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## APPLICATION OF THE INVESTMENT ADVISERS ACT TO PRIVATE EQUITY ADVISERS

*Under the Investment Advisers Act, as amended by the Dodd-Frank Act, most investment advisers to private equity funds will be required to register with the SEC and comply with the Advisers Act, including many provisions not designed for their business model. Focusing on the distinctive concerns of these advisers, the author addresses (i) the process of registering with the SEC under the Advisers Act, (ii) the SEC inspection and examination function, and (iii) the statutory and regulatory requirements with which registered investment advisers must comply.*

By Jason E. Brown \*

On July 21, 2010, President Obama signed into law the Private Fund Investment Advisers Registration Act of 2010 (the “Registration Act”), as part of the Dodd-Frank Act, which substantially alters the registration and reporting schemes under the Investment Advisers Act of 1940 and the rules thereunder (together, the “Advisers Act”).<sup>1</sup> In particular, the Registration Act will require registration under the Advisers Act for most U.S. advisers to private funds, including advisers to private equity funds (“private equity advisers”).<sup>2</sup> The Registration Act accomplishes this by removing the

private investment adviser exemption previously set forth in Section 203(b)(3) of the Advisers Act for investment advisers with fewer than 15 clients that do not hold themselves out to the public as investment advisers, upon which most private equity advisers currently rely.<sup>3</sup>

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<sup>1</sup> See Title IV of the Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>2</sup> The Registration Act defines a “private fund,” for all purposes under the Advisers Act, as an issuer that would be an investment company under the Investment Company Act of 1940 (the “1940 Act”) but for Sections 3(c)(1) or 3(c)(7) (*i.e.*, funds sold in private offerings to 100 or fewer investors or funds sold in private offerings exclusively to highly sophisticated investors known as “qualified purchasers,” respectively). Registration Act § 402(a).

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<sup>3</sup> The Registration Act adds certain additional exemptions from registration under the Advisers Act, but these are unlikely to apply to most U.S.-based private equity advisers. The new exemptions apply to (a) certain advisers registered as commodity trading advisers under the Commodity Exchange Act (Registration Act § 403(4)(D)), (b) advisers with no place of business in the U.S. that have fewer than 15 U.S. clients and investors in private funds and aggregate assets under management attributable to U.S. clients and U.S. private fund investors of less than \$25 million (the “foreign private adviser exemption”) (Registration Act § 403(2)), (c) advisers acting solely as advisers to private funds that have assets under management in the U.S. of less than \$150 million (the “private

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### IN THIS ISSUE

• APPLICATION OF THE INVESTMENT ADVISERS ACT  
TO PRIVATE EQUITY ADVISERS

The Registration Act provides for a one-year transition period from the date it was enacted before the new requirements under the Advisers Act take effect (*i.e.*, July 2011). Investment advisers may register voluntarily during the one-year transition period.

Subjecting private equity advisers to the requirements of the Advisers Act will require many important changes to their business and operations. Additionally, the requirements of the Advisers Act are complex and subject to constantly evolving interpretations by the SEC and its staff, and many of these requirements were not drafted with the private equity business model in mind. Consequently, the application of the Advisers Act creates numerous interpretive and compliance issues for private equity advisers, in light of the unique nature of their operations and historical industry practice.

Focusing on these distinctive concerns of private equity advisers, this article will address (i) the process of registering with the SEC as an investment adviser under the Advisers Act, (ii) the SEC inspection and examination function, and (iii) the statutory and regulatory requirements with which registered investment advisers must comply.<sup>4</sup> As there is no clear resolution to the interpretive issues posed herein and the

operations of each private equity adviser will vary, it would be imprudent to recommend a uniform approach to compliance with the Advisers Act. Consequently, each private equity adviser will need to reach its own conclusions regarding its compliance practices, based on its particular circumstances and tolerance for risk of non-compliance with the Act.<sup>5</sup>

## REGISTRATION

To register under the Advisers Act, an investment adviser must complete and file an application for registration (which consists of Form ADV) electronically with the Investment Adviser Registration Depository (the “IARD”).<sup>6</sup> After the registration application is filed, the SEC has 45 days to (i) grant registration or (ii) institute proceedings to determine whether registration should be denied.<sup>7</sup> Registration is effective upon receipt from the SEC of an order granting it.<sup>8</sup>

### ***Determining the Entity (or Entities) to Register***

In a more traditional investment advisory business, determining the entity to register is a relatively straightforward task (*i.e.*, the entity that is a party to the investment management agreement with a client and that provides advisory services). In the context of an adviser to a private equity fund, however, identifying the appropriate entity (or entities) to register is not necessarily as simple. For example, depending on the structure of an adviser and the fund,

- the general partner of the fund makes the ultimate investment decision for the fund, based on the

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fund adviser exemption”) (Registration Act § 408) and (d) advisers that act solely as advisers to venture capital funds (Registration Act § 407).

