Securities Law Committee
Of the Business Law Section
Washington State Bar Association

May 17, 2013

Jill Vallely, Associate General Counsel
Department of Financial Institutions, Securities Division
P.O. Box 9033
Olympia, WA 98507-9033

Via Email

Re: Proposed Investment Adviser Rules

Dear Ms. Vallely:

This letter represents the views of the Securities Law Committee ("**Committee**") of the Business Law Section of the Washington State Bar Association ("**WSBA**"). The Committee's members, approximately 30 lawyers who practice in the field of corporate law and securities regulation, represent small, medium and large businesses throughout the state of Washington. This letter was approved by more than 75% of the Committee. Neither the Board of Governors of the WSBA nor the Business Law Section of the WSBA has taken a position on the Proposed Investment Advisor Rules, nor does this letter necessarily represent the views of individual members of the WSBA or their associated firms or companies.

The Committee has reviewed the proposed rules of the Securities Division ("**Division**") of the Washington State Department of Financial Institutions ("**DFI**") amending and, in some cases, adding new sections to, the investment adviser rules contained in Chapter 460-24A WAC (the "**Proposed Rules**"). This letter raises concerns with the Division's overall regulatory approach to investment advisers and, in the attached appendix, provides specific comments and suggestions with respect to certain of the Proposed Rules.

Introduction

The Proposed Rules continue the evolution of investment adviser regulation. Most of the Proposed Rules emanate from changes made by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd Frank**"), enacted in 2010. While the Committee recognizes the need for the Division to update its rules in this area, the Committee believes that in certain important respects, as described below, the Proposed Rules do not strike the appropriate balance between regulating investment advisers of private funds and investor protection. In particular, the Committee believes that certain of the Proposed Rules depart from the updated model rules

adopted by the North American Securities Administrators Association ("**NASAA**") as they apply to certain private fund managers, will create a significant lack of uniformity as compared to the laws of other states, and are inconsistent with SEC regulations. From an economic development perspective, the Committee believes the Proposed Rules may harm the private fund industry in our state by discouraging formation of new private funds in this state as well as prompting private funds whose operations are portable to move to jurisdictions with regulatory regimes similar to federal law and NASAA Model Rules. The Proposed Rules may also discourage out-of-state private funds from allowing more than a de minimis number of Washington residents to invest in the private fund.

The Investment Management Industry in Washington

The investment management industry in Washington includes traditional registered investment advisers, as well as advisers to venture capital, private equity, and hedge funds, "funds of funds", and wealth managers. The Committee believes that to a large degree the investment management industry in Washington has grown and developed over the last 25 years in response to the significant shareholder and employee wealth created by our state's many successful companies, such as Microsoft, Amazon, Starbucks, Nordstrom, Costco, Expedia, Coinstar, and Zillow, to name just a few.

We believe that the state's investment management industry not only is an important growth industry for our state that provides high wage "clean and green" jobs, but provides significant benefits by its local presence. Despite this historical growth, the industry of advisers managing pooled investment vehicles, which in this letter we refer to generically as "private funds," remains unstable in the Northwest and, in certain subsets such as venture capital and private equity, has contracted significantly over the past 5 years. We cannot understate the significance this shrinking pool of capital may have on our region's ability to foster the growth of its startup and emerging growth companies in creating jobs and wealth. In addition, many investors prefer to invest through advisers and funds whom they know through their personal and professional contacts. We believe there are significant "investor protection" benefits to maintaining a healthy private fund industry, especially if the effect of the Proposed Rules is to diminish the choices available to investors in Washington.

The Committee believes that certain of the Proposed Rules may significantly hinder the growth of private funds in Washington because they are more aggressive – and burdensome – for the private fund industry than comparable rules in many other jurisdictions, including the federal rules adopted by the Securities and Exchange Commission ("**SEC**") pursuant to Dodd Frank. The Proposed Rules will impose the greatest costs and constraints on the smallest private funds and their advisers[1]. Given the difficulty of raising capital for a new fund manager, it is important that the Proposed Rules permit advisers of smaller private funds to keep their costs low in order

[1] Although the Proposed Rules do not specifically require audits of private funds to be conducted by accounting firms that are registered with the Public Company Accounting Oversight Board, we are concerned that will be the result, which will cause smaller private funds to incur significantly higher costs than if they could engage non-registered independent accountants.

both to stay in business and to maximize returns to their investors (which is, of course, in the best interests of those investors).[2] We believe there are approaches that can achieve the dual goals of promoting and not suffocating the growth of small private funds, while at the same time providing adequate protection to those investors.

