

T O O U R F R I E N D S A N D C L I E N T S

M e m o r a n d u m



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SEC Addresses Principal Transactions For Private Fund Advisers

The SEC staff recently issued a no-action letter clarifying its position regarding the treatment of private funds as principal accounts for purposes of Section 206(3) of the Advisers Act. The letter essentially provides that a private fund will not be viewed as a principal account of an adviser where the adviser and its control persons own, in the aggregate, 25% or less of the fund. See *Gardner Russo & Gardner*, SEC No-Action Letter (June 7, 2006), available at:

www.sec.gov/divisions/investment/noaction/gardner060706.htm.

Background

The application of Section 206(3) to private funds (including hedge funds and private equity funds) has proved challenging for industry participants, including regulatory attorneys and compliance personnel. In particular, industry participants have struggled to determine what level or percentage of ownership by the adviser and its personnel would cause a private fund to be viewed as a principal account. The challenge was highlighted by an SEC's enforcement action Gintel Asset Management in 2002 where the SEC viewed an investment fund that was 34% owned by the adviser's control person to be a principal account of the adviser.

The resolution of this issue is particularly significant for private fund advisers because these firms and their personnel typically invest, either directly or through an affiliated general partner, in the private funds they manage. Some of these advisers also effect cross transactions between private funds (or between private funds and separately managed accounts) for rebalancing and other purposes. Section 206(3) generally prohibits cross transactions involving principal accounts unless, prior to the completion of each such transaction, the adviser (1) discloses to the client in writing the capacity in which the adviser is acting and (2) obtains the client's consent to the transaction. Obtaining consents can prove cumbersome and some uncertainty surrounds the question of who may provide consent in the case of a private fund.

As recently as last year, the SEC staff was asked to provide specific guidance on this issue. In response, the staff offered only limited guidance that suggested a facts and circumstances analysis. See *Letter to the American Bar Association*, SEC No-Action Letter (Dec. 8, 2005), available at:

www.sec.gov/divisions/investment/noaction/aba120805.htm.

SEC Staff Position

In the *Gardner* letter, the SEC staff considered whether a private fund would be viewed as a principal account where a general partner of the fund's investment manager, who was also the sole general partner and portfolio manager of the fund, owned a 6.237% interest in the fund. The SEC staff determined that this level of ownership interest by the partner did not cause the fund to be a principal account for purposes of Section 206(3). The staff's conclusion was based in part on the representation

that neither the adviser nor any employees other than the partner had any additional ownership interest in the fund.

More significantly, the SEC staff provided broader guidance on the principal account issue. The staff concluded that Section 206(3) would not apply to a transaction between a client account and a private fund of which the investment adviser and/or its controlling persons, in the aggregate, own 25% or less. Section 206(3) would apply, however, if the percentage ownership exceeds 25%. In its discussion, the SEC staff emphasized that it would treat ownership interests of controlling persons of an investment adviser as essentially belonging to the adviser and such interests must therefore be included when calculating the 25% threshold. The staff also noted that for purposes of this analysis, advisers should look to the definition of control in Section 202(a)(12) of the Advisers Act, which defines control as “the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.”

Finally, the SEC staff reminded advisers that cross transactions, including those involving private funds in which an adviser and its personnel have an ownership interest, present the opportunity for significant conflicts of interest. Because these transactions also are subject to the Advisers Act anti-fraud provisions, an adviser has a duty to make full and fair disclosure of all material facts regarding cross transactions.

Open Issues

Despite the SEC’s clarification regarding ownership percentages, certain related issues remain unresolved, including the following:

- Ownership interests of non-controlling persons. The SEC staff noted that the requesting letter did not ask for guidance regarding the treatment of ownership interests by non-controlling persons employed by an adviser. Accordingly, the SEC staff affirmatively took no position regarding whether those interests must be aggregated when calculating the 25% threshold. We believe that this determination will generally depend on a non-control person’s role within the adviser, including with respect to the investment decision making process.
- Ownership interests of a control person’s family members. The SEC staff did not expressly state that an adviser should apply a beneficial ownership test when calculating a control person’s percentage ownership interest. However, the staff suggested that it may be appropriate to aggregate the ownership interest of a control person’s family members, including a spouse or dependent child. For the sake of simplicity, we recommend that advisers apply a beneficial ownership test, which would result in the aggregation of ownership interests held by a spouse and dependent children.

Compliance Tips

We expect that industry participants will find the SEC staff’s guidance very helpful. In relying on this guidance, we recommend that investment advisers consider taking the following compliance-related steps:

1. Periodically calculate ownership percentages. An adviser should periodically calculate the ownership percentage of any private fund that is attributable to the adviser, its control persons and any other firm personnel to determine whether the fund will be viewed as a principal account for purposes of Section 206(3). If the aggregate percentage approaches 25% of a fund, the adviser should perform the calculation more frequently and, if necessary, prior to each cross trade involving that fund.

2. Review internal compliance procedures. An adviser should consider the potential conflicts of interest involved in effecting cross trades, including the possibility that one private fund or account could be favored over another. In particular, an adviser should have appropriate pricing procedures that are applied on a consistent basis whenever the adviser effects a cross trade. An adviser also should ensure that the transaction is in the best interest of all participating private funds and/or accounts. Finally, an adviser should occasionally evaluate cross trades over a period of time to determine that no patterns of favoritism appear to exist.

3. Reevaluate client disclosures. An adviser that engages in cross trades should have appropriate disclosure in its private fund offering documents and its Form ADV (if registered). An adviser should take this opportunity to review its disclosures to ensure that, among other matters, the disclosures note: (1) the potential conflicts of interest that may arise in connection with cross trades, including that the adviser and its personnel may have different economic interests in the participating funds and will have a potentially conflicting division of loyalties and responsibilities to clients on both sides of the transaction; (2) whether the adviser might also engage in principal transactions; and (3) in the case of the Form ADV, a brief description of the adviser's policies and procedures regarding cross trades.

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If you have any questions about this memorandum or want to discuss in more detail the recent SEC staff guidance, please call **Terrance O'Malley** at (212) 859-8402 or **Jessica Forbes** at (212) 859-8558, or any of the other partners in the Fried Frank Asset Management Group.

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