SEC Registration and Compliance Obligations for Private Investment Advisers Facing New Regulatory Requirements

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Investment Adviser Association
Valerie Baruch
Paul Glenn

Dechert LLP
Jane Kanter
Julien Bourgeois
Mike Sherman

15915438

Agenda

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BACKGROUND

Definition and Registration Requirement

- Under the Advisers Act, an investment adviser is, among other things, any person who:
  - for compensation
  - engages in the business of advising others
  - as to the value of securities or as to the advisability of investing in, purchasing or selling securities
- Advisers Act provides certain exceptions for banks, broker-dealers and other specified persons.
- Subject to certain thresholds for, and exemptions from, registration with the SEC, it is "unlawful for any investment adviser, unless registered …, to make use of the mails or any means or instrumentality of interstate commerce in connection with his business as an investment adviser"
- NOTE: After Dodd-Frank, an increasing number of advisers will need to register with one or more states or switch from SEC to state registration.

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The Private Adviser Exemption

- The private adviser exemption is currently relied upon by many advisers to hedge, private equity funds and venture capital funds
- An adviser may rely if on the private adviser exemption if it:
  - does not hold itself out generally to the public
  - fewer than 15 clients during the preceding 12 month period
  - no advice to U.S. registered investment companies (ICs) or registered business development companies (BDCs)
- NOTE: The private adviser exemption will no longer be available as of July 21, 2011 (per Dodd Frank).
- Therefore, it is important that advisers that currently rely on the private adviser exemption should begin to consider if they are able to rely on the exemptions available under Dodd Frank.

Continuing Registration Exemptions

- Intra-State Advisers (post-Dodd-Frank, cannot advise private funds)
- Insurance Company Advisers
- Charitable Organizations
- Internal Revenue Code Section 414(e) "Church" Plans
- Registered Commodity Trading Advisors (CTAs) – subject to limitations on portion of the CTA's business that is securities related (post-Dodd-Frank, this would depend on whether the CTA advises a private fund vs. a commodity pool or account)
- Private Funds: Dodd-Frank defines a "private fund" as "an issuer that would be an investment company . . . but for section 3(c)(1) or 3(c)(7) of [the Investment Company Act of 1940]."
- NOTE: The Dodd-Frank amendments to these exemptions become effective on July 21, 2011.

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DODD-FRANK ACT:
AMENDMENTS TO ADVISERS ACT
PROVISIONS RELATED TO REGISTRATION
OF INVESTMENT ADVISERS

Dodd-Frank Act Significantly Alters Advisers Act Registration Requirements

- New Exemption for Foreign Private Advisers
- New Exemption for CTAs Advising Private Funds
- New Exemption for Small Business Investment Company (SBIC) Advisers
- New Exemption for Mid-Size Private Fund Advisers
- New Exemption for Advisers Solely to Venture Capital Funds
- Modified Exemption for Family Offices
- Increased SEC Registration Threshold for Most Domestic Advisers

NOTE: The new exemptions, modification of exemptions and registration thresholds become effective on July 21, 2011. In many cases, the exemption and/or relevant terms will be defined by SEC future rulemaking.

New Exemptions from SEC Registration

- Foreign Private Adviser – requirements:
  - has no place of business in the US
  - has fewer than 15 "US Persons" directly as clients OR indirectly as investors in private funds advised by the foreign adviser
  - manages less than $25M in aggregate assets attributable to US Persons
  - does not hold itself out generally to the public in the US
  - does not advise an IC or BDC

  NOTE: A non-US adviser that exceeds the US Person or US AUM thresholds may be able to rely on an alternate exemption or exception.

- CTAs to Private Funds, provided that the adviser's business does not become "predominately the provision of securities related advice."

- Advisers solely to SBICs are exempt from registration, unless the adviser is, itself, a BDC, in which case it would need to register.

New Exemptions

- Mid-Sized Private Fund Advisers
  - SEC is required to adopt rules to exempt an adviser solely to private funds with less than $150M in US assets under management (AUM)
  - NOTE: That small and mid–sized advisers to separately managed accounts (SMAs) are not permitted to rely on the threshold of $150M in US AUM applicable to private fund advisers and will need to think about the new registration thresholds in Dodd Frank.

