January 5, 2015

Annual Investment Adviser Compliance and Regulatory Review

The beginning of each year provides an opportunity for investment advisers to review annual compliance and regulatory matters, including issues related to private investment funds and commodity pools. This alert briefly summarizes some of the primary issues that advisers might consider in their 2015 annual review and update processes. Many of these issues apply to unregistered advisers as well as registered advisers.

Registration and Disclosure Issues

Form ADV Annual Update. Investment advisers registered with the Securities and Exchange Commission (the "*SEC*") are required to amend their Form ADV each year within 90 days after the end of their fiscal year electronically on the Investment Adviser Registration Depository ("*IARD*") system. Before filing the amendment, the filer's IARD account must be funded with an amount sufficient to cover the IARD filing fees for investment adviser registration. For investment advisers registered with the SEC, for amendments filed from January 1, 2015 through December 31, 2015, the applicable fees are: $40 for advisers with assets under management below $25 million; $150 for advisers with assets under management of at least $25 million but less than $100 million; and $225 for advisers with assets under management of $100 million or more.

Exempt Reporting Advisers. The Investment Advisers Act of 1940 (the "*Advisers Act*") and SEC rules generally provide exemptions from SEC registration for, among other things, (1) advisers that act as an investment adviser solely to venture capital funds and (2) advisers that act as an investment adviser solely to private funds with total assets under management in the United States of less than $150 million. The Advisers Act and SEC rules require certain initial and ongoing reporting on Form ADV for these "exempt reporting advisers." As a result, exempt reporting advisers, although not registered, are required to file Form ADV and amend their Form ADV each year within 90 days after the end of their fiscal year (or more frequently if required) electronically on the IARD system and pay a filing fee of $150. Exempt reporting advisers are only required to provide information relating to certain items in Form ADV.

Certain events may cause an adviser to no longer remain eligible for exempt reporting adviser status, which will trigger the requirement that the adviser register with the SEC. If a U.S.-based exempt reporting adviser relying on the smaller private fund adviser exemption has regulatory assets under management of $150 million or more, then the adviser will no longer qualify for the exemption and must apply for registration with the SEC within 90 days after the adviser's fiscal year end. During this 90 day period the adviser may continue to advise its private fund clients, provided that the adviser does not accept a non-private fund client until its application for registration has been approved. In addition, if at any time an exempt reporting adviser relying on the smaller private fund adviser exemption accepts a non-private fund client, then the adviser will lose its ability to rely on the exemption immediately and must register with the SEC. Exempt reporting advisers relying on the small private fund adviser exemption who anticipate accepting a non-private fund client should register with the SEC before accepting such a client. Similarly, exempt reporting advisers relying on the venture capital fund exemption must register with the SEC before accepting a client that is not a venture capital fund unless another exemption would apply.

Annual Filing and Delivery Requirements for Form ADV Part 2. All advisers registered with the SEC are required to file an updated Form ADV Part 2A (the "*brochure*") annually as part of their Form ADV filing. Form ADV Part 2B (the "*supplement*") should be updated annually and maintained in a firm's files. Both the brochure and supplement should generally be delivered to new and prospective clients before or at the time of entering into an advisory contract. The brochure must also be delivered to existing clients within 60 days of filing. After the initial delivery, advisers may provide to each client a summary of material changes, an offer to provide a copy of the updated brochure and supplement, and information on how a client may obtain the brochure and supplement instead of providing a copy of the updated brochure and supplement. Such a summary would need to be filed on the IARD system as an exhibit to the brochure as part of the annual updating amendment. It has been a customary practice of many advisers to private investment funds to make an offer or actual delivery of the brochure and supplement to investors in private investment funds managed by the adviser. Advisers should consider delivering the entire brochure and supplement to investors in private investment funds managed by the adviser.

Form ADV Ongoing Updates. In addition to the annual update to Form ADV, SEC-registered advisers must amend Part 1 of their Form ADV promptly during the year if (a) any information provided in response to Item 1, 3, 9 (except 9.A.(2), 9.B.(2) and 9.F.) or 11 of Part 1A or Items 1, 2.A. through 2.F. or 2.I. of Part 1B becomes inaccurate in any way or (b) any information provided in response to Item 4, 8 or 10 (including Schedules A and B) of Part 1A or Item 2.G. of Part 1B become materially inaccurate. The brochure and supplement must be updated promptly during the year if any information becomes materially inaccurate except if the material inaccuracies are solely the result of changes in the amount of client assets managed or because the fee schedule has changed.

