UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

August 10, 2006

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Section of Business Law
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Jeffrey E. Tabak, Vice Chair, Subcommittee on Private Investment Entities
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Dear Messrs. Roth and Tabak:

This is in response to your letter of July 31, 2006 requesting our views on matters affecting investment advisers to certain private investment funds ("hedge fund advisers") that arise as a result of the decision of the United States Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC* (the "*Goldstein* opinion" or "*Goldstein* decision").[1] In the *Goldstein* decision, the Court of Appeals vacated rule 203(b)(3)-2 under the Investment Advisers Act of 1940 ("Advisers Act" or "Act") as well as other related rule amendments. The Commission adopted the rule and the amendments in 2004 in Investment Advisers Act Release No. 2333 (Dec. 2, 2004) (the "Adopting Release"). The principal design of rule 203(b)(3)-2 was to require additional hedge fund advisers to register with the Commission under the Advisers Act.

The issues you present arise because of the breadth of the *Goldstein* decision which, as you note, appears to vacate the entire rulemaking. As a result, the court may have vacated not only those provisions of the Commission rulemaking that required hedge fund advisers to treat hedge fund investors as "clients" for purposes of determining the availability of the exemption from registration under section 203(b)(3) of the Act, but

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1 *Goldstein v. Securities and Exchange Commission*, No. 04-1434, 2006 (D.C. Cir. June 23, 2006).

also other rules, interpretations, and transitional provisions designed to facilitate the ability of newly registered hedge fund advisers to conduct their operations in accordance with the Advisers Act and Commission rules.

The statements in this letter represent the views of the Division of Investment Management. To the extent that we indicate in this letter that we would not recommend enforcement action to the Commission based on the facts and circumstances in your letter, our response expresses the Division's position on enforcement only and does not purport to express any legal conclusion on the issues presented. Because any such position is based on the facts and representations in your letter, you should note that any different facts and circumstances may require a different conclusion.

Investment Advisers That Remain Registered

A. Offshore Investment Advisers to Offshore Funds

Question: In order to limit the extraterritorial application of the Act that would otherwise result from the new rule, rule 203(b)(3)-2(c) provided that an adviser having a principal office and place of business outside the United States (an "offshore adviser") may treat a private fund organized and incorporated in a country other than the United States (an "offshore fund") as its "client" for all purposes under the Advisers Act other than sections 203, 204, and 206(1) and (2). Because the Commission does not apply most of the substantive provisions of the Act to a non-U.S. client, the substantive provisions of the Act generally would not apply to the offshore adviser's dealings with the offshore fund.[2] Your letter requests confirmation that, except as outlined in the Adopting Release, offshore advisers that remain registered as investment advisers with the Commission will not be subject to the substantive provisions of the Act with respect to offshore private funds (or other non-U.S. clients).

Answer: We agree that, under principles laid out in prior staff guidance and letters, the substantive provisions of the 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. An offshore adviser registered with the Commission under the Advisers Act must, of course, comply with all of the Act and the Commission's rules thereunder with respect to any U.S. clients (and any prospective U.S. clients) it may have.

B. Records Supporting Performance Information

Question: Rule 204-2(a)(16) requires a registered investment adviser that makes use of performance information to keep certain records that "form the basis for or demonstrate the calculation of the performance or rate of return." In connection with the adoption of

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

rule 203(b)(3)-2, the Commission amended rule 204-2 to add a new paragraph (e)(3)(ii), which created a limited "transition" exception for advisers to private funds. Under this exception, certain advisers to private funds were not required to maintain books and records meeting the requirements of rule 204-2(a)(16) to support the performance of any private fund or other account for any period ended prior to February 10, 2005. The rule was designed to accommodate newly registered hedge fund advisers that may not have kept records meeting the requirements of the rule and to prevent them from being at a competitive disadvantage as a result of their inability to use their performance records if they had not maintained records sufficient to meet the requirements of rule 204-2(a)(16). You ask us to interpret paragraph (a)(16) of rule 204-2 as not applying to an investment adviser to a private fund on the same terms and conditions that were set forth in the vacated rule.

Answer: The staff would not recommend enforcement action to the Commission under section 204 of the Act or rule 204-2(a)(16) if an investment adviser that registered as a result of the Commission's adoption of rule 203(b)(3)-2 does not maintain or preserve the books and records required by rule 204-2(a)(16), provided the adviser meets the terms and conditions of vacated rule 204-2(e)(3)(ii).

