SEC NO-ACTION LETTER PROVIDES GUIDANCE UNDER SECTION 206(3) OF THE ADVISERS ACT ON CROSS TRADES BETWEEN CLIENT ACCOUNTS AND ACCOUNTS OWNED IN PART BY THE ADVISER

On June 7, 2006, the Office of the Chief Counsel of the Division of Investment Management of the Securities and Exchange Commission issued a no-action letter dealing with a subject that has become a thorn in the side of many investment advisers. The subject is the applicability of Section 206(3) of the Investment Advisers Act of 1940 to transactions between an investment vehicle in which an adviser has an ownership interest and other clients of the adviser. On its face, Section 206(3) applies only to transactions between an adviser and its clients. However, the SEC and the SEC staff (the "Staff") have read the provision broadly as potentially applying to transactions between a client of the adviser and an investment vehicle deemed proprietary to the adviser.

In a no-action letter to Gardner Russo & Gardner, the Staff has now taken the position that Section 206(3) will not apply to a cross transaction between a client account and an account of which the investment adviser and/or its controlling persons, in the aggregate, own 25% or less.[1] The Staff further stated that an account of which the adviser and/or its controlling persons hold in excess of 25% would be deemed to be a principal account for purposes of Section 206(3).

Facts Presented by *Gardner*

Gardner Russo & Gardner ("GRG") is as investment adviser to various client accounts and to two investment limited partnerships (the "Funds"). An entity that controls GRG acts as the general partner of the Funds and holds a 6.237% interest in the first Fund and a 1.4405% interest in the second Fund. Neither GRG nor any employee of GRG has an ownership interest in the Funds. Due to timing of capital flows into and out of the client accounts and the Funds, GRG from time to time disposes of a particular security from one account that it is contemporaneously acquiring for a Fund. GRG sought assurances from the Staff that it would not recommend enforcement action against it if GRG were to cross the trades of a Fund with another account to, among other things, reduce transaction costs.

Section 206(3) of the Advisers Act and the *Gardner* ruling

Section 206(3) of the Advisers Act, in relevant part, makes it unlawful for any investment adviser (whether or not registered), directly or indirectly, acting as principal for its own account, knowingly to sell any security to, or purchase any security from, a client without specifically disclosing to such client in writing, before the completion of the transaction, the capacity in which the adviser is acting and obtaining the client's prior consent to the transaction. Section 206(3) is intended to address the potential for self-dealing that could arise when an investment adviser acts as principal in transactions with clients.

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[1] *Gardner Russo & Gardner*, SEC No-Action Letter, publicly avail. June 7, 2006.

The SEC, in an enforcement settlement years ago, and the Staff more recently, have taken the position that whether Section 206(3) applies to transactions involving client accounts and accounts in which an investment adviser and/or its personnel have ownership interests depends upon all of the facts and circumstances.[2] Two significant factors for determining whether a client account is tantamount to a principal account are identified and addressed by the Staff in *Gardner*: (1) the nature of the relationship of the owners of the account to the investment adviser and (2) the extent of the ownership interest of the investment adviser and/or its personnel in the account. As stated above, the Staff in *Gardner* concluded that an account of which an adviser and/or its controlling persons own in excess of 25% of the interests would constitute a principal account for purposes of Section 206(3), while an account of which 25% or less of the ownership interests are owned by such persons would not constitute a principal account for purposes of Section 206(3).

In *Gardner*, the Staff stated, with respect to the relationship of the owners of the account to the investment adviser, that it would deem the ownership interest of a controlling person of an investment adviser to be the ownership interest of that adviser. Thus, according to the Staff, an investment adviser may be acting "as principal for his own account" for purposes of Section 206(3) in effecting transactions involving the account, depending on the extent of the controlling person(s) and the investment adviser's aggregate ownership interest in the account.

We note that although the *Gardner* letter provides greater clarity as to what accounts do and do not constitute principal accounts, certain questions remain unresolved. For example, the Staff does not address the effect of an ownership interest in a client account by non controlling personnel of the adviser, if any, nor does it address whether an incentive fee, an incentive allocation or the existence of a significant amount of deferred compensation would be counted toward an adviser's ownership interest in a private fund or account when applying the 25% test.

Anti Fraud Rules of Section 206 and ERISA Continue to Apply to Cross Trades

Cross trades undertaken by hedge fund managers and other advisers raise issues not only under Section 206(3), but also under Section 206(1) and Section 206(2) of the Advisers Act and under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

In reaching its conclusion in *Gardner*, the Staff noted that ownership interests of an investment adviser and/or its controlling persons of 25% or less of an account may present the opportunity for significant conflicts of interest between an investment adviser and its clients, creating incentives to overreach and treat unfairly the clients with which the account engages in transactions. Cross transactions involving such an account may therefore implicate Sections 206(1) and (2) of the Advisers Act. Sections 206(1) and 206(2) are the anti fraud provisions of

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[2] Letter from Office of Chief Counsel, Division of Investment Management, SEC to Subcommittee on Private Investment Entities, American Bar Association (Dec. 8, 2005), *available at* http://www.sec.gov/divisions/investment/noaction/aba120805.htm.

the Advisers Act and have been read to impose a federal fiduciary duty on an investment adviser with respect to its clients and a duty of full and fair disclosure of all material facts. Those provisions may require an investment adviser to disclose information about transactions effected by the adviser involving any account in which the adviser and/or its controlling persons have an ownership interest, regardless of whether Section 206(3) also applies.

In addition, if a client account is subject to ERISA, cross transactions between that account and an account in which the adviser or its personnel have an interest may be prohibited by that statute even though permitted under the Advisers Act.

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