State Filings. In states where an investment adviser has clients or a place of business, SEC-registered advisers may have notice filing and fee obligations in addition to the federal filing and fee obligations. Advisers typically receive instructions for making such filings and fee payments through the IARD system during the fall. While certain states require only an update and filing of the Form ADV, other states may require the filing of other documents (including the brochure and/or brochure supplement) in addition to their separate fees. Links to the applicable state regulations are available through the North American Securities Administrators Association's website here.

State Registration of Investment Adviser Representatives. In each state where a representative of an SEC-registered adviser has clients or a place of business, the adviser may be required to make applicable state registrations of such representative. Investment advisers should review all personnel and determine: (a) in which states such personnel have clients or a place of businesses and (b) whether such personnel should be registered as investment adviser representatives in those states. Where applicable, those investment adviser representatives should be registered in the appropriate states.

Review of Policies and Procedures

Code of Ethics. SEC-registered investment advisers are required to adopt a code of ethics that establishes a standard of conduct in accordance with the adviser's fiduciary duties and that requires that supervised persons comply with the federal securities laws including restrictions on insider trading. SEC-registered investment advisers must review their code of ethics annually for sufficiency and evaluate current business practices for consistency with the code of ethics. In completing this review and evaluation, the adviser should modify the code of ethics as necessary and develop training and/or policies to increase the effectiveness of its implementation.

Pursuant to the applicable code of ethics, certain supervised persons may be required to report current securities holdings to the investment adviser's chief compliance officer upon becoming an "access person" and at least once during each 12-month period thereafter along with making quarterly reports of transactions. Additionally, the applicable code of ethics may require (or, if not, advisers should consider adding a policy requiring) that all employees attest to acknowledgement, receipt and continued compliance with the code of ethics annually. The code of ethics must be provided to any client or potential client upon request. Regardless of whether an entity is registered with the SEC, maintaining and regularly reviewing a code of ethics is an advisable practice.

Compliance Policies and Procedures. SEC-registered advisers must complete a review of their compliance policies and procedures annually, document such review, require their employees to certify their compliance with all policies and procedures annually and modify the policies and procedures as necessary to ensure their effectiveness. The review should address any compliance matters that arose in the last year, any new participation or withdrawal in activities by the company, changes to applicable law and any other developments that may impact the appropriateness of current policies and procedures.

Policies Relating to Use of Social Media. The SEC has suggested that SEC-registered investment advisers which use social media should adopt, and periodically review the effectiveness of, policies and procedures regarding social media as part of their obligations related to compliance policies and procedures. Use of social media must comply with the antifraud provisions of the securities laws as well as the compliance and recordkeeping provisions of the Advisers Act. The SEC completed a review of several registered investment advisers of varying sizes and strategies that use social media and in 2012 issued a Risk Alert to highlight certain observations and suggestions that may be helpful to advisers when reviewing compliance policies. For more information about the Risk Alert, please see our client alert available here. In 2014, the SEC published additional guidance for advisers relating to third party testimonials on social media sites which is available here.

Policies Relating to Adviser Custody. In 2013, the staff of the SEC issued a Risk Alert announcing that is has observed widespread compliance deficiencies related to Rule 206(4)-2 under the Advisers Act which sets forth requirements for SEC-registered investment advisers that have "custody" of client funds or securities. The SEC highlighted four categories of custody rule deficiencies: failure by an adviser to recognize that it has “custody” as defined under the custody rule; failure to comply with the “surprise exam” requirements; failure to comply with the “qualified custodian” requirements; and failure to comply with the “audit approach” for pooled investment vehicles. For more information about the Risk Alert, see our client alert available here. Following the publication of the Risk Alert, the SEC initiated several enforcement actions in 2014 against advisers for violations of the custody rule. Investment advisers should review their practices in light of the deficiencies identified by the SEC.

Business Continuity and Disaster Recovery Plans. All advisers should review and test business continuity and disaster recover plans at least annually. In 2013, the SEC, the Commodity Futures Trading Commission (the “*CFTC*”) and the Financial Industry Regulatory Authority, Inc. (“*FINRA*”) issued a joint advisory regarding best practices for business continuity planning. For more information, please see our client alert available here.

