A PRACTICAL GUIDE FOR PRIVATE EQUITY AND HEDGE FUNDS : REGISTRATION WITH THE SEC AS AN INVESTMENT ADVISER

By Bettina Eckerle, September 19, 2011

On June 22, 2011, the SEC adopted significant changes to the regulations made under the Investment Advisers Act of 1940. The amendments limited the use of exemptions from registration as an investment adviser with the SEC. As a result, under the new rules, many managers of private equity and hedge funds are required to register as investment advisers with the SEC by March 30, 2012.

The new rules also create a number of complex new exemptions from registration based on factors such as size of the fund, location (foreign funds) and the nature of the fund (venture capital).

Before you embark on the journey to registration, conduct a careful analysis of the amendments to determine whether an exemption from registration may be available to you.

Registration with the SEC is accomplished by filing Form ADV with the SEC and paying a fee. Form ADV consists of two parts and both parts are now required to be filed on the IARD electronic system that is managed by FINRA. To file the form, hedge funds and private equity groups will need to open an IARD user account by completing an IARD Entitlement Packet. The SEC will review the Form ADV for completeness. The SEC must approve the registration or begin proceedings to deny the registration in 45 days. Under the Advisers, the adviser or its personnel are not required to pass any tests or obtain certifications. An individual analysis is required as to state requirements which may require investment adviser representatives to obtain the Series 65 license.

Since the SEC may take 45 days to process and approve the registration, the application should be submitted no later than February 14, 2012.

Filing the Form ADV is just one step. Prep work is required before filing the Form ADV to comply with the Advisers Act.

Chief Compliance Officer. SEC Rule 206(4)-7 requires each investment adviser to designate an individual as Chief Compliance

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Officer to be responsible for administering the policies and procedures developed by the adviser. There is no requirement that the Chief Compliance Officer be an employee and outsourcing is a common practice.

The first step in "project" registration should be the appointment of a CCO as project manager. If outsourced, please make sure to have a primarily responsible person on the ground as liaison to ensure an effective compliance program. There are many firms offering outsourced CCO services, which in any cases is less expensive than hiring a full time in-house person with the appropriate expertise.

Compliance Manual. The Advisers Act requires investment advisers to adopt policies and procedures. When the SEC adopted the rules, it sets forth a laundry list of matters it expected would be covered, such as:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions;
- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;
- Proprietary trading of the adviser and personal trading activities of supervised persons;
- The accuracy of disclosures made to investors, clients, and regulators, including in Form ADV, account statements and advertisements;
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized use and protects them from untimely destruction;
- Marketing advisory services, including the use of solicitors;
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the privacy protection of client records and information; and
- Business continuity plans.

It is tempting to buy an "of the shelf", "one size fits all" manual because it is undoubtedly convenient and inexpensive. However, resist this temptation. The SEC does not like this approach and you may create more --unnecessary-- work for your daily compliance leg-work as many of the areas above may not apply to your business. So do spend the time at the beginning and create a manual that matches your business. It is also vital that the CCO tests compliance with the policies and procedures periodically.

Full and Fair Disclosure. Under the anti-fraud rules of the Advisers Act, it is imperative that in communications with investors, full and fair disclosure is made of information that may impair an adviser's judgment and independence.

It is imperative that before a fund sponsor begins drafting fund offering documents, to consider potential or actual conflicts of interests, such as the receipt of management fees and carried interest, solicitation arrangements, principal transactions or cross trades, co-investments by principals and affiliates and many others.

Code of Ethics. Advisers must establish, maintain and enforce a written code of ethics that, at a minimum, includes:

- A standard (or standards) of business conduct that is required of supervised persons, whicvh standard must reflect the fiduciary obligations of the investment adviser and those of its supervised persons;
- Provisions requiring supervised persons to comply with applicable Federal securities laws;
- Provisions that require all "access persons" (people who have access to non-public client information) to report their personal securities transactions and holdings periodically;
- Provisions requiring supervised persons to report any violations of the code of ethics promptly to the CCO; and
- Provisions requiring the adviser to provide each of its supervised persons with a copy of the code of ethics and any amendments receive a written acknowledgment of their receipt

Insider Trading. The code of ethics also needs to be reasonably designed to prevent insider trading.

Some private equity groups may believe this to be inapplicable because they do not trade in the public markets. For example, in the transition period of exiting and re-entering as well as in dealings with listed companies, private equity funds acquire very significant inside information.

