LATHAM & WATKINS

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SEC LETTER

Rule 203(b)(3)-1

August 24, 1998

Our Ref. No. 98-471-CC
Latham & Watkins
File No. 132-3

Your letter dated August 6, 1998 requests our concurrence that offering limited partners the option of receiving partnership distributions in cash or in kind would not, by itself, require counting the limited partners, rather than the partnership, as investment advisory clients of the general partner for purposes of Section 203(b)(3) of the Investment Advisers Act of 1940 ("Advisers Act").

Facts

You state that you represent the general partners of certain entities, such as venture capital funds and hedge funds, that are organized as limited partnerships ("Limited Partnerships"). You represent that the Limited Partnerships are excluded from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940. You further represent that the general partners of the Limited Partnerships do not register as investment advisers under the Advisers Act in reliance on Section 203(b)(3) of the Advisers Act.

You represent that the general partners of the Limited Partnerships have the sole power, consistent with any investment restrictions contained in the partnership agreements, to make investment decisions for the Limited Partnerships and to cause the Limited Partnerships to acquire or dispose of any portfolio security. You state that the individual limited partners have no investment discretion, and are bound by the general partners' investment decisions. You further state that, if a general partner decides to dispose of a portfolio security, it typically decides either to distribute the security to the limited partners in accordance with the limited partners' relative interests in the Limited Partnership (an "in-kind distribution"), or to sell the security and distribute the proceeds in like fashion (a "cash distribution").

The general partners propose to offer limited partners a choice between receiving distributions in cash or in kind.1 You state that the general partners would make no recommendations to the limited partners about whether they should take their distributions in cash or in kind. In addition, you represent that the decision to dispose of a security will be made exclusively by the general partner based upon the investment objectives of the Limited Partnership and not the investment objectives of the individual limited partners.

Analysis

Section 203(a) of the Advisers Act requires investment advisers to register under the Advisers Act unless excepted from that requirement by Section 203(b) or Section 203A. Section 203(b)(3), in relevant part, excepts from the requirements of Section 203(a) any investment adviser with fewer than 15 clients during the preceding 12 months that neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any registered investment company or business development company.

Rule 203(b)(3)-1 under the Advisers Act provides a non-exclusive safe harbor for determining the circumstances in which a general partner, or other person acting as an investment adviser to a limited partnership, may count the partnership, rather than each of the individual limited partners, as a "client" for purposes of Section 203(b)(3) of the Advisers Act. Specifically, subsection (a)(2)(i) of Rule 203(b)(3)-1 provides, in relevant part, that a "limited partnership . . . that receives investment advice based on its investment objectives rather than the individual investment objectives of its . . . limited

partners" may be deemed a single client for purposes of Section 203(b)(3) of the Advisers Act. Conversely, subsection (b)(1) of the rule requires a limited partner to be counted as a client "if the investment adviser provides investment advisory services to the [limited partner] separate and apart from the investment advisory services provided to the [limited partnership]."

The Commission stated that Rule 203(b)(3)-1 was intended to be available "to situations where the general partner advises the partnership based on the investment objectives of the limited partners as a group" and to "prevent a general partner . . . from using the partnership to do what it could not do directly itself, namely, provide individualized investment advice to 15 or more clients without registering as an investment adviser."2 The staff of the Commission has stated that the "determination of whether the partnership itself may be considered to be the client depends in large part on the surrounding facts and circumstances."3

You believe that providing limited partners a choice in the form of Limited Partnership distributions may raise an issue as to whether the general partner would in fact be providing the limited partners with investment advisory services separate and apart from the services provided to the Limited Partnership. You state that this issue may arise in part because of an "overly broad reading of . . . Burr, Egan, Deleage & Co., Inc. (pub. avail. Apr. 27, 1987) ('Burr, Egan')."

In Burr, Egan, the investment adviser ("Bedco") to a series of limited partnerships proposed to accommodate the tax situations of some of the limited partners by restructuring each limited partnership into two pools of assets, one pool holding stock of an intermediary corporation that in turn would hold partnership interests in the portfolio companies, and the other pool holding partnership interests directly in the portfolio companies. The amount of the existing capital of the limited partnerships to be allocated to each pool would be fixed at the outset and thereafter each investment would be divided between the two pools in the ratio of the respective capital allocated to each. The gains and losses of the two pools would be allocated specially to the limited partners depending on the pool in which they invested. You state that the staff refused to provide assurance that Bedco could implement its proposal and continue to fall within the safe harbor of Rule 203(b)(3)-1 because the proposed restructuring appeared to be tailored to meet the investment objectives of the individual limited partners. You believe that the staff's rationale in Burr, Egan should not preclude the general partners from offering the limited partners a choice between taking distributions from the Limited Partnerships in cash or in kind.