The Registration Act also changes certain substantive requirements of the Advisers Act (primarily the reporting, recordkeeping, and examination requirements), which are noted in this article when applicable. A number of those changes will be implemented through rules that have been proposed, but, as of this writing, are yet to be adopted by the SEC. *See, e.g.*, Adv. Act Rel. Nos. IA-3110 and 3111 (2010).

<sup>4</sup> This article focuses primarily on U.S.-based advisers. Many non-U.S.-based private equity advisers will be able to rely on exemptions in the Registration Act to avoid registration, namely, as noted above, the foreign private adviser exemption or the private fund adviser exemption. A full discussion of the application of the Registration Act and Advisers Act to non-U.S.-based private equity advisers is beyond the scope of this article.

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<sup>5</sup> *See* “Inspections and Examinations” below for further discussion of the issues faced by private equity advisers in light of these open questions.

<sup>6</sup> Advisers Act Rule 203-1(a).

<sup>7</sup> Advisers Act § 203(c)(2).

<sup>8</sup> Although the SEC may ask the applicant to consent to a longer period of review, the SEC commonly grants registration in fewer than 45 days after filing.

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recommendation of the affiliated private equity adviser;<sup>9</sup>

- there is no investment adviser for the fund other than a general partner of the fund;
- there is no separate management agreement, but rather the mechanics for the management of the fund's assets, including the payment of management fees, are set forth in the limited partnership agreement;
- for tax or other operational purposes, the entity that is paid management fees by the fund is separate from the entity that houses the relevant investment personnel (although the entities are typically under common control);
- multiple entities are involved in the investment decision-making process for the fund, but they are all under common control and have substantially the same personnel; and/or
- different advisory entities are organized for each private equity fund, but the entities are all under common control and have substantially the same personnel.

The SEC staff has provided guidance in the context of the first example above (*i.e.*, where an adviser and affiliated general partner both make investment recommendations/decisions for a fund).<sup>10</sup> In short, the staff stated that it would not require the affiliated general partner to register as an investment adviser with the SEC, provided that all of the investment advisory activities of the general partner are subject to the Advisers Act and the general partner is subject to examination by the SEC.<sup>11</sup> For example, the general partner would be subject to the Advisers Act requirements regarding performance-based fees and

books and records.<sup>12</sup> In this circumstance the general partner would look to, and essentially rely upon, the affiliated investment adviser's registration with the SEC in not registering itself. However, as noted above, the advisory and fund structures for many private equity funds are significantly more complex than the structure addressed in the SEC guidance. Consequently, a private equity adviser will need to determine, in light of the advisory and fund structure that it has established and the policy rationale that appears to be behind the SEC guidance,<sup>13</sup> the entity or entities that will need to register. Regardless of which entities actually register, any other affiliated entities involved in providing investment advice, along with their employees and persons acting on their behalf, should be subjected to a registered adviser's supervision and control. Thus, such persons should be deemed "persons associated with an investment adviser" (as that term is defined in Section 202(a)(17) of the Advisers Act) so that the SEC could enforce the requirements of the Advisers Act against the other unregistered entities, those persons, and the registered private equity adviser.<sup>14</sup>

### **Completing and Delivering Form ADV**

Form ADV consists of two parts, each of which has multiple subparts. Part 1A of Form ADV is filed electronically with the IARD and solicits information about the registered adviser, its business practices, the persons who own and control it, and the persons who provide investment advice on its behalf.<sup>15</sup> Part 2 consists of two distinct components. One component is the adviser's brochure ("Part 2A"), which contains narrative disclosure regarding 18 specific topics relating to the adviser's services, fees, business practices, disciplinary information, and conflicts of interest. The second component is the brochure supplement ("Part 2B"), unique to each client, which contains information regarding the advisory personnel on whom the client relies for investment advice. An adviser must file Part 2A (and any updates thereto) electronically with the

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<sup>9</sup> As limited partnerships are the predominant form of organization for U.S. private equity funds, for purposes of this article I have assumed that a private equity fund is a limited partnership. However, the references to limited partnerships herein can be applied equally to any legal structure for a fund (*e.g.*, references to a general partner, limited partners, or a limited partnership would be equivalent to a reference to a managing member, members, or a limited liability company, respectively).

<sup>10</sup> *ABA Subcommittee on Private Inv. Entities*, Dec. 8, 2005.

<sup>11</sup> *Id.*

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<sup>12</sup> See "Statutory and Regulatory Requirements" below for more information on these requirements.

<sup>13</sup> That is, registration of an entity is unnecessary if an affiliated registered adviser effectively controls the advisory activities of the entity and its personnel, and the protections of the Advisers Act are in place with respect to the entity's advisory activities.

<sup>14</sup> *ABA Subcommittee on Private Inv. Entities*, Dec. 8, 2005.

<sup>15</sup> Advisers Act Rule 203-1(a). Part 1B of Form ADV is completed only by state-registered advisers, and it is uncommon for private equity advisers to register with a state.