Notice of Privacy Policy. The SEC, CFTC and/or Federal Trade Commission (“*FTC*”) regulations governing the privacy of consumer financial information (the “*Privacy Regulations*”) require every investment adviser and fund domiciled in the U.S. or having U.S. clients or investors, commodity pool operators (“*CPOs*”) and commodity trading advisors (“*CTAs*”) to establish policies and procedures to protect the confidentiality of clients and investor records. Such policies and procedures should be reviewed annually and updated according to privacy laws and regulations. Annual notice must be given to each client or investor who is an individual disclosing the types of non-public personal information that the adviser, fund, CPO or CTA collects and the extent of disclosure. Notice of privacy policies and procedures is required under the Privacy Regulations and must be delivered to clients or investors at least once during any twelve-month period. The notice may be provided along with other information so the beginning of the year is generally a good time for delivery (e.g. along with a bill or annual report). The Privacy Regulations were amended in 2009 and now include a model privacy notice form. Persons subject to the Privacy Regulations are provided a safe harbor for the privacy notice delivery requirement if they deliver a privacy notice that conforms to the model privacy notice form. After providing a notice to such client or investor, you may not disclose any non-public information about clients or investors other than as described in the notice without first giving notice to the client or investor describing the proposed disclosure. Parties should obtain legal consultation before obtaining consumer credit reports on clients or sharing investor information with anyone including affiliated entities.

Proxy Voting Policy. SEC-registered investment advisers are required to adopt policies and procedures on proxy voting designed to ensure that securities are voted in accordance with the best interest of their clients and that material conflicts of interest are addressed. Advisory clients must be given a description of such policies, a copy of such policies upon request and informed as to how they can obtain a list of such proxy votes relating to such client’s securities. In 2014, the SEC’s Division of Investment Management and Division of Corporate Finance jointly issued a Staff Legal Bulletin providing guidance on the proxy voting responsibilities of advisers. The guidance provides examples of how advisers can comply with their fiduciary duties to clients when voting proxies. The guidance also provides SEC staff interpretation of when voting a proxy is not required, the considerations an adviser should take into account when selecting a proxy advisory firm and an adviser’s ongoing duty to oversee any proxy advisory firm it retains. The staff expects advisers to implement any changes to their current systems and processes necessary to comply with the new guidance in advance of the 2015 proxy season. The joint Staff Legal Bulletin can be found here. Investment advisers should review their proxy voting policies in light of this guidance.

Anti-Money Laundering (“AML”) Policy. AML policies and procedures are recommended and should be maintained, updated periodically and adhered to. Additionally, compliance programs should be reviewed to ensure compliance with the economic sanctions programs administered by the Office of Foreign Assets Control (“*OFAC*”). Maintaining an effective AML program may be considered as a positive factor in assessing penalties for a violation of OFAC regulations. In 2013, the Director of the Treasury Department’s Financial Crimes Enforcement Network (“*FinCEN*”), Jennifer Shasky Calvery, noted that the Treasury Department was working on a regulatory proposal that would require investment advisers to establish AML programs and report suspicious activity. Current FinCEN regulations apply to banks, broker-dealers, and open-end mutual funds, but not to investment advisers. If FinCEN ultimately adopts rules requiring investment advisers to establish AML programs, investment advisers (who have not already done so) will likely be required to adopt written policies and procedures reasonably designed to comply with Bank Secrecy Act regulations and to detect and report suspicious transactions (including customer identification requirements). These rules would also likely require that investment advisers appoint an AML compliance officer, provide AML training for personnel, and annually test their AML program.

Policies Relating to Exemptive Orders. Advisers that have received and rely upon exemptive orders are encouraged to periodically review all representations and conditions of those orders to ensure continued compliance as failure to comply with applicable representations and conditions pose the risk of violating federal securities law. In May 2013, the SEC issued an IM Guidance Update encouraging firms to incorporate specific policies or procedures designed to ensure ongoing compliance with each representation and condition of any exemptive orders. The SEC's IM Guidance Update is available here.