We agree that Burr, Egan is distinguishable from the facts in the instant case. In Burr, Egan, the general partner accommodated the tax situations of the limited partners by substantially altering the structure and operation of the limited partnerships. In the instant case, you propose that the general partner, after making the decision to dispose of a portfolio security, would accommodate the tax situations of the limited partners by either liquidating the security and then distributing the proceeds, or distributing the security, to the limited partners in accordance with their wishes. We believe that such an accommodation does not substantially alter the structure and operation of the Limited Partnerships, and thus does not constitute individualized investment advice for purposes of Rule 203(b)(3) - 1.

We therefore agree that offering limited partners the option of receiving partnership distributions in cash or in kind would not, by itself, require counting the limited partners, rather than the partnership, as investment advisory clients of the general partner for purposes of Section 203(b)(3) of the Advisers Act. Our position is based particularly on your representations that (1) the general partner, as investment adviser to the Limited Partnership, will determine whether and when to dispose of any specific portfolio security based on the investment objectives of the Limited Partnership as a whole, and (2) the general partner will make no recommendation to any limited partners about whether they should take a distribution in cash or in kind.

This position is based on the facts and circumstances set forth in your letter and our telephone conversation. Any different facts or circumstances may require a different conclusion.

Wendy Finck Friedlander
Senior Counsel

Footnotes

1 You state that a limited partner may prefer to receive Limited Partnership distributions in kind for tax planning purposes and that, if a choice were offered, cash distributions would be made net of brokerage fees incurred to liquidate the security. Telephone conversation on August 10, 1998, between Wendy Friedlander and Brendan Fox of the staff and Randall C. Bassett of Latham & Watkins.

2 Definition of "Client" of an Investment Adviser for Certain Purposes Relating to Limited Partnerships, Investment Advisers Act Rel. No. 956 at n.18 and accompanying text (Feb. 22, 1985) (proposing Rule 203(b)(3)-1).

3 Valuemark Capital Management, Inc. (pub. avail. June 4, 1997).

August 6, 1998

Office of the Associate Director (Chief Counsel)
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
Attention: Wendy F. Friedlander, Esq.

Dear Ms. Friedlander:

As you and I have discussed by telephone, our firm represents a number of entities that act as general partners of partnerships that are excluded from the definition of "investment company" under the Investment Company Act of 1940, as amended (the "Investment Company Act"), by operation of Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. These partnerships, which are referred to herein as "investment partnerships," have a variety of different investment strategies and objectives. They range from venture capital funds, which may take minority positions in a variety of early-stage enterprises that require growth capital, to hedge funds, which may purchase on the open market positions in a diverse portfolio of publicly traded debt and equity securities. Investment partnerships typically are organized as limited partnerships. Limited partners may include institutional investors, such as banks, insurance companies and pension funds, as well as a limited number of high net-worth individuals.

Investment partnerships are organized such that their general partners have the sole power to cause the investment partnerships to make and to dispose of an investment. In some cases the relevant partnership agreement may impose certain investment parameters -- for example, the agreement may specify what industries in which the partnership may invest or it may prohibit the partnership from investing more than a given percentage of its committed capital in any given investment. In these cases, an amendment or waiver of the applicable partnership agreement provisions may require the affirmative vote of a specified percentage of the limited partners or their representatives. However, even in these cases, the ultimate investment decision is made by the general partner, and the individual limited partners have no discretion and are bound by the general partner's decision.

The general partners of investment partnerships may be deemed to be "investment advisors" of the investment partnerships under the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act"), under the reasoning of Abrahamson v. Fleschner, 568 F.2nd 862 (2d Cir. 1977), as well as under Investment Advisers Act Rule 203(b)(3)-1(b)(3). Nevertheless, the general partners of investment partnerships frequently do not register as investment advisers under the Investment Advisers Act in reliance on Section 203(b)(3) of the statute, which excludes from the registration requirements investment advisers that during the course of the preceding twelve months have had fewer than 15 clients, that do not hold themselves generally to the public as investment advisers and that satisfy certain other requirements not relevant here. Critical to the conclusion by the general partners that they are not required to register is their belief that they are, pursuant to the safe harbor

established under the Investment Advisers Act by Rule 203(b)(3)-1(a)(2) thereunder, entitled to treat the limited partnerships for which they act as general partners as a single client for purposes of Section 203(b)(3), without their being required to treat the individual limited partners of the investment partnership as investment advisory clients.

