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A legal update from Dechert's Financial Services Group

SEC Staff Issues Guidance in Wake of the Goldstein Opinion

Introduction

On August 10, 2006, the Staff of the Division of Investment Management (the "Division") of the Securities and Exchange Commission (the "SEC") released its response to the July 31, 2006, letter (the "ABA Letter")[1] submitted by the Chair and Vice Chair of the Subcommittee on Private Investment Entities of the American Bar Association, requesting guidance on matters affecting hedge fund managers that are registered investment advisers (the "No-Action Letter").[2]

The request followed the decision of the Court of Appeals for the District of Columbia[3] to vacate amended Rule 203(b)(3)-1 and new Rule 203(b)(3)-2 under the Investment Advisers Act of 1940 (the "Advisers Act") as well as other related rule amendments discussed in the release adopting these rules (the "Adopting Release").[4]

The No-Action Letter was issued three days after SEC Chairman Christopher Cox's statement stating that the SEC would not appeal the appellate court's decision. In that statement, the Chairman said that the SEC would move aggressively on an agenda of rulemaking and staff guidance and that such staff guidance "can be expected to address the grandfathering, transition and other miscellaneous relief necessitated by the vacating of the rule."[5]

The ABA Letter expressed concern that registered hedge fund advisers face an uncertain regulatory environment because the breadth of the Goldstein Opinion vacated all of the amendments, interpretations, and transitional provisions set forth in the Adopting Release that were intended to facilitate the ability of newly registered hedge fund advisers to conduct their operations in accordance with the Advisers Act.

The No-Action Letter provides relief to both hedge fund managers that remain registered with the SEC and to managers that have decided to withdraw their registration.

Guidance for Hedge Fund Managers that Remain Registered

Compliance with the Advisers Act By Offshore Investment Advisers

In the Adopting Release, the SEC stated that registered advisers having a principal office and place of business outside the United States ("offshore advisers") that advise private funds

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1 American Bar Association Subcommittee on Private Investment Entities (pub. avail. Aug. 10, 2006) available at http://www.sec.gov/divisions/investment/noaction/aba081006.pdf.

2 *Id.*

3 *Goldstein v. Securities and Exchange Commission*, No. 04-1434, 2006 (D.C. Cir. June 23, 2006) (the "Goldstein Opinion"). *See also Dechert OnPoint: Court Overturns Hedge Fund Rule* (June 2006) available at http://www.dechert.com/library/FS_Alert_6-06.pdf and *Dechert OnPoint: Court Throws Out Hedge Fund Adviser Registration Rule – What Happens Now?* (August 2006) available at http://www.dechert.com/library/FS_Update9_7-06.pdf.

4 Rel. No. 2333 (Dec. 2, 2004).

5 *Statement of Chairman Cox Concerning the Decision of the U.S. Court of Appeals in Philip Goldstein, et al. v. SEC* (Aug. 7, 2006).

organized and incorporated outside the United States ("offshore funds") but have no direct U.S. clients would not be subject to the substantive provisions of the Advisers Act with respect to the offshore fund.[6] Under the "Regulation Lite" regime, such offshore advisers were to comply with the requirements relating to the filing and maintenance of Form ADV, the maintenance of certain records and the anti-fraud provisions of the Advisers Act, and remained subject to inspection by SEC examiners.

The ABA Letter requested confirmation that, except as outlined in the Adopting Release, offshore advisers that remain registered as investment advisers with the SEC will not be subject to the substantive provisions of the Advisers Act with respect to offshore private funds (or other non-U.S. clients).

In the No-Action Letter, the Division agreed that, under the principles laid out in prior staff guidance and letters, the substantive provisions of the Advisers Act do not apply to offshore advisers with respect to such advisers' dealings with offshore funds and other offshore clients to the extent described in those letters and the Adopting Release. As such, an offshore adviser may continue to comply with the Regulation Lite regime as set forth in the Adopting Release and in prior SEC no-action letters.[7]

With respect to any U.S. clients (and any prospective U.S. clients), offshore advisers registered with the SEC must comply with all of the provisions under the Advisers Act and the rules thereunder.