C. Performance-Based Compensation Arrangements

Question: Section 205(a)(1) of the Advisers Act prohibits advisers from receiving compensation on the basis of a share of a client's capital gain or appreciation ("performance-based compensation"). Rule 205-3 under the Advisers Act provides an exemption from this prohibition with respect to persons that are "qualified clients" as defined in the rule. The Commission amended rule 205-3 to add new paragraphs (c)(2) and (3), which allowed investment advisers to private funds that registered with the Commission as a result of the adoption of rule 203(b)(3)-2 to continue receiving performance-based compensation from private funds with non-qualified investors and from other clients who are not "qualified clients" if those persons became equity investors in the private fund or entered into investment advisory contracts with the adviser before February 10, 2005, the effective date of the amendments to rule 205-3. As you point out, without this amendment, newly registered hedge fund advisers that remain registered with the Commission may be required to terminate certain existing advisory contracts and fee arrangements that provide for performance-based compensation. You therefore request the staff to interpret the exemption provided by rule 205-3 as being available to certain hedge fund advisers notwithstanding their receipt of performance-based compensation from certain persons who are not qualified clients under the rule.

Answer: The staff would not recommend enforcement action to the Commission under section 205(a)(1) of the Act against a hedge fund adviser registered with the Commission that receives performance-based compensation if and to the extent that the adviser would have been exempt from the prohibition on receiving such compensation under vacated rule 205-3(c)(2) or (3).

D. Custody Rule

Question: Rule 206(4)-2 under the Advisers Act specifies certain procedures that must be followed by registered advisers that have custody of client funds or securities. Among other things, the rule requires that quarterly account statements be provided to advisory clients, and if the account statements are provided by the adviser, the adviser must engage an independent public accountant to annually verify all client funds and securities. In the case of a client that is a limited partnership (or other type of pooled investment vehicle), the quarterly account statements must be sent to all limited partners (or members or other beneficial owners). The rule provides an exception from these requirements for a pooled investment vehicle ("fund") if it is subject to an annual audit of its financial statements prepared in accordance with generally accepted accounting principles and the audited financial statements are distributed to all limited partners (or members or other beneficial owners) of the fund within 120 days of the end of the fund's fiscal year (the "annual audit exception").[3]

When it adopted rule 203(b)(3)-2, the Commission also amended rule 206(4)-2 to extend the deadline from 120 to 180 days following a fiscal year end for delivery of audited financial statements of a "fund of funds" as defined in the rule.[4] As you point out, the amendment was designed to address the practical difficulties faced by advisers to funds of funds in obtaining completion of their final fund audits prior to completion of the audits for the underlying funds in which they invest.[5] You request that the staff interpret rule 206(4)-2 to permit an adviser to a fund of funds relying on the annual audit exception to distribute the required audited financial statements to investors in the fund of funds within 180 days following the end of the fund of fund's fiscal year.

Answer: The staff would not recommend enforcement action to the Commission under section 206(4) of the Act or rule 206(4)-2 against an adviser to a fund of funds (as such term was defined in vacated rule 206(4)-2(c)(4)) relying on the "annual audit exception" of rule 206(4)-2 if the audited financial statements of the fund of funds are distributed to investors in the fund of funds within 180 days of the fund of fund's fiscal year end.

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3 Rule 206(4)-2(b)(3).

4 A "fund of funds" was defined as a "limited partnership (or limited liability company, or another type of pooled investment vehicle) that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person (as defined in Form ADV (17 CFR 279.1)), of the limited partnership, its general partner, or its adviser."

5 *See* Section II.H of *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Investment Advisers Act Release No. 2266 (July 20, 2004).

Investment Advisers That Withdraw Their Registrations

A. Continued Availability of Section 203(b)(3)

Question: Before registering with the Commission, many hedge fund advisers relied on section 203(b)(3) of the Act, which provides an exemption from registration for any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients *and* who does not hold himself out generally to the public as an investment adviser. During the period it has been registered with the Commission, a hedge fund investment adviser may have held itself out generally to the public as an investment adviser, or taken on additional clients so that it has had more than 14 clients (counting each private fund as a single client). You request that we confirm that such an adviser could withdraw from registration by a certain date and still be able to rely on section 203(b)(3) if it ceases holding itself out as an investment adviser and reduces the number of clients it has to fourteen or fewer by the date it withdraws. In order to give a hedge fund adviser time to determine whether it wishes to remain registered with the Commission, you suggest that advisers to private funds be able to rely on this staff position if they withdraw from registration by February 1, 2007.

Answer: The staff would not recommend enforcement action to the Commission under section 203(a) of the Act against a hedge fund adviser that registered as a result of the Commission's adoption of rule 203(b)(3)-2 and that withdraws from registration in reliance on the exemption from registration provided by section 203(b)(3) without regard to whether the adviser (i) held itself out generally to the public while it was registered, and/or (ii) had more than fourteen clients while it was registered (counting each private fund as a single client). An adviser relying on this staff position must withdraw its registration with the Commission by no later than February 1, 2007. For the first 12 months following withdrawal from Commission registration, the adviser may, for purposes of assessing its eligibility for the 203(b)(3) exemption, determine the number of clients it has had (and thus the availability of the section 203(b)(3) exemption) by reference to a period of time beginning on the date of withdrawal, which may be a period of less than 12 months.

