

ACT 1940  
SECTION 206(3)  
RULES \_\_\_\_\_  
PUBLIC  
AVAILABILITY 2-22-99

February 22, 1999  
Our Ref. No. 98-592-CC  
Goldman, Sachs  
& Company  
File No. 801-16048

RESPONSE OF THE OFFICE OF CHIEF COUNSEL  
DIVISION OF INVESTMENT MANAGEMENT

Your letter dated October 8, 1998, requests that the staff concur with your view that, for purposes of Section 206(3) of the Investment Advisers Act of 1940 ("Advisers Act"), Goldman, Sachs & Company ("Goldman") would not be engaging in a sale of a security to, or a purchase of a security from, an advisory client if Goldman provides the client with prime brokerage services, including extending margin credit and facilitating short sales of securities, as further described in your letter.

Facts

Goldman, a registered investment adviser and a registered broker-dealer, provides prime brokerage services for its clients. Prime brokerage services include coordinated clearance, custody, settlement, and recordkeeping for securities transactions executed through multiple broker-dealers. Typically, prime brokerage services also include the extension of margin credit and the facilitation of short sales of securities. Goldman Sachs Asset Management ("GSAM") is a business unit of Goldman that operates and supervises Goldman's asset management businesses. GSAM's investment advisory clients, which include institutions, high net worth individuals, and investment vehicles, may use Goldman's prime brokerage services.

A. Margin Transactions

When Goldman provides margin credit to a GSAM client, it receives a general security interest in any securities, property, proceeds or other obligations that Goldman holds for the client. This security interest secures all obligations owed by the client to Goldman, including any extension of margin credit to the client. When brokerage customers are not maintaining sufficient cash and securities in their accounts, their brokers will generally notify them that prompt payment of cash or securities is necessary. Such notification is known as a "margin call." Upon notification of a margin call, a GSAM client usually will transfer cash or securities into its margin account. If the client needs to liquidate securities to meet a margin call, it may place the order with a broker. The client then would notify Goldman of the liquidation transaction and Goldman would clear and settle the transaction. Alternatively, the client could direct the trade to Goldman and Goldman would handle the trade on an agency basis. In the event that a client does not respond to a margin call by increasing its equity in the margin account,

Goldman is required by law to exercise its rights as a creditor and liquidate assets in the account ("liquidation transaction"). 1/

#### B. Short Sales

As part of its prime brokerage services, Goldman facilitates short sales on behalf of clients or fiduciaries, such as GSAM, that are advising clients. When a client or its fiduciary decides to sell a security short, the client or its fiduciary places its order to sell the securities with the executing broker and promptly notifies Goldman of the trade. The executing broker then looks to Goldman for the securities to be delivered to the short sale counter party. Goldman may use securities from its own inventory, or may borrow them from a general pool of customer margin account securities, or from other brokers or stock lenders such as institutional investors or mutual funds. Goldman alone, not any advisory or other client, acts as principal to the stock loan transaction and has the obligation to return the securities to any stock lender. Goldman also clears and settles the trade.

-When Goldman is notified of the short sale, an amount equal to the market value of the security sold short is debited to the client's margin account. In accordance with the Federal Reserve Board regulations on margin accounts, the margin account must contain approximately 150% of the market value of the securities sold short, two-thirds of which is usually supplied by the short sale cash proceeds. The debit balance arising from the short sale is marked-to-market on a daily basis, and interest is paid to Goldman on the entire margin debit. The client or its fiduciary closes the short position by notifying Goldman that it has placed a covering transaction. The client covers the transaction by purchasing securities through an executing broker who confirms the trade with Goldman. As prime broker, Goldman then clears and settles the transaction. 2/ The client's obligation to Goldman is to deliver the number of shares borrowed

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1/ Regulation T generally provides that, if any margin call is not met in full within the required time, the creditor shall liquidate securities sufficient to meet the margin call or eliminate any margin deficiency existing on the day that such liquidation is required, whichever is less. 12 C.F.R. § 220.4(d).

2/ Goldman could be engaged by an advisory client as executing broker on the covering transaction, in which case Goldman customarily would purchase the securities in the open market, acting as agent. You represent that Goldman would not sell securities to an advisory client of GSAM or Goldman from Goldman's own inventory without providing written disclosure and obtaining consent in full compliance with Section 206(3).

and is unaffected by the market price. You state that, from Goldman's perspective as prime broker, the market price of the covering securities is irrelevant. You also state that Goldman's facilitation of a prime brokerage customer's short sale does not create, reduce or otherwise alter Goldman's economic exposure to the market price of the securities involved.

### Analysis

Section 206(3) of the Advisers Act makes it unlawful for any investment adviser, directly or indirectly

acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.

Section 206(3) also provides that its prohibitions "shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction."

Section 206(3) is intended to address the potential for self-dealing that could arise when an adviser acts as principal in a transaction with a client, or as agent on both sides of a transaction effected on behalf of a client. <sup>3/</sup> In particular, Congress was concerned that principal transactions may lead to price manipulation (*i.e.*, an adviser buying securities from a client at a below market price, or selling securities to a client at an inflated price) or the dumping of unwanted securities into client accounts. <sup>4/</sup> In adopting Section 206(3), Congress chose not to prohibit advisers from engaging in principal transactions, but rather to impose a disclosure and consent requirement.

You ask us to concur with your view that a client's granting of a general security interest in any securities, property, or other obligations held by Goldman for the client in connection with maintaining a margin account does not constitute a purchase or sale of securities within the meaning of Section 206(3). The Advisers Act does not define the terms "purchase" or "sale." The Supreme Court has stated that the meaning of the terms "purchase"

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<sup>3/</sup> See Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. on Securities and Exchange of the Comm. on Banking and Currency, 76th Cong., 3d. Sess. 320 (1940).

<sup>4/</sup> *Id.* at 322.

and "sale" must be interpreted in the context of the particular provision in the securities laws that is at issue. 5/ You note that the term "sale" as used in the Securities Act of 1933 and the Investment Company Act of 1940 ("Investment Company Act") has been interpreted by the courts and the Commission staff to include a pledge of securities when such an interpretation was consistent with the purposes underlying the provision at issue. 6/

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5/ See Securities and Exchange Commission v. National Securities, Inc., 393 U.S. 453, 465 (1969).