Records Supporting Performance Information

Rule 204-2(a)(16) under the Advisers Act requires a registered investment adviser to maintain all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return used by the adviser in advertising and similar materials.

In the Adopting Release, the SEC amended Rule 204-2 to create a transitional exception for advisers of private funds that had registered because of vacated amended Rule 203(b)(3)-1 that excuses such advisers to private funds and other accounts from maintaining specific books and records pertaining to the investment performance of any private fund or other account for any period ended prior to February 10, 2005, provided that they were not registered with the SEC prior to February 10, 2005, and that they retain whatever records they have in possession that pertain to the performance for such period.[8]

The transitional provisions were added to accommodate newly registered hedge fund advisers that may not have kept records meeting the requirements of Rule 204-2(a)(16) and to prevent them from being at a competitive disadvantage as a result of their inability to use the performance of their private funds and other accounts.

Vacating the amendment to Rule 204-2 under the Advisers Act had the adverse effect of precluding newly registered advisers from using performance information with respect to their private funds and other accounts for periods ended prior to their registration.

In the No-Action Letter, the Division stated that it would not recommend enforcement action if a registered hedge fund adviser that registered because of vacated Rule 203(b)(3)-2 does not maintain or preserve all of the supporting books and records required by Rule 204-2(a)(16) provided that such adviser meets the terms and conditions of vacated Rule 204-2(e)(3)(ii).

Performance-Based Compensation Arrangements

Section 205(a)(1) of the Advisers Act generally prohibits registered investment advisers from charging a performance fee or allocation based on a share of capital gains upon or capital appreciation of the funds of a client. Rule 205-3 under the Advisers Act provides an exemption from this prohibition whereby a registered investment adviser may charge a performance fee or allocation from a person that is a "qualified client" as defined in Rule 205-3(d)(1).

In the Adopting Release, the SEC amended Rule 205-3 to "grandfather" existing accounts with equity owners in private funds that are exempt from being an "investment company" in reliance on Section 3(c)(1) of the Investment Company Act of 1940 and existing

6 *See* Adopting Release, Section II.D.4.c, notes 210-211, 215-216 and 221.

7 *See* Uniao de Bancos de Brasileiros S.A., SEC No-Action Letter (pub. avail. July 28, 1992); Adopting Release, Section II.D.4.c.

8 *See* vacated rule 204-2(e)(3)(ii) under the Advisers Act.

investment advisory contracts, e.g. separately managed accounts, advised by newly registered hedge fund advisers.[9] The purpose of the grandfather clauses is to permit such advisers to continue to charge a performance fee or allocation with respect to investors and advisory clients who are not "qualified clients" that have been invested in the private funds or entered into investment advisory contracts, respectively, prior to February 10, 2005.

Vacating the amendments to Rule 205-3 under the Advisers Act had the adverse effect of requiring newly registered advisers of 3(c)(1) funds that charge a performance fee or allocation to revise or terminate advisory contracts and fee arrangements with respect to investors who are not "qualified clients."

In the No-Action Letter, the Division stated that it would not recommend enforcement action against a registered hedge fund adviser that receives performance-based compensation if and to the extent that such adviser would have been exempt from the prohibition on receiving a performance fee or allocation under vacated Rule 205-3(c)(2) or (3) under the Advisers Act, i.e., the grandfather clauses.

Delivery of Audited Financial Statements (Fund of Funds)

A registered investment adviser that is deemed to have custody is required to furnish an account statement to its clients on a quarterly basis that is either distributed by the qualified custodian holding the client's cash and securities, or distributed directly by the adviser, which in such case subjects the adviser to "surprise audit" to be conducted by an independent public accountant.[10] In the alternative, an adviser to a private fund or similar pooled investment vehicle that is deemed to have custody may distribute financial statements audited in accordance with generally accepted accounting principles ("GAAP") to each of the fund's beneficial owner within 120 days following such fund's fiscal year end.

