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

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Investment Management Regulatory Update

A number of significant developments occurred at the SEC during the first quarter of the year. This Client Alert summarizes some of the more significant developments as they relate to hedge fund and other private fund advisers.

I. Comment Period Ends for SEC Proposed Amendments to the "Accredited Investor" Rules

March 9th marked the closing of the comment period for the SEC's proposed amendments to the "accredited investor" rules and the proposed new Advisers Act anti-fraud rule for fund managers. The comment letters received by the SEC are available at: www.sec.gov/comments/s7-25-06/s72506.shtml. Fried Frank submitted a comment letter in which we requested that the SEC permit an employee of a 3(c)(7) Fund or a 3(c)(1) Fund or its investment adviser to invest in the vehicle if he or she is a "knowledgeable employee" as defined in Rule 3c-5 under the Investment Company Act without meeting the applicable accredited investor standard. We also suggested that the SEC propose a rule easing the restriction on general solicitations for 3(c)(7) Funds and 3(c)(1) Funds if the new accredited investor standards are adopted. In addition, we urged the SEC not to allow the proposed Advisers Act anti-fraud rule to be used as a means for indirectly creating additional regulatory requirements for hedge fund and other private fund advisers through the SEC's inspection program. A copy of the Fried Frank letter can be found at: www.sec.gov/comments/s7-25-06/s72506-550.pdf. We expect that the SEC may take up to several months to review the comments before adopting any final rules and rule amendments.

II. No-Action Letters

A. SEC Staff Permits Certain Charitable Foundations to be Treated as "Qualified Purchasers"

On March 13, the Division of Investment Management issued a no-action letter expressing the staff's view that certain charitable foundations formed as non-profit, non-stock corporations and that qualify for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code may be treated as "qualified purchasers" under Section 2(a)(51)(A) of the Investment Company Act. The staff's letter clarifies an apparent anomaly arising under the definition of a "qualified purchaser" in which a charitable foundation

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formed as a trust might meet the definition, but a similar charitable foundation formed as a corporation would not meet the definition. The SEC staff agreed that a charitable trust formed as a corporation can be treated as a "qualified purchaser" provided that it was not formed for the specific purpose of acquiring interests in a 3(c)(7) Fund and either (1) all of the persons who have contributed assets to the corporation are related in one or more ways enumerated in Section 2(a)(51)(A)(ii) and the corporation owns not less than $5 million in "investments" or (2) each person authorized to make investment decisions with respect to the corporation, and each person who has contributed assets to the corporation, is a "qualified purchaser" within the meaning of subsections (i), (ii) or (iv) of Section 2(a)(51)(A). The request letter was prepared by Fried Frank partner Jessica Forbes. *See Goldman Sachs Asset Management, L.P.*, SEC No-Action Letter (March 13, 2007), available at: www.sec.gov/divisions/investment/noaction/2007/gsam031307-3c7.htm.

B. SEC Staff Allows Limited Use of Hedge Clauses in Advisory Agreements

On February 12, the Division of Investment Management issued a no-action letter allowing an adviser to use hedge clauses in investment advisory agreements under certain circumstances. More specifically, the SEC staff stated generally that the use of the terms "gross negligence" and "willful malfeasance" in an advisory agreement to describe an adviser's degree of liability would not *per se* violate Sections 206(1) and (2) under the Advisers Act. Rather, the determination would turn on all of the facts and circumstances including (1) whether the client was sophisticated and (2) whether the advisory agreement also contained adequate disclosure informing the client that it had not otherwise waived rights under applicable federal securities laws or other laws. In stating its position, the SEC staff suggested that sophisticated clients could include, among others, registered investment companies; "qualified institutional buyers" as defined in Rule 144A under the Securities Act; "qualified clients" as defined in Rule 205-3 under the Advisers Act; and "qualified purchasers" as defined in Section 2(a)(51) of the Investment Company Act. The SEC's no-action letter represents a modification from the position it previously took in a 1974 no-action to *Auchincloss & Lawrence Inc*. *See Heitman Capital Management, LLC*, SEC No-Action Letter (Feb. 12, 2007), available at: www.sec.gov/divisions/investment/noaction/2007/heitman021207.pdf.

C. SEC Staff Relaxes Code of Ethics Reporting of Certain UK Fund Securities

On March 1, the Division of Investment Management issued a no-action letter permitting an adviser to treat securities of certain UK-regulated investment funds as non-"reportable securities" for purposes of the adviser's code of ethics. Rule 204A-1 requires that an adviser's access persons must disclose personal holdings of, and transactions in, all "reportable securities." The definition of "reportable securities" generally excludes securities issued by SEC-registered mutual funds, but does not extend this exclusion to offshore mutual funds. The SEC staff's recent no-action letter extends the exclusion to

securities issued by limited types of investment vehicles regulated under the laws of the United Kingdom. These excluded securities must be issued by specifically-identified investment vehicles that are generally structured and operated similarly to SEC-registered mutual funds and that effect purchases and sales on a forward pricing basis. *See M&G investment Management Ltd.*, SEC No-Action Letter (Mar. 1, 2007), available at: www.sec.gov/divisions/investment/noaction/2007/mgim030107-204a-1.pdf.

D. SEC Staff Clarifies Certain Soft Dollar Arrangements

On January 17, the Division of Market Regulation issued a no-action letter affirming that third parties who provide research services and are compensated from a commission pool set aside in client commission arrangements under Section 28(e) do not also need to register as broker-dealers merely because they receive payment from the executing broker. In affirming this position, the SEC staff included a number of conditions, including generally that (1) the adviser retains responsibility for determining that the commissions paid are reasonable in relation to the value of the research services, although the adviser can receive input from the research provider; (2) the executing broker is not involved in determining the value of the research services; (3) the research provider receives payment from a pool of commissions that, by agreement between the executing broker and the adviser, the executing broker has set aside for obtaining the third-party research; (4) payment to the research provider is not conditioned, directly or indirectly, on the execution of any particular transaction(s) in securities that are described or analyzed in the research services; and (5) the research provider does not perform other functions that are typically characteristic of broker-dealer activity. *See Goldman Sachs & Co.*, SEC No-Action Letter (Jan. 17, 2007), available at: www.sec.gov/divisions/marketreg/mr-noaction/2007/goldmansachs011707-15a.pdf.

III. Director of the Division of Investment Management Outlines Regulatory Priorities

On March 22, Andrew Donohue delivered a speech in which he reviewed regulatory priorities for the investment adviser industry. First, the Division of Investment Management will generally be reviewing existing investment adviser regulations to determine whether certain regulations may no longer be relevant or necessary or could be improved to reflect modern practices. Second, the Division is conducting a comprehensive review of recordkeeping requirements, particularly in light of technological advances. The Division also may issue specific e-mail guidance in connection with this review. Third, the Division anticipates recommending that the SEC re-propose amendments to Form ADV Part 2 to account for industry and regulatory developments that have occurred since the amendments were first proposed in 2000. Fourth, the SEC has arranged for a third-party, independent contractor to study the activities of broker-dealers and investment advisers. The Division will consider the results of this study and what if any additional regulations are necessary to delineate the two function while ensuring that investors receive important protections. Finally, the Division is in the process of evaluating comments received on

its proposed new Advisers Act anti-fraud rule that will impact hedge fund advisers, as well as amendments to the "accredited investor" standard for hedge fund investors. *See Speech by Andrew J. Donohue: Remarks Before the IA Week and the Investment Adviser Association 9th Annual IA Compliance Best Practices Summit* (March 22, 2007), available at: www.sec.gov/news/speech/2007/spch032207ajd.htm.

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