Consistent with the appreciation in share values generally experienced in U.S. equity markets over the past several years, a number of the portfolio companies held by investment partnerships recently have increased significantly in value. The general partners of a number of investment partnerships are now making decisions about whether to cause these partnerships to sell all or some of their positions in certain portfolio companies -- in some cases in connection with a liquidation of the limited partnership as a whole, while in other cases solely in connection with a decision either to sell down or sell off entirely the partnership's position in a given portfolio company. In making these decisions, the general partners typically choose between causing the investment partnership to distribute securities in the portfolio company at issue to the partners in accordance with the partners' relative interests in the investment partnership or causing the investment partnership to sell the securities for cash, then distributing the proceeds to the partners in like fashion. In our experience, in implementing exit strategies for particular portfolio investments, general partners seldom cause their investment partnerships to offer the limited partners a choice between accepting a distribution in cash or in kind -- i.e. in securities of a portfolio company valued on a basis consistent with the price obtained in the substantially concurrent sale of the securities by the investment partnership for cash.

We believe that the reluctance on the part of general partners to offer their limited partners a choice between taking distributions in cash or in kind may in part result from an overly broad reading of the Division's no-action position set forth in Burr, Egan, Deleage & Co., Inc. (April 27, 1987) (“Burr, Egan”). In Burr, Egan, the Division declined to give no-action relief under circumstances in which the investment adviser to a series of investment partnerships proposed to restructure each partnership into two pools of assets, one consisting primarily of corporate stock and the other consisting primarily of limited partnerships interests. The investment adviser apparently proposed to give the limited partners a one-time option whether to allocate their capital to the corporate stock pool or to the partnership interest pool within a given limited partnership. The purpose of the proposed restructuring was to accommodate different tax situations of the limited partners that had resulted from the enactment of the Internal Revenue Code of 1986. Notwithstanding the fact that each pool within a given limited partnership would be invested in the same underlying portfolio securities in which the partnership as a whole had made its investment, the Staff of the Division expressed concern that, in implementing the proposed restructuring, the investment adviser would be providing services tailored to meet the individual investment objectives of the limited partners. In the Staff's view, this result precluded the investment adviser from treating the limited partnership as the client for purposes of the safe harbor established by Rule 203(b)(3)-1 as then in effect.1

We do not believe that the rationale underlying Burr, Egan should preclude general partners from offering limited partners a choice between taking distributions from the investment partnership in the form of cash or in the form of stock or other securities of a portfolio company.2 In Burr, Egan, the proposed arrangement was to be a continuing one that presumably would continue over the life of the partnership and would therefore be operative over the course of the general partner's ongoing management of the underlying portfolio of securities. Here, in contrast, the fundamental decision -- to take the value represented by some portion of the partnership's underlying portfolio and to convey that value to the partners -- has already been made by the general partner on behalf of the limited partnership. In implementing the partnership's exit strategy for a particular investment, the general partner has already affirmatively decided no longer to manage that particular subset of the partnership's assets for the benefit of the partners as a group, and the limited partners will have had no role in the making of that core decision. The choice, therefore, solely relates to the form of distribution the limited partners will take after the general partner has determined that the investment objectives of the partnership as a whole would be better served by the partnership's disposing of the investment. We believe that whether a given limited partner will take the value being conveyed in the form of cash or in kind is unrelated to the fundamental decision already made by the general partner, which is to dispose of the investment altogether. Accordingly, we ask the Staff to concur in our view that affording limited partners a choice between accepting their distributions in cash or kind would not, by itself, cause the limited partners to be treated as investment advisory clients of the general partner and thus preclude further reliance by the general partner on the safe harbor created by Rule 203(b)(3)-1(a)(2).

If for any reason you do not concur in our conclusion, we respectfully request a conference with the Staff before any adverse written response is given to this letter. Should you or any member of the Staff have any questions concerning the foregoing or need further information or clarification, please call either me at (202) 637-2237 or Randall C. Bassett of the Los Angeles office of this firm at (213) 891-8383. Thank you very much for your consideration of this request.

Very truly yours,

John D. Watson, Jr.
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Footnotes

1 The Staff also expressed concern that the arrangement described in Burr, Egan provided a means in substance for the limited partners to shift from one limited partnership arrangement to another, which would also preclude reliance on Rule 203(b)(3)-1. Concern about migration from one limited partnership to another is not relevant to the inquiry set forth herein.

Since the Burr, Egan letter, a number of amendments to the relevant rules under the Investment Advisers Act have been made, including the adoption of Rule 203(b)(3)-1(a)(2), which spells out circumstances under which limited partnerships and other business entities, not their owners, are to be treated as clients of the investment adviser. We do not believe that the question posed by this letter has been mooted by the adoption of the current regulatory scheme.

2 In expressing this view, we of course have assumed that the general partner would make no recommendation to the investment partnership or the limited partners about whether the limited partners should take their distributions in cash or kind. We recognize that a different result might obtain if the general partner were to make such a recommendation.