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Re: Interpretive Issues Regarding New Rules and Rule Amendments For Investment Advisers Under the Investment Advisers Act of 1940 (the "Advisers Act")

Gentlemen:

This letter addresses the new rules and rule amendments under the Advisers Act that will require certain hedge fund advisers to register as investment advisers with the Securities and Exchange Commission (the "SEC") pursuant to such provisions (Rel. No. IA-2333) (the "Rules").

This letter is submitted by the undersigned Chair and Vice Chair of the Subcommittee on Private Investment Entities (the "Subcommittee") of the Committee on Federal Regulation of Securities (the "Committee"), Section of Business Law (the "Section") of the American Bar Association (the "ABA"). Since adoption of the Rules, we have sought to compile a comprehensive list of relevant interpretive issues with, in many instances, recommendations as to their resolution. At various panels and by other means on an ongoing basis we have requested those who became aware of such issues to send them to us so that we could submit, for the assistance of the SEC Staff (the "Staff"), a letter providing identification, discussion and resolution of those issues which may be of general interest and significance. This letter reflects the comments and suggestions of those persons who responded, including Subcommittee members. The comments expressed in this letter have not been approved by the ABA House of Delegates or Board of Governors and, therefore, do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Section, Committee or Subcommittee, nor does it necessarily reflect the views of all who have reviewed it. This letter also does not represent the views of any other ABA Section.

We request that the Staff issue interpretive guidance, in question and answer format or otherwise, that addresses these issues and other issues of general interest of which the Staff may be aware. We believe that such interpretive guidance will facilitate timely and effective compliance with the Rules.

In Part I of this letter, we identify a number of issues under the Rules and the adopting release that accompanied the Rules (the "Adopting Release") that we believe currently require interpretation and clarification.[1] In Part II of this letter, we identify a number of additional issues that we believe already exist under the Advisers Act for hedge fund advisers and that we believe will take on added significance now that many hedge fund advisers will be required to register with the SEC.

I. The Rules

A. Definition of "Private Fund" – Two Year Redemptions

Under new Rule 203(b)(3)-2, an investment adviser must look through each "private fund" that it advises and count each of the fund's owners as a client for purposes of Section 203(b)(3) of the Advisers Act. Section 203(b)(3) generally requires an investment adviser to register with the SEC if during the preceding twelve months the adviser had more than fourteen clients. Amended Rule 203(b)(3)-1(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) ("Unregistered Funds"); (2) that permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and (3) in which its interests are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.

Issue 1: Redemptions Within Two Years. The SEC has stated that hedge funds generally offer investors liquidity access following an initial lock-up period, which is typically for less than two years, and that the two year lock-up requirement will require most hedge fund advisers to register under the Rules.[2] The SEC also has stated that the definition of a "private fund" is intended to be simple "and provide a 'bright-line' indicator of when an adviser must look through a client that is a legal organization."[3] Accordingly, the SEC determined that two years represents a convenient cut-off period to distinguish hedge funds from other types of funds, even though it recognized that this cut-off period would mean that the definition of a "private fund" would include most, but not necessarily all, Unregistered Funds other than private equity and venture capital funds.

We are aware of recent statements made by the Staff expressing reservations that some hedge fund managers may seek two year lock-ups from investors and that, at least in part due to

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1 See *Registration under the Advisers Act of Certain Hedge Fund Advisers*, Advisers Act Release No. 2333 (Dec. 2, 2004).

2 Adopting Release at n.232 and related discussion.

3 Adopting Release at n.223.

these reservations, the Staff will interpret the "within two years" language to mean at least two years and one day. We are not in a position to determine how many hedge fund managers will ultimately adopt a two year lock-up for their funds. Indeed, this would depend on the willingness of investors to accept these restrictions. However, we believe that the clear intent of the "within two years" requirement means only that an investor's interest in a fund be at risk without liquidity for two years.

By way of example, we believe that if an investor purchases an interest in an Unregistered Fund on January 1, 2007 and redeems that interest as of December 31, 2008, the interest in the fund has been held for a full two years. The purchase will have been made as of the start of the day on January 1, 2007 (typically funds admit new capital on the first day of a month), as reflected on the books of the fund, and redeemed as of the end of the day on December 31, 2008 (typically funds redeem capital on the last day of a month or other fiscal period), also as reflected on the books of the fund. Adding one day to the calculation of a period may cause inadvertent and unintended regulation with no substantive purpose to be served. Moreover, some advisers could inadvertently fail to register by misinterpreting the "within two years" language based on what we believe is a plain reading of the phrase. Accordingly, we request the Staff's confirmation that the "within two years" language means that an investor's investment in a fund must be at risk without liquidity for two years.

Issue 2: Redemptions by the Advisory Firm and its Employees. In most cases, an adviser and its personnel (through its affiliated general partner, as described below) will make proprietary investments or otherwise hold proprietary interests in an Unregistered Fund managed by the adviser. For example, the adviser and its personnel typically make a proprietary contribution to a fund at its inception. Investors expect this contribution so that the interests of the adviser and its personnel are aligned with the interests of the investors. We believe that proprietary holdings in a fund by the adviser and its personnel should not be viewed as interests in an Unregistered Fund for purposes of the two year lock-up provision because the adviser and its personnel are not "owners" with respect to the fund.

The definition of a "private fund" under Rule 203(b)(3)-1(d) refers to "owners," but does not define the term. However, the term "owners" is defined in Rule 203(b)(3)-2 to mean the shareholders, limited partners, members or beneficiaries of a "private fund" unless the owner is (1) the fund's advisory firm or (2) a person described in paragraph (d)(1)(iii) of Rule 205-3 (i.e., "knowledgeable employees" of the adviser).[4] Reading Rule 203(b)(3)-1(d) together with Rule 203(b)(3)-2, we conclude that the adviser and its "knowledgeable employees" are not "owners," and that they should be permitted to withdraw their interests in an Unregistered Fund, without regard to the two year lock-up period and without causing the fund to fall within the definition of

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[4] Rule 205-3(d)(1)(iii) identifies the following persons: a natural person who immediately prior to entering into the contract is: (A) an executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or (B) an employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

a "private fund." Accordingly, we request the Staff's confirmation of our interpretation that the adviser and its knowledgeable employees will not be viewed as owners of the fund for purposes of determining whether an Unregistered Fund is a "private fund."