Other Selected State and Federal Filing Issues

SEC Form D and State Blue Sky Filing Requirements. Form D is required to be filed with the SEC by all issuers that sell securities in reliance on Regulation D under the Securities Act of 1933 ("*Securities Act*"). This includes interests in hedge funds, private equity funds or other privately-offered pooled investment vehicles. Form D must be amended on or before the anniversary of the issuer's filing if the offering is continuing at that time. Form D must also be amended to correct any material mistake or error along with certain other changes. Form D and amendments thereto must be filed with the SEC using its electronic filing system. Additionally, Form D and some combination of a Form U-2 and filing fee are generally required to be filed in states where a fund sells interests to U.S. persons. Certain states require the filing of additional disclosure documents while other states may have additional blue sky filing requirements (and exemptions thereto). These requirements should be evaluated and fulfilled as needed prior to offering or selling any interests in a fund to U.S. investors in any new states to ensure compliance.

Form 13H "Large Trader" Reporting Obligations. "Large traders" meeting certain definitional thresholds in transactions in "NMS securities" are required to identify themselves to the SEC and make certain disclosures to the SEC on Form 13H. In general, "NMS securities" include exchange-listed equity securities and standardized options, but do not include exchange-listed debt securities, securities futures, or shares of typical open-end mutual funds, which are not currently reported pursuant to an effective transaction reporting plan. In addition to an initial filing, all large traders must submit an annual filing on Form 13H within 45 days after the end of the calendar year and submit any amendments promptly after the end of any calendar quarter where information in the form becomes materially inaccurate. Upon receiving Form 13H for the first time, the SEC will assign large traders an identification number (an "*LTID*"). Large traders are required to provide their LTIDs to all registered broker-dealers carrying their accounts and/or effecting transactions in NMS securities on their behalf. Registered broker-dealers are required to maintain certain records in connection with such transactions and provide such information to the SEC upon request if they (1) are large traders, (2) carry accounts of large traders or (3) effect transactions in NMS securities on behalf of large traders. All registered-broker dealers are also required to perform monitoring of accounts to identify potential large traders that have not identified themselves to the SEC.

Schedule 13D and 13G and Form 13F Filings. Persons (individuals or entities) with the right to exercise investment discretion or voting power over five percent or more of any class of outstanding equity securities of a public U.S. company may be required to file Schedule 13D or Schedule 13G with the SEC. The eligibility, filing thresholds, amendment requirements and timing requirements for each such Schedule varies and persons should review the requirements if they have or are about to cross such threshold with respect to any security. If a person, whether or not a registered adviser, exercised investment discretion over $100 million or more invested in "13(f) securities" (as included on the list published by the SEC) as of the last day of any calendar month, those holdings must be reported to the SEC by filing a Form 13F. Such reports must be filed for year-end holdings for the first year this occurs and quarterly thereafter. Such reports must be filed quarterly within 45 days after the relevant reporting date.

Section 16 Filings. Persons (individuals or entities) that hold a beneficial ownership of ten percent of any class of equity securities registered under Section 12 of the Securities Exchange Act of 1934 (the "*Exchange Act*"), if the person is an officer or director of such issuer, may be required to file Form 3, 4 or 5 regarding crossing certain thresholds, reporting certain sales and making certain annual reports.

Form PF. Investment advisers registered with the SEC that advise one or more private funds and have at least $150 million in private fund assets under management are required to file Form PF with the SEC. The CFTC rule requires commodity pool operators and commodity trading advisors registered with the CFTC to satisfy certain CFTC filing requirements with respect to private funds by filing Form PF with the SEC, but only if those CPOs and CTAs are also registered with the SEC as investment advisers and are required to file Form PF under the Advisers Act. The CFTC rule also allows such CPOs and CTAs to satisfy certain CFTC filing requirements with respect to commodity pools that are not private funds by filing Form PF with the SEC. Advisers must file Form PF electronically, on a confidential basis. Under the reporting requirements, private fund advisers are divided by size into two broad groups: large advisers and smaller advisers. Large private fund advisers include any adviser with $1.5 billion or more in hedge fund assets under management, $1 billion in liquidity fund or registered money market fund assets under management, or $2 billion in private equity fund assets under management. Large private fund advisers must file Form PF on a quarterly basis and must provide more detailed information than smaller advisers. Smaller private fund advisers must file Form PF only once a year within 120 days of the end of the fiscal year, and report only basic information regarding the private funds they advise. In February 2014, the SEC's Division of Investment Management updated its frequently asked questions regarding Form PF to address a variety of issues, including reported borrowings, reverse repos, fund categorization, parallel managed accounts, investments in other unregistered funds, and calculation of a fund's gross assets. The updated frequently asked questions can be found here.