In addition, the Proposed Rules may put certain private fund advisers at a significant competitive disadvantage to their larger, federally registered competitors, as well as private fund advisers located in surrounding states such as California that have adopted rules consistent with NASAA model rules and related SEC rules. The Proposed Rules also will put large private investment fund managers who may not fit within the technical parameters of the "venture capital fund" definition, but who are competitively similar to venture capital in their investment philosophy, in the difficult position of determining whether it is economically feasible to remain in our state when other states and the federal government are not requiring the same level of regulation.

We acknowledge that DFI issued a small business economic impact statement with respect to the Proposed Rules; however, we question the validity of certain of its conclusions as the process did not survey several subsections of the investment management industry in Washington. In particular, we understand that only current state and federal registered investment advisers were surveyed. The survey was not sent to any unregistered or federally "exempt reporting advisers." Many of these types of advisers have been operating in our state for decades believing, in good faith, that their operations did not require investment adviser registration based on the "private adviser" exemption (now repealed by Dodd Frank) and/or various statutory analyses under Washington law. These unregistered and federally exempt reporting advisers might be the most dramatically affected by the Proposed Rules, in that they could become subject to state registration as a result of the Proposed Rules. We believe that if this survey had reached the "to be regulated" audience of currently unregistered advisers, the results would have shown a dramatically increased economic impact that we believe the Division should consider in evaluating the Proposed Rules.

With respect to specific, material provisions of the Proposed Rules, we call your attention to the following elements:

- Proposed WAC 460-24A-107(2)(b)(ii) (as well as WAC 460-24A-105(4)(a) & 4(b)(i)), requires private funds to disclose quarterly to each limited partner or member a report that identifies all 5% or greater portfolio positions (long and short). The private fund's portfolio positions and transactions represent the fund's investment strategy as actually implemented, and are regarded as proprietary to the investment adviser, and arguably a trade secret. These required disclosures create substantial risks to the fund's performance, especially if the fund is required to disclose its short positions in illiquid securities, which

[2] For example:
- For a $1 million private fund, a $20,000 annual compliance costs represent a 2% reduction in investors' returns;
- For a $10 million fund, that same cost represents only a 0.2% reduction in investors' returns.

is especially sensitive information. Since neither the SEC nor most states require the same disclosures, this requirement will discourage advisers from operating private funds in Washington state and should be eliminated.

- WAC 460-24A-035 defines the term "client" to include each member/partner of a private fund. This approach is at odds with the regulatory approach taken by the SEC and NASAA's Model Rules, as it creates a fiduciary duty to the members and partners of a fund, even though the adviser is obligated to manage the fund according to the goals and objectives of the fund, rather than the individual objectives of each member or partner, whose goals and objectives may be in conflict or change over time. Put another way, the notion of being able to act in the 'best' interests of separate individual investors, each with their own unique investment goals, horizons, and tolerances, seems fundamentally incongruous with management of capital on a collective pooled basis, where all the capital in the pool is managed pursuant to a single stated set of investment objectives, strategies, investment horizons, and risk tolerances for the fund as a whole. This definition should be modified to delete these elements.

- We believe investors in these funds understand these basic concepts. As a result, since other states do not "look through" the funds in imposing fiduciary duties, the Proposed Rules create uncertainty and potential litigation for advisers and funds that will discourage private funds from being based and operated in Washington state.

- The Proposed Rules would require advisers to private funds that are exempt under the Investment Company Act of 1940 pursuant to section 3(c)(1) (*i.e.*, accredited investor funds with fewer than 100 beneficial owners) to become registered investment advisers. This differs materially from the SEC's federal exemption, the exemptions of surrounding states including Oregon and California, and the NASAA Model Rules. As a result, the Proposed Rules will require those advisers in our state that may not satisfy at all times the venture capital fund definition to incur the initial and ongoing costs of regulation. We are concerned that those advisers may relocate solely based on this issue. The Proposed Rules should include an exemption for these types of private funds.

- The Proposed Rules contain many provisions that appear applicable to advisers of private funds even when those advisers are not registered or required to register as investment advisers. While some of these instances may be unintentional drafting glitches, which we respectfully ask be corrected, others may be intentional and would impose significant costs and restrictions on venture capital and venture-like fund advisers. Since the Division will not register, examine, or regulate these advisers in an ongoing manner, we believe certain of these ongoing compliance obligations create significant costs with no significant, countervailing regulatory purpose. The Proposed Rules should be modified to eliminate these regulatory burdens.

- Under Dodd Frank, when a registered investment adviser's assets under management exceed $100 million, and when a private fund's assets exceed $150 million, the

investment adviser is required to switch its investment adviser registration from the state to the SEC, at which time it will become subject to the SEC's rules and policies for investment advisers. Since the Proposed Rules are not consistent with the SEC's requirements, state-registered advisers will need to create operational and reporting systems that differ significantly from those that will be needed if and when the adviser is required to register with the SEC. When the adviser registers with the SEC, the adviser will need to spend considerable resources to revise its operational and reporting systems to comply. As a result, the substantial additional costs – whatever they may be – are likely to discourage advisers from developing, operating and growing their fund management business in Washington state. The Proposed Rules should be tailored to be far more consistent with SEC rules, departing from them only when there is a compelling reason.