6/ For example, the Supreme Court has held that a pledge of securities is a "sale" for purposes of the general antifraud provisions of the Securities Act of 1933. See Rubin v. U.S., 449 U.S. 424, 430-31 (1981).

The staff has taken the position that a loan of a security involves a sale for purposes of Section 17(e) of the Investment Company Act, which generally prohibits any affiliated person of a fund, acting as agent, from accepting compensation from any source for the purchase or sale of any property to or for the fund. See United Services Funds (pub. avail. Apr, 23, 1993). Section 17(e) was designed to eliminate the potential for self-dealing that exists when persons affiliated with an investment company, acting as agents, receive compensation for purchases of property from and sales of property to the investment company. See Drinker Biddle & Reath (pub. avail. Dec. 18, 1998). In United Services Funds, the staff stated that, when an affiliated custodian accepts a fee for arranging a loan of the fund's securities, the transaction presents the potential for conflict of interest that Section 17(e) was intended to address.

In addition, the Commission has granted exemptions from Sections 17(a)(1) and (2) of the Investment Company Act with respect to pledges of securities and certain borrowing transactions. See, e.g., In the Matter of Janus Investment Funds, Investment Company Act Rel. Nos. 22922 (Dec. 2, 1997) (notice) and 22983 (Dec. 30, 1997) (order) (permitting funds to borrow money from affiliated funds); In the Matter of Aim Equity Funds, Investment Company Act Rel. Nos. 22663 (May 15, 1997) (notice) and 22697 (June 10, 1997) (order) (permitting a fund to transfer securities to an affiliated bank in connection with a reverse repurchase agreement). Section 17(a)(1) generally prohibits an affiliate from selling any security or other property to a fund, and Section 17(a)(2) generally prohibits an affiliate from purchasing any security or other property from a fund. In each application, applicants asserted that the relevant transaction may constitute a purchase or sale of a security under Sections 17(a)(1) and (2).

As noted above, the purpose of Section 206(3) is to prevent price manipulation and the dumping of unwanted securities by any investment adviser into client accounts. You assert that granting a security interest in securities held by Goldman for a client for purposes of maintaining a margin account does not, by itself, present any opportunity for price manipulation or dumping of unwanted securities by the adviser. We agree that a client's granting of a security interest for purposes of maintaining a margin account does not create the potential for the conflict of interest that Section 206(3) was intended to address, 7/ and therefore believe that granting such a security interest does not involve a purchase or sale of a security for purposes of that section. We therefore agree that a client would not be engaged in the purchase or sale of securities within the meaning of Section 206(3) solely by reason of granting a security interest for purposes of establishing a margin account.

You also request that we concur with your view that Goldman would not be "acting as an investment adviser in relation to" any liquidation transaction, and therefore the transaction should not be subject to Section 206(3). You state that any decision to make a margin call, and any liquidation transaction, is wholly separate from any investment advice provided by GSAM. 8/ You also note that margin calls are often remote in time from the account transactions for which the adviser provided investment advice. You further note that the Goldman personnel who administer the margin requirements are separate from the personnel responsible for making investment management decisions.

We believe that the liquidation of securities in a margin account may constitute a purchase or sale within the meaning of Section 206(3). We agree, however, that Goldman would not be acting as an investment adviser in relation to a liquidation transaction. We therefore believe that Section 206(3) would not apply to the liquidation transaction described in your letter.

Similar issues arise in the context of short sale transactions. In a short sale transaction, Goldman transfers securities on behalf of its client to an executing broker, which then transfers them to the short sale counterparty. In effect, Goldman is loaning the securities to the client so that the

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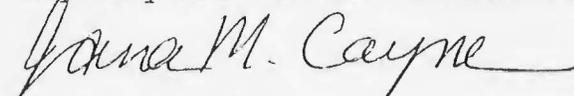
7/ We note, however, that GSAM may have a conflict of interest to the extent that it recommends to its clients that they enter into arrangements with Goldman, including margin accounts, from which Goldman might benefit. Any such arrangements would be subject to the general antifraud provisions of the Advisers Act: Sections 206(1) and (2).

8/ Telephone conversation of February 22, 1999 between Jana Cayne and Jeremy Rubenstein of Wilmer, Cutler & Pickering.

client can sell the securities needed to effectuate the short sale. You state that the transfer of securities to the executing broker to cover the advisory client's delivery obligation could indirectly be considered a sale of securities to the client. You believe that, although a loan may constitute a purchase or sale of a security of purposes of various other provisions in the federal securities laws, 9/ Goldman's transfer of securities to an executing broker in connection with a short sale transaction is not a purchase or sale for purposes of Section 206(3). You state that the client is merely obligated to replace the exact number of securities that it borrowed and there is no transfer of economic exposure to or from the owner of a borrowed security at any point during the transaction. Thus, you argue that there is no potential for dumping or price manipulation by the adviser.

We agree that a transfer or loan of securities on behalf of a client to facilitate a short sale does not appear to present the same potential for abuse as an actual sale of securities by the adviser to the client. 10/ Accordingly, we concur with your view that, for purposes of Section 206(3) of the Advisers Act, Goldman would not be engaging in the sale of a security to, or purchase of a security from, an advisory client if Goldman facilitates short sales of securities, as described in your letter.

Based on the foregoing analysis, we would not recommend enforcement action to the Commission under Section 206(3) of the Advisers Act if Goldman extends margin credit to clients or facilitates short sales on behalf of clients as described in your letter. These positions are based on the facts and circumstances set forth in your letter. Any different facts or circumstances may require different conclusions.



Jana M. Cayne  
Senior Counsel

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9/ See supra, n.6.

10/ We believe, however, that GSAM may have a conflict of interest to the extent that it recommends that its client engage in short sale transactions from which Goldman might derive some benefit, and that Sections 206(1) and (2) would apply to these transactions. See also supra, n.7.