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IARD.<sup>16</sup> Under certain circumstances, an adviser must amend the information contained in its Form ADV.<sup>17</sup>

Because Form ADV is intended to cover a wide spectrum of investment advisers, a literal reading of the disclosure requirements will raise interpretive issues or require disclosure that may not have been intended for private equity advisers. Although there are numerous instances throughout Form ADV, a few examples include the following:

- Part 1A requires disclosure of certain criminal and regulatory actions against the adviser, certain of its personnel, and persons “controlling” or “controlled” by the adviser; consequently, a private equity adviser may need to disclose such information regarding any portfolio companies that it is deemed to control through its funds, even though such companies will likely be operating companies and may be uninvolved in the securities business.<sup>18</sup>
- The items in Form ADV soliciting disclosure regarding proprietary interests in client transactions may be broad enough to require information regarding common practices in the private equity industry that are not traditionally thought to give rise to conflicts of interest.<sup>19</sup>
- Part 2B, Item 6, requires disclosure of certain information regarding the supervision of investment personnel that may not be applicable to a private equity adviser, as decisions for many private equity advisers are made by an “investment committee” of equals that is not overseen by any particular person or entity.

- Form ADV solicits information already set forth in the private placement memorandum provided to investors in a fund. For example, Form ADV requires disclosure regarding the material risks of each significant investment strategy, and private placement memoranda for private equity funds commonly include an extensive section on risks. A private equity adviser will need to consider whether such information should be repeated verbatim or simply summarized in its Form ADV (*i.e.*, weighing the risks of using different disclosure on the same topic against the requirement in Form ADV to be concise and direct and to use plain English).

Additionally, an issue arises as to exactly who is the “client” that is required to be furnished with Part 2. Practice varies among registered private equity advisers as to whether Part 2 is delivered to investors in a fund or to the fund itself (or the general partner of the fund on the fund’s behalf). The Registration Act authorizes the SEC to define the term “client,” among other terms, for purposes of the Advisers Act, and it is not clear at this point whether the SEC will exercise its power to define “client” as the fund or the investor for purposes of the Part 2 delivery requirement.<sup>20</sup>

## INSPECTIONS AND EXAMINATIONS

A registered investment adviser is subject to examination by the SEC’s Office of Compliance, Inspections, and Examinations (the “OCIE”). OCIE performs routine examinations on relatively short notice, and such examinations may last between a few days and several months, depending on the size of the adviser, issues that emerge during the examination, and the nature of the adviser’s business. The period between routine examinations varies, depending on various factors, including the results of prior exams. OCIE also may perform “for cause” inspections without notice if it believes that there are ongoing violations of law and may perform “sweep” examinations, focusing on specific issues, of a broad range of registered advisers that share particular business characteristics.

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<sup>16</sup> *Id.* Rules 203-1(a) and 204-1; Form ADV, General Instructions, Question 8.

<sup>17</sup> *Id.* Rule 204-1(a); Form ADV, General Instructions, Question 4.

<sup>18</sup> Form ADV, Part 1A, Item 11.

<sup>19</sup> For example, Item 8 of Part 1A of Form ADV requires an adviser to identify whether it or any “related person” (which would typically include a fund advised by a private equity adviser) recommends securities to advisory clients in which the adviser or any related person has some other proprietary (ownership) interest. A follow-on investment (*i.e.*, an additional investment made by a fund in a portfolio company that it already owns) may require an affirmative answer to the question, even though such an investment by itself would not likely raise significant conflicts of interest.

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<sup>20</sup> Registration Act § 406. In a footnote to the release adopting the recent amendments to Part 2 of Form ADV, the SEC stated the following: “Two commenters urged us to adopt an exception for ‘hedge funds,’ or clarify that advisers to hedge funds are not required to deliver copies of brochures to their investors. We note that Rule 204-3 of the Advisers Act requires only that brochures be delivered to ‘clients.’ We further note that the Court of Appeals for the D.C. Circuit stated that the ‘client’ of an investment adviser managing a hedge fund is the fund itself, not an investor in the fund.” Adv. Act Rel. No. IA-3060 (2010) (internal citations omitted).

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The Registration Act directs the SEC to conduct periodic examinations of records maintained by a registered investment adviser with respect to a “private fund” and authorizes the SEC to conduct additional, special, and other examinations of such records if it determines such examinations to be necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk.<sup>21</sup> The SEC is required to share with the Financial Stability Oversight Council (the “Council” – a new regulatory body created to identify emerging systemic risks and to improve interagency cooperation) all reports, documents, records, and information provided to the SEC regarding a private fund as the Council may consider necessary to assess the systemic risk posed by the private fund.<sup>22</sup> The Registration Act also amends Section 210(c) of the Advisers Act, which generally prohibits the SEC from requiring an adviser to disclose the identity, investments, or affairs of the adviser’s clients, to allow the SEC to require an adviser to disclose such information for purposes of assessing potential systemic risk.<sup>23</sup>