- Venture Capital Fund Advisers - an adviser solely to one or more "venture capital funds" (to be defined by SEC in future rulemaking)

- Advisers that are exempted from SEC registration requirement are still subject to certain provisions of and rules under the Advisers Act including Section 206 and Rule 206(4)-8.

- In addition, Mid-Sized Private Fund Advisers and Venture Capital Fund Advisers will be subject to recordkeeping and reporting requirements to be determined by the SEC through future rulemaking.

Exception for Family Offices

- Subject to SEC rulemaking to define the term "family offices"
  - SEC is instructed to define the term in a manner that:
    - is consistent with current exemptive and other relief and
    - "recognizes the range of organizational, management and employment structures and arrangements employed by family offices"
- Special application of the Advisers Act to family offices.
  - Dodd-Frank includes a "grandfather" provision that will subject certain family offices to limited coverage under the Advisers Act when the family office advises certain non-family officers, directors and employees.
  - Family offices will be subject to the general anti-fraud provisions of Section 206 (but will not be subject to the Advisers Act limitations and restrictions on principal and agency cross trades)

New SEC Registration Thresholds

- Under Dodd Frank, advisers must meet certain qualifications (including increased AUM thresholds) to register with the SEC as of July 21, 2011.
- Those that do not generally meet the new thresholds should consider whether they will need to register with one or more states.
- Current SEC threshold: $25 AUM million for most US advisers
- Post Dodd-Frank threshold: For US advisers for don't advise ICs and BDCs, $100 AUM million (unless (i) there is no registration and examination provisions in the home state or (ii) the adviser would be required to register in 15+ states)
- No threshold of AUM for advisers to ICs and BDCs.
- Foreign advisers and certain others: $25 AUM million threshold attributable to US persons.

IMPACT ON INVESTMENT ADVISERS

What Does this Mean Post Dodd Frank?

- Unless an adviser can rely on an exemption, the adviser will need to register with the SEC or the states by July 21, 2011.
  - Different states impose different registration requirements. Advisers that no longer meet SEC requirements will need to check the specific laws of those states in which they have their principal office and place of business or clients.
  - Mid-Size Private Fund Advisers with assets over $100 million may wish to consider SEC registration to avoid state regulation.
- SEC and state advisers are subject to significant disclosure, recordkeeping, reporting and compliance obligations.
- SEC registered advisers must comply with the Advisers Act and rules, including:
  - (i) registration requirements, (ii) providing a written brochure to clients; (iii) adopting written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act, (iv) appointing a chief compliance officer; (v) establishing and maintaining required books and records; and (vi) filing reports with the SEC (including private fund reporting mandated by the Dodd-Frank)

Foreign Advisers – "Regulation Lite" and Unibanco

- The "Unibanco" no-action letters included relief allowing, among other things, a foreign adviser that was SEC registered to avoid certain Advisers Act requirements with respect to its non-US clients.
- Consistent with the Unibanco Letters, and as a part of the prior rules (since vacated) that required registration of certain private fund advisers, a "Lite Regulation" option applied to advisers whose principal office and place of business is outside the US and which has no direct clients in the US.
- An adviser under Regulation Lite is excepted from most of the substantive requirements of the Advisers Act, provided that they:
  - keep certain records;
  - avoid improper representations to the public; and
  - Cooperate with SEC examinations, inquiries and investigations.
- We expected that Regulation Lite and the Unibanco approach will continue to be available following implementation of the rules under Dodd-Frank.

Real Estate and Other Non-Securities Advice

- Someone who provides advice solely about non-securities assets, such as real estate, is outside the definition of an investment adviser.
- When advice includes advice about securities (e.g., cash management using securities to support a real estate portfolio), registration as an adviser may be required. One alternative to avoid registration should be to use a bank money market account for such cash management purposes.
- Currently, for purposes of Form ADV, an account is included in "assets under management" only if it is a "securities portfolio" (*i.e.*, 50% or more of the value of the account is comprised of securities and cash).
- The SEC has not yet indicated whether it will adopt this calculation methodology for purposes of the new registration and exemption thresholds.
- It may be possible for an adviser whose business is substantially restricted to non-securities assets to request an exception from the definition of an adviser pursuant to Section 202(a)(11)(H) or an exemption from some or all of the substantive provisions of the Advisers Act pursuant to Section 206A. No-action or interpretative relief is also possible and probably less time consuming and costly.