WILMER, CUTLER & PICKERING

2445 M STREET, N.W.  
WASHINGTON, D.C. 20037-1420

TELEPHONE (202) 663-6000  
FACSIMILE (202) 663-6363

JEREMY N. RUBENSTEIN  
DIRECT LINE (202) 663-6159

100 LIGHT STREET  
BALTIMORE, MD 21202  
TELEPHONE (410) 986-2800  
FACSIMILE (410) 986-2828

4 CARLTON GARDENS  
LONDON SW1Y 5AA  
TELEPHONE 011 (44) 711 872-1000  
FACSIMILE 011 (44) 711 839-3537

RUE DE LA LOI 15 WETSTRAAT  
B-1040 BRUSSELS  
TELEPHONE 011 (32) 285-4900  
FACSIMILE 011 (32) 285-4949

FRIEDRICHSTRASSE 95  
D-10117 BERLIN  
TELEPHONE 011 (49) 301 2022-6400  
FACSIMILE 011 (49) 301 2022-6500

October 8, 1998

Investment Advisers Act  
Section 206(3)

Douglas J. Scheidt, Esquire  
Associate Director & Chief Counsel  
Division of Investment Management  
Mail Stop 5-6  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Re: Goldman, Sachs & Company

Dear Mr. Scheidt:

We are writing on behalf of Goldman, Sachs & Company ("Goldman") and its Goldman Sachs Asset Management ("GSAM") division concerning the potential application of section 206(3) of the Investment Advisers Act of 1940 ("Advisers Act") to the arrangements described below. Goldman is a registered broker-dealer that provides a wide range of brokerage and securities related services to its clients. These services include prime brokerage, in which clients utilize Goldman to coordinate clearance, custody, settlement, and recordkeeping for securities transactions executed through multiple broker-dealers. Typically, prime brokerage services also include the extension of margin credit and the facilitation of short sales of securities.

GSAM is a business unit of Goldman that, acting under Goldman's registration as an investment adviser, operates and supervises Goldman's asset management businesses. The advisory clients of GSAM are institutions and high net worth individuals, including hedge funds and other investment vehicles. These clients may authorize GSAM to utilize strategies that include the use of margin credit or selling securities short. Certain GSAM clients have expressed an interest in receiving prime brokerage services from Goldman.

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## I. INTRODUCTION AND SUMMARY

When a broker-dealer provides margin credit to a client, it receives a general security interest in the marginable assets, including securities, held in the client's account. This raises the question of whether such a general security interest should be regarded as a "purchase" of the client's securities for purposes of section 206(3). The Advisers Act does not define the terms "purchase" or "sale." In the context of other securities laws, however, the courts and the Securities and Exchange Commission ("SEC") sometimes have treated loans and pledges of securities as purchases or sales, and sometimes have not, depending largely on the policy behind the particular provision at issue.

Section 206(3) was intended to address the potential for "dumping" or below market purchases by advisers. We respectfully submit that the creation of a general security interest does not implicate those concerns. We also submit that, in the rare event that Goldman had to exercise its rights as creditor, as required by Regulation T and rules of Self-Regulatory Organizations ("SROs"), Goldman would not be acting as an adviser "in relation to" the subsequent transaction. In addition, there would be little risk of the abuses at which section 206(3) is addressed: absent extraordinary circumstances, Goldman would sell margin securities in market transactions with third parties rather than acquire the securities directly, using the proceeds to satisfy the obligation.

Related issues are raised by short sales. When a client sells securities short, a broker-dealer supplies the security to the counter party. The client closes the position by purchasing the same number and type of securities in a covering transaction, and delivers them to the broker-dealer. Although these transactions could be regarded as "sales" and subsequent "purchases" of securities, at most they involve loans. Because the transactions present no opportunity for dumping or below market purchases, we respectfully submit that section 206(3) should not be deemed to apply. A lender of securities cannot transfer its market risk to a borrower: the lender eventually receives identical securities back. If the security declines substantially in value, the borrower *benefits* because it will be able to purchase securities for delivery at a lower price.

If section 206(3) were deemed to apply to margin and short sale arrangements, advisory clients of GSAM would have to forego such transactions, use a different prime broker, or lose the benefits of prime brokerage services. There are a limited number of firms that provide comprehensive prime brokerage services. Eliminating Goldman from consideration would diminish a client's ability to obtain high quality prime brokerage services and its ability to negotiate with other providers for prime brokerage services. We therefore request that the Staff concur with our view that Goldman would not violate section 206(3) if it extends margin credit to, or facilitates short sales of securities by, advisory clients that retain Goldman to act as prime broker.

## II. BACKGROUND

### A. Prime Brokerage Services - Generally

Prime brokerage is a bundle of services created by full-service firms to facilitate the coordination of clearance and settlement of securities trades for large retail and institutional investors that are active market participants. Such investors actively execute trades through many brokers ("executing brokers"), including their prime broker.<sup>1/</sup> Under its prime brokerage agreements, Goldman acts as a clearing facility and recordkeeper for many of the client's security transactions, whether executed through Goldman or other executing brokers, and as a central custodian for the client's securities and funds. In addition to clearing and settling trades, Goldman, as prime broker, provides margin financing for client trades, including trades effected by outside executing brokers. As noted above, GSAM clients have expressed an interest in receiving such prime brokerage services from Goldman.<sup>2/</sup>

When a client or its authorized representative places a trade order, the executing broker buys or sells securities in an account designated "Goldman fbo/XYZclient" as per the client's instructions. On the same day, the client and the executing broker notify Goldman of the order placed with the executing broker. Goldman records the transaction in the client's cash or margin account and in a good faith account set up with the executing broker.<sup>3/</sup> The executing broker and, when so directed by the client, Goldman issue confirmations or notifications to the client.

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<sup>1/</sup> In connection with this request, we are not seeking no-action assurances for Goldman, acting as executing broker, to engage in conventional principal transactions with clients of GSAM without compliance with section 206(3).

<sup>2/</sup> See also *Prime Broker Committee Request*, SEC No-Action Letter, 1994 WL 808441 (Jan. 25, 1994) ("1994 Prime Broker Letter") (describing prime brokerage services in connection with no-action response under certain sections of the Securities Exchange Act of 1934).