Performance Based Fees. The Advisers Act places limitations on charging performance based fees unless the clients are "qualified clients", which is important to note in light of the carried interest private equity funds receive from the fund. Until September, 19, 2011, a "qualified client" is an individual or a legal entity that, immediately after entering into the contract:

- Has at least $750,000 under the management of the investment adviser; or
- In the reasonable belief of the adviser either:
- Has a net worth (together with assets held jointly with a spouse) of more than $1,500,000; or
- Is a qualified purchaser under the Investment Company Act of 1940 at the time the contract is entered into; or
- Is an officer, director or employee of the investment adviser. On September 19, 2011, higher qualification standards for "qualified clients" become effective with the levels for assets under management and net worth increasing to $1,000,000 and $2,000,000, respectively.

Registered Advisers making Regulation D offerings must not only ensure that their investors are "accredited investors", but also "qualified clients". It is also important to make full and fair disclosure of all such arrangements to satisfy the fiduciary duties under the Advisers Act. Also, as a consequence of the higher standards, firms should start amending the disclosure documents and subscription and management agreements. Also, expect that the levels will rise over time, as the SEC has indicated that it will adjust the threshold with inflation.

Advertising. To protect investors, the SEC prohibits certain types of advertising practices by advisers. An "advertisement" includes any communication addressed to more than one person that offers any

investment advisory service with regard to securities. It is important to note that an advertisement includes both a written publication, such as a website, newsletter or marketing brochure, and oral communications, and includes any announcements made on radio or television.

Registered investment advisers are generally prohibited from:

- The use of testimonials about the adviser and any services provided by the adviser;
- References to past specific recommendations that are not properly qualified;
- Representations that graphs, charts, formulas or other devices can be used as tools for making investment decisions without explaining the limitations of their use;
- Statements suggesting that reports, analyses or other services, are, or will be, free of charge, unless actually free without conditions or obligations.

For private equity funds, "advertisements" should be interpreted broadly and include flip-books, marketing presentations, letters to investors, due diligence questionnaires, press releases, press interviews etc. The term probably does not extend to offering memoranda; however, many managers make it best practice to use the advertising rules as guidelines. A response to a specific request for a proposal from individual investors (RFP's) would not be covered; however, if the fund sponsor provides substantially similar information to multiple investors, the Advisers Act advertising provisions apply.

> There should be one point person at the adviser to review all marketing materials, including scripts to speeches, of the adviser to ensure the requirements are met.

Record Keeping. Registered advisers must make and keep true, accurate and current certain books and records relating to their investment advisory business. Some of the more important books and records are:

- Advisory business financial and accounting records, including: cash receipts and disbursements journals; income and expense account ledgers; checkbooks; bank account statements; advisory business bills; and financial statements.
- Records that pertain to providing investment advice and transactions in client accounts with respect to such advice, including: orders to trade in client accounts (referred to as "order memoranda"); trade confirmation statements received from broker-dealers; documentation of proxy vote decisions; written requests for withdrawals or documentation of deposits received from clients; and written correspondence sent to or received from clients or potential clients discussing the advisers recommendations or suggestions;
- Records that document the advisers authority to conduct business in client accounts, including: a list of accounts in which it has discretionary authority; documentation granting discretionary authority; and written agreements with clients, such as advisory contracts;
- Advertising and performance records, including: newsletters; articles; and computational worksheets demonstrating performance returns;
- Records related to the code of ethics, including those addressing personal securities transaction reporting by access persons;
- Records regarding the maintenance and delivery of written disclosure documents

and disclosure documents provided by certain solicitors who seek clients on the advisers behalf.

- Policies and procedures adopted and implemented under the compliance manual, including any documentation prepared in the course of the annual review.

If using an outside vendor, please ensure that it is familiar with the record keeping requirements under the Advisers Act. But whether outsourced or handled internally, periodic testing is vital to ensure that the records are kept properly.

Privacy Policy. An investment adviser must adopt a privacy policy that complies with Regulations S-P and S-AM.

Other. Other specific SEC rules to be considered include:

- Rules regarding payments to finders for referring new clients to investment advisers.
- Rules regarding custody of assets.
- The new "Pay-to-play" rules that are implicated when political contributions are made or persons are paid to solicit government entities.

State Registration. While registering with the SEC generally preempts state investment adviser registration, states can still impose notice filings and charge a fee if you have investment advisers in that state.

Please place questions concerning the topics discussed in this memorandum to Bettina Eckerle at bettina.Eckerle@eckerlelawyers.com.