B. Form ADV-W Balance Sheet Requirement

Question: An investment adviser must file Form ADV-W to withdraw its registration under the Advisers Act.[6] Form ADV-W is filed electronically through the Investment Adviser Registration Depository (IARD). Item 7 of Form ADV-W requires an adviser to complete a balance sheet prepared in accordance with generally accepted accounting principles if the adviser responds affirmatively to one of the items on Form ADV-W

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6 Rule 203-2.

involving custody, money owed to clients, or judgments and liens.[7] Most hedge fund advisers have custody of client assets, but are no longer required to file a balance sheet with the Commission in connection with their annual update of their Form ADV registration form.[8] You state that as a matter of fairness, we should not require a balance sheet as a condition of withdrawing from Commission registration.

Answer: We would not recommend enforcement action to the Commission if a hedge fund adviser that registered as a result of the Commission's adoption of rule 203(b)(3)-2 and that withdraws from registration with the Commission in reliance on the exemption from registration provided by section 203(b)(3) (counting each private fund as a single client) by February 1, 2007 does not provide the information required in a balance sheet on Form ADV-W, Schedule W2 as a result of a "yes" answer to Item 3 of Form ADV-W. Investment advisers that have a "yes" answer to Item 3 and that wish to rely on this relief must complete a Schedule W2 but may enter "0" for all entries on Schedule W2.

Other Matters Not Raised by Letter

We are also taking this opportunity to address two other matters not raised by your letter, but which we believe will be of interest to hedge fund advisers.

A. Form ADV

Question: In connection with the adoption of rule 203(b)(3)-2, the Commission made several changes to Part 1A of Form ADV and Schedule D, which require advisers to identify and provide certain information on the "private funds" they advise. The *Goldstein* decision appears to vacate these changes and, as a result, Form ADV will revert to the version of the form that was in effect immediately prior to adoption of the rule. How should a registered investment adviser or an applicant for registration complete Form ADV?

Answer: Due to system and programming constraints, Form ADV as it appears on the IARD will continue to reflect these form changes. The Commission has directed our contractor to make the necessary changes to IARD programming. The staff will post, on the Commission's website at http://www.sec.gov/divisions/investment/iard.shtml, additional guidance on how SEC-registered advisers may complete Form ADV until these changes are implemented on the IARD.

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[7] The items relating to custody, money owed to clients, and judgments and liens are Items 3, 4, and 6, respectively, of Form ADV-W; the balance sheet must be provided on Schedule W2 to Form ADV-W.

[8] *See* Section II.E. of *Custody of Funds or Securities of Clients by Investment Advisers,* Investment Advisers Act Release No. 2176 (Sept. 25, 2003) (amending Form ADV to eliminate the requirement that advisers with custody include an audited balance sheet in their brochures to clients).

B. Access to Records

Question: When it adopted rule 203(b)(3)-2, the Commission also adopted an amendment to rule 204-2 that provided that the records of a private fund are records of the adviser (and thus subject to examination by the Commission staff), if the adviser or any related person acts as the private fund's general partner, managing member, or in a comparable capacity. Must registered hedge fund advisers provide these records to the Commission's examiners now that the rules have been vacated?

Answer: A registered investment adviser must make records available for examination in accordance with section 204 of the Act. The adviser may not evade this requirement by holding records by or through any other person, including a related person or private fund.

Sincerely,

Robert E. Plaze
Associate Director

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July 31, 2006

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Re: Interpretive Issues Raised by *Goldstein v. SEC*

Dear Mr. Plaze:

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") to request that the staff (the "Staff") of the Securities and Exchange Commission (the "Commission") address various interpretive issues affecting certain investment advisers of private investment funds ("hedge fund advisers") that arise as a result of the decision of the United States Court of Appeals for the District of Columbia Circuit (the "DC Circuit") in *Goldstein v. Securities and Exchange Commission* (the "Goldstein Opinion").[1] In the Goldstein Opinion, the DC Circuit vacated the regulatory framework for hedge fund advisers established by the Commission through its adoption of Rule 203(b)(3)-2 and amendment of Rule 203(b)(3)-1, and its amendment of other rules that had the effect of requiring many such advisers to register with the Commission as investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act").[2]

We are requesting that the Staff address the interpretive issues that arise as a result of the Goldstein Opinion that are set forth below. These issues, and

[1] Goldstein v. Sec. and Exch. Comm'n, NO. 04-1434 (D.C. Cir. June 23, 2006).