In the context of Unregistered Funds, frequently the adviser is an entity separate and apart from the general partner, although the two entities are under common control or are related persons.[5] In most cases, it is the general partner that makes an investment in the Unregistered Fund, rather than the adviser. We believe that such an investment by the general partner (which is an entity separate from the investment adviser but under common control with, and a related person of, the adviser) should not require the Unregistered Fund to treat the general partner entity as an "owner" of the Unregistered Fund.[6] In such circumstances, we also believe that the third condition of the definition of a "private fund" (i.e., interests in the fund must be offered based on the investment advisory skills, ability or expertise of the investment adviser) does not apply to the general partner interest because the adviser and the general partner are not relying upon the skills of any other person. We believe that this position further supports the conclusion that a general partner should not be viewed as an owner of an Unregistered Fund. Accordingly, we request the Staff's confirmation of our interpretation that the general partner of an Unregistered Fund is not an "owner" of the Unregistered Fund.

Issue 3: Withdrawals of Incentive Allocations and Incentive Fees. An adviser to an onshore Unregistered Fund typically receives, directly or indirectly, through an affiliated general partner, a performance-based "incentive allocation." This "incentive allocation" generally is added to the general partner's capital account in the fund. For the reasons described above, we do not believe that the adviser or its affiliated general partner should be viewed as an "owner" of the fund.

An adviser to an offshore Unregistered Fund (i.e., a fund organized under the laws of a country other than the United States) typically receives, directly or indirectly, an "incentive fee" as part of its compensation for managing the fund. The incentive fee typically is paid by the fund to the offshore fund adviser (i.e., an adviser whose principal office and place of business is outside the United States) when it is earned. We believe such a current payment of the incentive fee for the investment manager raises no issues under the Rules. Moreover, in many circumstances, the offshore adviser defers the fee and it remains an obligation of the fund to the adviser. Because we believe (as noted above) the adviser is not an "owner" of the offshore fund, we believe the exercise of a deferral option would not convert the adviser to an "owner."

We request the Staff's interpretation to the effect that the withdrawal of accrued incentive allocations or deferred incentive fees within two years after the accrual or deferral would not cause an Unregistered Fund to fall within the definition of a "private fund."

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[5] See Rule 204-2(l) which states generally that, if the adviser and the general partner of a fund are related persons, the books and records of the private fund are records of the adviser for purposes of Section 204 of the Advisers Act.

[6] See Adopting Release at n.193 and related discussion stating that for purposes of Rule 203(b)(3)-2 an adviser does not have to count itself as a client "regardless of the form its ownership in the pool takes."

Issue 4: Transfers Among Classes of an Unregistered Fund. An investor in an Unregistered Fund may seek, or be required, to transfer its interest in the fund from one class to another class within the same fund due, for example, to a change in the investor's legal status or residence. For instance, an investor that may have been unrestricted from participating in new issues under NASD Rule 2790 may later become restricted because of a change in employment. In addition, an investor may seek to move from a Euro-denominated class to a dollar-denominated class, or vise versa, because of a change in residence. The change would be limited to classes with substantially similar investment objectives, risk portfolio compositions, risk/return characteristics and liquidity. We request the Staff's interpretation to the effect that, under the circumstances described above, a change in fund classes within two years (1) would not be viewed as a redemption, and therefore would not cause an Unregistered Fund to fall within the definition of a "private fund" and (2) would not start a new two-year holding period.

Issue 5: Transfers of Ownership Interests Among Master Funds in a Captive Structure. An adviser to Unregistered Funds may establish a captive master-feeder structure consisting of multiple master and feeder funds. Investors may invest only in one or more feeder funds and the adviser then allocates the assets of the feeder funds exclusively among a group of advised master funds. The adviser purchases and sells investment securities only at the master fund level, and each master fund has a distinct investment objective and portfolio. Only the designated feeder funds may invest in the master funds; the master funds do not accept direct investments from any third-party investors.[7] The feeder funds do not permit investors to redeem their ownership interests within two years after the purchase of such interests and the feeder funds otherwise fall outside the definition of a "private fund." The adviser, at its sole discretion, may from time to time reallocate the interests of the feeder funds among the master funds to meet the feeder funds' investment objective (e.g., concentration limitations in certain sectors), and these reallocations may occur within two years after the initial allocations or subsequent reallocations. Such reallocations only affect the composition of the portfolio of each feeder fund, and not the ownership interests of the investors in each feeder fund. We request the Staff's interpretation to the effect that, under the circumstances described above, the master funds would not fall within the definition of a "private fund" because (1) investors' interests would be locked up for at least two years at the feeder fund level and (2) reallocations of the interests of the feeder funds among the master funds would be initiated only by the adviser in its sole discretion and not by the investors.

B. Definition of a Private Fund – Extraordinary Events

Amended Rule 203(b)(3)-1(d)(2)(i) provides that an Unregistered 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. The Adopting Release provided examples of circumstances that the SEC would consider to be extraordinary.[8] We describe below certain additional events likely to

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[7] A similar structure was described in the Staff's no-action letter to *Willkie Farr & Gallagher* (Oct. 30, 1998).

[8] Adopting Release at n.240 (stating generally that an Unregistered Fund will not meet the definition of a private fund if it offers redemption rights in the following circumstances: "in the event continuing to hold the investment became impractical or illegal, in the event of an owner's death or total disability, in the event key

occur that we believe are extraordinary and, to remove uncertainty, request the Staff to confirm our interpretation.

Issue 1: Dissolution of an Investor. An investor in an Unregistered Fund may be organized as a partnership, limited liability company, corporation or other type of entity. We believe that the dissolution and/or liquidation of such an investor would constitute an extraordinary event, because the investor is ceasing to operate. In many cases, partnership or similar agreements provide that it is an event of withdrawal if a natural person limited partner dies or becomes disabled or if an entity limited partner declares bankruptcy or dissolves. We believe that a dissolution of an entity that is certified by the investor to the Unregistered Fund to be for a bona fide purpose (not for the purpose of avoiding the two-year lock-up) is similar to a natural person investor dying or becoming totally disabled (each of which the Adopting Release describes as an extraordinary event). We request the Staff's interpretation regarding whether the dissolution and/or liquidation of an investor for a bona fide purpose (and not to avoid the two year lock-up) would be viewed as an extraordinary event.

Issue 2: Significant Withdrawals of Capital by the Adviser. As noted above, investors in an Unregistered Fund typically expect that the adviser and its personnel will make significant proprietary investments in the fund and also often negotiate for a redemption right if the adviser or its personnel withdraw a significant amount of their proprietary investments. This redemption right often is triggered by the withdrawal of a percentage (e.g., one-third or more) of the proprietary investments of the adviser and its personnel from the time an investor acquires its interest. We believe that a significant withdrawal of proprietary investments 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.[9] We do not suggest that a particular percentage reduction be used as a benchmark, but believe it should be negotiated between investors and the Unregistered Fund. We request the Staff's interpretation concerning whether a significant withdrawal of proprietary investments by an adviser and its personnel (without an intention to reinvest) would be viewed as an extraordinary event, so long as the redemption right is included in the partnership or similar agreement of the Unregistered Fund (or an agreement between an investor and the Unregistered Fund) at the time of the investment.