There are relatively few private equity advisers currently registered with the SEC, and even fewer that have actually been the subject of an OCIE examination. Consequently, the SEC is not as familiar with the private equity business model as it is with respect to other advisory businesses (*e.g.*, advisers to mutual funds, separately managed accounts, and hedge funds).<sup>24</sup> As noted above, there is also a dearth of published SEC guidance relating specifically to private equity advisers. This lack of SEC experience with, and guidance regarding, private equity advisers creates several issues

for private equity advisers in the context of an SEC examination. First, certain SEC staff members examining private equity advisers have analogized the private equity adviser’s business to businesses with which they may be more familiar, and these analogies may not always be a good fit. For example, the transactions in which private equity funds engage are not as common (and in most cases non-existent) in other advisory businesses. One of the challenges, therefore, that a registered private equity adviser may face during the examination process is helping the examiners to understand better the nature of the adviser’s business and operations, and how the adviser has sought to comply with the Advisers Act in light of its specific circumstances. Second, a private equity firm will not know in advance of an exam the SEC’s position on certain interpretive questions regarding the application of a particular provision of the Advisers Act to its business. Therefore, until the SEC’s position on these interpretive questions is clarified through published guidance or other public pronouncements, a private equity adviser may not know whether its chosen approach will be cited as a “deficiency” in an examination. In effect, the SEC may be in the position of providing such guidance through its examination function (as it determines whether it regards certain practices as “deficiencies”), and until a private equity adviser is examined (or learns of deficiencies in the examination of other private equity advisers), the adviser will be in the position of making interpretations based on its tolerance for non-compliance risk.<sup>25</sup>

## STATUTORY AND REGULATORY REQUIREMENTS

Investment advisers that are registered with the SEC must comply fully with the Advisers Act. The following is a summary of key provisions of the Act relevant to a private equity adviser, as well as interpretive issues arising from the application of such requirements to a private equity business.

### ***Terms of the Advisory Agreement***

Investment advisory agreements of registered investment advisers are required to provide that no assignment of the advisory agreement (including for this purpose certain changes in the actual control or management of the adviser) may be made by the adviser

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<sup>21</sup> Registration Act § 404. *See also* “Statutory and Regulatory Requirements – Books and Records” below for a discussion of records to be maintained by a registered adviser with respect to a private fund.

<sup>22</sup> *Id.* § 404.

<sup>23</sup> *Id.* § 405. Although the Registration Act contains certain provisions addressing the confidentiality of information regarding private funds provided to the SEC (in particular, proprietary information regarding investment strategies and trading), including an exemption from Freedom of Information Act requests, the effectiveness of these provisions in protecting the confidentiality of such information remains to be seen. *Id.* § 404.

<sup>24</sup> In fact, the SEC staff has been working to develop priorities on private equity funds and has recently hired a private equity expert. Malini Manickavasagam, *SEC Allocating Private Equity Priorities Ahead of Final Registration Requirements*, BNA Mergers & Acquisitions Law Report (Dec. 6, 2010).

<sup>25</sup> For example, if it is unclear whether a particular practice violates the Advisers Act, a private equity adviser will need to decide whether to discontinue the practice or to run the risk that the SEC staff will disagree with its analysis and conclusion that the practice complies with the Advisers Act.

without the client's consent.<sup>26</sup> In addition, such agreements may not: (i) provide for a penalty upon termination,<sup>27</sup> (ii) waive compliance with the Advisers Act,<sup>28</sup> (iii) lead the client to believe that it has waived any right of action against the adviser,<sup>29</sup> or (iv) except as described in "Performance Fees" below, provide for performance-based compensation of the adviser.<sup>30</sup> A private equity adviser must determine whether certain practices common in the private equity industry violate these rules, such as whether (i) "no fault" termination clauses, in which the adviser is paid a portion of its future management fees if investors determine to remove the manager, are prohibited or (ii) a change of control of the unregistered general partner of the fund would require client consent (even if there is no change of control of the affiliated private equity adviser). These determinations can be complicated further when there is no separate investment management agreement, and any terms applicable to the advisory relationship are set forth in a limited partnership agreement (*i.e.*, deciding which terms apply to the advisory function and are, therefore, subject to these requirements).

### Performance Fees

A registered investment adviser may charge a performance-based investment advisory fee only to certain sophisticated or non-U.S. clients, including "qualified clients."<sup>31</sup> Although private equity advisers

managing funds relying on Section 3(c)(7) of the 1940 Act are not affected, advisers managing funds relying on Section 3(c)(1) of the 1940 Act may be limited in their ability to charge a performance-based fee.<sup>32</sup> It is worth noting that, in connection with adopting a rule that would have required most investment advisers to hedge funds to register under the Advisers Act (which was later vacated by a court), the SEC adopted transition rules that would have allowed hedge fund advisers that registered as a result of the rule to continue receiving performance fees from private funds with non-qualified client investors if those persons became investors in the private fund before the effective date of the rule.<sup>33</sup> Presumably, the same principle should also apply to a private equity adviser that registered as a result of the Registration Act.