Focus of US Regulation of Advisers

SEC regulation of advisers focuses primarily on registration, anti-fraud provisions in furtherance of fiduciary duties and disclosure and compliance with Advisers Act provisions and rules:

- However, there are no SEC:
  - prohibitions or limitations on investments or strategies used by advisers
  - net capital, business plan or qualification/testing requirements
- Advisers Act has been interpreted to establish a fiduciary duty between the adviser and clients, requiring avoidance or disclosure of conflicts of interest
  - failure to properly disclose conflicts of interest is often cited as a deficiency by SEC inspectors and may subject an adviser to enforcement actions.
  - most disclosures will be made through Form ADV Part 2 and agreements with clients.
- As noted above, the regime requires advisers to develop and maintain internal compliance programs to promote adherence to the fiduciary duty and provisions of and rules under the Advisers Act.

INVESTMENT ADVISER REGISTRATION

Registration Process

- An adviser must file Form ADV through the Investment Adviser Registration Depository (IARD).
  - New SEC registrants file only Part 1A and Part 2 (beginning Jan. 1, 2011).
  - Filing of Part 2 by existing SEC registrants phases in during 2011 on a rolling basis.
  - New state registrants file Part 1A, Part 1B and Part 2.
- Basic Difference Between Part 1 and Part 2
  - Part 1 is primarily a registration document.
  - Part 2 is primarily a disclosure document. Effective October 1, 2010, Part 2 has been changed to be a wholly narrative disclosure brochure.
  - Once filed, an adviser's Form ADV (both Part I and Part 2) is *publicly available* through SEC's Investment Adviser Public Disclosure Website (IAPD) .
- The SEC generally must grant registration or initiate proceedings to deny registration within 45 days.

Form ADV Part 1 – Content and Updating

- Content
  - General information on adviser's business
  - Information on adviser's affiliates
  - Identity of officers, directors, and control persons
  - Disciplinary information
  - Types of advisory clients, services and fees
  - Whether the adviser has custody of client assets
- Updating Requirements
  - Update ALL information within 90 days of adviser's fiscal year-end
  - Update certain information <u>promptly</u> if it becomes inaccurate

State Filings by SEC Registrants

- Each state may require SEC-registered investment advisers also to (i) make notice filings and (ii) pay notice filing fees if the adviser has more than a de minimis connection (place of business/clients) in the state.
  - Such state requirements need to be considered for any state in which the adviser (or its associated persons) has a place of business and a minimum number of clients.
  - Notice filing is accomplished through Item 2.B of Form ADV Part 1.
  - Fees are paid through IARD.
- Each state may require registration of each investment advisory representative that (i) has a place of business in the state and (ii) a minimum number and percentage of retail clients
  - Filings are made on Form U-4 through IARD
  - Related fees are paid through IARD.

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Registration Concerns – Additional Information

- Public Availability of Form ADV Information
  - An adviser's Form ADV (Part I *and* Part 2) will be available to the public through the IAPD at www.adviserinfo.sec.gov.
  - Advisers should keep this in mind in drafting their Form ADV, since the information in the Form ADV will be carefully scrutinized by others.
- Advisers can find additional information about SEC registration at:
  - SEC website: www.sec.gov/iard (for information on SEC rules and the Investment Advisers Act of 1940).
  - IARD website: www.iard.com (for information about IARD or Investment Adviser Registration Depository).
  - NASAA website: www.nasaa.org

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Content of the Brochure and Supplement

- Part 2A – a narrative, plain English document that discusses the following with particular attention paid to exposing and addressing any potential conflicts:
  - Advisory services and fees
  - Investment strategies
  - Trading practices (best execution, soft dollars, trade allocation, etc.)
  - Personal trading and Code of Ethics
  - Side-by-side management
  - Proxy voting
  - Client referrals
  - Dealings with affiliates of the adviser or its key personnel
  - Financial and disciplinary matters
- Part 2B – the Brochure Supplement:
  - Provides clients with biographical and disciplinary information about relevant personnel of the adviser.
  - This part of Form ADV is not required to be filed through IARD.