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

Amended Rule 203(b)(3)-1(d)(2)(ii) provides that an Unregistered 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 interests acquired through reinvestment of distributed capital gains or income.

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personnel at the fund adviser die, become incapacitated, or cease to be involved in the management of the fund for an extended period of time, in the event of a merger or reorganization of the fund, or in order to avoid a materially adverse tax or regulatory outcome" or "in order to keep [a fund's] assets from being considered 'plan assets' under ERISA").

9 Id.

Issue: "Distributed" Versus "Allocated" Gains or Income. In the ABA comment letter to the SEC, dated September 28, 2004, submitted by the Task Force on Hedge Fund Regulation (the "ABA Comment Letter"), it was suggested that then proposed Rule 203(b)(3)-1(d)(2)(ii)[10] be revised to make it clear that allocations of gains or income in an Unregistered Fund which are redeemed by an investor be treated similarly to distributions which are reinvested and not subject to a two-year redemption test. As the final rule was not so revised, we do not suggest here that investors in an Unregistered Fund should be permitted to withdraw these allocated gains or income within two years after purchasing the underlying investment without causing the fund to fall within the definition of a "private fund." However, we believe that these allocated gains or income and any subsequent appreciation on these gains or income do not represent a purchase of an interest in an Unregistered Fund. Accordingly, we believe that allocated gains or income and any subsequent appreciation thereon should be assigned the date of the investor's original investment to which the allocated gains or income are attributable. Therefore, an investor should be able to redeem its original investment and any gains or income and subsequent appreciation on the gains or income at any time after two years of the original investment without causing an Unregistered Fund to fall within the definition of a "private fund." We request the Staff's concurrence in this view.

D. Definition of a Private Fund – Transfers of Interests

The SEC has stated that an investor's transfer of an interest in an Unregistered Fund in a secondary market transaction will not be considered a redemption and thus would not cause the fund to fall within the definition of a "private fund."[11]

Issue: Attribution of Holding Period. Because the transfer of an interest in a secondary market transaction is not considered a redemption, the question arises whether (because the same interest remains outstanding throughout the transfer process) the date of the original purchase of the interest should attach to the interest. We believe the date of the original purchase should attach because that is the date of the most recent transaction between the fund and an investor (and there is no issuance of a new interest), provided there has been no preestablished arrangement between the fund and the investor to circumvent the two year lock-up. Accordingly, we request the Staff's interpretation to the effect that, if an investor in an Unregistered Fund transfers its ownership interest in the fund to another investor (including a transfer without consideration, e.g., a gift), the fund may attribute the transferor's acquisition date to the acquired interest for purposes of the two year holding period.

E. Definition of a Private Fund – Subadvisers

An investment adviser to an Unregistered Fund may seek to assign management of a portion of the fund's assets to a subadviser. For instance, the adviser may seek exposure to strategies or products in which a subadviser has specialized expertise.

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[10] Rule 203(b)(3)-1(d)(2)(ii) was originally proposed as Rule 203(b)(3)-2(d)(2)(ii).

[11] Adopting Release at n.241.

Issue: Application of the Two Year Holding Period to Third-Party Subadvisers to "Private Funds." We believe it is unclear whether, in all circumstances, a subadviser to a "private fund"[12] should be required to look through the fund to count owners as clients for purposes of Section 203(b)(3) of the Advisers Act. This issue arises particularly with offshore subadvisers (see infra., "Part F. Offshore Advisers. Issue 1: Offshore Subadviser"), but is also relevant to domestic subadvisers. The Rules can be read literally to require such an interpretation, but we believe that such an interpretation is neither mandated nor sound from a policy perspective.

The third prong of the test of a "private fund" is a company "Interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser." Accordingly, we understand that the adviser to a private fund must "look through" the fund and count the owners thereof as clients, and the adviser may not avoid registration by the use of subadvisers or a "manager of managers" structure.[13] However, if the adviser is registered, then we question whether public policy also requires that subadvisers to the private fund always be required to register as investment advisers. For example, if the registered investment adviser to a private fund allocates a portion of the fund's assets to one or more subadvisers with special expertise, such as in private equity or certain structured products, and the subadvisers are not named in the offering memorandum and are hired (and fired) by the investment adviser, then we believe that the intent of the Rules is not in any way subverted if the look-through does not apply to the subadvisers. Under these circumstances, the interests in the private fund are not offered based on the advisory skills of the subadviser. In addition, we believe that the subadvisers are not managing the private fund (although they may have discretionary authority with respect to a portion of its assets), but are providing valuable skills to the registered adviser to the private fund. Thus, in our view, the third prong of the test of a "private fund" does not apply to subadvisers in this context, and they should be able to rely upon Rule 203(b)(3)-1(a)(2)(i). Finally, we are concerned that, if in this circumstance, subadvisers must look through to count the owners of the private fund as clients, they may be unwilling to provide their services.

In light of this analysis, we recommend the Staff interpret the Rules as they relate to subadvisers to include a materiality threshold. For example, we do not believe the language in the Rules or the Adopting Release should be read to require a subadviser managing one percent of a private fund's assets to look through and count the investors in the fund as clients. We recommend that, consistent with a materiality standard, the Staff consider a threshold of 10% to 15% of a private fund's assets at the time the subadviser is hired as a safe harbor, and that a subadviser managing a portion of a private fund's assets within the safe harbor should not be required to look through and count the private fund's investors as clients.

Accordingly, we believe that a subadviser to a "private fund" which is engaged by a registered adviser to provide unique expertise should not be required to register, provided that the subadviser is (1) not managing such a substantial amount of the fund's assets such that it is

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[12] Subadviser relationships are frequently contractual relationships between the adviser and the subadviser. However, tax considerations may dictate that the subadviser relationship involves the use of a special purpose vehicle (such as a limited liability company or limited partnership) in which the subadviser manages on a discretionary basis a portion of the assets of the fund, but the fund adviser (or general partner) controls the nature and duration of the relationship.

[13] Adopting Release at n.243.

identified in the fund's offering memorandum (and, as noted above, manages an amount of the fund's assets within a safe harbor of 10% to 15% at the time the subadviser is hired); (2) not controlled by, or under common control with, the adviser; and (3) not otherwise required to register. In such a situation, there is unlikely to be the type of abuse referred to in the Adopting Release regarding the avoidance of the registration requirement.[14] The provisions of Section 208 should be sufficient to prevent abuses which might be imagined (such as using a "straw" adviser), should the Staff find that the arrangement is subject to abuse. We request the Staff's concurrence in this view.