Treasury International Capital Reporting. The Department of the Treasury's Treasury International Capital ("*TIC*") Form SLT is required to be filed by all U.S. individuals or entities who qualify as U.S. resident custodians, issuers and/or end-investors and whose consolidated long-term reportable securities exceed $1 billion as of the last business day of the reporting month. The form is designed to gather information on cross-border ownership of long-term securities by U.S. foreign residents for use in forming U.S. international financial and monetary policies. Where the securities are held by a U.S.-resident custodian, the Form SLT would be due from the custodian and not from the beneficial owner of the securities. Form SLT is required to be filed based on a reporting date of the last business day of each quarter and as of the last business day of each month in which the $1 billion threshold is exceed and monthly thereafter. The form must be submitted no later than 23rd calendar day of the month following the applicable reporting date. Beginning in June 2014, all Form SLTs must be submitted electronically using the Federal Reserve System's "Reporting Central" system, and forms submitted by fax or mail are no longer accepted. Advisers should review whether they have any reporting obligations with respect to Form SLT with respect to any accounts where they act as adviser and/or custodian. As a result of their responses on Form SLT, certain firms may be required to perform additional reporting on annual Forms SHCA and/or SHLA. Firms have no reporting obligations on Form SHCA or Form SHLA unless contacted individually by the Federal Reserve Bank of New York.

The Department of the Treasury now requires certain investment advisers to private funds with significant claims and/or liabilities with non-U.S. entities to report certain information on the TIC Form B series. Investment advisers to private funds are generally required to report on the Form B series if the claims or liabilities of the funds to which the serve as adviser are, on a consolidated basis, at least $25 million in any individual country or at least $50 million aggregated across all non-U.S. geographic areas. The specific forms required to be submitted depend on the types of claims or liabilities exceeding the reporting threshold amounts. The extent of information collected and frequency of reporting vary by form. More information about TIC reporting requirements can be found here.

Hart-Scott-Rodino Filings. Parties to certain transactions (including purchases of publicly traded securities) that meet certain thresholds are required to file premerger notification forms with the FTC and Department of Justice Antitrust Division and may be required to make filings under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "*HSR Act*"). If a fund is making an acquisition that would result in the ownership of voting securities or assets valued above the minimum threshold ($75.9 million in 2014 with the 2015 threshold to be released in early 2015) using the HSR Act's valuation mechanics, legal consultation should be obtained regarding the filing obligations or the availability of applicable exemptions.

FBAR Reporting. U.S. persons having financial interests in or signatory or other authority over bank, securities or other financial accounts in a foreign country must file a FinCEN Report 114 (Report of Foreign Bank and Financial Accounts or "*FBAR*") reporting such relationship by June 30th of the year following that in which the relationship existed. FinCEN Report 114 may only be filed through the Treasury's e-filing system. Final regulations governing FBAR were promulgated in 2011. Under these regulations, financial accounts subject to FBAR include accounts with a mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions. The final regulations reserve on the treatment of "other investment funds," however, under guidance on the Internal Revenue Service ("*IRS*") website, hedge funds and private equity funds that do not issue shares to the general public do not fall within the scope of FBAR. The final regulations also provide exceptions to reporting for officers and employees of financial institutions, entities registered with and examined by the SEC that provide services to investment companies registered under the Investment Company Act of 1940 (the "*Investment Company Act*") and certain entities that have equity securities listed on any U.S. national securities exchange or registered under Section 12(g) of the Exchange Act, in each case that have signature authority over, but not financial interests in, foreign financial accounts owned or maintained by such entity. FinCEN Notice 2014-1 extended the due date for filing FBARs by certain individuals with signature authority over, but no financial interest in, foreign financial accounts of their employers or a closely related entity to June 30, 2016.

CPOs and CTAs. Registered CPOs and CTAs are required to update their National Futures Association ("*NFA*") registration information and pay annual NFA dues on or before the anniversary of the date the CPO's or CTA's registration became effective. As of the date due, failure to file the update will be deemed a request for withdrawal from registration which will be effective in 30 days after the failure to complete the update. Any person claiming an exemption or exclusion from registration under CFTC Regulations 4.5, 4.13(a)(1), 4.13(a)(2), 4.13(a)(3), 4.13(a)(5) or 4.14(a)(8) is required to annually affirm the applicable notice of exemption or exclusion within 60 days of the calendar year end. Failure to affirm an exemption or exclusion will be deemed as a request to withdraw the exemption or exclusion and result in the automatic withdrawal of the exemption or exclusion. These affirmations can be made through the NFA's website.