In the Adopting Release, the SEC amended Rule 206(4)-2(b)(2) under the Advisers Act to extend the deadline for delivery of audited financial statements to beneficial owners from 120 days to 180 days with respect to funds that are "fund of funds" as defined in vacated Rule 206(4)-2(c)(4). The SEC had recognized the practical difficulties advisers of fund of funds face to comply with the 120 day deadline because their annual audits cannot be completed prior to completion of the audits of the financial statements of the underlying funds in which they invest.

Vacating the amendments to Rule 206(4)-2 under the Advisers Act had the adverse effect of precluding registered advisers of most fund of funds from being able to comply with the custody rule by distributing audited financial statements to beneficial owners of their funds.

In the No-Action Letter, the Division stated that it would not recommend enforcement action against an adviser to a fund of funds (as defined in vacated Rule 206(4)-2(c)(4)) relying on the "annual audit exception" if the audited financial statements of the fund of funds are distributed to investors in such fund within 180 days following the fund of fund's fiscal year end.

Guidance for Registered Hedge Fund Advisers that Deregister

Continued Reliance on Section 203(b)(3)

The ABA Letter requested confirmation that a hedge fund adviser that had registered because of vacated amended Rule 203(b)(3)-1 and Rule 203(b)(3)-2 and subsequently withdraws registration can again rely on the Section 203(b)(3) exemption from registration.[11] It noted that, during the period such an adviser had been registered, the adviser may have held itself out generally to the public as an investment adviser and may have taken on additional clients so that it has more than 14 clients in the preceding 12 months (counting each private fund as a single client).

In the No-Action Letter, the Division stated that it would permit a hedge fund adviser that had registered because of vacated Rule 203(b)(3)-2 to withdraw registration with the SEC in reliance on the Section

9 *See* vacated Rule 205-3(c)(2) and (3) under the Advisers Act.

10 *See* Rule 206(4)-2(a)(3) under the Advisers Act.

11 Section 203(b)(3) of the Advisers Act provides an exemption from registration for any investment adviser who, during the course of the preceding 12 months has had fewer than 15 clients, and who does not hold itself out generally to public as an investment adviser nor acts as an investment adviser to any registered investment company or business development company.

203(b)(3) exemption from registration without regard to whether the adviser:

- Held itself out generally to the public while it was registered
- Had more than 14 clients while it was registered (counting each private fund as a single client)

Relief is conditioned on the adviser withdrawing its registration with the SEC by no later than February 1, 2007. Moreover, for the first 12 months following withdrawal, the adviser may, for purposes of assessing its eligibility for the Section 203(b)(3) exemption, count only the number of clients it had on the date of deregistration.

Submitting a Balance Sheet Not Required when Filing Form ADV-W

When a registered investment adviser withdraws from registration, such adviser files a Form ADV-W. Item 7 of Form ADV-W requires an adviser to include on Schedule W2 an unaudited balance sheet of the adviser as of the end of the month prior to the filing of Form ADV-W, prepared in accordance with GAAP, if *inter alia* the adviser or a related person of the adviser has custody over client cash or securities.[12]

Since in most cases a registered adviser of a private fund is deemed to have custody of client cash or securities by virtue of being a general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, a registered hedge fund adviser that decides to deregister would in almost all cases be required to provide an unaudited balance sheet in connection with its deregistration.

In the No-Action Letter, the Division stated that it would not recommend enforcement action against a hedge fund adviser that had registered because of vacated Rule 203(b)(3)-2 and subsequently withdraws registration with the SEC in reliance on the Section 203(b)(3) exemption from registration (counting each private fund as a single client) by February 1, 2007, if such adviser does not provide the information required in a balance sheet on Schedule W2 of Form ADV-W as a result of responding "yes" to custody in Item 3 of Form ADV-W.[13] Furthermore, the Division stated that an adviser that responds "yes" to custody in Item 3 must still complete a Schedule W2 but may enter "0" for all entries on Schedule W2.