F. Offshore Advisers

The Rules contain special provisions for offshore advisers to "private funds." We seek the Staff's guidance with respect to the application of certain aspects of the Rules to offshore advisers.

Issue 1: Offshore Subadvisers. An adviser to a "private fund" may sometimes identify a third-party offshore manager with specialized investment expertise or access to non-U.S. markets and delegate the management of some portion of the fund's assets to that manager. For example, an adviser may seek exposure to the Chinese securities markets and engage the services of a third-party manager (i.e., a subadviser) located in Shanghai who otherwise has no U.S. clients and does not market its services to U.S. clients. In addition, if the portion of the fund's assets delegated to that manager is relatively small in comparison to the overall size of the fund, the manager typically is not identified in the fund's offering memorandum.

As noted previously, the SEC has stated generally that subadvisers to "private funds" must look through the fund to count owners as clients for purposes of Section 203(b)(3) of the Advisers Act.[15] This statement would suggest that offshore managers who are engaged as subadvisers to "private funds" would be required to register with the SEC. Although we are not addressing the SEC's jurisdiction with respect to this issue, we believe that this conclusion would not be consistent with the intention that the Rules not limit U.S. investor access to foreign markets. Moreover, as previously discussed, we believe that if a subadviser is not named in the offering memorandum and is hired (and fired) by the investment adviser, then the fund is not being offered based on the advisory skills, ability or expertise of the subadviser within the meaning of Rule 203(b)(3)-1(d)(1)(iii). As a practical matter, either the subadviser will not be aware of the registration requirement, or the registration requirement will likely cause the subadviser to decline the opportunity to manage any portion of the fund's assets and thereby preclude U.S. investors from gaining access to talented offshore managers and investment opportunities. Finally, we believe that a materiality threshold should apply and a safe harbor should exist where the subadviser manages not more than 10% to 15% of the private fund's assets at the time the subadviser is hired.

We believe that an offshore manager retained as a subadviser to a "private fund" by a registered adviser should not be required to register, provided that the subadviser is (1) not

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14 Id.

15 Id.

managing such a substantial amount of the fund's assets that it needs to be disclosed in the fund's offering memorandum (and, as noted above, manages an amount of the fund's assets within a safe harbor of 10% to 15% at the time the subadviser is hired); (2) not controlled by, or under common control with, the adviser; and (3) not otherwise required to register. In such a situation, there is unlikely to be the type of abuse referred to in the Adopting Release regarding the avoidance of the registration requirement. As noted previously, the provisions of Section 208 should be sufficient to prevent abuses which might be imagined should the Staff find that the arrangement is subject to abuse. Absent such findings, however, we are concerned that foreign advisers with no connections to the United States other than acting as a subadviser to a "private fund" (which could be an offshore fund with U.S. tax exempt investors, or a domestic fund) will make their services unavailable to "private funds." We request the Staff's concurrence in this view.

Issue 2: Separate Redemption Provisions for an Offshore Unregistered Fund's U.S. Investors. As described previously, a "private fund" permits its owners to redeem their ownership interests within two years of purchase. An offshore Unregistered Fund may have owners that are both U.S. and non-U.S. investors. The issue arises whether an Unregistered Fund advised by an offshore adviser should be considered a "private fund" if U.S. investors may not redeem any portion of their ownership interests within two years of purchase, but non-U.S. investors are not subject to the two year lock-up period.

We believe that the intent of the Rules is served if U.S. investors do not have liquidity for two years, and therefore an offshore Unregistered Fund should be permitted to offer different redemption provisions to offshore investors, without becoming a "private fund." As a practical matter, interpreting the Rules in this manner will eliminate the need for offshore advisers to establish side-by-side Unregistered Funds, one for U.S. investors that prohibits redemptions within two years and one for non-U.S. investors that permits earlier redemptions. We further believe that this view is consistent with other positions taken by the SEC and the Staff where distinctions have been made between U.S. and non-U.S. investors in offshore funds. For instance, Rule 203(b)(3)-1(b)(5) distinguishes U.S. and non-U.S. clients for purposes of determining whether an offshore adviser must register with the SEC by providing that an offshore adviser is not required to count clients that are not U.S. residents. Similarly, the Adopting Release states that an offshore adviser to an offshore "private fund" must count only investors that are U.S. residents as clients.[16] Finally, an offshore Unregistered Fund with both U.S. and non-U.S. investors must ensure that only its U.S. investors satisfy the requirements of Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, as applicable.[17] Accordingly, we request the Staff's interpretation concerning whether an offshore Unregistered 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."

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16 Adopting Release at n.201 and related discussion.

17 See, e.g., *Touche Remnant & Co.*, SEC No-Action Letter (Aug. 27, 1984) and *Goodwin, Procter & Hoar*, SEC No-Action Letter (Feb. 28, 1997).

G. Registration of Related Persons

Advisers to "private funds" often are part of a group of related legal entities that are organized to address various tax or liability issues. The related entities typically are organized by a core set of individuals who ultimately provide advice to the funds. We are concerned that under a technical reading of the Rules each legal entity could be viewed as an investment adviser to the funds and thus be required to register with the SEC. We believe that this result would create unnecessary regulatory burdens and costs for these advisers, as well as confusion among investors (e.g., through the receipt of multiple Forms ADV Part II), without satisfying any apparent rationale for requiring registration. We describe below two circumstances that raise particular concerns in this context.

Issue 1: Registration of the Adviser and the General Partner or Managing Member. An adviser to a "private fund" often creates a special purpose vehicle ("SPV") to act as the fund's general partner or managing member.[18] In these situations, the formation documents for the SPV also designate the adviser to manage the fund's assets and the SPV has no employees or other persons acting on its behalf other than officers, directors, partners or employees of the adviser. A literal reading of the Rules and Section 203(b)(3) of the Advisers Act may lead to the conclusion that under the circumstances described above both the adviser and the SPV may be required to register with the SEC. We believe that the registration of both entities would be unnecessary and that it should be sufficient if only the adviser registers. We note that any individual acting on behalf of the SPV would be an "associated person" (as defined in Section 202(a)(17) of the Advisers Act) of the registered adviser and subject to the registered adviser's supervision. We request the Staff's interpretation to the effect that, under the circumstances described above, it is not necessary for the SPV also to register with the SEC.[19]

Issue 2: Registration of Affiliated Entities. An adviser to a private fund often establishes operations in several jurisdictions in order to take advantage of local investment opportunities. For tax and liability purposes, these operations typically are organized as separate legal entities that are affiliates, rather than as branch offices. Each entity typically has at least one portfolio manager, as well as analysts and support personnel, and the portfolio manager has authority to manage some portion of the fund's assets. In this scenario, a private fund (including a private fund organized in the United States) might be advised by affiliated entities located, for example, in the United States, the United Kingdom and Singapore.