Form ADV Part 2 – Updating and Delivery

With respect to Form ADV Part 2, advisers must:

- Prepare, file through the IARD, maintain, and deliver a current Form ADV Part 2 (Brochure) to most new clients, other than certain “excepted clients” such as ICs and BDCs.
- Update the Brochure annually (or promptly upon material changes).
- Annually deliver (within 120 days of the end of the adviser’s fiscal year) either (i) current amendment Brochure or (ii) a summary of material changes to the Brochure accompanied by an offer to deliver the full, updated Brochure.
- Promptly deliver to clients Form ADV Part 2 when a change relates to any material financial or disciplinary events.
- As fiduciaries, disclose to clients certain information even when such information is not required to be included in Form ADV Part 2.
- NOTE: Form ADV is publicly available through the IAPD

SUBSTANTIVE REQUIREMENTS OF THE ADVISERS ACT: COMPLIANCE

Compliance Programs – Rule 206(4)-7

In accordance with Rule 206(4)-7, an adviser must:

- Establish, adopt and implement written compliance policies and procedures that (Compliance Program) are reasonably designed to prevent violations of the Advisers Act.
- Designate a chief compliance officer (CCO) to oversee the Compliance Program.
- Review no less frequently than annually:
  - The adequacy of the Compliance Program and the effectiveness of its implementation.
  - The SEC suggests, but the rules do not require, using risk matrices and similar tools in connection with the review.
- Compliance Program is not just a procedural burden.
  - Failure to maintain a Compliance Program is a violation of the Advisers Act.
  - Maintaining and following an adequate Compliance Program can (i) avoid other violations of the Advisers Act and (ii) operate as a defense to a charge of a failure in the duty to supervise.

Duty to Supervise – Section 203(e)(6)

- The SEC may sanction an adviser, or a person associated with an adviser, who fails to reasonably supervise any person acting on its behalf that violates the federal securities law.
- However an adviser or an associated person *cannot* be found to have failed to reasonably supervise a supervised person if:
  – The adviser "established procedures, and a system for applying those procedures, which would be reasonably expected to prevent and detect, in so far as is practicable, any such violation by such [supervised] person"
  – The adviser or supervisor, as applicable, "reasonably discharged the [applicable] duties and obligations [imposed by] such procedures and system without reasonable cause to believe that such procedures and system were not being complied with"
- Who is a "supervised person" for this purpose?
  – adviser has authority over the person; and
  – adviser has the power to control critical aspects of the person's conduct and behavior.

Compliance Programs – Key Policies

An adviser's Compliance Program should address, among other things and as relevant, the following:

- Portfolio management processes/research/proxies
- Trading practices, including best execution obligation, soft dollars, aggregation, and allocation
- Proprietary and personal trading
- The accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements
- Safeguarding of client assets
- Recordkeeping
- Marketing and solicitation
- Valuation
- Safeguards for the protection of client records and information
- Business continuity plans

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Compliance Programs – Review Requirement

- How can an adviser assess the "adequacy and effectiveness" of its Compliance Program?
- Among the more common methods are:
  - Risk mapping
  - Checklists
  - Periodic reviews/monitoring
  - Forensic testing
  - Risk committee meetings
- CCOs should report findings as to the adequacy of the Compliance Program to senior management.
- While the Advisers Act does not require that any written report or other work product be produced in terms of the annual review, advisers should consider documenting the review and any related reports.
- If documentation is made, it must be retained pursuant to the Recordkeeping Rule under the Advisers Act.

SUBSTANTIVE REQUIREMENTS OF THE ADVISERS ACT: ANTI-FRAUD

Section 206 and Related Anti-Fraud Rules

- Section 206(1) and (2) of the Advisers Act are the general anti-fraud provisions, which have been interpreted to impose a fiduciary obligation on advisers in connection with dealings with their advisory clients.
- This obligation applies equally to registered and unregistered advisers.
- Section 206(3) of the Advisers Act addresses the ability of an adviser to engage in principal and agency cross transactions (discussed below).
- Section 206(4) of the Advisers Act permits the SEC to define, and prescribe rules reasonably designed to prevent, potentially fraudulent practices.
  - SEC has used this authority to adopt several rules (discussed below) related to, among other things, advertising, custody and pay-to-play.
  - Most, but not all, of the rules adopted pursuant to this authority apply only to advisers that are (or should be) SEC-registered.