Registered CPOs and CTAs must complete and retain the NFA's "self-examination questionnaire" annually including with respect to any pools that have liquidated. This includes CPOs and CTAs that qualify for disclosure exemptions under CFTC Regulation 4.7. As part of this review, CPOs and CTAs should review compliance policies and procedures, confirm whether amendments to those procedures are necessary and determine whether additional procedures may be warranted in light of the occurrences of the previous year. At least annually, CPOs and CTAs must also test disaster recovery plans and adjust as necessary, deliver privacy policies to every current participant, provide ethics training as described in the CPO/CTA's written ethics training procedures and update disclosure documents. CPOs and CTAs are subject to certain quarterly and annual reporting requirements absent applicable exemptions. CPOs and CTAs should ensure that their compliance policies and procedures reflect applicable requirements and that applicable reporting to pool participants is being addressed as required.

FINRA Entitlement Program. The FINRA Entitlement Program is intended to provide a secure way for firms to access many of FINRA's web-based systems with a single user ID and password. Each adviser is required to designate an authorized employee or officer as the Super Account Administrator ("*SAA*") who is able to create, modify and delete account administrator and user accounts for FINRA applications used by the adviser. Additionally, the SAA can manage his or her own access to those FINRA applications. More information about the FINRA Entitlement Program, including 2014 developments is available here.

Specified Foreign Financial Assets. U.S. citizens and residents are required to file Form 8938 under U.S. Internal Revenue Code Section 6038D to report an interest in a "foreign financial asset" if the aggregate value of all such assets exceeds certain threshold. Nonresident aliens are also required to file if they make an election to be treated as a resident alien for purposes of filing a joint income tax return or if they are a bona fide resident of American Samoa or Puerto Rico. A reportable foreign financial asset for this purpose includes financial (deposit and custodial) accounts held at foreign financial institutions, foreign stock or securities not held in a financial account, foreign partnership interests, foreign mutual funds, foreign hedge funds and foreign private equity funds. An "interest" exists when any income, gain, loss, deduction, credit, gross proceeds, or distribution from holding or disposing of the account or asset would be required to be reported on an income tax return. The threshold for filing varies based on filing status and whether the individual lives within the United States. For example, an unmarried taxpayer living within the United States must file if the aggregate value of the foreign financial assets is more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year. The initial penalty for failure to file is $10,000, plus $10,000 for each 30-day period of non-filing occurring 90 days after an IRS notice of failure to disclose, with a maximum total penalty of $60,000.

Change of Address or Agent Filings. Upon moving office locations, amendments to an entity's certificates of limited partnership, articles of incorporation, articles of formation and all other documents on file with the applicable state of organization should be updated to ensure accuracy.

Other Issues

Examination of Advisers That Have Never Had an SEC Exam. In 2014, the SEC staff announced an initiative to conduct examinations of a significant percentage of advisers that have not been examined since they registered with the SEC. While not formally announced, it is generally expected that the SEC will continue this initiative in 2015. Advisers that have never had a SEC exam should make sure to review their compliance programs to ensure that policies and procedures are current and being followed. For more information, please see our client alert available here.

Broker-Dealer Registration. Investment advisers should review their firm's and their employees' activities and services to determine whether they may be engaged in conduct requiring the firm to register with the SEC as a broker-dealer under the Exchange Act. Absent an available exemption or other relief, a person engaged in the business of effecting transactions in securities for the account of others must generally register under Section 15(a) of the Exchange Act. In 2013, the chief counsel of the SEC's Division of Trading and Markets gave a speech in which he noted that the staff of the SEC had observed many advisers to private funds that were not registered as broker-dealers engaged in conduct that may implicate broker-dealer registration under the Exchange Act. In particular, the chief counsel identified two types of practices by advisers that raise significant broker-dealer registration concerns. First, registration may be required based on certain capital raising conduct by advisers where employees are compensated based on how successful they are in marketing or selling fund interests and/or where employees' sole or primary function is the sale of interests in the adviser's private funds. Second, registration may be required where advisers receive transaction fees relating to the purchase or sale of one or more of their funds' portfolio companies for services that could be characterized as broker-dealer activities. The chief counsel further noted that the SEC and staff have long viewed receipt of transaction-based compensation as a hallmark of being a broker. A transcript of the speech is available here. Private fund advisers in particular should periodically review how capital is raised by their firms and how the firm and its employees are compensated to determine whether they need to revise their current practices or consider registration as a broker-dealer with the SEC.