<sup>3/</sup> Under the 1994 Prime Broker Letter, these transactions have been recorded in broker-dealer credit accounts. Recently adopted amendments to Regulation T, however, reclassify the accounts that may be set up between broker-dealers and their customers, including other broker dealers. Securities Credit Transactions; Borrowing by Brokers and Dealers, 63 F.R. 2806, 2809-10, 2813 (F.R.B. Jan. 16, 1998). Under the new account classifications, which became mandatory on July 1, 1998, prime brokerage transactions will be recorded by the executing broker in a good faith account.

Regulation T regulates the borrowing of money by a customer from a broker to engage in a securities transaction by requiring the customers to maintain cash and securities equal to a portion of the market value of the transaction when the transaction is made ("initial margin"). For example, a customer wishing to purchase an equity security on credit must post initial margin equal to 50% of the market value of the security it wishes to purchase. Regulation T requires brokers to monitor their clients accounts for compliance and issue "margin calls" for more collateral if the client is not maintaining sufficient cash and securities. Additional requirements, including minimum equity requirements for new margin accounts and maintenance margin requirements,<sup>4/</sup> are imposed by SROs such as the NYSE and NASD. If margin calls are not met, brokers are required to liquidate securities in the account.<sup>5/</sup> Under a prime brokerage arrangement, Goldman computes all the applicable credit and Regulation T amounts since it is actually extending the credit, not the executing broker. After the executing broker and Goldman confirm the transaction between themselves, Goldman settles the trade in the usual manner. If the client was an advisory client of GSAM, the client actions above, e.g., placing the trade order or notifying Goldman of the trade, may be performed by GSAM or, with respect to assets managed by another firm, an unrelated investment manager on behalf of the client.

Among other reasons, clients enter into prime brokerage arrangements because they receive consolidated statements of account that include all security transactions during a time period together with the resultant security positions and money balances, even though they were effected through a variety of brokers. This helps clients that actively participate in the market monitor their various investments, while giving them the flexibility needed to seek best execution by executing transactions through one or more other broker-dealers. Prime brokerage clients also may retain a number of different investment managers, and use the service to obtain consolidated custody, reporting, and recordkeeping with respect to their aggregate investment positions.

## **B. Specific Prime Brokerage Services**

### **1. Margin Accounts**

As indicated by the general description of prime brokerage services above, many prime brokerage clients maintain margin accounts with their prime broker so that the benefits of

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<sup>4/</sup> Maintenance margin requirements specify the amount of collateral that must be retained on an ongoing basis.

<sup>5/</sup> See *Margin Accounts: Buying Securities on Credit*, 1994 WL 744603 (S.E.C. Oct. 18, 1994) (summary of the mechanics of opening and maintaining margin accounts issued by the SEC's Office of Consumer Affairs) (hereinafter, "*Margin Accounts*").

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having a central clearing facility, custodian and recordkeeper encompass securities purchased on margin, securities sold short and other margin transactions. When clients open margin or cash accounts at Goldman, they grant Goldman a general security interest in any securities, property, proceeds or other obligations that Goldman holds for the client. This security interest secures all obligations owed by the client to Goldman. This includes any extension of margin credit by Goldman to the client.

Pursuant to section 7 of the Exchange Act of 1934 ("Exchange Act") and Regulations T and U thereunder, the Federal Reserve Board ("FRB") regulates the extension of credit by banks, broker-dealers, and other lenders for the purchase or carrying of securities. As noted earlier, additional margin requirements are prescribed by SROs, and lenders may themselves impose higher margin requirements. In accordance with these regulations and policies, Goldman monitors margin accounts and issues margin calls as necessary. As described by the SEC:

Before a brokerage firm liquidates all or part of a margin account, it tries to notify the investor by telephone or telegram that prompt payment of cash or securities is necessary or the account must be liquidated. Such notification is known as a margin call. Brokerage firms do this to minimize the liquidations of accounts and to maintain good investor relations, although neither the Federal Reserve Board or the SEC requires brokers notify customers that their margin has fallen below maintenance requirements. The law does require brokers to liquidate accounts promptly if maintenance requirements are not met.<sup>6/</sup>

As a matter of ordinary business practice, clients meet margin calls when they are made. Usually, clients transfer cash or securities into margin accounts. In fact, NYSE and NASD rules prohibit a broker from permitting a customer to "make a practice" of meeting Regulation T margin requirements by liquidating securities in its margin account.<sup>7/</sup> If the client needs to liquidate securities to meet a margin call, they are free to place the order with any broker they choose. As with other prime brokerage transactions, the client would then notify Goldman of the transaction and Goldman would clear and settle the transaction. If the client chooses to direct the trade to Goldman, Goldman would handle the trade on an agency basis, subject to the duty of best execution.

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<sup>6/</sup> *Id.*

<sup>7/</sup> NYSE Rules 431(f)(7) and 432(b); NASD Conduct Rule 2520(f)(7).

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In the rare event that a client does not voluntarily respond to a margin call by increasing the equity in its margin account, Goldman is required by law to exercise its rights as creditor and liquidate assets in the account. Regulation T states:

If any margin call is not met in full within the required time, the creditor shall liquidate securities sufficient to meet the margin call or to eliminate any margin deficiency existing on the day such liquidation is required, whichever is less.<sup>8/</sup>

Similarly, the NASD and NYSE rules provide that required maintenance margin "shall be obtained as promptly as possible and in any event within fifteen business days from the date such deficiency occurred" unless extensions of time are specifically granted to the member.<sup>9/</sup> Finally, it should be noted that the personnel at Goldman that are responsible for administering the margin requirements are separate from the personnel responsible for investment management decisions.

## 2. Short Sales

Prime brokerage arrangements also typically involve certain services in connection with short sales made by the client or by a fiduciary on behalf of the client. Generally, short sales involve the sale of securities that an investor does not own or securities that the investor owns, but does not wish to deliver. Again, clients may authorize fiduciaries, such as GSAM, to enter into short sales and make the necessary arrangements to cover resulting delivery obligations. Like other brokerage clients, a prime brokerage client that wants to sell securities short first must provide assurances to the executing broker that the securities to be

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<sup>8/</sup> 12 C.F.R. § 220.4(d). Currently, Regulation T requires that margin deficiencies be eliminated within five business days. *Id.* at §§ 220.2, 220.4.

