Proposed US Legislation Requires Advisers of Private Investment Funds to Register with the SEC

In an effort to provide increased transparency to the financial markets and protect investors from fraud and abuse, Congress and the Obama administration have proposed several bills (the "Legislation") that would require certain advisers to private investment funds to register with the US Securities and Exchange Commission (the "SEC") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). If passed, the Legislation will remove the exemptions from registration currently enjoyed by advisers of private funds, including hedge funds, venture capital funds and private equity funds. In addition to imposing registration requirements, the Legislation will also subject these investment advisers to the recordkeeping, reporting and compliance requirements of the Advisers Act as well as to periodic inspections and examinations by the SEC.[1]

This client update briefly outlines the SEC's investment adviser registration process as well as some of the general requirements and regulatory filings investment advisers must comply with upon becoming registered with the SEC.

Process of Registration – Form ADV

- **Registration** — To register with the SEC, an adviser must complete Form ADV,[2] which consists of two parts. Part 1 is filed with the SEC and is aimed at providing information to clients and to regulators for use in examinations. The SEC has 45 days to approve the registration application. Upon approval by the SEC, the registration is effective. Part II is for delivery to clients; it describes various aspects of the adviser's business such as services, fees, types of clients and investments, and other business activities and practices.
- **Delivery** — An investment adviser must deliver to an advisory client or prospective advisory client a written document containing at least the information required of Form ADV (a "brochure") no less than 48 hours before entering into the agreement (or at the time of entering into the agreement if the agreement is terminable without penalty by the client within five days of entering into it). The adviser must also annually, in writing, offer to deliver the brochure without charge, and the brochure must be mailed or delivered within seven days of receipt of request.
- **Amendments** — The Form ADV must be updated and current at all times.

Inspections

Once registered, an investment adviser will be subject to routine examination by the SEC's Office of Compliance, Inspections and Examinations (OCIE). Routine examinations are generally performed on relatively short notice, by either letter or phone, and may last two days or several weeks, depending on the size of the adviser and the nature of its business. OCIE's target is to examine each adviser every two to four years, although this timetable may slow if thousands of hedge fund managers are required to register.

There are three possible outcomes in an examination. First, the examiners may find only minor deficiencies, which are typically discussed in an exit interview followed by a form letter indicating that the examination process is complete. Second, if more serious deficiencies are found, OCIE reports them to the adviser in a deficiency letter. In response, the adviser must detail the steps it will take to correct the deficiencies, and it can expect follow up from the SEC staff on these points in the next examination. Third, if the examiners

find violations of law, OCIE will refer the adviser to the Enforcement Division for legal action. OCIE may also perform "for cause" inspections without notice if it believes there are ongoing violations of law, and may perform "sweep" examinations of all registrants with particular business characteristics, as it has done recently with hedge fund operators

Investment Advisers Act

Investment advisers that are registered with the SEC must fully comply with the Advisers Act including all of the rules thereunder. These include:

- **Terms of the advisory agreement**
  - » No assignment without the client's consent;
  - » Termination must be without penalty and without delay;
  - » No waiver of compliance with the Advisers Act or the rules thereunder; and
  - » Hedge clauses may not lead an advisory client to believe that it has waived any right of action against the adviser
- **Solicitation arrangements** — must be made pursuant to a written agreement in accordance with Rule 206(4)-3 of the Advisers Act. This requires that:
  - » The agreement be in writing;
  - » The solicitor cannot be subject to any statutory disqualifications;
  - » The investment adviser must be a registered investment adviser; and
  - » The disclosure be provided to the prospective clients — in the case of an affiliated solicitor, the disclosure should describe the nature of the relationship; in the case of an unaffiliated solicitor, the disclosure should contain a copy of the adviser's brochure as well as a copy of a separate written disclosure document containing basic information relating to the solicitation (including the names of the solicitor and adviser, the nature of the relationship or affiliation between them, a description of the terms of the compensation arrangement between the parties, and the amount the client is being charged in addition to the advisory fee as a consequence of the solicitation agreement).
- **Performance fees** — clients must be "qualified clients"[3] or "qualified purchasers."
- **Trading practices** — must comply with certain trading restrictions on certain types of trades, including principal transactions,[4] agency cross-trades[5] and transactions involving affiliates.
- **Advertising rules** — all advertising must comply with Rule 206(4)-1 of the Advisers Act and the SEC's interpretations thereunder, including restrictions on the use of testimonials, performance results and past recommendations.
- **Books and records** — must maintain extensive books and records pursuant to Rule 204-2 of the Advisers Act; records must be kept in readily accessible place for five years. In addition, advisers must keep a copy of its policies and procedures, along with records documenting their annual review.
- **Custody** — additional regulations may apply if adviser has actual custody, or is deemed to have custody, of client's assets.
- **Written Compliance manuals** — must include, at a minimum:
  - » Insider trading procedures
  - » Proxy voting guidelines
  - » Privacy policies
  - » Portfolio management processes
  - » Trading practices
  - » Proprietary trading of the adviser and personal trading activities of supervised persons
  - » Accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements
  - » Safeguarding of client assets from conversion or inappropriate use by advisory personnel (Custody)
  - » Accurate creation of required records and their maintenance
  - » Marketing advisory services
  - » Processes to value client holdings and assess fees based on those valuations
  - » Safeguards for privacy protection of client records and information
  - » Supervision of service providers