- We are also concerned that the Division, in connection with the registration of an adviser to a private fund, as a matter of policy, requires submission and review by the Division of all offering materials, including confidential private placement or information memoranda. We object to the Division's policy because it expands the scope of regulation (especially since the offerings are typically exempt under Rule 506 of Regulation D so that state registration requirements are preempted under Section 18 of the Securities Act of 1933, as amended), and causes such documents to become public records, available to anyone under Washington's open records law, rather than being confidential. For these reasons, we believe the Proposed Rules and the Division's policies with respect to the review of private funds when registering investment advisers need to be modified.

As residents of Washington State we have been appalled by the fraud that has occurred both nationally (Madoff) and locally (Darren Berg) and we support reasonable regulation of investment advisers and their related funds. Nevertheless, we think the Division needs to balance investor protection with the regulatory costs (especially the particularly broad expansion of registration and on-going reporting requirements) and effects on the private fund industry. Given the economics of the investment advisory business, higher regulatory costs have a significant magnified effect on the sustainability of existing funds and on the viability of new private funds in the state. We believe that the Division can develop a more nuanced regulatory approach, focusing on problematic fund practices, that will minimize the regulatory burden on private funds in Washington while still protecting investors.

When the regulatory burden becomes so great, especially compared to other states, we think that investment advisers and private funds will limit the number of Washington investors permitted in their funds so as to avoid Washington's burdensome and costly regulatory regime. Washington investors may be left to choose only from among SEC registered private funds, even though studies show that smaller funds tend to have better investment returns.

As a result, if our predictions as to the effects of the Proposed Rules on the investment management industry in this state come true, the Division's no-doubt well intentioned provisions

will reduce the number of private funds that provide capital to start-up and emerging growth companies in Washington as well as limit the ability of Washington investors to invest in out-of-state private funds.

Owners of Private Funds as "Clients"

Following the Long Term Capital Management debacle in 1998, Congress brought renewed attention to the financial and systemic risks posed by hedge funds. Hedge fund managers historically were not registered as investment advisers, relying on section 203(b)(3) of the Advisers Act (the so-called "private adviser" exemption, which exempted an adviser who did not hold itself out to the public as an investment adviser and who had fewer than 15 clients). Although Congress ultimately never took legislative action (at least until 2010), the SEC began an initiative to require advisers of hedge funds to register as investment advisers under the Investment Advisers Act of 1940. In 2004, the SEC adopted Rule 203(b)(3), which provided that, solely for purposes of determining the application of the registration requirements, the adviser was required to count as a "client" each shareholder, limited partner, member or beneficiary of a fund managed by the adviser. Since most hedge funds had more than 15 owners, the hedge fund manager would be required to register.

In Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006), the court of appeals struck down the SEC's rule, holding that the rule exceeded the SEC's authority, concluding that the SEC's interpretation fell "outside the bounds of reasonableness." The court noted that "the Commission's interpretation of the word 'client' comes close to violating the plain language of the statute. At best it is counterintuitive to characterize the investors in a hedge fund as the 'clients' of the adviser." The court continued:

> *If the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest. Consider an investment adviser to a hedge fund that is about to go bankrupt. His advice to the fund will likely include any and all measures to remain solvent. His advice to an investor in the fund, however, would likely be to sell. For the same reason, we do not ordinarily deem the shareholders in a corporation the "clients" of the corporation's lawyers or accountants... While the shareholders may benefit from the professionals' counsel indirectly, their individual interests easily can be drawn into conflict with the interests of the entity. It simply cannot be the case that investment advisers are the servants of two masters in this way.*

We believe the relationship of the adviser to the fund and its owners is clear and that the Division is relying on a theory rejected by the courts for sound reasons that even the SEC recognized in 1997:

> ***[A]*** *client of an investment adviser typically is provided with individualized advice that is based on the client's financial situation and investment objectives. In contrast, the investment adviser of an investment company need not consider the individual needs of the company's shareholders when making investment*

> *decisions, and thus has no obligation to ensure that each security purchased for the company's portfolio is an appropriate investment for each shareholder.*

Status of Investment Advisory Programs Under the Investment Company Act of 1940, *62 Fed. Reg. 15,098, 15,102 (Mar. 31, 1997).*

The SEC's approach in Rule 203(b)(3) became a footnote in history with the passage of Dodd Frank, since that act eliminated the private advisor exemption and thus required many hedge fund managers to register as investment advisers (and eliminated the need for the "look through" rule in defining "client").