<sup>9/</sup> NYSE Rule 431(f)(6); NASD Conduct Rule 2520(f)(6). The SEC has described the rationale behind margin requirements as follows:

A customer's failure to pay down his account in the case of a loss leaves the broker-dealer bearing the financial burden of the loss. Not only do such losses deplete the broker-dealers' net capital and thereby threaten his ability to continue doing business, but also present on a larger scale a threat to the financial integrity of the entire stock market.

delivered to the counter party may be borrowed.<sup>10/</sup> The client or its fiduciary typically calls the securities lending desk at Goldman and asks for a "locate" on the security, which is a best efforts indication that the security is available. The client or its fiduciary may obtain a locate from another dealer and inform Goldman, but under the prime brokerage agreement Goldman would still clear and settle the trade, borrowing the stock from the dealer that gave the client the locate.

After receiving a locate, the client or its adviser places its order with the executing broker and promptly notifies Goldman of the trade. The executing broker then looks to Goldman for the securities to be delivered to the short sale counter party. Goldman may use securities from its own inventory or may borrow from a general pool of customer margin account securities. Goldman also may borrow the securities from other brokers or other stock lenders (often institutional investors or mutual funds). Finally, Goldman may borrow some "fully-paid securities" from Goldman customers who have a securities lending agreement with Goldman. Goldman alone, not any advisory or other client, acts as principal to the stock loan transaction and alone has the obligation to return the securities to any stock lender.

When Goldman is notified of the short sale, an amount equal to the market value of the security sold short is debited to the client's margin account. Goldman calculates margin requirements and issues initial margin calls as needed. In accordance with Federal Reserve Board regulations on margin accounts, the margin account must contain approximately 150% of the market value of the securities sold short, two-thirds of which is usually supplied by the short sale cash proceeds. The debit balance arising from the short sale is marked to market on a daily basis, and interest is charged on the entire margin debit.

The client or its fiduciary closes the short position by notifying Goldman that it has placed a covering transaction. Like other prime brokerage transactions, the covering transaction is placed with an executing broker who confirms it with Goldman. As prime broker, Goldman then clears and settles the transaction. The client's obligation to Goldman is to deliver the number of shares borrowed and is unaffected by the market price. From Goldman's perspective as prime broker, the market price of the covering securities is irrelevant. Further, Goldman's facilitation of a prime brokerage customer's short sale does not create, reduce or otherwise alter Goldman's economic exposure to the market price of the securities involved. Goldman could be engaged by an advisory client as executing broker on the covering transaction, but Goldman customarily would purchase the securities in the open market, acting as agent. Goldman would not sell securities to an advisory client of GSAM or Goldman from Goldman's

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<sup>10/</sup> These assurances allow the executing broker to make the affirmative determination required by NASD Conduct Rule 3370 that the stocks will be available for settlement.

own inventory without providing written disclosure and obtaining consent in full compliance with section 206(3).

### III. DISCUSSION

#### A. Section 206(3) of the Advisers Act

Section 206(3) of the Advisers Act prohibits an adviser that is "acting as an investment adviser" in relation to a transaction from knowingly purchasing or selling any security from or to a client (a "principal securities transaction") or effecting a transaction for its client if it acts as a broker on both sides of the transaction (an "agency cross transaction"), unless the adviser, before the completion of the transaction, makes written disclosure to the client of the capacity in which it is acting and obtains the client's consent to such transaction. The legislative history of section 206(3) indicates that the section was intended to address the possibility that an investment adviser acting as principal or agent for another client in the transaction might dump a "sour issue" on its clients.<sup>11/</sup> In addition, the Staff has expressed concern regarding the potential for price manipulation in principal transactions with advisory clients.<sup>12/</sup> The concern is the possibility that the adviser would exert its influence to affect the terms of the transaction in a manner that benefits itself and harms its client. The Staff has stated subsequently, however, that price manipulation was not the primary concern underlying section 206(3).<sup>13/</sup>

As the Staff is aware, due to the growing consolidation of the securities industry, broker-dealer firms increasingly have asset management affiliates or provide such services directly. In light of such consolidation, the Staff has indicated that it is reviewing the application of section 206(3) to limit the extent to which it applies to situations in which there is limited risk

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<sup>11/</sup> *Investment Trusts and Investment Companies: Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 32, 320-322 (1940)* (Statement of David Schenker, Chief Counsel, SEC, Investment Trust Study).

<sup>12/</sup> *Method of Compliance with Section 206(3) of the Investment Advisers Act of 1940 with Respect to Certain Transactions*, Investment Advisers Act Rel. No. 557 (Dec. 2, 1976).

<sup>13/</sup> *Salomon Brothers Asset Management, Inc.*, SEC No-Action Letter (Oct. 10, 1990).

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of the abuses at which the provision is directed.<sup>14/</sup> We respectfully submit that the provision of margin credit and the facilitation of short sale arrangements are not the type of transactions to which section 206(3) should be deemed to apply.

**B. Principal Securities Transactions--The Purchasing or Selling of Any Security**

In our view, the prime brokerage services described above do not constitute principal securities transactions for purposes of section 206(3) because they do not involve a conventional purchase or sale of any security between a client and Goldman, for its own account, and do not create the potential for dumping that section 206(3) guards against. The Advisers Act does not define the words "purchase" or "sale." In other securities law contexts, transactions that are not easily characterized as conventional purchases and sales have been determined to be within the statutory definitions of "purchase" or "sale" when their inclusion furthers the underlying purpose of the statute in question. The same or similar transactions, however, are not considered to be "purchases" or "sales" when including them would not serve the underlying purposes of the statute. Under this analytical framework, pledges of securities and security loans have been considered sales in some contexts, but not in others. In the context of section 206(3), the provision of margin credit and facilitation of short sales should not be considered "purchases" or "sales" because these services do not raise a significant risk of dumping or price manipulation and do provide important benefits to prime brokerage customers.