Other Matters Addressed in the No-Action Letter

Part I of Form ADV Will Revert to Pre-Adopting Release Version but IARD Will Not Immediately Reflect this Change

In connection with the adoption of vacated Rule 203(b)(3)-2, the SEC made several changes to Part 1A and Schedule D which had required registered advisers to identify and to provide certain information on the "private funds" they advise. As a result of the Goldstein Opinion, Part I of Form ADV and Schedule D reverted to the version of the form that was in effect prior to the Adopting Release.

Registered investment advisers and applicants for registration should note that due to system and programming constraints, Form ADV as it appears on IARD will continue to reflect the version that went into effect after the Adopting Release. Until Part I of Form ADV as it appears reverts to the pre-Adopting Release version, the SEC staff will post on the SEC's website additional guidance on how SEC-registered advisers may complete Form ADV.[14]

Under this guidance, an adviser is permitted to answer Item 7.B of Part I, as it existed prior to the Adopting Release. Thus, an adviser who responded in the affirmative solely because it advises a "private fund" other than an investment related limited partnership or limited liability company to which the adviser or a related person is general partner or managing member, may now change its response to "No." In which case, such adviser must also delete any such

12 Except for this requirement under Form ADV-W, there is no requirement that an adviser file a balance sheet with the SEC. Form ADV was amended to eliminate the requirement that advisers with custody include an audited balance sheet in their brochures to clients. *Letter*, note 8.

13 Note that a withdrawing adviser would remain obligated to furnish a balance sheet if such adviser responds "Yes" to Item 4 (money is owed to clients) or to Item 8 (there are unsatisfied judgments or liens) in Schedule 2 of Form ADV-W.

14 *See* http://www.sec.gov/divisions/investment/iard.shtml.

private fund listed on related Section 7.B of Form ADV, Schedule D.

Only limited liability companies and limited partnerships that are not "private funds" for which the adviser or a related person serves as general partner or managing member must be listed on Schedule D. An adviser is no longer required to identify the general partner or managing member of such entities; however, because IARD will not allow a blank response, advisers are instructed to either respond voluntarily to the question or enter "NOT REQUIRED" in the space provided.

In instances when both private funds and limited liability companies and limited partnerships that are not "private funds" have been listed on Schedule D, beginning August 21, 2006, IARD will allow an adviser to clear the names of listed private funds, if it so desires. Note that the remaining questions on Schedule D (regarding whether clients are solicited to invest in the fund, percentage of clients invested, minimum investment commitment, and current value of the total assets) must be answered for each fund that an adviser is required, or volunteers, to list.

Access to Records

In the Adopting Release, the SEC amended Rule 204-2 under the Advisers Act to provide that the records of a private fund are records of the adviser, and thus subject to examination by the SEC staff if the adviser or any related person acts as the private fund's general partner, managing member, or in a comparable capacity.[15] Vacating Rule 204-2(l) removed this recordkeeping requirement. The No-Action Letter did not directly address the question of whether the books and records of the private fund would continue to be deemed to be records of the adviser following the Goldstein Opinion.

Instead, the Division issued a blanket statement that "a registered investment adviser must make records available for examination in accordance with section 204 of the [Advisers] Act." The Division added that "[t]he adviser may not evade this requirement by holding records by or through any other person, including a related person or private fund." This statement suggests that the examination staff may assert that the books and records held by any affiliate of the adviser or by its private fund would be subject to inspection by SEC examiners if they are required records under Section 204 or if the adviser attempts to evade its obligation under the Advisers Act by shifting records to the fund.[16] Advisers may wish to review whether they can demonstrate full compliance with Section 204 without relying on records maintained by the funds they manage.

Future Developments

A negative consequence of the Goldstein Opinion is that it has cast doubt on the continued applicability of a number of interpretations discussed in the Adopting Release and in subsequent releases that have provided guidance specifically for advisers of private funds.