However, the Division continues to follow the "look through" interpretation, despite the inherent fiction of requiring the manager to invest and act as a fiduciary to the fund and to each owner. In addition, we believe the benefits of having Washington securities law be consistent with federal securities law (not to mention other states' laws) outweighs any investor protection arising from the Division's interpretation.

Further, the Division's approach does not reflect the reasons investors invest in private funds. If investors want the protection intended by the Division, investors can opt for an investment adviser to manage their personal account, optimized for their own personal investment criteria. In private funds, investors invest in the fund manager and the fund strategy. Investors assess fund performance at the fund level, and on their share of fund total return over time.

For these reasons, we believe that the Division's proposal to incorporate the client "look through" concept into its Proposed Rules creates an unnecessary burden on private fund advisers in Washington and should be deleted from the Proposed Rules.

Conclusion

As a Committee, we believe that the Division's regulatory approach, exemplified by the Proposed Rules, reflects a broad expansion of registration and reporting requirements that does not appropriately balance investor protection with the adverse effects on Washington's investment management industry, pooled investment funds, their advisers and the investors they serve. We have reviewed Oregon's and California's regulations on investment adviser and private funds and believe that Washington's existing and Proposed Rules are significantly more burdensome. We are concerned that the Proposed Rules will lead to further concentrations of wealth by federal covered investment advisers with assets under management of more than $100 million. We respectfully request that the Division reconsider certain of the Proposed Rules and develop revised rules that allow the private fund industry the opportunity to grow and thrive in Washington.

Thank you for your consideration in this matter.

Respectfully,

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Attachment: Appendix with detailed comments

Appendix

Our detailed comments on the Proposed Rules follow.

Comment 1 - Definition of Qualifying Private Fund; WAC 460-24A-005(9).

We believe that the definition of "qualifying private fund" should conform to the NASAA Model Rules and to the SEC's federal exemption, and exclude the clause "other than a private fund that qualifies for the exclusion from the definition of 'investment company' provided in section 3(c)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-3(c)(1)."

The Division's proposed "venture capital" exemption will only exempt from investment adviser registration those fund managers that fit into the federal exemption for venture capital fund advisers. Unlike Dodd Frank and the NASAA Model Rules, the Proposed Rules have **no** exemption for other private funds. The federal venture capital exemption has many notable restrictions that will often limit or render unavailable the type of venture-like investments that, in our experience, are often used by local fund managers. For example, even pure venture capital funds may sometimes acquire shares directly from founders or use leverage. Furthermore, in recent years fund managers have entered the market with 'venture like' investment offerings, such as revenue-based loans, that are competitively similar to venture but would not satisfy the technical requirements of the SEC's venture capital fund definition since they are not pure equity investments. The federal rules and NASAA Model Rules provided an alternative exemption for these funds, so long as they remain relatively small (under $150,000,000).

The Proposed Rules differ from both the SEC and NASAA Model Rules and would limit the Washington State exemption to funds organized under Section 3(c)(7) of the Investment Company Act of 1940, which funds are limited solely to qualified purchasers. In practice, it is extremely rare for an adviser to private funds with assets under management of less than $150,000,000 to have investors that are entirely qualified purchasers. As a result, most of these funds are formed under, or have a related fund formed under, Section 3(c)(1) of the Investment Company Act of 1940 with no more than 100 accredited investors. Accordingly, we believe the limitation in the Proposed Rules is a significant and problematic departure from the federal and NASAA Model Rules.

Comment 2 – Treatment of Private Fund Advisers (who are not required to register)

The Proposed Rules contain many provisions that appear applicable to private fund advisers even when those advisers are not registered or required to register as investment advisers. In particular, we believe the following provisions should be modified because we believe they are inadvertent drafting oversights in rules that are not intended to apply to venture capital fund advisers or other exempt, unregistered advisers. We believe our suggested revisions avoid regulatory uncertainty as to whether such exempt, unregistered advisers must comply with these rules. If our understanding is incorrect, and there is an intent that these provisions apply to exempt, unregistered advisers, we believe the Division should explain that unambiguously and

we would appreciate the opportunity to provide further comment on why that approach is not appropriate. Our suggestions are as follows:

- **WAC 460-24A-106(2)**: At the beginning of paragraph (2), the reference to "you have" should be changed to "you are an investment adviser registered or required to be registered under RCW 21.20.040 who has". This is consistent with the approach in paragraph (1) of this rule.
- **WAC 460-24A-107(2), (3) and (4)**: Similarly, paragraph (1) of this rule indicates an intended application of the rule to "investment advisers registered or required to be registered under RCW 21.20.040," but paragraphs (2), (3) and (4) lack similar language. We believe that:
    - At the beginning of paragraph (2), after the phrase "if you are an investment adviser" there should be added the phrase "registered or required to be registered under RCW 21.20.040";
    - At the beginning of paragraph (3), the phrase "you have" should be changed to "you are an investment adviser registered or required to be registered under RCW 21.20.040 who has"; and
    - At the beginning of paragraph (4), "You" should be changed to "If you are an investment adviser registered or required to be registered under RCW 21.20.040, you".
- **WAC 460-24A-145(2), (3), (4), (5) and (6)**: Similarly, we believe that all paragraphs of the brochure rule should be revised to clarify, consistent with paragraph (1), that the rule does not apply to exempt, unregistered advisers. We suggest that:
    - In paragraph (2), directly after the caption "Delivery" and before subsection (a) begins, there should be added an introductory clause that reads: "If you are an investment adviser registered or required to be registered under RCW 21.20.040:";
    - At the beginning of paragraph (3), "You" should be changed to "If you are an investment adviser registered or required to be registered under RCW 21.20.040, you";
    - At the beginning of paragraph (4), after "you are" there should be added the phrase "an investment adviser registered or required to be registered under RCW 21.20.040 and you are";
    - At the beginning of paragraph (5), after "you" there should be added the phrase "are an investment adviser registered or required to be registered under RCW 21.20.040 and you".
    - At the beginning of paragraph (6), "Nothing" should be changed to "If you are an investment adviser registered or required to be registered under RCW 21.20.040, nothing".
- **WAC 460-24A-170(6), (7), and (8)**: For similar reasons, we believe that all paragraphs of the minimum financial requirements rule should be revised to clarify, consistent with paragraphs (1), (2), (3), and (4) of the rule, that it does not apply to exempt, unregistered advisers:

- At the beginning of paragraph (6), after the phrase "if you are an investment adviser" there should be added the phrase "registered or required to be registered under RCW 21.20.040";
- In paragraph (7), the phrase "that a current appraisal be submitted" should be changed to "an investment adviser registered or required to be registered under RCW 21.20.040 to submit"; and
- At the beginning of paragraph (8), after the phrase "if you are an investment adviser" there should be added the phrase "registered or required to be registered under RCW 21.20.040".

- **WAC 460-24A-170(6), (7), and (8)**: For similar reasons, we believe that all paragraphs of the minimum financial requirements rule should be revised to clarify, consistent with paragraphs (1), (2), (3), and (4) of the rule, that it does not apply to exempt, unregistered advisers:
- **WAC 460-24A-200(4) and (7)**: For similar reasons, we believe that all paragraphs of the books and records rule should be revised to clarify, consistent with paragraphs (1), (2), (3), (5), (6) and (10) of the rule, that it does not apply to exempt, unregistered advisers:
  - At the beginning of paragraph (4), "Any" should be changed to "If you are an investment adviser registered or required to be registered under RCW 21.20.040, any"; and
  - At the beginning of paragraph (7), before subsection (a) begins, there should be added an introductory clause that reads: "If you are an investment adviser registered or required to be registered under RCW 21.20.040:".

In addition, we believe other provisions may be intentionally applicable to venture capital and venture-like fund advisers who the Division will not register, examine, or regulate in an ongoing manner. We are concerned that the Division's efforts to draft rules applicable to such exempt, unregistered parties places them in a particularly awkward position given market practices and their existing contractual obligations, as well as their legal obligations under applicable laws of other jurisdictions.

In particular, we believe WAC 460-24A-220 should be revised so that:

- the introductory language reads: "If you are registered or required to be registered under RCW 21.20.040 as either an investment adviser or an investment adviser representative, or you are a federally covered adviser,"; and
- in the final sentence before paragraph (1), "you" should be replaced with "such advisers" or like language that clarifies the following list of items does not apply to venture capital or venture-like fund advisers.

We do not believe that, as a matter of law, unregistered, exempt advisers are fiduciaries to "clients" using the look-through definition that the Division applies. In our experience, many private funds are organized under the laws of Delaware, where recent case law has held that funds organized as limited liability companies or limited partnerships may contractually fashion fiduciary duties as they deem appropriate in the circumstances. Accordingly, our experience is that the sophisticated investors in these funds heavily negotiate the standards of care and other

duties in the special context of private funds. We are unaware of any case law that would superimpose on these relationships a separate fiduciary obligation under state securities laws in the context of venture capital or venture-like funds. As a result, without our requested changes, the Division may place such advisers in a position where their existing contractual obligations are uncertain, their existing systems and procedures inadequate, and their compliance costs unduly burdensome.