The Rules suggest that each affiliated entity would be required to look through the private fund and therefore need to register separately with the SEC as an investment adviser. As a practical matter, we see no reason why each affiliated entity should be required to register merely because it has been established as a separate legal entity for tax and liability reasons rather than as a branch office. We believe that it should be sufficient if (1) only one entity registers with the SEC as an investment adviser; (2) the registered entity treats each non-registered entity as a "participating affiliate" as described in the Staff's no-action letter to *Mercury Asset Management*

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[18] The SEC has acknowledged this practice. Adopting Release at n.259.

[19] The Staff previously has given similar affirmative guidance in this area. See *Thomson Advisory Group L.P.*, SEC No-Action Letter (Sept. 26, 1995) and *Glenwood Associates, Inc.*, SEC No-Action Letter (Aug. 6, 1992).

plc (SEC Staff No-Action Letter (Apr. 16, 1993)) and in subsequent no action letters;[20] (3) the registered and unregistered entities comply with the conditions established by the Staff in the *Mercury* letter and in subsequent no-action letters; and (4) the registered entity treats all of the employees of the non-registered entities as its "associated persons" and subject to its supervision. We believe that the SEC's concerns regarding investor protection, disclosure and the ability to inspect each entity will be adequately addressed under the conditions described above. Moreover, this approach will avoid unnecessary burdens for advisers and confusion for investors. Accordingly, we request the Staff's concurrence in this view.

In addition, we note that in the Staff's no-action letter to *Mercury* and in subsequent no-action letters, the Staff has not explicitly confirmed that a registered adviser whose principal office and place of business are located in the United States (i.e., an onshore adviser) may treat its offshore affiliates as "participating affiliates."[21] The Staff has only stated explicitly that an offshore registered adviser may treat its offshore affiliates as "participating affiliates." Thus, as a matter of clarification, we request the Staff to confirm the interpretation that a registered onshore adviser may in fact treat its offshore affiliates as "participating affiliates."

H. Family Offices and Family Funds

Many wealthy families, for family tax and estate planning purposes, or to more effectively coordinate the families' investments, organize entities to manage their assets. Given the proliferation of so-called family offices and to minimize future requests for interpretation from the Staff, we seek the Staff's guidance with respect to certain issues arising in connection with these activities.

Issue 1: Treatment of Family Funds as "Private Funds." The ABA Comment Letter recommended that the family-owned company part of the definition of "qualified purchaser" contained in Section 2(a)(51)(A)(ii) of the Investment Company Act[22] be incorporated into Rule 203(b)(3)-1(a) and that a fund composed solely of family members not be considered a "private fund" because interests in such funds are sold based on the relationships among the various related investors and not primarily on the advisory skills of the adviser.

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[20] See, e.g., *Kleinwort Benson Investment Management Limited*, SEC No-Action Letter (Dec. 15, 1993); *Murray Johnston Holdings Limited*, SEC No-Action Letter (Oct. 7, 1994); *ABM AMRO*, SEC No-Action Letter (July 1, 1997); and *Royal Bank of Canada*, SEC No-Action Letter (June 8, 1998). These letters were related to, and issued by the Staff subsequent to, *Uniao de Banco de Brasileiros*, SEC No-Action Letter (July 28, 1992).

[21] The Staff, however, appears to have implicitly endorsed this position based on the facts presented in its no-action letter to ABM AMRO (July 1, 1997) where the registered adviser was located in the United States and its participating affiliates were located offshore.

[22] Section 2(a)(51)(A)(ii) of the Investment Company Act provides in relevant part that a "qualified purchaser" means "any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (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."

The SEC recognized that there may be circumstances where interests in a fund are not offered based on the expertise of the adviser, but did not describe those circumstances.[23] We believe that an investment fund composed solely of family members – regardless of whether they live in the same household, advised by a family member or an entity owned and controlled primarily by members of the same family – is such a circumstance where the Staff should not require registration of the adviser under the Advisers Act. Additionally, the SEC cited several letters granting exemptive relief from registration under the Advisers Act to "family office advisers," where the advisers were formed primarily to provide services to family-owned funds or their close friends.[24] In granting the relief, the SEC did not focus on whether the family members were all members of the same household. We believe that no investor protection purpose would be served in requiring the adviser to incur the costs of registration where the fund is composed solely of members of the same family. We request the Staff's interpretation to the effect that an investment vehicle composed solely of family members described in Section 2(a)(51)(A)(ii) of the Investment Company Act, where the adviser is a family member or an entity organized and controlled primarily by family members, would not be deemed a "private fund," and such an adviser would not be required to look through the vehicle for purposes of determining whether the adviser must register under the Advisers Act.

Issue 2: Treatment of Non-Family Members as Clients. There may be some circumstances where a limited number of non-family members own an interest in an investment fund organized primarily for members of a single family. As described above, we believe that family members in such a circumstance do not require the protections afforded by registration of the investment adviser. We believe that, where non-family members also are investors in a family fund, there would be an alignment of interests among all the owners of the private fund and that registration of the adviser should not be required. We further believe that the purposes of the Rules would be satisfied if only the non-family members were counted as clients such that the adviser (regardless of whether the adviser was owned and controlled primarily by members of the family) would be required to register only if there were fifteen or more non-family members in the fund. For these purposes, we would count as clients trustees, executors, guardians and legal representatives who are non-family members. We request the Staff's concurrence in this view.

I. Compliance Dates

The SEC has established February 1, 2006 as the date by which all advisers to "private funds" must have their registration with the SEC effective if they are required to register with the SEC as a result of the Rules. In addition, Section 203(c)(2) of the Advisers Act provides that the SEC will declare an adviser's registration effective within 45 days of the date of filing the Form ADV (unless the SEC institutes proceedings to determine whether registration should be denied). Accordingly, an adviser who must register as a result of the Rules likely must file its Form ADV with the SEC by December 15, 2005.

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[23] Adopting Release at n.249.

[24] Id. citing, e.g., *Bear Creek Inc.*, Investment Advisers Act Release No. 1931 (Mar. 9, 2001) [66 FR 15150 (Mar. 15, 2001)] (notice); *Moreland Management Co.*, Investment Advisers Act Release No. 1700 (Feb. 12, 1998) [63 FR 8710 (Feb. 20, 1998)] (notice).

