

INVESTMENT FUNDS ALERT

SEC ISSUES GUIDANCE ON ABILITY OF PRIVATE FUND MANAGERS TO ENGAGE IN CROSS TRADES



On June 7, 2006, the staff of the Securities and Exchange Commission (SEC) issued a no-action letter that allows a registered investment adviser serving as investment manager to two private investment funds (each, a Fund) to perform cross trades between the two Funds without first obtaining client consent as long as the adviser has less than a 25 percent ownership interest in each Fund.¹ The issue presented before the SEC staff was whether the adviser would be required to treat cross trades between the two Funds for which it acts as discretionary investment manager as “principal transactions” under Section 206(3) of the Investment Advisers Act of 1940 (Advisers Act).

ANALYSIS

Section 206(3) of the Advisers Act prohibits an investment adviser acting on a “principal” basis for its own account to conduct transactions with a client unless the adviser first discloses in writing the capacity in which it is acting and obtains the consent of the client. As noted by the SEC staff, principal transactions present the potential for conflicts between the interests of the adviser and the client and create the potential for advisers to engage in self-dealing.

As noted above, the adviser acts as investment manager to various client accounts, including two Funds. The adviser is organized as a general partnership and the general partner of the adviser is the sole general partner and portfolio manager of each Fund (the Partner). The Partner has a 6.237 percent ownership interest in one Fund and a 1.4405 percent ownership interest in the other Fund. The adviser noted that due to cash flow needs of the various accounts it manages, it would often be beneficial to sell a security for one account and buy the same security on behalf of another. The adviser sought the ability to conduct cross trades between accounts, including the Funds, without first having to obtain consent from its clients, as is required by Section 206(3) of the Advisers Act.

In its request for no-action relief, the adviser proffered that the Partner’s ownership interest in each Fund should not implicate Section 206(3) of the Advisers Act unless the Partner owns 25 percent or more of a Fund. In its response, the SEC staff concurred with this position, with

¹ See *Gardner Russo & Gardner* (June 7, 2006, File No. 801-41357), available at www.sec.gov/divisions/investment/noaction/gardner060706.htm.

a few caveats that are worth noting. First, in determining the ownership interest of the adviser, the SEC staff looked to both the interests of the adviser and its controlling persons and noted that neither the adviser nor any of its employees other than the Partner had any additional ownership interest in either Fund. In the letter, the SEC staff takes the position that interests of controlling persons of the adviser must be aggregated with the interest of the adviser to determine whether or not the combined interest of the adviser and its controlling persons is more than 25 percent of a Fund.

Second, the SEC staff noted that cross trades where the adviser owns 25 percent or less of an interest in an account may still present a potential conflict of interest, and reminds that such transactions continue to be subject to Sections 206(1) and (2) of the Advisers Act, which impose a fiduciary duty upon an investment adviser to deal fairly with its clients and disclose all material facts. Thus, under these provisions, the adviser may still be required to disclose information about the transactions (although presumably not obtain prior consent), even though Section 206(3) does not apply. Finally, the SEC staff suggests that in adopting procedures related to cross transactions involving accounts where the adviser has an ownership interest, compliance personnel should consider other interests, such as those of family members and others with social and/or business relationships with the adviser and/or its controlling persons, as well as economic interests of the adviser, that may create incentives to favor one account over another.

PRACTICAL CONSIDERATIONS

Determine ownership percentages. Unfortunately, the SEC staff did not provide much guidance regarding how the 25 percent ownership threshold should be determined. For example, the SEC staff did not address whether, under certain circumstances, the adviser's incentive fee or carried interest should be counted for purposes of the 25 percent test.² Regarding aggregation of ownership interests for purposes of the threshold, the SEC staff noted that it may be appropriate to consider the interests of family members, such as a spouse or child, with relationships to the adviser. Although the SEC staff did not provide a methodology for performing such an analysis, advisers should consider applying a beneficial ownership test to determine whether interests of family members should be aggregated with that of a principal of the adviser for purposes of the calculation.

Review policies and procedures regarding cross trades. An adviser's policies and procedures regarding the circumstances under which it will engage in cross transactions should be reviewed to ensure that potential conflicts of interest associated with such trades are considered. Procedures should address both how the adviser will ensure, prior to the trade being executed, that the transaction is in the best interest of all participating accounts, as well as a process for reviewing trades after they occur on a regular periodic basis to determine whether all accounts have been treated fairly over time. In addition, procedures should be implemented to periodically review the adviser's ownership interest in any private investment funds under management to determine whether the fund would be deemed a principal account for purposes of Section 206(3) of the Advisers Act. It should be noted that the SEC staff's guidance only relates to the applicability of the Advisers Act to cross transactions. The ability of advisers to engage in cross transactions on behalf of accounts subject to ERISA is further restricted by that statute and procedures should be drafted accordingly.

Review Form ADV disclosure. If an adviser contemplates engaging in cross transactions between client accounts, the adviser should ensure that its Form ADV includes: (1) a summary of the adviser's policies and procedures regarding cross trades, including procedures related to principal transactions, and (2) disclosure regarding the potential conflicts

² The staff noted that "control," for purposes of the Advisers Act, is defined under Section 202(a)(12) as "[T]he 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." An argument could be made, for example, that under certain circumstances the adviser's incentive fee or carried interest could be deemed an ownership interest in a private investment fund given the added economic interest it may provide to the adviser.

of interest that may arise in connection with such trades, including differing economic interests and conflicting loyalties that an adviser may have on either side of a transaction by virtue of its relationship with each client.

CONCLUSION

We believe that this letter provides private investment fund managers with much-needed clarification regarding the ability to engage in cross transactions between funds and other accounts under management, to create efficiencies and reduce transaction costs for clients.

CONTACT INFORMATION

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