[2] *See Registration Under the Advisers Act of Certain Hedge Fund Advisers; Final Rule*, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

comments and suggestions contained herein, were identified by certain Subcommittee members.

The comments expressed in this letter have not been approved by the House of Delegates or Board of Governors of the ABA and, therefore, do not represent the official position of the ABA. In addition, this letter does not represent the official position of the Section (or any other ABA Section), the Committee or the Subcommittee, and does not necessarily reflect the views of the Subcommittee members who have reviewed it.

We respectfully request the Staff's guidance and positions with respect to the matters discussed herein prior to the first date as of which the DC Circuit's order may take effect.[3] We note that in testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, on July 25, 2006, Chairman Cox stated that he has directed the Staff to take action to ensure that the transitional and exemptive rules adopted in Release No. IA-2333, Registration Under the Advisers Act of Certain Hedge Fund Advisers (the "Adopting Release")[4], are restored to their full legal effect.[5] By responding to this request, the Staff can provide immediate assurance to the advisory community prior to any proposal and adoption of new rules or rule amendments by the Commission relating to these matters. Without clear guidance from the Staff, hedge fund advisers will face an uncertain regulatory environment.

I. Implications of the Goldstein Opinion

In pertinent part, Section 203(b)(3) of the Advisers Act exempts from registration any investment adviser who, during the preceding 12 months, has had fewer than 15 "clients" and who neither holds itself out generally to the public as an investment adviser nor acts as investment adviser to an investment company registered under the Investment Company Act of 1940 (the "Company Act") or a company that has elected to be regulated as a business development company pursuant to Section 54 of the Company Act and has not withdrawn its election (a "BDC").[6] Many hedge fund advisers have historically relied on this Section, and on

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[3] Under the Circuit Rules of the DC Circuit, the DC Circuit "ordinarily will include as part of its disposition an instruction that the clerk withhold issuance of the mandate until the expiration of the time for filing a petition for rehearing or a petition for rehearing en banc and, if such petition is timely filed, until 7 calendar days after disposition thereof." Circuit Court Rule 41. The instruction to the clerk that followed the Goldstein Opinion addressed only the situation where a petition was filed and disposed of by the DC Circuit, but was silent as to when the mandate would issue in the event that the Commission did not seek to petition for rehearing. Assuming that Circuit Court Rule 41 governs the issuance of the mandate in the absence of specific language in the order, then the mandate will issue on August 7, 2006, which is the date that the Commission's time to file a petition for rehearing or rehearing en banc expires.

[4] *Supra*, note 2.

[5] *Regulation of Hedge Funds: Hearing Before the S. Comm. On Banking, Housing and Urban Affairs*, 109th Cong. (2006) (statement of Christopher Cox, Chairman, Sec. & Exch. Comm'n).

[6] 15 U.S.C. § 80(b)-3(b)(3) (1997).

Rule 203(b)(3)-1 under the Advisers Act (as in effect prior to its recent amendment by the Commission), so as to be exempt from the requirement of registration under the Advisers Act. The Commission's action (with a compliance date of February 1, 2006) adopting Rule 203(b)(3)-2 and amending Rule 203(b)(3)-1 caused many hedge fund advisers to register as investment advisers by requiring advisers of "private funds," as defined by paragraph (d) of amended Rule 203(b)(3)-1, to count shareholders, limited partners and other owners of private funds as clients for purposes of the fewer than 15 client limitation set forth in Section 203(b)(3).[7]

In the Goldstein Opinion, the DC Circuit held that the Commission lacked the authority to adopt rules requiring hedge fund advisers to count investors in private funds as clients for purposes of Section 203(b)(3) of the Advisers Act and rejected the Commission's "equation of the term 'client' with 'investor.'"[8] The Goldstein Opinion vacated the "Hedge Fund Rule," a term that the DC Circuit indirectly defined to mean the entire Adopting Release.[9] Thus, the Goldstein Opinion can be viewed not only as vacating the adoption of Rule 203(b)(3)-2 and the amendment of Rule 203(b)(3)-1, but also as vacating various other actions and interpretations taken by the Commission in the Adopting Release, which were intended, in large part, to facilitate the ability of newly registered hedge fund advisers to conduct their operations in accordance with the Advisers Act and the rules thereunder.

The Goldstein Opinion raises issues for hedge fund advisers that registered with the Commission as a result of the Hedge Fund Rule and will remain registered as investment advisers, as well as for those hedge fund advisers that may wish to withdraw from registration as a result of the Goldstein Opinion.