### Client Solicitation Arrangements

Arrangements involving compensation paid by a registered investment adviser to persons for client solicitation or referral are subject to certain restrictions under the Advisers Act.<sup>34</sup> Currently, such restrictions generally do not apply to the solicitation of investors for a fund managed by a private equity adviser (*i.e.*, placement agent arrangements in which such persons are generally regarded as being solicited to become investors in the fund rather than advisory clients of the adviser).<sup>35</sup> As noted above, however, the SEC may exercise its power to define "client" for such purposes in a manner that would make such restrictions applicable.

### "Pay-to-Play" Restrictions

Certain "pay-to-play" practices are prohibited.<sup>36</sup> The applicable rule prohibits:

- an investment adviser from receiving compensation for providing advice to a government entity<sup>37</sup> within two years after the adviser or any of its covered

<sup>26</sup> Advisers Act §§ 205(a)(2) and 202(a)(1).

<sup>27</sup> See, e.g., *Stephenson & Co.*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77,010 (Dec. 29, 1980).

<sup>28</sup> Advisers Act § 215(a); see also, e.g., *McEldowney Fin. Servs.*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,373 (Oct. 17, 1986).

<sup>29</sup> E.g., *McEldowney Fin. Servs.*, *supra* note 28. The SEC staff has indicated, however, that advisers may use disclaimers of liability in contracts under certain conditions. See, e.g., *Auchincloss & Lawrence, Inc.*, Feb. 8, 1974; *Auchincloss & Lawrence, Inc.*, Apr. 5, 1974; *Heitman Capital Mgmt., LLC, et al.*, Feb. 12, 2007.

<sup>30</sup> Advisers Act § 205(a)(1).

<sup>31</sup> *Id.* § 205(b)(5); Advisers Act Rule 205-3(a). For purposes of charging a performance fee to a fund, all investors must be "qualified clients." A "qualified client" currently is defined to include generally (i) natural persons having at least \$750,000 under management with the adviser, (ii) persons having a net worth of more than \$1,500,000, (iii) "qualified purchasers," as defined under the 1940 Act, and (iv) certain "knowledgeable employees" of the adviser. Advisers Act Rule 205-3(d)(1). The Registration Act requires the SEC to adjust the foregoing dollar amount tests for inflation one year after enactment of the

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Registration Act and every five years thereafter. See Registration Act § 418.

<sup>32</sup> Advisers Act § 205(b)(4).

<sup>33</sup> Advisers Act Rule 205-3(c); see also *American Bar Ass'n.*, Aug. 10, 2006.

<sup>34</sup> Advisers Act Rule 206(4)-3.

<sup>35</sup> *Mayer Brown LLP*, July 28, 2008.

<sup>36</sup> See generally Advisers Act Rule 206(4)-5.

<sup>37</sup> Government entities include all state and local governments, their agencies and instrumentalities, and all public pension plans and other collective government funds. *Id.* Rule 206(4)-5(f)(5).

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associates<sup>38</sup> makes a contribution<sup>39</sup> to an official of the government entity;<sup>40</sup>

- an investment adviser or its covered associates from providing (or agreeing to provide), directly or indirectly, payment to any third party (such as a solicitor or placement agent) to solicit a government entity for investment advisory services on behalf of the adviser, unless the third party is a registered investment adviser or a registered broker-dealer subject to similar “pay-to-play” restrictions;<sup>41</sup> and
- an investment adviser and certain of its executives and employees from coordinating or soliciting any person or political action committee to make any (i) contribution to an official of a government entity to which the adviser is providing or seeking to provide investment advisory services (so-called “bundling”) or (ii) payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.<sup>42</sup>

The rule includes a provision that applies each of the foregoing prohibitions to an investment adviser that manages the assets of a government entity through certain pooled investment vehicles, including private equity funds, and, therefore, private equity advisers will need to comply with the rule with respect to government entity investors.<sup>43</sup>

### **Trading Practices**

A registered private equity adviser must comply with requirements relating to principal transactions<sup>44</sup> and

cross trades.<sup>45</sup> These requirements may be applicable to a private equity adviser when, for example, the adviser has warehoused an investment prior to the initial closing of a fund (the first date on which investors are admitted to the fund), or parallel funds rebalance their portfolios at their final closing (the final date on which the funds accept new capital commitments). Issues specific to private equity advisers include whether

- certain funds should be considered a principal for purposes of these requirements (for example, if a fund is deemed to be a proprietary vehicle for the investment adviser by virtue of the size of the interest of the adviser and its affiliates in that fund);
- whether consent of an affiliated general partner to a principal transaction is sufficient (or whether advisory board or investor consent should be obtained); and
- whether mechanics for principal and cross transactions that are set forth in limited partnership agreements and agreed to by all investors *ex ante* satisfy any consent and valuation requirements.

### **Advertising Rules**

A registered investment adviser must ensure that any advertising complies with the Advisers Act and the SEC’s substantial interpretative guidance. “Advertising” is broadly defined for purposes of the Advisers Act and would include, for example, any offering memoranda for a fund, pitchbooks, and adviser websites.<sup>46</sup> As a first

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<sup>38</sup> Covered associates include, for example, general partners, managing members, executive officers, and soliciting employees and their supervisors. *Id.* Rule 206(4)-5(f)(2).