Issue: Effective Date of Registration. Typically, an adviser's registration is declared effective sooner than 45 days, and often within only a few weeks after filing its Form ADV. Under this scenario, an adviser could have its registration declared effective, and be subject to all requirements of the Advisers Act, well before February 1, 2006. Moreover, an adviser may not know the exact date that its registration is declared effective without making repeated telephone calls to the Staff. We believe that this situation interjects a degree of uncertainty into the registration process that was not intended by the SEC. In addition, we have observed that in past years, the Investment Adviser Registration Depository, the system through which registrations are filed, has been shut down during the latter half of December. In order to provide certainty to first time registrants under the Rules, we request that the Staff permit an adviser who must or decides to register as a result of the Rules to simply file its Form ADV with the SEC by January 13, 2006, and, provided that the adviser submits a Form ADV that is complete in all material respects by that date, the adviser will be deemed to have met the February 1, 2006 deadline and its registration will be deemed effective as of that date.

II. Related Issues

A number of issues arise under the Advisers Act that we believe are unique to hedge fund managers. As suggested previously, we believe these issues will take on added significance now that many hedge fund advisers will be required to register with the SEC. We describe these issues below and request the Staff's further guidance with respect to them.

A. Trading Issues – Principal Transactions and Rebalancing

An adviser may manage multiple Unregistered Funds with the same investment strategy. For example, an adviser may manage an onshore fund relying on Section 3(c)(1) of the Investment Company Act, an onshore fund relying on Section 3(c)(7) of the Investment Company Act and an offshore fund relying on Section 7(d) of the Investment Company Act. The adviser may seek to rebalance the portfolios of the funds on a monthly or quarterly basis to reflect contributions and redemptions that are disproportionate among the funds. When rebalancing, the adviser may sell securities from one or more funds and purchase the securities for one or more of the other funds in a simultaneous transaction (i.e., a cross transaction) so that each fund maintains the same *pro rata* ownership of each securities position. Rebalancing transactions raise a principal transaction issue for registered and unregistered advisers.

Issue: Determination of the Status of an Unregistered Fund for Principal Transaction Purposes. Section 206(3) of the Advisers Act restricts the ability of an adviser, whether or not registered, to engage in principal transactions with any of its client accounts and generally provides that, prior to the completion of any principal transaction, the adviser must notify the client in writing of the transaction (which notification must include certain information about the transaction) and obtain the client's consent. We understand that the primary purpose for this restriction is to prevent an adviser from placing unwanted securities in a client's account.[25]

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[25] See *Investment Trusts and Investment Companies: Hearings on S. 3580 Before Subcomm. of the Comm. on Banking and Currency*, 76th Cong., 3d Sess. 320 (1940) at p. 322 ("[I]f a fellow feels he has a sour issue and finds a client to whom he can sell it, then that is not right. . . .") (statement of David Schenker).

Because one or more of the Unregistered Funds managed by the adviser may contain proprietary assets of the adviser and its personnel, the funds could be viewed as a principal account of the adviser and any trade involving such funds could be viewed as a principal transaction.

Many Unregistered Funds are structured as master-feeder funds (with a domestic and an offshore feeder fund both relying on Section 3(c)(1) or 3(c)(7) of the Investment Company Act) so that the rebalancing in effect takes place automatically at the master fund level. However, there are frequently tax and other reasons (such as one fund relying on Section 3(c)(1) and another relying on Section 3(c)(7) of the Investment Company Act) why a master-feeder structure is not appropriate, and the funds are set up on a "side-by-side" basis. In such situations, we believe that rebalancing transactions should not be viewed as principal transactions because these transactions occur on a regularly scheduled basis and are solely for the purpose of maintaining the same *pro rata* ownership of each securities position by the funds. As a result, the concern that the adviser may place an unwanted security in a client's account does not arise in a rebalancing transaction. Thus, we request the Staff's interpretation to the effect that it would not view a rebalancing transaction effected among an adviser's Unregistered Funds on a *pro rata* basis as a principal transaction. Alternatively, if the Staff would view a rebalancing transaction as a principal transaction, we request that the Staff provide guidance as to the threshold percentage of an Unregistered Fund that must be owned by the adviser and its personnel before the Unregistered Fund must be viewed as a principal account of the adviser for purposes of Section 206(3).

B. Form ADV

In the ABA Comment Letter, there was reference to several interpretive issues that arise when attempting to apply questions in the Form ADV to advisers to "private funds," including (1) the meaning of the term "client" as used in the form and (2) the purpose of questions contained in Schedule D, Section 7.B. (See Section VI of the letter.)

Issue 1: Clarification of the Term "Client" in Form ADV. The ABA Comment Letter described various references in the form to the word "client" and noted that many questions that use the word "client" were unclear as to whether the word was intended to elicit information about a "private fund" or the investors in the fund. We believe that the term "client" as used in Form ADV should refer to "private funds" consistently throughout the form, rather than to the investors in the funds. We further believe that this view is consistent with statements made in the Adopting Release to the effect that the Rules are designed only to amend the method of counting that advisers to "private funds" use for purposes of applying Section 203(b)(3).[26] Finally, we believe that a lack of clarification on this point may create confusion and raise costs for advisers as they complete and update the form. Accordingly, we request that the Staff consider recommending that the following sentence be added to the definition of "client" in the Glossary of Terms of the Form ADV: "If your firm advises a 'private fund' as defined in Rule

[26] Adopting Release at n.187 and related discussion. The Adopting Release also stated that the Rules are not intended to alter the duties or obligations owed by an investment adviser to its clients and that, independent of the Rules, the antifraud provisions of the Advisers Act apply to the adviser's relationship with the fund's limited partners. Id. We are not aware of any statute, rule or court case specifically establishing the principle that an adviser to an Unregistered Fund has an investment advisory relationship with investors in the fund.

203(b)(3)-2, you should respond to the following Items with respect to the private fund and not any investors in the fund: Part 1A, Items 5.C. and 5.D., and Items 8.A. through 8.E, and Part II, Items 2, 9, 12.B. and 13.A."

Issue 2: Schedule D, Section 7.B. We also request that the Staff consider reexamining the usefulness of two questions contained in Schedule D, Section 7.B., regarding whether "clients" are solicited, and the percentage of "clients" that are solicited, to invest in the entities described therein. The Staff has provided guidance with respect to those questions in a website posting titled, "Frequently Asked Questions on Form ADV and IARD."[27] The guidance suggests that the term "client" for purposes of these questions should be viewed as the Unregistered Funds managed by the adviser, as well as any persons whose accounts are separately managed by the adviser. The questions nevertheless have created significant confusion among advisers to Unregistered Funds and the questions do not appear to elicit useful information. Accordingly, we request that the Staff consider recommending either the revision or deletion of these two questions in Schedule D, Section 7.B.