The No-Action Letter did not address all of the questions posed by the ABA Letter. The ABA Letter inquired whether a newly registered hedge fund adviser that withdraws its registration would violate the custody rule if the adviser had not yet distributed audited financial statements to beneficial owners of its private fund as an alternative to furnishing quarterly account statements. The ABA Letter sought confirmation that a hedge fund adviser should not be deemed to violate the custody rule if such adviser deregisters and subsequently does not distribute audited financial statements within the period required by Rule 206(4)-2 under the Advisers Act. Perhaps further guidance on this issue will be provided.

In Chairman Cox's testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, he indicated that the SEC intends to enact a new antifraud rule under the Advisers Act which would expressly extend the fiduciary duties of a private fund manager to the investors in the private fund and not just to the fund itself.[17] The intention is to reverse the "side-effect of the Goldstein decision that the antifraud provisions of Sections 206(1) and 206(2) of the [Advisers] Act apply only to 'clients,'" i.e., the fund

15 *See* vacated Rule 204-2(l) under the Advisers Act.

16 However, the anti-avoidance message of the Division's response may be extended to funds organized with boards.

17 The July 25, 2006, testimony of Chairman Christopher Cox before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, available at http://www.sec.gov/news/testimony/2006/ts072506cc.htm.

itself, and not to the beneficial owners of the fund.[18] The proposed anti-fraud rule would "clearly state that hedge fund advisers owe serious obligations to investors in the hedge funds."[19] The hedge fund industry should expect the next release to be the proposal to adopt a new anti-fraud rule specifically for advisers of private funds.

Note that Chairman Cox also stated that he has asked the staff to analyze and report to the SEC on the possibility of amending the current definition of "accredited investor."[20]

We will monitor and alert you on any further developments.

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The update was authored by David A. Vaughan (+1 202 261 3355; david.vaughan@dechert.com), Alan Rosenblat (+1 202 261 3332; alan.rosenblat@dechert.com), Roderick J. Cruz (+1 212 698 3644; roderick.cruz@dechert.com), and Michael L. Sherman (+1 202 261 3449; michael.sherman@dechert.com).

18 *Id.*

19 *Id.*

20 *Id.*

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you are in regular contact. Visit us at www.dechert.com/financialservices.

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Allison R. Beakley
Boston
+1 617 728 7124
allison.beakley@dechert.com

Sander M. Bieber
Washington
+1 202 261 3308
sander.bieber@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Timothy M. Clark
New York
+1 212 698 3652
timothy.clark@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick
Newport Beach
+1 949 442 6060
douglas.dick@dechert.com

Jennifer O. Epstein
Washington, D.C.
+1 202 261 3446
jennifer.epstein@dechert.com

Ruth S. Epstein
Washington
+1 202 261 3322
ruth.epstein@dechert.com

Susan C. Ervin
Washington
+1 202 261 3325
susan.ervin@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington
+1 202 261 3381
brendan.fox@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

Terrie J. Hanna
Boston
+1 617 728 7174
terrie.hanna@dechert.com

David J. Harris
Washington
+1 202 261 3385
david.harris@dechert.com

Robert W. Helm
Washington
+1 202 261 3356
robert.helm@dechert.com

Jane A. Kanter
Washington
+1 202 261 3302
jane.kanter@dechert.com

Stuart J. Kaswell
Washington
+1 202 261 3314
stuart.kaswell@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy
Washington
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Fran Pollack-Matz
Washington
+1 202 261 3442
fran.pollack-matz@dechert.com

Jeffrey S. Puretz
Washington
+1 202 261 3358
jeffrey.puretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Kimberly D. Rasevic
Washington
+1 202 261 3447
kimberly.rasevic@dechert.com

Robert A. Robertson
Newport Beach
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson
Washington
+1 202 261 3386
keith.robinson@dechert.com

Alan Rosenblat
Washington
+1 202 261 3332
alan.rosenblat@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Patrick W. D. Turley
Washington
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

David A. Vaughan
Washington
+1 202 261 3355
david.vaughan@dechert.com

Anthony H. Zacharski
Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

Dechert LLP

www.dechert.com

U.S.

Austin
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