II. Issues Affecting Hedge Fund Advisers That Remain Registered

Although many hedge fund advisers will no longer be required to be registered as investment advisers as a result of the Goldstein Opinion, it is likely that certain hedge fund advisers will nonetheless choose to remain registered. To address the needs of these advisers, and to avoid creating incentives for such advisers to withdraw their registrations, we believe the Staff should make available the relief from certain requirements of the Advisers Act and the rules thereunder that would have been available but for the Goldstein Opinion.

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[7] 17 C.F.R. § 275.203(b)(3)-1(d) (2006).

[8] *Goldstein*, at 2.

[9] "This is a petition for review of the Securities and Exchange Commission's regulation of 'hedge funds' under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.* *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. Pts. 275,279)("*Hedge Fund Rule*")." *Goldstein*, at 2.

A. Offshore Advisers.

In adopting Rule 203(b)(3)-2(c) under the Advisers Act, consistent with existing Staff positions relating to the exterritorial application of the Advisers Act,[10] the Commission made clear that an adviser having a principal office and place of business outside the U.S. (an "offshore adviser") and advising a private fund organized or incorporated under the laws of a country other than the U.S. (an "offshore fund") would not be subject to the substantive provisions of the Advisers Act with respect to the offshore fund, but only to the client-counting and antifraud provisions of the Act.[11] As adopted, the Rule reads "If you have your principal office and place of business outside of the United States, you may treat [an offshore fund] as your client for all purposes under the [Advisers] Act, other than Sections 203, 204, 206(1) and 206(2)."[12]

As contemplated by the Commission, although an offshore adviser would have been required to register as an investment adviser as a consequence of the amendment of Rule 203(b)(3)-1 (the rule requiring that investors in private funds be counted in determining whether an adviser had fewer than 15 clients and in determining the number of U.S. resident clients of an offshore adviser), it would not have been required to comply with many of the rules adopted under the Advisers Act, assuming it had no U.S. clients other than for counting purposes under Rule 203(b)(3)-1.[13] Moreover, in the Adopting Release the Commission stated that: "Because we do not apply most of the substantive provisions of the [Advisers] Act to non-U.S. clients of an offshore adviser, and because an offshore fund would be a non-U.S. client, the substantive provisions of the [Advisers] Act generally would not apply to the adviser's dealings with the offshore fund."[14]

Even though the Goldstein Opinion vacated the Hedge Fund Rule and, therefore, may be deemed to have vacated the interpretive positions of the Commission set forth in the Adopting Release relating to the application of the Advisers Act to offshore advisers of offshore funds, an offshore adviser required to register solely because of Rule 203(b)-1 and wishing to remain registered with the Commission may no longer be able to rely on those positions. As a result, because

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[10] *Uniao de Bancos de Brasilerios S.A.*, avalable July 28, 1992.

[11] *Registration Under the Advisers Act of Certain Hedge Fund Advisers; Proposed Rule*, 69 Fed. Reg. 45172, at 45184 (Jul. 28, 2004) (to be codified at 17 C.F.R. pts. 275, 279) ("[W]e propose to permit an offshore adviser to an offshore fund to treat the fund as its client (and not the investors) for all purposes under the Act, other than (i) determining the availability of the private adviser exemption (section 203(b)(3)), and (ii) those provisions prohibiting fraud (sections 206(1) and 206(2)) [footnotes omitted].")

[12] 17 C.F.R. § 275.203(b)(3)-2(c) (2006).

[13] For example, the following rules under the Advisers Act would not have applied to such advisers: (i) the compliance rule (17 C.F.R. § 275.206(4)-7 (2006)); (ii) the custody rule (17 C.F.R. § 275.206(4)-2 (2006)); and (iii) the proxy voting rule (17 C.F.R. § 275.206(4)-6 (2006)). *See generally*, Adopting Release, at 72072-72073.

[14] Adopting Release, text at notes 211 to 213 [footnotes omitted].

certain of such offshore fund advisers will in all likelihood remain registered with the Commission as investment advisers, we believe it appropriate for the Staff to reconfirm that, except as outlined in the Adopting Release, such offshore advisers will not be subject to the substantive provisions of the Advisers Act with respect to offshore funds or offshore clients.[15] We believe that this position would be consistent with the approach generally taken in prior Staff positions relating to the application of the Advisers Act to offshore advisers.[16]

B. Records Supporting Performance Information.

Generally, paragraph (a)(16) of Rule 204-2 under the Advisers Act requires a registered investment adviser to maintain certain specified records that form the basis for or demonstrate the calculation of performance information used by the adviser in advertising and similar materials.[17] In the Adopting Release, the Commission amended Rule 204-2 to create a limited "transition" exception from this requirement for investment advisers to private funds. Under this exception, an adviser to a private fund was not required to maintain books and records pertaining to the investment performance of any private fund or other account for any period ended prior to February 10, 2005.[18] This rule amendment was intended to facilitate the ability of an adviser to a private fund to continue to use performance information for periods prior to its registration with the Commission despite lacking for the pre-registration period all of the records needed to comply with Paragraph (a)(6) of Rule 204-2.

