other controlling person of GRG, were to own, in the aggregate, more than 25% of a Private Fund.

John L. Sullivan
Senior Counsel

Endnotes

1 You state that the Partner controls GRG (as "control" is defined in section 202(a)(12) of the Advisers Act: "[T]he power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company."). A person may control a company through a variety of means, including stock ownership. See generally In the Matter of Investors Mutual, Inc., et al., Investment Company Act Release No. 4595 (May 11, 1966) (Commission determination as to whether a person or group of persons are in control (as defined in section 2(a)(9) of the Investment Company Act of 1940) of an investment company's adviser and company controlling such adviser. The definition of control under section 2(a)(9) is identical to the definition of control under section 202(a)(12) of the Advisers Act, but for the inclusion of certain presumptions.).

2 Telephone conversation between John L. Sullivan of the staff and Anne D. Gardner of GRG on January 13, 2006.

3 You represent that GRG will not receive additional compensation for effecting the Proposed Transactions.

4 Section 206(3) also makes it unlawful for any investment adviser acting as broker for a person other than its client knowingly to effect any sale or purchase of any security for the account of such client without providing disclosure and obtaining consent consistent with the requirements of the section. You do not ask, and we take no position regarding, whether transactions among the Accounts, including the Private Funds, would implicate that provision. See generally Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Advisers Act Release No. 1732 (July 17, 1998).

5 See Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. of the Comm. on Banking and Currency, 76th Cong., 3d Sess. 320-22 (1940).

6 See Opinion of Director of Trading and Exchange Division, Advisers Act Release No. 40 (Feb. 5, 1945) ("[T]he requirements of written disclosure and of consent contained in [section 206(3)] must be satisfied before the completion of each separate transaction. A blanket disclosure and consent in a general agreement between investment adviser and client would not suffice."). The Commission has instituted enforcement actions against investment advisers for violating section 206(3) when they entered into principal transactions with their clients using only prior blanket disclosures and consents. See In the Matter of Stephens, Inc., Advisers Act Release No. 1666 (Sept. 16, 1997); In the Matter of Clariden Asset Management (New York) Inc., Advisers Act Release No. 1504 (July 10, 1995).

7 In the Matter of Gintel Asset Management, et al., Advisers Act Release No. 2079 (Nov. 8, 2002). See also SEC v. Beacon Hill Asset Management, LLC, et al., Litigation Release No. 18950 (Oct. 28, 2004) (Commission alleged that an unregistered investment adviser violated section 206(3) and that the adviser's four principals aided and abetted the adviser's violation of section 206(3) 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 capacity in which the adviser was acting and obtaining the consent of the client to such transactions).

8 Specifically, we addressed the application of section 206(3) of the Advisers Act to unregistered pooled investment vehicles.

9 The Commission has deemed ownership interests of controlling persons of an investment adviser to be ownership interests of the adviser for purposes of section 206(3) of the Advisers Act. See note 7, supra. You do not ask, and we take no position regarding, whether section 206(3) applies to cross trades between client accounts when non controlling personnel of an adviser have ownership interests in the accounts.

10 In some cases, it may be appropriate to aggregate the ownership interest in the account of a family member of a controlling person (e.g., a spouse or a dependent child) with the ownership interest of the controlling person and/or investment adviser.

11 GRG is, of course, free to set more stringent standards for itself and its employees than those suggested in this letter. For example, GRG may choose to provide written disclosure to its clients, before the completion of the transaction, of the capacity in which GRG is acting and obtain the consent of its clients, even when GRG and/or a controlling person of GRG own(s) 25% or less of that account.

12 See Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., et al., 375 U.S. 180, 196-97 (1963).

13 See ABA Letter at text accompanying note 32.

14 See, e.g., rule 206(4)-7 under the Advisers Act, which generally provides, among other things, that an investment adviser must adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder; section 203(e)(6) of the Advisers Act, which provides that procedures reasonably designed to detect and prevent violations of the federal securities laws can serve as a defense against a charge that an investment adviser has failed to reasonably supervise its advisory personnel who have, for instance, violated the antifraud provisions of the Advisers Act. We suggest that compliance personnel of an investment adviser consider, to the extent practicable, interests of an adviser and/or its controlling persons in accounts, in addition to direct economic interests, that may create incentives to favor one account over another (e.g., economic interests of family members, and persons with social and/or business relationships with the adviser and/or its controlling persons).

15 This letter confirms the conclusion that the staff provided orally on January 13, 2006 to Anne D. Gardner of GRG.

Incoming Letters

The Incoming Letters, in Acrobat format, are available on the SEC's website:

May 3, 2005 letter:
http://www.sec.gov/divisions/investment/noaction/gardner-incoming050306.pdf

June 6, 2006 letter:
http://www.sec.gov/divisions/investment/noaction/gardner-incoming050306.pdf