In addition, to the extent the advisers of these funds are exempt reporting advisers under federal law,[3] they would have fiduciary duties under federal law that apply to their "clients" as defined under federal law. As discussed elsewhere in this letter, the federal definition of "client" in the context of an adviser to a private fund means only the fund the adviser managers; the federal standard does not "look through," for instance, to the members of a limited liability company or to the limited partners of a limited partnership. As a result, without our requested changes, the Division may place such an adviser in a position where it has fiduciary duties under federal and state law to take inconsistent actions. In such circumstances, we believe there is a legitimate, open question of federal preemption. We believe that a more appropriate regulatory approach would eschew the possibility of preemption, while providing certainty without excessive compliance costs to important participants in Washington's economy.

Comment 3 – Definition of Discretionary Authority; WAC 460-24A-005(10)(b).

We believe that this definition is confusing. Although we believe the federal definition (which includes only Items (a) and (b) below) is sufficient, if DFI believes additional clarification is needed, we recommend the following:

"Discretionary authority" means the authority, directly or indirectly, to:
(a) decide which securities to purchase and sell for a client
(b) make decisions as to which investment advisers to retain on behalf of a client
An adviser meeting the standards of (a) or (b) has discretionary authority notwithstanding investment powers retained by a client or delegated by the client to others.

Comment 4 – Application of rules to out-of-state investment advisers; WAC 460-24A-010.

We believe that this provision should be clarified regarding the definition of "business within the State of Washington," and suggest the following:

"If you are an investment adviser or investment adviser representative with your principal office and place of business outside the State of Washington, these rules apply only to your relationships with clients residing in the State of Washington."

[3] Similar logic applies to any "investment adviser" under federal law.

Comment 5 – Materials Required to be Filed; WAC 460-24A-050(5)(c).

This section requires an adviser to a private fund to file copies of various fund documents, including the private placement memorandum or other offering circular used to solicit investors. This provision should be modified to provide an exclusion for the private placement memorandum and offering materials to maintain the confidentiality of the information and thereby prevent competitors and others from obtaining copies of this information under the state's open records laws. In addition, the Division's policies in reviewing any of these documents that are filed should be limited since the private funds are not being registered and, in fact, the Division has no authority to review these fund documents if the security being offered is a "covered security" as defined in Section 18 of the Securities Act of 1933, as amended.

Comment 6 – Waiver of audited balance sheet requirement; WAC 460-24A-106(3).

The word "solely" is in the wrong place in this section and should be:

"*(3) Waiver of audited balance sheet requirement. If you have custody* ***[]*** *as defined in WAC 460-24A-005(1)* ***[solely]*** *because you have the authority to directly deduct fees from client accounts,...*"

We think the word "solely" is intended to modify the cause of custody, not the form of custody, in the same way it is used in the preceding paragraph 106(2).

Comment 7 – Requirements to Report Portfolio Positions and Transactions; WAC 460-24A-105 and 107.

In our view, proposed WAC 460-24A-107(2)(b)(ii) (as well as WAC 460-24A 105(4)(a) & 4(b)(i), as applied to private funds) are problematic for reasons described above. Those rules would require an investment adviser to provide to investors in private funds, on at least a quarterly basis, a listing of the securities transactions effected by the fund during the period and a listing of the fund's positions (long and short) as of the end of the period.

A private fund's portfolio positions and transactions are the tangible manifestation of the investment strategy deployed by the fund's investment adviser. In our experience, that information typically is regarded as proprietary to the investment adviser and, indeed, arguably constitutes a trade secret. As described below, a requirement that advisers disclose detailed portfolio information—even if that disclosure is made only to the fund's investors—produces adverse effects not only on the advisers that are subject to the requirement but also on Washington's investment management industry. Moreover, we believe that the disclosure requirement does not substantially augment investor protection, at least not to an extent sufficient to outweigh its considerable costs. Accordingly, we encourage you to eliminate this requirement.

First, a requirement to disclose portfolio positions and transactions is potentially harmful to investment advisory businesses. Investment advisers typically manage the assets placed with them pursuant to proprietary investment strategies. An adviser's strategy may require years and

substantial resources to develop. Similar to concerns advisers have long expressed as to Rule 13f under the Securities Exchange Act of 1934 (for which confidential treatment may be granted by the SEC), an adviser's disclosure of a portfolio's positions and transactions may be tantamount to disclosure of the adviser's "secret sauce." Conceivably, such extensive disclosure could permit recipients effectively to reverse engineer the adviser's strategy, thereby eroding, if not destroying, the adviser's proprietary edge in the securities markets. The circumstances that, under the rules, disclosure need be made only to the limited group of persons holding interests in a particular fund does not alleviate these concerns. Beyond the risk that any recipient could distribute the information more widely is the worry that recipients—who may themselves be funds or other institutional investors—may be in a position to exploit the information to their own advantage.