By vacating the Hedge Fund Rule, the Goldstein Opinion may be deemed to have vacated the amendment to Rule 204-2. Such a result will adversely affect hedge fund advisers that registered as investment advisers with the Commission in reliance upon the adoption of the amendment to Rule 203(b)(3)-1 because it may prohibit certain of these advisers from using performance information for periods ended prior to their registration under the Advisers Act. The exception to Rule 204-2 that the Commission sought to make available to advisers of private funds may well have factored into a hedge fund adviser's decision to register rather than to adopt another strategy to deal with the impending registration requirement. Not permitting hedge fund advisers this transitional relief is inconsistent with public policy because it creates an incentive for them to withdraw their registrations. For these reasons, we request that the Staff interpret paragraph (a)(16) of Rule 204-2 as inapplicable to an adviser of a private fund that makes use of investment

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[15] Nothing in the text is intended to affect the Staff's guidance regarding the recordkeeping obligations of registered advisers that are located offshore. *See* Adopting Release, notes 215, 216 and surrounding text.

[16] *See supra*, note 9. *See also Royal Bank of Canada*, available June 3, 1998.

[17] 17 C.F.R. § 275.204-2(a)(16) (2006).

[18] This relief was to be given provided that the adviser was not registered with the Commission as an investment adviser during that period and that the adviser continues to preserve any books and records in its possession pertaining to investment performance during the period.

performance for any private fund or other account for any period ended prior to February 10, 2005, provided that the adviser was not registered with the Commission as an investment adviser during that period and continues to preserve any books and records in its possession that pertain to investment performance of such fund or other account during the period.

C. Performance-Based Compensation Arrangements.

With certain exceptions, Section 205(a)(1) of the Advisers Act prohibits advisory contracts that provide for compensation to a registered investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds of a client ("performance-based compensation").[19] Rule 205-3 under the Advisers Act provides an exemption from this prohibition under which a registered investment adviser may generally receive performance-based compensation from a person that is a "qualified client," as defined by the Rule.[20]

In the Adopting Release, the Commission amended Rule 205-3 to "grandfather" existing advisory arrangements of hedge fund advisers that were required to register as a result of the amendment of Rule 203(b)(3)-1.[21] The grandfather clause would allow such advisers to continue receiving performance-based compensation from persons that are not qualified clients. Without such an amendment, many hedge fund advisers registering with the Commission would have been required to revise or terminate advisory contracts and fee arrangements that provided for performance-based compensation.

The Goldstein Opinion may be deemed to have vacated this amendment of Rule 205-3 to the extent that the DC Circuit vacated the Hedge Fund Rule. Such a result will adversely affect hedge fund advisers that were required to register as investment advisers with the Commission because of the adoption of the amendment to Rule 203(b)(3)-1 and would create an incentive for hedge fund advisers to withdraw their registrations so as not to be forced to revise or terminate contractual arrangements involving performance-based compensation. Accordingly, we request that the Staff interpret Rule 205-3 as inapplicable to an adviser of a private fund that receives performance-based compensation from a person that is not a "qualified client," as defined in Rule 205-3(d)(1), provided that: (i) the arrangements with such person were in effect prior to February 10, 2005; and (ii) the adviser was exempt from registration pursuant to Section 203(b)(3) of the Advisers Act prior to February 1, 2006.

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[19] 15 U.S.C. § 80(b)-5(a)(1) (1997).

[20] The term "qualified client" is defined in paragraph (d)(1) of Rule 205-3.

[21] 17 C.F.R. § 275.205-3(c)(1),(c)(2) (2006).

D. Custody Rule.

In the Adopting Release, the Commission also amended Rule 206(4)-2 under the Advisers Act. That Rule specifies certain procedures that must be followed by registered investment advisers having custody of client funds or securities. Paragraph (a)(3) of the Rule generally requires that a client be provided with either: (i) quarterly account statements by a qualified custodian identifying the amount of funds and of each security in its account and setting forth all transactions in its account; or (ii) a similar quarterly account statement by the adviser and, in the latter case, that an independent public accountant verify all funds and securities by conducting an examination once each year at a time chosen by the accountant without prior notice to the adviser and provide notice to the Commission of material discrepancies.[22] In the case of a client that is a limited partnership (or other type of pooled investment vehicle), the quarterly account statements must be sent to each limited partner (or member or other beneficial owner).[23] Paragraph (b)(3) of Rule 206(4)-2 provides an exception from these requirements for limited partnerships and other pooled investment vehicles if there is an annual audit of their financial statements prepared in accordance with generally accepted accounting principles and such financial statements are distributed to all limited partners (or members or other beneficial owners) within a specified period following the end of the fund's fiscal year.[24]