<sup>39</sup> A contribution, very generally, means anything of value intended to influence an election, subject to certain *de minimis* and other limited exceptions. *Id.* Rules 206(4)-5(f)(1) and 206(4)-5(b).

<sup>40</sup> *Id.* Rule 206(4)-5(a)(1).

<sup>41</sup> *Id.* Rule 206(4)-5(a)(2)(i).

<sup>42</sup> *Id.* Rule 206(4)-5(a)(2)(ii).

<sup>43</sup> *Id.* Rule 206(4)-5(c).

<sup>44</sup> Principal transactions are generally transactions in which the adviser is acting as principal for its own account to sell any security to or to purchase any security from a 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. Advisers Act § 206(3).

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The same restrictions apply when certain affiliates of the adviser, such as a fund that is owned 25% or more by the adviser and/or a controlling person of the adviser, are acting in a principal capacity with advisory clients. *E.g., Gardner Russo & Gardner*, June 7, 2006.

<sup>45</sup> A cross trade involves a transaction between two advisory clients of an adviser. Although, unlike principal transactions, there are no specific regulatory requirements applicable to cross trades, the SEC has brought numerous enforcement actions for breach of fiduciary duty in the context of cross trades, often with respect to the valuation of the crossed securities. *E.g., Adv. Act Rel. No. IA-1393* (1993); *Adv. Act Rel. No. IA-2064* (2002).

<sup>46</sup> Advisers Act Rule 206(4)-1(b). The term “advertisement” includes “any notice, circular, letter, or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers: (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which

step, a private equity adviser will need to examine its external communications to determine whether they may constitute advertising, including communications that may not traditionally be considered to be advertising, such as communications to current investors,<sup>47</sup> responses to due diligence requests from investors,<sup>48</sup> press releases regarding completed portfolio company transactions, and communications with potential portfolio companies.

If a communication is deemed to be “advertising,” the use of testimonials, past recommendations, charts, graphs, models, and similar tools and historical performance results (particularly, gross performance) are prohibited or heavily restricted.<sup>49</sup> Certain of the advertising requirements that are most likely to affect a private equity adviser are set forth below. The SEC’s enforcement program is quite vigorous with respect to adviser advertising, and advisers may be subject to significant sanctions for misleading or inappropriate advertising. Although the SEC staff has stated that whether an advertisement is misleading will require an analysis of the sophistication of the adviser’s client, there are no specific exemptions from the requirements below based on the sophistication of a fund’s investors.<sup>50</sup> Consequently, absent further guidance, a private equity adviser should comply with these requirements, notwithstanding the fact that non-compliance may be unlikely to mislead typical private equity fund investors.

- (i) *Past Profitable Performance.* It is considered a deceptive and misleading practice to present past

profitable recommendations without presenting all recommendations over a fixed time period that includes at least the prior year.<sup>51</sup> That presentation must include the familiar statement to the effect that past results are not indicative of future results.<sup>52</sup> In certain situations, the adviser may present a partial list if the basis for selection is not related to performance of the investments and is fully disclosed (including the effect of using a sample on the results presented) and the gains or losses from particular securities included in the list are not discussed.<sup>53</sup> These principles would apply to descriptions of prior portfolio company investments typically included in private placement memoranda and other marketing documents of private equity funds. For private equity advisers, this rule typically is satisfied by including a full list of relevant portfolio company investments (including investment returns) in any documents in which an individual portfolio company investment is discussed, or by including a partial list of portfolio companies without performance data chosen on the basis of objective, non-performance based criteria.

- (ii) *Performance Reporting: Net vs. Gross Results.* The SEC staff requires performance results to be presented net of all advisory fees (including any carried interest) and other expenses (other than custodian fees, which are viewed as expenses the client would have otherwise have had to bear).<sup>54</sup> Gross returns may be presented in addition to net returns so long as the gross and net returns are presented with equal prominence.<sup>55</sup> It is not enough to present gross returns with a note disclosing the fee rates of the adviser, since such presentation fails to reflect the compounding effect of fee payments on the net returns.<sup>56</sup> The adviser may present gross returns without net returns in “one-on-one” presentations to financially sophisticated persons provided that (i) disclosure is

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security to buy or sell, or (2) any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities.” *Id.*

<sup>47</sup> *Inv. Counsel Ass’n of America, Inc.*, Mar. 1, 2004. The SEC staff observed that (1) communications with existing clients that do not offer advisory services and (2) communications to prospective clients in response to unsolicited requests for information are not “advertisements,” and, accordingly, are not subject to the restrictions in Rule 206(4)-1(a)(1) and (2) of the Advisers Act. Nevertheless, the SEC staff noted that such communications remain subject to the anti-fraud provisions in Rule 206(4)-1(a)(5) under the Advisers Act.