- Business continuity plans
- Anti-money laundering policies

- **Designate a Chief Compliance Officer** — this chief compliance officer must be someone who has the knowledge and authority to develop and enforce appropriate policies and procedures.
- **Annual Review** — advisers must conduct an annual review of their policies and procedures to ensure the adequacy and effectiveness of the compliance program.
- **Code of Ethics** — investment advisers must adopt a written code of ethics that, at a minimum:
  - Reflect the investment adviser's fiduciary obligations and those of its supervised persons, and must require compliance with federal securities laws;
  - Include provisions reasonably designed to prevent access to material non-public information about the investment adviser's securities recommendations and client securities holdings and transactions, unless those individuals need the information to perform their duties;
  - Require personal trading reports from access persons of the investment adviser. Access persons must: (i) pre-clear investments in initial public offerings and private placements, and (ii) report their personal securities transactions and holdings, including transactions in mutual funds advised by the investment adviser or an affiliate; and
  - Require prompt internal reporting of any violations of the code of ethics to the investment adviser's chief compliance officer. Investment advisers must provide each supervised person with a copy of the code of ethics and any amendments, and require each supervised person to acknowledge, in writing, his or her receipt of those copies. Investment advisers are also required to maintain and enforce the provisions of their codes of ethics.

Commodities and Futures

Additional rules and regulations may apply if an adviser will be trading in futures or commodities.

ERISA Requirements

Additional rules and regulations may apply if an adviser's clients are subject to ERISA.

State Law

Certain state laws and regulations may apply depending upon the state in which the US client is located.

Endnotes

1 This client update is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. You should receive specific legal advice before taking any action with respect to the matters discussed herein.

2 A copy of the entire Form ADV is available at http://www.sec.gov/about/forms/formadv.pdf.

3 A qualified client is defined in Rule 205-3 under the Advisers Act to generally include: (i) natural persons having $750,000 under management with the adviser, (ii) persons having a net worth of $1,500,000, (iii) "qualified purchasers" under the 1940 Act, or (iv) "knowledgeable employees" of the investment adviser.

4 Principal transactions are transactions in which the adviser is acting as principal for his own account to sell to or purchase any security from a client, or acting as broker for a person other than such client. An adviser must (i) disclose any such principal transactions to the client in writing and (ii) obtain the consent of the client prior to the completion of such transaction. See Section 206(3) of the Advisers Act. This also applies where an affiliate of the adviser is acting in a principal capacity with the advisory clients.

5 An agency cross-trade may occur when an adviser is also a broker dealer. The adviser may execute a client's securities trades by "crossing" these trades with securities trades of nonadvisory clients, thus saving brokerage commissions and related transaction costs (i.e. custody expenses and transfer taxes), so long as such trade is made in accordance with the requirements set forth in Rule 206(3)-2 promulgated under the Advisers Act.

If you have any questions or require further information on any matter discussed in this client update, please contact the Mayer Brown attorney with whom you normally communicate or any of the following attorneys.

Michael R. Butowsky
+1 212 506 2512
mbutowsky@mayerbrown.com

James B. Carlson
+1 212 506 2515
jcarlson@mayerbrown.com

Michele L. Gibbons
+1 212 506 2180
mgibbons@mayerbrown.com

Robert F. Hugi
+1 312 701 7121
rhugi@mayerbrown.com

Paul A. Jorissen
+1 212 506 2555
pjorissen@mayerbrown.com

Gary A. Jungels
+1 312 701 8449
gjungels@mayerbrown.com

Elizabeth M. Knoblock
+1 202 263 3263
eknoblock@mayerbrown.com

Olga A. Loy
+1 312 701 8093
oloy@mayerbrown.com

Stephanie M. Monaco
+1 202 263 3379
smonaco@mayerbrown.com

John W. Noell, Jr.
+1 312 701 7179
jnoell@mayerbrown.com

Lennine Occhino
+1 312 701 7966
locchino@mayerbrown.com

Amy Ward Pershkow
+1 202 263 3336
apershkow@mayerbrown.com

Matthew A. Posthuma
+1 312 701 8437
mposthuma@mayerbrown.com

A. Kelly Ryan
+1 312 701 8686
kryan@mayerbrown.com