The amendment of Rule 206(4)-2 extended the deadline for delivery of audited financial statements to investors from 120 to 180 days following fiscal year end for a "fund of funds" as defined by the Rule. A "fund of funds" was defined by paragraph (b)(3) to mean a limited partnership, limited liability company or other type of pooled investment vehicle, that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a "related person," as defined in Form ADV, of the limited partnership or other pooled vehicle, its general partners or its adviser.[25] The Commission provided this extended period for distributing audited financial statements of funds of funds recognizing that advisers to funds of funds may not be able 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. This extended period was made available to all registered investment advisers and not just to private fund advisers that registered because of the amendment of Rule 203(b)(3)-1.

The Goldstein Opinion may be deemed to have vacated the amendment of Rule 206(4)-2 to the extent that it vacated the Hedge Fund Rule. However, given the practical difficulty that would be faced by advisers of funds of funds if they

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[22] 17 C.F.R. § 275.206(4)-2(a)(3) (2006).

[23] The requirements of Rule 206(4)-2 are not applicable to pooled investment vehicles that are registered under the Company Act. 17 C.F.R. § 275.206(4)-2(b)(4) (2006).

[24] 17 C.F.R. § 275.206(4)-2(b)(3) (2006).

[25] *Id.*

were required to distribute audited annual financial statements to investors within 120 days, we believe that the Staff should interpret Rule 206(4)-2 so as to permit an adviser to a "fund of funds" to distribute such financial statements to investors within 180 days following the end of the fund of fund's fiscal year.

III. Issues Affecting Hedge Fund Advisers that Withdraw their Registrations

The Goldstein decision also has implications for hedge fund advisers that registered as a consequence of the amendment of Rule 203(b)(3)-1 and may now have determined to withdraw their registrations if and when the order of the DC Circuit set forth in the Goldstein Opinion takes effect. We believe that, in fairness to these hedge fund advisers, the provisions of the Advisers Act and the rules thereunder should be interpreted by the Staff so as: (i) to ensure that withdrawing hedge fund advisers may rely on Section 203(b)(3) under the Advisers Act beginning as of the date their withdrawal from registration with the Commission is filed and (ii) to minimize the requirements applicable to these advisers in connection with their withdrawal from registration.

A. Effect of Existing Regulations on Withdrawing Hedge Fund Advisers.

With respect to hedge fund advisers that were required to register solely as a result of the requirements of amended Rule 203(b)(3)-1 and Rule 203(b)(3)-2 and who seek to withdraw their registrations as investment advisers, we request that the Staff confirm that: (i) an adviser to a private fund that withdraws its registration will not be deemed to have violated any provision of the Advisers Act or the rules thereunder (other than those that are applicable to unregistered advisers) as a result of any act or omission of such adviser occurring subsequent to the date it files a Form ADV-W with the Commission, provided that the adviser files its Form ADV-W on or before a specified date;[26] and (ii) an adviser to a private fund that withdraws by the specified date will not be precluded from again relying on the Section 203(b)(3) exemption from registration as an investment adviser if, during the period it was registered as an adviser, it held itself out generally to the public as an investment adviser or had more than 14 clients (excluding investors in funds that would not have been treated as clients but for the amendment of Rule 203(b)(3)-1). We believe that it is appropriate for the Staff to interpret the Advisers Act in this manner because hedge fund advisers that registered solely because of the

[26] We recommend that the Staff specify February 1, 2007 as the date by which advisers to private funds must file a Form ADV-W if they wish to rely on this requested Staff position. This will provide hedge fund advisers a reasonable period of time within which to make a reasoned decision about whether to remain registered and to assure that those hedge fund advisers that withdraw from registration have a reasonable period of time within which to take any steps necessary for them to rely on the Section 203(b)(3) exemption from registration. Hedge fund advisers that do not file their Form ADV-Ws by February 1, 2007 would be treated as fully subject to the Advisers Act and the rules thereunder from the date of their registration like any other registrant.

amendment of Rule 203(b)(3)-1, which has now been vacated, and determine within a reasonable period to withdraw from registration in light of the Goldstein Opinion should not be prejudiced by having complied with the Commission's rules or by having engaged in conduct permissible for registered advisers during the period of their registration.