**C. Interpretations of the Terms "Purchase" and "Sale" under the Investment Company Act, the Securities Act and the Exchange Act**

In *Securities and Exchange Commission v. National Securities, Inc.*, the Supreme Court warned that the meaning of the terms "purchase" and "sale" must be interpreted in the context of the particular provision in the securities laws being interpreted.<sup>15/</sup> Declining to apply the 'no-sale doctrine' developed with respect to certain mergers under section 5 of the Securities Act of 1933 ("Securities Act") to a case arising under section 10(b) of the Exchange Act, the Court stated:

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<sup>14/</sup> Cf. *Interpretation of Section 206(3) of the Investment Advisers Act of 1940*, Investment Advisers Act Rel. No. 1732, 1998 WL 400409 (July 17, 1998) (SEC noted concern that advisers will "unnecessarily avoid engaging in . . . transactions that may serve their clients best interests" when clarifying certain interpretive issues under section 206(3)).

<sup>15/</sup> 393 U.S. 453 (1969).

Although the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen, ordinary rules of statutory construction still apply. The meaning of particular phrases must be determined in context. Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase 'unless the context otherwise requires.' We must therefore address ourselves to the meaning of the words 'purchase or sale' in the context of section 10(b). Whatever these or similar words may mean in the numerous other contexts in which they appear in the securities laws, only this one narrow question is presented here.<sup>16/</sup>

Noting that the definitions of "purchase" and "sale" found in the Exchange Act were "for the most part unhelpful," the Court examined whether the alleged conduct was the "type of fraudulent behavior which was meant to be forbidden" by section 10(b) and rule 10b-5.<sup>17/</sup> Finding that the "broad antifraud purposes of the statute would clearly be furthered by their application" to the merger at issue, the *National Securities* Court held that there had been a sale for purposes of section 10(b) and rule 10b-5 "[w]hatever the terms 'purchase' and 'sale' may mean in other contexts."<sup>18/</sup>

Interpretations by the courts and the Staff of whether pledges of securities are a "purchase" or "sale" for the purposes of different provisions of the Securities Act, the Investment Company Act of 1940 ("Company Act") and the Exchange Act have also varied from provision to provision.<sup>19/</sup> Under the broad definitions of the term "sale" found in the Securities Act and the Company Act, which include the disposition of an interest in a security, courts and the Staff have held that pledges and loans of securities are "sales" when such a holding was consistent with the policies underlying the provision at issue.<sup>20/</sup> As noted by the Staff in *United Services Funds*,

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<sup>16/</sup> *Id.* at 466 (citations omitted).

<sup>17/</sup> *Id.* at 466-67.

<sup>18/</sup> *Id.* at 467.

<sup>19/</sup> See, e.g., *Rubin v. United States*, 449 U.S. 424 (1981); *United Services Funds*, SEC No-Action Letter, 1993 WL 145658 (Apr. 23, 1993); *Interpretive Release on Rules Applicable to Insider Reporting and Trading*, Exchange Act Release No. 18114, Q&A No. 50 & n.64 ("Release 34-18114").

<sup>20/</sup> See, e.g., *Rubin*, 449 U.S. at 429-30; *United Services Funds*, SEC No-Action Letter, 1993 WL 145658.

however, courts have split on whether a pledge is a sale for the purposes of section 10(b) under the narrower definition of sale found in the Exchange Act.<sup>21/</sup> A mere pledge ordinarily is not considered a sale for purposes of the short-swing profits provisions of section 16 of the Exchange Act,<sup>22/</sup> but is considered a sale for purposes of the general antifraud prohibitions in section 17(a) of the Securities Act.<sup>23/</sup> In taking a "no-sale" position under 16(a), the Staff stated, "Given the different statutory objectives, the Staff does not regard the *Rubin* decision as dispositive for reports filed under Section 16(a)."<sup>24/</sup>

Even when governed by the broad definition of "sale" found in the Securities Act, the Staff has looked to the underlying policies. For example, rule 144 under the Securities Act imposes a holding period to ensure that purchasers of restricted securities are not acting as conduits for the sale of unregistered securities to the public.<sup>25/</sup> The question arose whether depositing restricted securities in margin accounts in connection with certain call option transactions was a "resale" in violation of rule 144's holding period.<sup>26/</sup> The Staff took the position under rule 144 that restricted securities should not be used for coverage and margin requirements for standardized listed call options, but may be deposited as margin for an unlisted, privately negotiated call option which is exercisable for fully registered, freely transferable stock. Since restricted securities deposited in a margin account with respect to standardized, listed calls may be required by the Options Clearing Corporation ("OCC") to be delivered at any time prior to the option's expiration, considering such margin deposits to be sales is consistent with the policy underlying rule 144's holding period.<sup>27/</sup> Depositing restricted securities to meet the margin requirements of unlisted call options for registered stock (or other transactions that are not subject to the OCC's random assignment rules), however, does not pose the same risk that the restricted securities will be sold to the public, or indicate that the purchaser of restricted securities is trying to pass the economic risks of investment in the restricted securities to the public.

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<sup>21/</sup> *United Services Funds*, 1993 WL 145658, at \*7 & n.9 (listing cases under section 10(b) of the Exchange Act).

<sup>22/</sup> See Release 34-18114.

<sup>23/</sup> See, e.g., *Rubin*, 449 U.S. at 429-30.

<sup>24/</sup> See Release 34-18114 at n.64.

<sup>25/</sup> *Preliminary Note to Rule 144*, 17 C.F.R. 230.144.

<sup>26/</sup> *Neuberger & Berman*, SEC No-Action Letter, 1986 WL 65323 (Mar. 13, 1986).

<sup>27/</sup> See *id.*

In the context of the Company Act, the Staff took the position that a loan of a security involves a "sale" for purposes of section 17(e) of that Act.<sup>28/</sup> We believe that the Staff's interpretive positions of the broad definition of "sale" under the Company Act in connection with securities lending programs are consistent with section 17(e)'s underlying policy. The position reflected section 17(e)'s purpose of limiting the amounts and types of compensation that an affiliated person may receive for acting as broker or agent for the "purchase or sale of any property" to or for an investment company. Since the securities lending agent had broad discretion which could affect its compensation as agent, finding that securities lending involves a "purchase" or "sale" was directly relevant to the regulatory purpose of section 17(e). In *Norwest Bank Minnesota, N.A.*, the Staff reiterated that securities lending constitutes a "sale" under 17(e), but granted no-action assurances to a more circumscribed securities lending program which it believed "would present little opportunity for the types of conflicts that section 17(e)(1) was designed to prevent."<sup>29/</sup>

#### **D. Prime Brokerage Services in Connection with Short Sales**

##### **1. Covering the Delivery Obligation**

Acting as prime broker, Goldman would arrange for the provision of the securities necessary to settle the short sale with a client's counter party. The transfer of securities to the executing broker to cover an advisory client's delivery obligation could, indirectly, be considered a sale of securities to the client. We believe, however, that a prime broker's facilitation of short sales should not be regarded as involving purchases or sales for purposes of section 206(3). Unlike the Securities Act, the Exchange Act, and the Company Act discussed above, the Advisers Act does not define the terms "purchase" and "sale." Accordingly, the important role played by a provision's underlying policy becomes pivotal under the Act.