Portfolio Management Practices

- Principal Transactions – are generally prohibited, unless the adviser discloses the specific transaction and related conflicts to, and receives written consent from, the client *before* settlement of each transaction.
- Agency Cross Transactions - Rule 206(3)-2(b) provides an adviser with the ability to obtain a written consent prospectively authorizing the adviser or any other person relying on the Rule to effect agency cross transactions.
- Best Execution – an adviser has a duty to seek to execute client transactions at the most favorable overall terms reasonably available under the circumstances.
- Soft Dollars – the acquisition of products or services that benefit the adviser using client commissions has been viewed as contrary to the duty to seek best execution.
  - An adviser using soft dollars must make appropriate disclosure; and
  - Assure that such use complies with the safe harbor in Section 28(e) of the 1934 Act
- Allocation of Investment and Trading Opportunities – advisers, as fiduciaries, have an affirmative duty to act in the best interest of clients and to treat clients fairly in connection with the allocation of these opportunities. Advisers are expected to disclose their allocation policies to clients.

Advertising – Rule 206(4)-1

- An “advertisement” is, generally, any material addressed to more than one person offering advisory services.
- *Per Se* Prohibitions:
  - Testimonials
  - Past Specific recommendations
  - Representing that a graph, chart formula or other device can be used to make or assist in making buy and sell determinations without disclosing prominently limitations or difficulties with respect to their use.
  - Representing that a service will be “free of charge” unless the service is entirely free and without any condition or obligation
  - Advertisements that contain an untrue statement of a material fact or which are otherwise false or misleading
- Extensive SEC staff no-action guidance respecting advertising must be considered in order to determine whether an advertisement is permissible.

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Custody – Rule 206(4)-2

- Custody includes:
  - Possession of client funds or securities
  - Authority to withdraw client funds or securities
  - Automatic deduction of advisory fees
  - Legal ownership of or access to client funds or securities (e.g., as general partner of a limited partnership or as trustee of a trust)
  - Related person holds client funds or securities
- The Custody Rule generally requires:
  - a “qualified custodian” to hold client funds and securities and provide quarterly account statements to clients
  - an annual surprise audit to verify client funds and securities an internal control report with respect to any affiliate serving as qualified custodian
  - with respect to private funds, an annual GAAP audit can substitute for the quarterly custodial statements and surprise audit
  - where custody arises solely as a result of automatic fee deductions, no surprise audit requirement

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Referral Fees – Rule 206(4)-3

- Cash Referral Fees may be paid only:
  - By a registered adviser
  - Pursuant to a written agreement to which the adviser is a party
  - To a person who is not a "Bad Boy"
- When paid to a third party (*i.e.*, someone other than an employee, officer, partner or director of the adviser or an affiliate) with respect to services other than "impersonal advisory services":
  - A written solicitation agreement must require that the solicitor provide to the prospect a copy of the adviser's Brochure and a separate disclosure statement providing certain specific information
  - The adviser must obtain and retain from the prospect a written acknowledgement that the prospect has received the Brochure and solicitor's disclosure statement
  - The adviser takes appropriate steps to assure that the solicitor complies with the terms of the solicitation agreement

Pay-To-Play – Rule 206(4)-5

- Recently adopted Rule 206(4)-5 addresses concerns that political contributions have been used to secure and retain advisory mandates (separate accounts or investments in a pooled vehicle) from state and local governments (including pension plans or other pools)
- Beginning March 14, 2011, advisers will be subject to a two-year time out (no advisory fees) with respect to state and local government mandates (including pension plans), if the adviser or any "covered person" has made an improper contribution to or engaged in improper political activities on behalf of a covered official.
- Beginning September 13, 2011, advisers will be limited in their ability to use third-party solicitors or placement agents that are not registered advisers (or associated persons of registered advisers within the scope of their employment) or FINRA member broker-dealers (or their registered representatives within the scope of their employment).

Proxy Voting – Rule 206(4)-6

- Advisers having proxy voting authority must:
  - Vote proxies in accordance with written proxy voting policies and procedures (PVPs) reasonably designed to assure that (i) proxies are voted in each client's best interests, and (ii) votes are isolated from material conflicts of interest between the adviser and the client (e.g., where the adviser manages assets for a soliciting issuer or where a related person of the adviser serves on the soliciting issuer's board)
  - Describe its PVPs to its clients and disclose how clients may obtain a copy of the PVPs. Going forward, Form ADV Part 2 requires this disclosure be included in the new Part 2.
  - Disclose to each client how it obtain information about how proxies relating to the client's account were voted.
- Unless otherwise agreed with the client, an adviser that has discretionary authority to invest client assets will be assumed to have proxy voting authority over the client's account.