Restricted New Issues. Members of FINRA are prohibited from selling "new issues" to any client unless such member receives a representation from the client within the past 12 months that the client is not a "restricted person" and restricted persons do not have more than a de minimis ownership interest in the client (e.g., a hedge fund) pursuant to FINRA Rule 5130. Investment advisers must reconfirm the "restricted person" status at least annually. This annual certification may be obtained through a negative consent letter.

Private Investment Funds. In addition to the foregoing, offering documents for any private investment fund should be updated at least annually to reflect any changes in the business or operations of the fund, such as changes in investment strategies, personnel, risks, performance data, annual financial information, soft dollar arrangement and other brokerage practices and tax and legal matters. If registered investment companies are owners of a fund, such registered investment companies should be reviewed at least annually to determine if such funds are "affiliated persons" under the Investment Company Act (e.g., if they own five percent or more of the fund). Exceptions from the definition of "investment company" under section 3(c)(1) of the Investment Company Act should be reviewed on an ongoing basis to confirm that investors do not exceed the 100 beneficial owner limit for section 3(c)(1) purposes (including the application of look-through rules for certain corporations, partnerships, trusts, funds and other companies).

FATCA Withholding. Part of the Hiring Incentives to Restore Employment Act passed into law in 2010 was the introduction of a 30 percent withholding on payments to non-U.S. entities. This is generally referred to as the Foreign Account Tax Compliance Act ("*FATCA*") withholding. FATCA withholding has two major parts:

- Payments to foreign financial institutions ("*FFIs*"): Payments to FFIs will be subject to withholding unless the FFI enters into an agreement with the IRS to determine whether the entity has any direct or indirect U.S. account holders. The agreement will also obligate FFIs to withhold on passthrough payments made by the FFI.

- Payments to non-financial foreign entities ("*NFFEs*"): Payments to NFFEs will be subject to the new withholding unless the NFFE certifies that it has no direct or indirect U.S. owners of more than 10 percent of the NFFE's equity (or provides information about those that it has).

On January 17, 2013, the IRS released the final FATCA regulations, which were updated in March 2014. Under the final rules, most offshore funds will be treated as FFIs and subject to these rules. Through a series of notices and proposed regulations, the IRS has delayed the implementation of FATCA. Assuming no additional postponement, in general, the new withholding applies to payments after July 1, 2014. The new rules apply to dispositions and passthrough payments after December 31, 2016. Certain obligations outstanding as of January 1, 2015 are exempt from certain provisions of FATCA under its grandfathering provisions (or, in some cases, exempt until July 1, 2016). For more information about FATCA withholding including the delays and effective dates associated with certain provisions please see our client alerts available here, here, and here.

Annual Audit Requirement. SEC registered advisers deemed to have custody of client assets are generally required to contract with an independent public accountant for an annual surprise audit to verify client assets. SEC registered advisers to hedge funds and other pooled investment vehicles are generally exempt from the annual surprise audit requirements if financial statements prepared in accordance with U.S. generally accepted accounting principals and audited by an independent public accountant are delivered to investors within 120 days after the end of a fund's fiscal year (180 days in the case of funds of funds). Advisers relying on this exemption should ensure that financial statements are delivered to investors in the form and at the time required.

Liability Insurance. Given the environment of investor lawsuits and increasing focus on the regulation of fund managers, investment advisers should regularly review the adequacy of all their insurance coverage. The annual review is a good time to consider obtaining management liability insurance or review your existing coverage.

ERISA Review. Investment advisers to private funds should consider whether they need to reconfirm whether any of the investors in their funds are "benefit plan investors" under the Employee Retirement Income Security Act of 1974 ("*ERISA*") and whether investments by benefit plan investors result in fund assets being characterized as "plan assets" for purposes of ERISA and the Internal Revenue Code of 1986. In particular, advisers should review benefit plan investors' investments in investment funds managed by the adviser to determine whether participation in the fund by "benefit plans" is "significant" (i.e. whether it qualifies for the 25% "significant participation" exemption under ERISA). This may be particularly important where a significant amount of assets have recently been withdrawn or redeemed.