As discussed above, the legislative history of section 206(3) indicates that it primarily was intended to address the possibility that an investment adviser might dump securities on its clients. At the time Goldman agrees to cover the client's delivery obligation and the security interest is granted when establishing the prime brokerage arrangement, there is no identification of any particular security, which removes any potential at that point for dumping. At the time of the short sale transaction, the client or its fiduciary sells the securities to a willing buyer at the same time as any borrowing. Because there is a willing buyer to whom Goldman could have sold the securities directly, the securities cannot be characterized as having been

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<sup>28/</sup> See *United Services Funds*, SEC No-Action Letter, 1993 WL 145658.

<sup>29/</sup> *Norwest Bank Minnesota, N.A.*, SEC No-Action Letter, 1995 WL 329622 (May 25, 1995).

“dumped” on the client. Finally, regardless of the source of the borrowed stock, Goldman ends up with the same securities at the closing of a short position as it had when the short sale was made.

As noted above, the customer's obligation to Goldman is to deliver the number of shares that Goldman borrowed in its behalf. Facilitation of a short sale does not transfer any economic exposure in the securities involved. If the borrowed shares came from Goldman's inventory, Goldman would retain all the economic risks and benefits of its investment in the shares. If the shares are borrowed from a pool of margin securities or an outside lender, that party retains the economic risks and benefits of its investment. Since there is no transfer of economic exposure to or from the owner of a borrowed security at any point from the opening of a short position through its closing, there is no risk of dumping.

Not only does covering the delivery obligation of a client pose no risk of dumping, it also does not pose any risk of price manipulation. Goldman provides a set number of securities, and the client has an obligation to return that same number. The price of the security sold short is essentially irrelevant to Goldman. Although the client may have to pay more or less to purchase the securities needed to close out the position, that amount ordinarily is determined by an open market purchase from an independent third party. There is no potential for Goldman to “profit” from dumping a security at an artificially low price. Rather, Goldman's compensation is derived from earning interest on any margin debit balance and from any earnings on the collateral.<sup>30/</sup>

## **2. Margin Transactions in Connection with Prime Brokerage Services**

A margin arrangement creates a security interest in all marginable securities held in a client's margin account. This general security interest could be deemed a “sale” of the securities by the client to the broker. Various letters to the Staff involving registered investment

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<sup>30/</sup> When the prime broker borrows the securities from an outside lender, the prime broker posts 102% of the market value of the securities as collateral with the lender. This cash collateral is then invested by the lender and any return is shared with the prime broker who, in turn, shares its portion with the client. The lender gives the prime broker the rate for overnight investments adjusted for the difficulty of finding the stock. If the stock is very difficult to locate, there may not be any investment income, and it is possible that the prime broker would have to pay a premium to borrow the securities.

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advisers have noted the extension of margin credit to advisory clients.<sup>31/</sup> The Staff, however, has not yet directly addressed whether such extensions are subject to section 206(3) and its requirement of disclosure and consent to each transaction. We believe that any extension of credit to a client by Goldman via a margin account should not be subject to section 206(3).

Section 17 of the Company Act expressly regulates a much wider variety of affiliated transactions than section 206(3). For example, section 17(a) expressly covers certain borrowing transactions, section 17(e) covers compensation received in transactions in which the affiliate acts as agent, and each of these provisions apply to transactions involving any "property." Section 206(3) of the Advisers Act, in contrast, does not expressly cover borrowing transactions, applies only to sales of securities, does not seek to regulate the compensation that an agent may receive, and applies only if the adviser is acting as such in relation to the specific transaction. Congress clearly was aware of these differences, as the Company Act and the Advisers Act are part I and part II of the same bill. Congress' more narrow focus in section 206(3) on the actual dumping of securities without regulating other kinds of property or lending transactions suggests that section 206(3)'s scope was not intended to include the grant of a general security interest in connection with margin accounts.

The general security interest created by a margin arrangement also should not be viewed as a purchase or sale of a security because it applies to all marginable securities in the client's account rather than involving a specific decision to pledge a particular security. Moreover, if the mere creation of a general security interest in the assets of a brokerage account were to be deemed a purchase or sale, either at the time the account is opened or at the time a negative balance arose, many other transactions would be unwittingly swept within the scope of section 206(3). It is common practice for broker-dealers, whether or not affiliated with advisers, to obtain security interests in the assets held in cash brokerage accounts, as well as margin accounts.<sup>32/</sup> These security interests secure all obligations of the client. It would be impractical for a broker to seek disclosure and consent from every customer that is also a client of an affiliated adviser prior to posting charges to its account. This simply is not the type of "dumping" transaction that section 206(3) was intended to address.

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<sup>31/</sup> See, e.g., *Morgan, Keegan and Company*, SEC No-Action Letter, 1990 WL 287059 (Oct. 2, 1990).

<sup>32/</sup> See, e.g., *Datek Online Customer Agreement*, available from <http://www.datek.com>; *Waterhouse Securities, Inc. Account Application*, available from <http://www.waterhouse.com>; *Howe Barnes Investments, Inc. Brokerage Services Account Agreement*, available from <http://www.netinvestor.com>; *DLJdirect Investment Account Agreement*, available from <http://www.dljdirect.com>; *Citicorp Investment Services Account Opening Form*, available from <http://www.citicorp.com>.