Protection of Pooled Investors Rule 206(4)-8

- Rule 206(4)-8 under the Advisers Act extends the anti-fraud protections of the Advisers Act to investors in various pooled investment vehicles (*i.e.*, ICs, BDCs and private funds) managed by the adviser.
- Rule 206(4)-8 prohibits an adviser from:
  - Making an untrue statement of material fact or omitting to state a material fact necessary in order to make statements made not misleading to a current or prospective investor in the relevant pooled investment vehicle
  - Otherwise engaging in an act, practice or course of business that is fraudulent, deceptive or manipulative to any current or prospective investor

OTHER SUBSTANTIVE REQUIREMENTS OF THE ADVISERS ACT

Insider Trading – Section 204A

Any adviser that is (or is required to be) registered with the SEC must:

> "establish, maintain and enforce written policies reasonably designed … to prevent the misuse … of material, nonpublic information by such investment adviser or any person associated with such investment adviser."

In addition, the Rule 206(4)-7 requires each registered adviser to put into place a Compliance Program that is reasonably designed to detect and prevent the misuse of of material, nonpublic information obtained by the adviser or any of its associated persons.

It should be noted that "controlling person" liability with respect to insider trading violations by its associated persons and employees may attach even where the controlling person is unaware of a particular violation. All that is necessary is some awareness on the part of the controlling person of the associated person's or employee's likelihood to commit a violation, and a knowing or reckless failure by the controlling person to take appropriate steps to prevent such violations.

Code of Ethics – Rule 204A-1

Pursuant to Rule 204A-1, each adviser must adopt a code of ethics that includes:

- Standards of business conduct
- Compliance with the federal securities laws
- Securities holdings and transaction reporting for access persons
- Pre-clearance of trading in IPOs and limited offerings by access persons
- Reporting of violations
- Distribution, and certification of receipt of, the Code of Ethics and amendments

- Many advisers have based their code of ethics on existing Rule 17j-1 codes and the ICI recommendations.
- Rule 204A-1 provides a limited exemption from certain of its provisions for advisers having only one supervised person.
- Advisers are required to describe their code of ethics in the Brochure and to provide a copy of the code of ethics to clients and prospective clients, on request.

Advisory Contract Requirements – Section 205

- Advisory contracts need not be in writing, but are subject to certain requirements, including:
  - must contain a provision (i) prohibiting their assignment of the contract without consent of the client and (ii) requiring disclosure of certain changes in an adviser's partners
  - Cannot provide for performance compensation, except for:
    - Section 3(c)(7) funds
    - Non-US clients
    - "Qualified Clients" as defined in Rule 205-3(d)(1) under Advisers Act (Dodd-Frank requires indexing of dollar-based thresholds)
    - Fulcrum fees for ICs or mandates in excess of $1 million
    - BDCs
- Dodd-Frank amendment to Section 205 allows (but does not require) the SEC to adopt rules limiting or prohibiting mandatory pre-dispute arbitration.

SUBSTANTIVE REQUIREMENTS OTHER THAN UNDER THE ADVISERS ACT

Privacy Requirements

- Regulation S-P imposes on U.S. each registered investment adviser, among others, an affirmative and continuing obligation to maintain the confidentiality and protect the security of certain non-public personal information of an adviser's clients
- Regulation S-P applies only to data related to clients that are individuals (*i.e.*, natural persons)
- The adviser's fiduciary duty may require an adviser to take steps to protect sensitive client data, even when such clients or data are not covered by Regulation S-P.
- In addition, there are certain state privacy requirements (e.g., MA or CA) that need to be considered by advisers depending on where their principal offices are or where they provide advisory services.

AML and OFAC Responsibilities

- As a general matter, advisers currently are not required to implement an AML Compliance Program under the Bank Secrecy Act
  - No requirement for customer identification program or suspicious activity reports (SARs)
  - Expect, however, that advisers will soon be required to implement these
- Advisers that are part of an organization that includes a Bank are subject to certain requirements:
  - Advisers that are subsidiaries of banks may be subject to bank AML requirements.
  - Advisers that are subsidiaries of bank holding companies are required to file SARs.
- Advisers that are US Persons must comply with economic and trade sanctions administered by the Office of Foreign Assets Control (OFAC).
- Pursuant to no-action relief, a broker-dealer may rely on an adviser to fulfill the broker-dealer's customer identification requirements. This relief expires in January 2011 and it is not clear whether it will be extended.