<sup>48</sup> *Id.*

<sup>49</sup> *E.g.*, Advisers Act Rule 206(4)-1; *Clover Capital Mgmt.*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,378 (Oct. 28, 1986).

<sup>50</sup> *E.g.*, Adv. Act Rel. No. IA-1644 (1997).

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<sup>51</sup> Advisers Act Rule 206(4)-1(a)(2).

<sup>52</sup> *Id.* Rule 206(4)-1(a)(2)(ii).

<sup>53</sup> *Franklin Mgmt. Inc.*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77,482 (Dec. 10, 1998).

<sup>54</sup> *Clover Capital Mgmt.*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,378 (Oct. 28, 1986); *see also Inv. Co. Inst.*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,451 (Aug. 24, 1987).

<sup>55</sup> *Ass’n for Inv. Mgmt. and Research*, Dec. 18, 1996.

<sup>56</sup> *Id.*



made that the presentation is before deduction of fees and that the net return is lower, (ii) the adviser's Form ADV discloses the fees charged, and (iii) a sample calculation is provided illustrating the effect of fee payments (including compounding).<sup>57</sup> For private equity funds, showing net performance of individual portfolio companies is not always possible due to the manner in which fees and carry are allocated at a fund level. Accordingly, when disclosing performance of portfolio companies, it may be necessary to consider whether the "net of fees" requirement would be satisfied by including the net performance for the funds in which particular investments were made. Additionally, private equity advisers will need to consider the application of this requirement to performance measurements typical in the industry, such as multiples of invested capital.

- (iii) *Performance Reporting: Performance results of individual partners while at previous firms.* Often, newly hired investment professionals at a private equity adviser wish to present their performance results at prior employers in the marketing materials of the new employer's funds. The SEC staff permits this disclosure only if, among other things, no person other than the new investment professionals played a significant role in producing the results at the prior employer being presented and the investment strategies of the prior employer's relevant client accounts were substantially similar to those of the new employer's funds being sold.<sup>58</sup> The presentation must include the results of all investments for the period shown for which the new investment professional was primarily responsible. These restrictions can create substantial issues for newly formed private equity advisers founded by principals of other private equity firms if (i) there is not "substantial identity" of the principals at both the prior and current firm

and (ii) the principals wish to show the performance of funds at the prior adviser or the performance of portfolio company investments "sourced" by the principals at the prior adviser.<sup>59</sup>

- (iv) *Other Principles.* The SEC staff requires performance results to be accompanied by various qualifications and explanations designed to prevent readers from drawing unwarranted conclusions. For instance, material market or economic conditions that affected the results may need to be disclosed, as well as any changes that have occurred or may occur that could affect future performance.<sup>60</sup> Changes in the adviser's investment policies or practices from those in effect when the performance results were generated should also be disclosed.<sup>61</sup> If reinvestment is permitted, the SEC staff believes it is misleading not to disclose the effect of reinvestment on the overall results.<sup>62</sup> The SEC staff also considers it misleading not to warn readers that with the possibility of gain goes the possibility of loss, and that past results are not necessarily indicative of future performance.<sup>63</sup> If the presentation compares results to an index, the appropriateness of the index and the basis for comparison must be explained.<sup>64</sup> As noted above, although the omission of such disclosure may not mislead typical private equity fund investors, private equity advisers are nonetheless subject to these requirements.
- (v) *Testimonials.* Testimonials in the advertising of investment advisers are prohibited because they are prone to selective inclusion to create an impression of universal customer satisfaction when in fact that may not be the case.<sup>65</sup> Lists of clients or investors may be presented if the basis for inclusion and

<sup>57</sup> *Inv. Co. Inst.*, Sept. 23, 1988.

<sup>58</sup> *Great Lakes Advisers, Inc.*, Apr. 3, 1992. In circumstances in which an adviser used a committee approach to manage client accounts, the SEC staff found that a "substantial identity" of portfolio managers was needed for a successor entity to be able to use a predecessor's performance. *Id.* In circumstances in which the predecessor entity's performance was achieved by a single portfolio manager, the successor entity can advertise the predecessor's performance only if the individual is actually responsible for making the investment decisions at the successor entity and the decisions do not require the approval of other committee members. *Horizon Asset Mgmt., LLC*, Sept. 13, 1996.

<sup>59</sup> In this situation, it may also be difficult for the current firm to meet the recordkeeping requirements related to performance data (described below) with respect to the prior firm's performance.

<sup>60</sup> *Clover Capital Mgmt.*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,378 (Oct. 28, 1986).

<sup>61</sup> *Id.*

<sup>62</sup> *Id.* For private equity advisers, this disclosure requirement would apply if, for example, fund documents permitted the proceeds from a realized sale of a portfolio company to be used again for investment by the fund.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> See generally Advisers Act Rule 206(4)-1(a)(1).

exclusion is independent of performance and is fully disclosed in the advertisement, which also presents a warning to the effect that inclusion of the list does not necessarily mean that the listed clients are satisfied with the adviser's services.<sup>66</sup> A common practice among private equity firms is to include quotes from the management of portfolio companies in its public disclosures (e.g., in a press release regarding a transaction or on the adviser's website). A private equity adviser will need to determine whether such quotes are properly categorized as testimonials for purposes of this requirement, as they relate to the ability of the adviser to provide management services to portfolio companies (in which case they may not be a prohibited testimonial), rather than the adviser's investment ability.