Even if the creation of a collateral interest were deemed a purchase or sale for purposes of section 206(3), Goldman or GSAM should not be regarded as acting as investment adviser "in relation to" margin lending for purposes of section 206(3). Congress implicitly recognized the debtor relationship created by margin accounts when it granted the FRB, a banking regulator, the authority to regulate the extension of credit by banks, broker-dealers, and other lenders. When a client opens a margin account, it agrees to secure any debits with whichever marginable securities are available in the account. As discussed above, it is also industry practice for the customer to grant a collateral interest in all securities in a cash account to secure any obligations to the broker.

Debits arise for a number of reasons, and any debit is the result of a variety of investment decisions made by the client rather than a single transaction. Similarly, whether a client has sufficient cash and securities deposited to meet initial and other margin requirements is determined in light of all the cash, margin securities, and security positions held in the account, rather than a single transaction. In light of the policies and purposes of section 206(3), the decision to effect a purchase or sale of a specific security is separate from any resulting margin borrowing which, by its nature, does not involve the identification or transfer of any particular security.

In the unlikely event that Goldman would be required to close out the margin position through exercise of its rights as a creditor, it would not be acting as investment adviser "in relation to" the liquidation transaction. Margin deficiencies in a prime brokerage account are the result of a variety of transactions, including transactions in which Goldman or GSAM may not have played any role. Further, margin calls are often triggered by sharp changes in market conditions, interest rates, and other economic factors. They are often remote in time from account transactions because brokers are prohibited under SRO rules from allowing customers to make a practice of liquidating securities to meet initial Regulation T margin requirements. Separate personnel of Goldman from the advisory personnel are responsible for administering these requirements. Goldman would be exercising its rights as creditor in a wholly separate transaction from an advisory transaction. Accordingly, in those rare occasions when Goldman must close out a margin position, it would not be acting as investment adviser "in relation to" the liquidation transaction. The extension of margin credit by Goldman to advisory clients of Goldman and GSAM should not be considered "purchase" or "sale" for purposes of section 206(3).

Finally, in Goldman's experience, the vast majority of their margin account clients meet their margin calls. On those rare occasions when Goldman would be required to liquidate margin securities, Goldman would sell the security into the market rather than taking the security directly into inventory absent unusual circumstances. Although the debtor-creditor relationship involved in secured lending differs from an advisory relationship, we note that there are protections available to clients when a broker-dealer liquidates a margin account. Under the

Uniform Commercial Code, as adopted by the state of New York ("N.Y.U.C.C."), a broker-dealer must act in a "commercially reasonable" manner when exercising its rights as a secured creditor.<sup>33/</sup> Whether a liquidation sale has been conducted in a "commercially reasonable" manner depends on the facts and circumstances surrounding the sale at issue and the burden of proof is on the creditor.<sup>34/</sup> Sales in the markets to willing third-parties provide objective evidence that the manner of sale was commercially reasonable. If a broker simply retains the foreclosed securities, it would have to establish that it was commercially reasonable to do so.<sup>35/</sup> Further, under general contract principles, brokers are required to act in good faith when exercising the discretion to liquidate an account.<sup>36/</sup>

#### E. Additional Considerations

As a practical matter, application of section 206(3) often would require that GSAM either avoid using margin or making short sales or that advisory clients choose an unaffiliated prime broker to handle their account even if GSAM only acts as adviser with respect to a portion of the client's assets. An adviser ordinarily may avoid application of section 206(3) simply by trading through another broker-dealer. An adviser with an affiliate that provided prime brokerage services for a client, however, often would be precluded from executing any trades that would create a margin debit or involve a short sale if section 206(3) were deemed applicable. The benefits of prime brokerage agreements to clients are derived from having trades cleared and margin financing through the prime broker, regardless of which executing broker is used. Carving out transactions frequently used by active market traders would greatly diminish those benefits. Further, there are not many firms that currently provide comprehensive prime brokerage services. Eliminating Goldman from consideration would impair a client's ability to obtain and negotiate for high quality prime brokerage services, and would place full-service firms that provide asset management services at a competitive disadvantage. Finally, while we do not believe that section 206(3) applies to the extension of margin credit or provision of prime brokerage services in connection with short sales, we note that Goldman and GSAM advisers would remain subject to the general antifraud provisions of the Advisers Act, including section 206(2)'s prohibition on transactions which work a fraud or deceit upon the client.

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<sup>33/</sup> N.Y.U.C.C. § 9-504.

<sup>34/</sup> See, e.g., *Granite Partners, L.P. v. Bear, Stearns & Co.*, --- F.Supp.2d ---, 1998 WL 547032 \*1, \*14 (S.D.N.Y. 1998).

<sup>35/</sup> See, e.g., *Telmark, Inc. v. Lavigne*, 508 N.Y.S.2d 737, 7338 (N.Y. App. Div. 1986); *Kohler v. Ford Motor Credit Co.*, 462 N.Y.S.2d 297, 299-300 (N.Y. App. Div. 1983).

<sup>36/</sup> See, e.g., *Granite Partners*, 1998 WL 547032 at \*15.

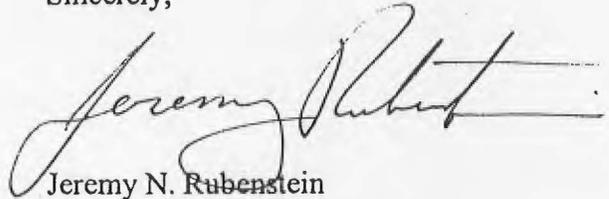
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Based on the foregoing, we respectfully request that the Staff concur with our view that Goldman will not be engaging in the sale to, or purchase from an advisory client of a security for the purposes of section 206(3) of the Advisers Act, if the advisory client engages Goldman for the provision of prime brokerage services, including the extension of margin credit and the furnishing of other services in connection with short sales; and assure Goldman that the Staff will not recommend that the Commission take enforcement action if it does not comply with the transaction by transaction disclosure and consent requirements of section 206(3) of the Advisers Act when it provides such prime brokerage services.

Please call me at 202-663-6159 or Janet Grossnickle at 202-663-6033 if you have any questions.

Sincerely,



Jeremy N. Rubenstein

cc: Ellen R. Porges, Esq.  
Steven L. Kessler, Esq.