With respect to these matters, we believe that the interpretations we request are necessary in order to clarify that hedge fund advisers that withdraw their registrations will not be deemed to have violated any provision of the Advisers Act or its rules applicable solely to registered advisers if they do not comply with any requirements of such provisions after they cease to be registered. One example illustrating the need for the Staff to address this matter relates to compliance with Rule 206(4)-2. In this regard, a hedge fund adviser may not have sent any quarterly statements to investors in private funds or other investment vehicles for which it serves as investment adviser in reliance on its expectation that within 120 days after the end of the current fiscal year (*e.g.*, December 31, 2006) it would distribute audited financial statements to investors in those private funds or other vehicles. If the hedge fund adviser files a Form ADV-W to withdraw from registration after the order of the DC Circuit takes effect, and subsequently does not distribute audited financial statements within the period required by Rule 206(4)-2, it should not be deemed to have violated that Rule.

Similarly, there is a need for the Staff to clarify that a hedge fund adviser that during the period of its registration as an adviser held itself out generally to the public as an investment adviser or took on additional clients should not be prejudiced by such actions, provided that it ceases holding itself out, reduces the number of clients that it advises to fewer than 15, or both, as applicable, on or prior to the date it files its Form ADV-W with the Commission. In this regard, the ability of a hedge fund adviser to withdraw its registration will depend on the availability of the exemption provided by Section 203(b)(3) of the Advisers Act. As previously noted, Section 203(b)(3) provides that the registration requirement of the Advisers Act does not apply to any investment adviser who during the course of the preceding 12 months has had fewer than 15 clients and who neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any registered investment company or BDC.

Under the circumstances, we believe it reasonable and appropriate for the Staff to interpret Section 203(b)(3) as applicable to a hedge fund adviser that withdraws its registration by a specified date[28] so that such adviser will not be precluded from relying on the Section 203(b)(3) exemption from registration if during the period it was registered it held itself out generally to the public as an investment adviser or had 15 or more clients.

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[28] See note 26, *supra*.

B. Form ADV-W Balance Sheet Requirement.

Item 7 of Form ADV-W requires an adviser withdrawing from registration under the Advisers Act 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 generally accepted accounting principles, if: (i) the adviser or a related person of the adviser has "custody" over client cash or securities; (ii) the adviser has received advisory fees for investment advisory services or publications that it has not rendered or delivered or has borrowed money from clients that it has not repaid; or (iii) there are any unsatisfied judgments or liens against the adviser.

In many cases, hedge fund advisers are deemed to have custody of client cash or securities.[29] However, because hedge fund advisers registered with the Commission are not registered under the laws of any state,[30] such advisers have not generally been required to include their balance sheets on Schedule G of Part II of their Form ADVs.[31] Most hedge fund advisers are, therefore, not required to provide their balance sheets to clients (as part of the Form ADVs they deliver to clients). Moreover, except for the requirement of Form ADV-W, there is no requirement that an adviser file a balance sheet with the Commission. Thus, except for the requirement of Form ADV-W, hedge fund advisers registered with the Commission generally are not required to provide their balance sheets to clients or to file their balance sheets with the Commission.

In view of the foregoing, we believe that as a matter of sound regulatory policy and fairness the Staff should interpret the requirements of Form ADV-W requiring the filing of a balance sheet as inapplicable to hedge fund advisers that withdraw from registration on or before a specified date.[32]

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In summary, we believe that there are important implications of the Goldstein Opinion that affect hedge fund advisers and that it would be appropriate for the Staff to address these implications by issuing interpretive advice as requested

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[29] The definition of "custody" in Rule 206(4)-2(c) means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. Custody includes: "[a]ny capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities." Because many hedge fund advisers form their domestic private funds as limited partnerships or limited liability companies and use an affiliated entity under common control and sharing the same offices as the investment adviser to act as general partner for a limited partnership or managing member for a limited liability company, the adviser may be deemed to have custody over the assets of a domestic private fund.

[30] Section 203A of the Advisers Act.

[31] Item 14 of Part II of Form ADV requires that an adviser having custody of client funds or securities include an audited balance sheet of the adviser on Schedule G of its Form ADV, but this requirement is not applicable to an adviser registering or registered only with the Commission.

[32] See note 26, *supra*.

herein. We appreciate the Staff's attention to this matter and its consideration of the issues we have identified. We would be pleased to discuss with you and other members of the Staff any aspect of this letter. Questions may be directed to Paul N. Roth at (212)-756-2450 or to Jeffrey E. Tabak at (212) 310-8343.

Respectfully submitted,

Paul N. Roth, Chair
Subcommittee on Private
Investment Entities

Jeffrey E. Tabak, Vice Chair
Subcommittee on Private
Investment Entities

cc: The Hon. Christopher Cox, Chairman, Securities and Exchange Commission
Andrew Donohue, Director, Division of Investment Management
Douglas J. Scheidt, Associate Director and Chief Counsel
Dixie L. Johnson, Chair, Committee on Federal Regulation of Securities
Keith F. Higgins, Vice Chair, Committee on Federal Regulation Securities
Members of the Subcommittee on Private Investment Entities