It should not be difficult to discern how a secondary effect of that result—or even a widespread concern about that result—could hamper the growth of a robust investment advisory industry in Washington. Faced with the requirement of disclosing its funds' positions and transactions on a quarterly basis, advisers that otherwise might base their businesses in Washington will instead choose alternate locations. Even states that, like Washington, have adopted an extensive regulatory regime governing investment advisers, have not embraced the portfolio disclosure requirement.

Second, we believe that the portfolio disclosure requirement is not necessary to achieve investor protection goals. Even if the requirement were eliminated, investors would remain entitled to quarterly information about the relevant fund's performance and would otherwise be protected by the other provisions of Rules 105 and 107, which include the requirements that the fund's funds and securities be verified, on a surprise basis, by an independent CPA, that an independent party verify all withdrawals from the fund, and/or that the fund be subject to an annual audit. If an adviser is not dealing properly with the funds and securities under its management, these other measures are the critical tools to address such compliance failures. In short, requiring advisers to disclose proprietary portfolio information does not, in our view, provide any protections that do not already exist by virtue of the other components of the custody rules.

If the Division determines to adopt the proposed rule, we recommend clarifying it as follows:

"(ii) A listing of ***[the pooled investment vehicle's or trust's]*** *long and short positions on the closing date of the statement* ***[in a form and to the extent required by]*** *FASB Rule ASC 946-210-50."*

As currently proposed, this paragraph could be interpreted as literally requiring a listing of "*…all long and short positions…*", while the FASB rule only requires discrete reporting of all positions in excess of 5% of the portfolio, with positions below that threshold reported in aggregate by industry, security type, and jurisdiction.

Comment 8 – Additional custody requirements for an investment adviser that manages a pooled investment vehicle or trust; WAC 460-24A-107(2)(b).

We request that this section be revised so that the information provided pursuant to 107(2)(b) satisfies the requirements of not only 105(4)(b)(i), but also 105(4)(a). We also recommend for clarity that 2(a) and (b) be combined, as follows:

*"(a) Send the account statements required under WAC 460-24A-105 to each limited partner (or member or other beneficial owner). If the limited partners (or members or other beneficial owners) are themselves limited partnerships (or limited liability companies, or another type of pooled investment vehicle) that are your related persons, you must send the account statements required under WAC 460-24A-105 to each beneficial owner of the fund that is unrelated to you**[, including the]** following information**[]**, which will satisfy the requirements under WAC 460-24A-105**[(4)(a) and 4(b(i)]**...."*

As currently proposed, it is not clearly evident that paragraph 107(2)(b) acts to modify the requirements of 107(2)(a), which we understand is the Division's intent and which we believe is an important feature of this revision. Such lack of clarity could lead to unnecessary confusion and an inequitable diversity in practice.

In addition, paragraph 107(2)(b) as currently proposed modifies the requirements of 105(4)(b)(i) concerning investor statements provided by the investment adviser, but fails to modify the same requirements in 105(4)(a) for investor statements provided by the custodian.

We understand it was the Division's intent that 107(2)(b) modify the requirements of both 105(4)(a) and 105(4)(b)(i), and we believe it is important that it modify both of these sections in a comparable manner.

Comment 9 – Information to be included in limited partner statements; WAC 460-24A-107(2)(b)(i).

We believe this paragraph needs to be modified as follows:

"*(i) The total amount of all additions to and withdrawals from the fund as a whole as well as the opening and closing **[net asset]** value of the fund at the end of the quarter based on the **[fund's governing documents]**.*"

This paragraph as currently proposed requires reporting "*the opening and closing value of the fund...based on the custodian's records*".

However, custodians as such are engaged to hold assets, not to value them. While some firms that serve as custodians are also engaged to value assets, many are not -- particularly for smaller, state-regulated pooled funds that don't use expensive, cost-prohibitive prime brokerage services.

Further, the values stated on basic custodial statements can be misleading – for instance, the value of an illiquid security held may be stated at its last price traded, rather than current bid prices, even if the security has not traded for weeks or months and its fair value is currently only a fraction of the last stated trade price.

Custodians who are not engaged to value the securities typically and appropriately disclaim warranting that the securities values stated on their statements represent fair value.

Similarly, investment advisers understand that prices listed on custodial statements do not relieve them of their responsibility to value securities positions at *fair value* when they report fund values.

We are also concerned that the Proposed Rules do not adequately reflect the meaning of and important distinctions between the terms "*net asset value"* and "*fair value.*" These are standard financial reporting terms of art, defined in generally accepted accounting principles (GAAP) and widely used in the private and public fund industry, so it is critical that the Proposed Rules use these terms appropriately and in a manner consistent with industry practice.