In addition and as described above, many Unregistered Funds are structured as master-feeder funds which may consist of a master fund and two or more feeder funds. Schedule D, Section 7.B. requires an adviser to complete a separate Schedule D Page Four for each limited partnership in which the adviser or a related person is a general partner, each limited liability company for which the adviser or a related person is a manager, and each other private fund that the adviser advises. Read technically, this instruction would require an adviser to a master-feeder structure to complete a Schedule D Page Four for the master fund and each feeder fund. This result would require a registered adviser to provide duplicate and potentially confusing information, and also would present an adviser with challenges in attempting to respond, for instance, to the question that requires the adviser to state the current value of the total assets of each fund. Accordingly, we request that the Staff consider recommending that an adviser to a master-feeder structure be required to complete a separate Schedule D Page Four only for each feeder 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.

Issue 3: Part 1A, Item 7.B. Part 1A, Item 7.B. requires an adviser to disclose in relevant part whether it advises any "private fund," and if so it must complete Section 7.B. of Schedule D. As suggested previously, an adviser to an Unregistered Fund may engage the services of a third-party subadviser to manage a portion of the fund's assets. In these circumstances, the subadviser often treats the fund the same way it treats any other separately managed account, and as such may have little or no information about whether the fund falls within the definition of a "private fund" (particularly with respect to offshore funds) or the fund's total assets under management. In addition, this information likely is being provided by the fund's primary adviser. Accordingly, we believe that requiring subadvisers to provide information about Unregistered Funds they advise may prove burdensome and provide the SEC with little or no additional information. Accordingly, we request that the Staff consider recommending that Part 1A, Item 7.B. be

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[27] Available at http://www.sec.gov/divisions/investment/iard/iardfaq.shtml.

amended to require an affirmative response only if an adviser (1) advises a "private fund" and (2) it or a related person also acts as the primary adviser or sponsor of the "private fund."

C. The Custody Rule

Rule 206(4)-2 under the Advisers Act provides that a registered adviser with custody of client assets must comply with certain conditions. In addition, the rule also contains a definition of custody that states generally that an adviser to an Unregistered Fund is deemed to have custody of the fund's assets. The primary conditions of the rule include that an adviser with custody of client assets must: (1) maintain client assets with one or more "qualified custodians"; (2) provide its clients with certain information about their qualified custodian; and (3) have a reasonable basis for believing that the qualified custodian is sending at least quarterly account statements directly to clients (or investors). An adviser to an Unregistered Fund generally is not subject to the third condition, so long as the fund provides its audited financial statements to investors within 120 days of the fund's fiscal year end (or 180 days in the case of a fund of funds).

Issue 1: The Use of Offshore Prime Brokers. Many advisers to pooled investment vehicles use the services of prime brokers[28] located outside the United States (located, for example, in the United Kingdom) as custodians for the fund's assets. The rule defines a "qualified custodian" to include, among others, "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." We are concerned that offshore prime brokers used by an adviser on behalf of a pooled investment vehicle may not always meet the full requirements of this definition.

We understand that it is the established practice among offshore prime brokers that they do not necessarily segregate customer assets from their proprietary assets in all situations. For example, cash balances typically are not segregated from proprietary assets by prime brokers located in the United Kingdom. Although cash balances are treated differently under Rule 15c3-3 of the Securities Exchange Act of 1934, which permits a broker to lend cash balances from one client account to another, but not to the broker-dealer, such balances are not completely free from risk of loss (e.g., in a situation where there are not sufficient funds and securities available from customer accounts to cover amounts owed to other customers and the broker-dealer has gone bankrupt). We believe that in order to meet the technical requirements of Rule 206(4)-2, offshore prime brokers would need to change fundamentally their method of operations and the treatment of customer assets, which they may be unwilling to do and which may not have been intended by the SEC when it adopted the "qualified custodian" requirement. Because advisers to pooled investment vehicles depend on the prime brokerage relationship to conduct their businesses, and investors in such funds are sophisticated (i.e., accredited investors and, for Section 3(c)(7) funds, qualified purchasers), we believe that all prime brokers should be qualified custodians under Rule 206(4)-2; and, as a condition to placing assets with a prime broker, that

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[28] Prime brokerage is a system developed by full-service broker-dealers to facilitate the clearance and settlement of securities trades and to provide other services for substantial retail and institutional investors who are active market participants. These other services include securities lending, margin lending and customized reporting, as well as capital introductions, start-up services, research and securities valuations.

the investment adviser disclose in a fund's offering memorandum and the adviser's Form ADV the specific risks inherent in the manner in which the prime broker holds the fund's assets.

In addition, it is our understanding that hedge funds generally do not maintain cash balances, but invest cash generally in liquid securities on an overnight or other basis. Accordingly, we believe that the difference in procedures between such U.K. prime brokers and their U.S. counterparts (which we understand relate primarily to the segregation of cash balances) will not have a meaningful effect on the risk a hedge fund incurs in using an offshore prime broker. Thus, we request the Staff's interpretation to the effect that the use of an offshore prime broker is acceptable under Rule 206(4)-2, provided that the adviser disclose in a fund's offering memorandum and the adviser's Form ADV the specific risks inherent in the manner in which the prime broker holds the fund's assets.

Issue 2: Definition of Privately Offered Securities. Rule 206(4)-2 provides an exemption from the custody rule with respect to securities defined as privately offered securities. For a pooled investment vehicle, this exemption provides relief from having to place such privately offered securities with a qualified custodian. The rule describes a "privately offered security" as a security that is: (1) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (2) uncertificated, and the ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and (3) transferable only with the prior consent of the issuer or holders of the outstanding securities of the issuer.

There are a number of securities offered in private transactions which, on the face of Rule 206(4)-2, may not be deemed "privately offered securities," but which we believe should nevertheless be exempted from the requirement that they be maintained with a qualified custodian. For example, assignments and participations of loans are not technically recorded on the books of the issuer or the issuer's transfer agent or transferable only with the prior consent of the issuer or holders of the outstanding securities. Instead, payments made in respect of such securities are typically administered by the lender managing the syndicate (in the case of an assignment) or by the person selling the participation. The evidence of the loan is often an assignment agreement or a participation agreement. Such agreements are not conventionally transferable, and the rights under such agreements in many, but not all, instances may only be assigned with consent of the packager or seller of the participation. Furthermore, hedge funds may also make loans or enter into privately negotiated derivatives or other instruments which often may not be transferred, nor may the payment under such an agreement be assigned, without the counterparty's consent. We seek the Staff's interpretation to the effect that where payment or transfer of a security is controlled by, or requires approval from, a third party that such securities would be deemed private offered securities under Rule 206(4)-2, and the evidence of such interests (i.e., the written agreements) would not be required to be held by a qualified custodian.