BOOKS AND RECORDS REQUIREMENTS

Books and Records – Section 204

- Authorizes the SEC to adopt rules requiring registered advisers to keep certain records and imposing time, place and manner requirements regarding such records
- Grants the SEC authority to inspect any records (regardless of whether they are required records)
- Dodd-Frank amendments to Section 204:
  - Authorize the SEC to require an adviser to maintain records and make certain reports with respect to private funds managed by the adviser
  - Treat private fund records as adviser records for inspection purposes
  - Require that all records (or extracts from records) be provided to the SEC staff upon reasonable request
  - Authorize sharing of information among regulators
  - Establish confidentiality protections for certain reports filed with the SEC
  - Authorizes the SEC to inspect the records of persons having custody or use of client securities, deposits or credits

Books and Records – Rule 204-2

- Rule 204-2 sets forth categories of records that must be kept:
  - Financial and corporate records
  - Records relating to management of client accounts
  - Advertisements (including performance information)
  - Client disclosures
  - Records relating to referral fees, personal trading by access persons, custody of client assets, proxy voting, and compliance policies and procedures
- Rule 204-2 also sets forth time, place and manner requirements
- Records generally may be kept in electronic form and electronic communications must be kept if they fall within a category of required record

Private Fund Records Post Dodd Frank

- Dodd Frank Act requires the SEC adopt rules requiring private fund advisers to keep records and make reports related to each private fund's:
  - assets under management
  - use of leverage
  - counterparty credit risk exposure,
  - trading and investment positions
  - valuation policies and procedures
  - types of assets held,
  - side agreements/letters,
  - trading practices,
  - such other information as the SEC in consultation with the Financial Stability Oversight Council may determine

SEC EXAMINATIONS AND ENFORCEMENT

SEC Examinations

An SEC-registered adviser, wherever located, is subject to examinations by the SEC's Office of Compliance Inspections and Examinations (OCIE)

- Types of Examinations
  - Periodic – routine on-site inspections
  - "For Cause" – takes place when the adviser may be violating the federal securities laws
  - Sweep Examinations – typically focus on advisers of a certain category or regarding a specific activity or practice
- Outcomes
  - "Closed Without Action" Notice
  - Deficiency Letter – 90% of all SEC inspections result in a deficiency letter
  - Referral to the SEC's Division of Enforcement – a small percentage of all advisers receiving deficiency letters are referred to enforcement (in some cases a firm may be referred to enforcement without receiving a deficiency letter)
- The Dodd-Frank Act imposes certain timing requirements on OCIE with respect to the completion of examinations.

SEC Examinations

Current Areas of Interest in Examinations

- Best execution
- Misappropriation of customer assets
- Personal securities trading and insider trading
- Side by side management
- Fund of fund and sub-adviser due diligence
- Data privacy
- Proxy voting policies and procedures
- Custody
- Pay-to-play

SEC Enforcement Authority

- The SEC is empowered to sanction an adviser for certain specified violations of the Act. Through civil enforcement actions, the SEC can:
  - Censure
  - Place limitations on activities, functions and operations
  - Suspend adviser for up to 12 months
  - Revoke the Adviser's registration
  - Impose fines of up to $500,000
  - Issue cease-and-desist orders (at times on an *ex parte* basis)
- Criminal penalties, including fines and imprisonment are also possible.

Questions

Speaker Contact Information

Investment Adviser Association

Valerie Baruch
Associate General Counsel
+1 202 293 4222
valerie.baruch@investmentadviser.org

Paul D. Glenn, Esq.
Special Counsel
+1 202 293 4222
paul.glenn@investmentadviser.org

Dechert LLP

Julien Bourgeois
Partner
+1 202 261 3451
julien.bourgeois@dechert.com

Jane A. Kanter
Partner
+1 202 261 3302
jane.kanter@dechert.com

Michael L. Sherman
Associate
+1 202 261 3449
michael.sherman@dechert.com