Review of "Pay-to-Play" Practices. Under the Advisers Act, an adviser is prohibited from providing advisory services for compensation to a government entity (either directly or through a pooled investment vehicle) for two years if the adviser or certain of its executives or employees make a political contribution to an elected official who is in a position to influence the selection of the adviser. Applicable rules further prohibit an advisory firm and certain executives and employees from soliciting or coordinating campaign contributions from others for elected officials (or to political parties in the state or locality where the adviser is seeking business) in a position to influence the selection of the adviser. Under the rules, advisers are prohibited from paying a third party to solicit government clients on behalf of the adviser unless such party is an SEC-registered investment adviser or a broker-dealer or municipal advisor subject to similar restrictions. In addition to applying to advisers registered under the Advisers Act, these rules apply to exempt reporting advisers and exempt foreign private advisers. Effective April 1, 2015, the applicable Advisers Act rules will prohibit an investment adviser from paying a FINRA member firm to solicit a government entity for investment advisory services unless the FINRA member firm is subject to an equivalent FINRA pay-to-play rule or otherwise meets the definition of a "regulated person" under the Advisers Act rule. In November 2014, FINRA proposed new "pay-to-play" rules that would regulate the activities of FINRA member firms engaging in distribution or solicitation activities with government entities on behalf of investment advisers. These FINRA rules are designed to address this requirement under the Advisers Act rule. For more information, see our client alert available here. Advisers that currently or may in the future provide advisory services to a government entity should periodically review their current recordkeeping and other practices in light of the applicable restrictions.

JOBS Act. In 2012, the Jumpstart Our Business Startups Act (the "*JOBS Act*") was signed into law which, among other things, directed the SEC to remove prohibitions on general solicitations and general advertising for certain private securities offerings. In 2013, the SEC adopted final rules which permit the use of general solicitation and advertising to offer and sell securities under Rule 506 of Regulation D under the Securities Act provided that the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors and all other terms and conditions of Regulation D are satisfied. In adopting the rules the SEC clarified that general solicitation and advertising pursuant to the proposed changes to Rule 506 would not be deemed a public offering under the federal securities laws and private funds relying on Section 3(c)(1) or 3(c)(7) of the Investment Company Act would not lose their status as private funds if they were to engage in such general solicitation or advertising. In 2014, the CFTC issued an exemptive letter permitting CPOs relying on exemptions in CFTC Regulations 4.7(b) and 4.13(a)(3) to engage in general solicitation and advertising as permitted under Rule 506. To claim relief, a CPO must file a notice with the CFTC that includes basic information regarding the CPO, the pool(s) for which the claim is being filed, the exemption upon which the CPO is relying and a representation that the CPO meets the requirements for that exemption. For more information, see our client alert available here. All registered investment advisers remain subject to applicable advertising regulations under the Advisers Act.

The SEC rules disqualify securities offerings involving certain felons and other "bad actors" from relying on the Rule 506 exemptions. The rules provide that any investment manager to an issuer that is a pooled investment fund is a "covered person" for the purposes of determining who may be deemed a bad actor. For more information on the bad actor rules, please see our client alert available here. Since adopting the bad actor rules in 2013, the SEC's Division of Corporation Finance has published and periodically updated a set of Compliance and Disclosure Interpretations providing guidance regarding certain aspects of the bad actor provisions including clarifying the scope of actors covered by the rule, which are available here.

Cybersecurity Initiative. On April 15, 2014, the SEC's Office of Compliance Inspections and Examinations ("*OCIE*") released a Risk Alert providing additional information concerning its forthcoming examination of over 50 registered broker-dealers' and registered investment advisers' cybersecurity preparedness. The OCIE's cybersecurity examinations focus on the examinee's cybersecurity governance, identification and assessment of cybersecurity risks, protection of networks and information, risks associated with remote customer access and funds transfer requests, risks associated with vendors and other third parties, detection of unauthorized activity, and experiences with certain cybersecurity threats. The Risk Alert provided a sample list of questions to help firms prepare for the examinations and assist in evaluating their own cybersecurity preparedness. The OCIE's Risk Alert is available here.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.