Issue 3: Amortization of a Fund's Start-Up Costs. As noted above, an adviser to an Unregistered Fund need not comply with the third condition of the rule relating to the delivery of account statements to investors, provided that the fund's audited financial statements are sent to investors within the required time frames. The rule provides that the audited financial statements must be prepared in accordance with generally accepted accounting principles ("GAAP"). We understand that accounting firms generally include a footnote to their audit opinions for an Unregistered Fund if the fund amortizes its start-up costs (unless in limited circumstances the

fund is large enough relative to the amount of the start-up costs to expense those costs). Such amortization is standard in the hedge fund industry, so that start-up costs are not borne solely by the initial investors. We further understand that a footnote to an audit opinion means that a fund's financial statements are not prepared in accordance with GAAP. We request the Staff's interpretation regarding whether a fund's financial statements nevertheless comply with the requirements of the Rule 206(4)-2 if the sole exception to GAAP in an audit opinion for an Unregistered Fund is the result of the fund amortizing its start-up costs.

D. Proxy Voting

Rule 206(4)-6 under the Advisers Act generally requires a registered adviser to: (1) adopt and implement proxy voting policies and procedures to ensure that proxies are voted in the best interest of clients; (2) disclose to clients how they may obtain information from the adviser about how the adviser voted with respect to their securities; and (3) describe to clients the adviser's proxy voting policies and procedures and, upon request, furnish a copy of the policies and procedures to the requesting client.

Issue: Application to Advisers with Certain Investment Strategies. Some advisers to Unregistered Funds employ investment strategies based on market trends, inefficiencies or mispricings that result in investment decisions that are not dependent on the management of the issuers whose securities are bought and sold by the adviser. We believe that investors in these funds do not expect the adviser to use the proxy voting mechanism to enhance the value of the fund's portfolio holdings. In addition, these advisers may not have the resources necessary to evaluate fully the merits of each proxy. As a result, we believe that these advisers might reasonably conclude that the cost of voting proxies exceeds the expected benefit to fund investors.[29] We further believe that under these circumstances, advisers should be able to adopt a policy of not voting proxies, and that such a blanket policy would eliminate the types of conflicts that the proxy voting rule was intended to prevent. Thus, we request the Staff's interpretation to the effect that advisers to Unregistered Funds who employ investment strategies that are not dependent on the management of the issuers, such as those based on market trends, inefficiencies or mispricings should be able to adopt a blanket policy not to vote proxies, provided that the policy is adequately disclosed to investors in an Unregistered Fund's offering memorandum, its subscription agreements, the adviser's Form ADV or otherwise. This policy could also provide that if the adviser's strategies change, the adviser would adopt and implement appropriate policies and procedures.

E. Record Retention

Rule 204-2 under the Advisers Act describes a set of books and records that registered advisers must maintain and states generally that most of the required books and records must be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser. The Rules added an amendment to Rule

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[29] See *Proxy Voting by Investment Advisers*, Advisers Act Release No. 2106 (Jan. 31, 2003) at n.18 and related discussion (stating there may be "times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client").

204-2 by providing generally that if an adviser advises a "private fund," and the adviser or any related person acts as the fund's general partner, managing member or in a similar capacity, the books and records of the fund are records of the adviser.

Issue 1: Retention of Private Fund Records by a Fund Administrator. An adviser to a "private fund" often engages the services of a third-party administrator to assist in coordinating the affairs of the fund. The third-party administrator typically has certain of the fund's original records identified in Rule 204-2. In addition, the service agreement between the adviser and the administrator may provide that the administrator will maintain and preserve those records as required by Rule 204-2 and provide those records to the adviser promptly upon request. We request the Staff's interpretation regarding whether it would view an adviser who engages the services of a third-party administrator and who has in place a service agreement with the provisions described above as satisfying the requirement to maintain and preserve the records of the fund for the first two years in an appropriate office of the adviser.

Issue 2: Records of an Offshore Private Fund with an Independent Board of Directors. Offshore "private funds" typically are formed as corporations and have a board of directors that handles the operational functions of the fund and oversees the records of the fund. A fund's board of directors often consists of a majority of members who are not affiliated with the adviser, and the board engages the adviser to provide investment advisory services to the fund and oversees the records of the fund. Prior to the adoption of amended Rule 204-2, advisers to offshore funds with independent boards of directors did not view those records as belonging to the adviser. In fact, the boards may have limited the adviser's access to certain of those records, including the identity of investors. Thus, the fund's records were not considered records of the adviser. We understand that amended Rule 204-2 contemplates that the records of a "private fund" will be considered records of the adviser only if the adviser or any related person also acts as the fund's general partner, managing member or in a similar capacity. In the case of an offshore fund with an independent board of directors, neither the adviser nor a related person acts in any of these capacities. Accordingly, we request the Staff's interpretation to the effect that it would not view the records of an offshore "private fund" with an independent board of directors as records required to be maintained by the fund's adviser pursuant to amended Rule 204-2.

Issue 3: Retention of E-mails and Instant Messages. As many advisers to "private funds" prepare to register, they face the task of establishing systems to assist in meeting the requirements of Rule 204-2. We suggest that the Staff review each requirement in light of new technologies. For example, e-mails and instant messages are received and sent with the frequency with which the spoken word was used. It has been the Staff's position that all documents that are available are subject to examination (whether or not the documents are specifically identified in Rule 204-2). This position has led to document requests, in the course of examinations of advisers, that are extremely costly, and frequently involve the need to screen and review hundreds of thousands of e-mails. We request, and offer our willingness to assist in any such effort, that the Staff consider, and hopefully issue guidance with respect to, a registered adviser's obligations to retain e-mails and how a registered adviser may comply with Staff requests without incurring such costs and burdens. In this regard, we note the concerns set forth in the letter dated May 11, 2005 submitted to the SEC by the Committee on Investment

Management Regulation of the Bar of the City of New York regarding the retention and production of e-mail by investment advisers that underscores the need for regulatory action.

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We appreciate the opportunity to identify interpretive issues and make recommendations concerning the new Rules. We would be pleased to discuss with the Commission or the Staff any aspect of this letter. Questions may be directed to Robert Todd Lang (212-310-8200) or Paul N. Roth (212-756-2450).

Respectfully submitted,

Robert Todd Lang

Robert Todd Lang, Chair
Subcommittee on Private
Investment Entities

Paul N. Roth

Paul N. Roth, Vice Chair
Subcommittee on Private
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cc: Meyer Eisenberg
Acting Director, Division of Investment Management
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Dixie L. Johnson, Chair, Committee on Federal Regulation of Securities
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Members of the Subcommittee on Private Investment Entities
Others who have reviewed a draft of this letter