The term "*net asset value*" is simply the sum of all securities positions at "*fair value",* plus other fund assets or liabilities (e.g., prepaid expenses, accounts payable) at carrying value.

Most **–** if not all **–** fund governing documents require that periodic reporting of fund values be made on a fair value and net asset value basis. The obligation to measure and report pooled fund portfolios and interests therein at fair value-based net asset values is the responsibility of the fund's adviser or general partner.

The Proposed Rules should therefore be modified to delete the requirement that valuations be reported based on the custodian's records.

Further, the custodian may not have custody of private securities, and larger hedge funds may use a firm other than the custodian to value complex positions, while smaller hedge funds typically measure fair values for illiquid securities internally in the manner required by the fair value valuation policies specified in their governing documents, which may differ from the potentially misleading values stated on custodial statements.

While we understand the Division may prefer to conform the language of this paragraph to the NASAA model rule as much as possible, it appears these valuation and reporting issues were not fully considered when the NASAA model paragraph was prepared.

Comment 10 – Mandatory Provisions in and Governing Law of Investment Advisory Contracts; WAC 460-24A-130

Proposed WAC 460-24A-130 would require investment advisers' contracts with their advisory clients to contain nine specific provisions. These provisions are in addition to those required by federal law. Not only will the Proposed Rules require investment advisers to customize their

agreements for each state (which adds significant costs for an investment adviser), amending contracts with every existing client can be a particularly burdensome and costly effort for many investment advisers. We request that the Division review the nine items and require the inclusion only of those provisions that, under Washington public policy, are viewed as particularly important to Washington investors. In addition, we request that the Division adopt a transition rule that takes into account the challenges of implementing the requirement or adopt a "deemed contract provision" to incorporate the provisions.

This section also requires that the investment advisory contract be governed by the laws of the state in which the client resides, and illustrates the absurd result arising from the Division's proposed rule (WAC 460-24A-035(2)(f)) that all owners of a private fund are clients of the advisor.

Collectively, in the context of funds whose owners reside in multiple states, these rules would result in multiple states' laws governing the interpretation of the contract, potentially leading to conflicting interpretations of the same contract and potentially resulting in different rights of owners of the same private fund. At the very least, if WAC 460-24A-035(2)(f)) is not revised, this rule needs to be revised so that the governing law be, at the option of the adviser, either the law of the State of Washington, the State of Delaware, or the law of the state in which a majority of the private fund's owners reside. Alternatively, WAC 460-24A-130(9) could be deleted, effectively allowing investors and fund managers to address routine contractual matters like choice of law without regulatory insistence on any particular jurisdiction.

Comment 11 – Performance compensation arrangements—Informed Consent; WAC 460-24A-150(6).

This rule requires the adviser or its representatives reasonably believe that the client understands the proposed method of performance compensation and its risks. Not only do we believe that the proposed requirement is unnecessary because of the nature of a "qualified client," it is difficult to imagine what inquiries and documentation advisors will need to satisfy that standard. The SEC has made a policy judgment that "qualified clients" are presumed to have the capability to assess performance fee arrangements. We believe it unfortunate and burdensome on Washington state registered advisers to be required to comply with an even higher, unknown burden.

Comment 12 – Financial Books and Records; WAC 460-24A-200(1)(f).

We recommend limiting financial recordkeeping requirements to a balance sheet and possibly an income statement, as reflected in the changes suggested below.

"(f) All trial balances, ***[internal audit working papers or other supporting financial records]****, and financial statements* ***[]*** *relating to your business as an investment adviser. For purposes of this subsection, "financial statements" shall* ***[include, at a minimum,]*** *a balance sheet prepared in accordance with generally accepted accounting principles, an income statement,****[]*** *and a net worth computation, if applicable, as required by WAC 460-24A-170."*

At a minimum, the requirement for a "*cash flow statement*" should be stricken. We understand that most investment advisers do not generate cash flow statements, as they typically have no substantive internal business reason or external business requirement to do so, and that cash flow statements are not a required GAAP financial statement for pooled funds. We also understand that the preparation of cash flow statements can be complex, and that typically only accountants can competently prepare them properly.

We do not believe financial statement preparation requirements and related costs should be imposed on advisers without a compelling regulatory purpose, especially where they do not also serve a substantive underlying business purpose.

We also suggest that the term "*internal audit working papers*" should be expanded to "*internal audit working papers or other supporting financial records.*" Investment advisers whose financial statements are not audited will not have 'internal audit working papers'. However, they should have 'supporting financial records', which is an accounting term of art that generally refers to the *sufficient competent evidential matter* that supports activity recorded on a trial balance or reported on a tax return or financial statements issued to third parties, whether audited or unaudited.