- (vi) *Recordkeeping*. Rule 204-2(a) under the Advisers Act requires registered investment advisers to retain copies of all advertisements and all documentation necessary to support the accuracy of performance or rate of return information shown in such advertisements.<sup>67</sup> Consequently, a private equity adviser will need to determine the information received from portfolio companies and other information regarding portfolio company transactions that need to be maintained to support the performance disclosure.

### **Books and Records**

A registered investment adviser must maintain extensive books and records (the relevant rule enumerates a number of different categories of required records).<sup>68</sup> Records (including electronic records, such as e-mails and instant messages, to extent they otherwise fall into the aforementioned categories) must be kept in a readily accessible place for five years, the first two of those years in an appropriate office of the adviser.<sup>69</sup>

The Registration Act authorizes the SEC to require any registered adviser to maintain such records of, and file with the SEC such reports regarding, private funds advised by the adviser as are necessary or appropriate in the public interest and for the protection of investors, or

for the assessment of systemic risk by the Council, and to provide such records and reports to the Council.<sup>70</sup> The Registration Act does not discuss the meaning of systemic risk but requires that these records and reports include information for each private fund advised by the adviser regarding assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposure, trading and investment positions, valuation policies and practices of the fund, types of assets held, side arrangements or side letters (affording certain investors more favorable rights or entitlements than other investors), trading practices, and any other information that the SEC, in consultation with the Council, determines to be necessary or appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk (which may include different reporting requirements for different classes of advisers).<sup>71</sup> The SEC has already proposed rules implementing certain of these requirements.<sup>72</sup>

The list of required books, records, and reports, however, was not drafted with private equity advisers in mind, and thus many requirements need some interpretation to fit in the context of private equity. For example, the recordkeeping rules require a memorandum for each purchase or sale of a security that "shall show the terms and conditions of the order, instruction, modification, or cancellation; shall identify the person connected with the investment adviser who recommended the transaction to the client and the person who placed such order; and shall show the account for which entered, the date of entry, and the bank, broker or dealer by or through whom executed . . ." <sup>73</sup> Most of this information does not exist for a typical private equity transaction; consequently, a private equity adviser may have difficulty identifying the information that needs to be maintained in its place.

### **Custody**

Because either the private equity adviser or its affiliate is typically the general partner of a fund, most private equity advisers are deemed to have "custody" of

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<sup>66</sup> *Denver Inv. Advisers, Inc.*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 76,689 (July 30, 1993).

<sup>67</sup> Advisers Act Rule 204-2(a)(16).

<sup>68</sup> See generally Advisers Act Rule 204-2.

<sup>69</sup> *Id.* There are limited exceptions to these time periods for certain records. See *id.*

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<sup>70</sup> Registration Act § 404. Under the Registration Act, the records and reports of any private fund to which a registered adviser provides investment advice are deemed to be the records and reports of that adviser. *Id.*

<sup>71</sup> Registration Act § 404. The SEC is also authorized to adopt rules regarding the time period that such records must be kept. *Id.*

<sup>72</sup> Adv. Act. Rels. No. 3110 (2010) and 3145 (2011). As of this writing, these rules had not yet been adopted.

<sup>73</sup> Advisers Act Rule 204-2(a)(3).

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the fund's assets.<sup>74</sup> Except for certain "privately offered securities,"<sup>75</sup> a registered investment adviser is prohibited from having custody of a client's funds or securities unless a "qualified custodian" maintains such funds and securities (i) in a separate account for each client under such client's name or (ii) in accounts that contain only the funds and securities of the adviser's clients, under the adviser's name as agent or trustee for the clients.<sup>76</sup> A "qualified custodian" is generally a bank or a registered broker-dealer holding assets in customer accounts.<sup>77</sup> Unless a fund is audited at least annually by an independent public accounting firm<sup>78</sup> registered with the Public Company Accounting Oversight Board and distributes its financial statements to investors within 120 days after the fund's fiscal year end<sup>79</sup> (the "audit exemption"), then, in addition to the "qualified custodian" requirement above:

- privately offered securities, which typically constitute a substantial portion of a private equity fund's holdings, must also be held by a qualified custodian;<sup>80</sup>
- the adviser must have a reasonable basis for believing that the qualified custodian provides account statements, at least quarterly, to fund investors;<sup>81</sup> and
- the fund's assets must be verified by a surprise examination, generally at least once each calendar year, by an independent public accountant, pursuant to a written agreement between the adviser and the

accountant, which must require, among other things, that the accountant make certain filings with and notifications to the SEC regarding such examination.<sup>82</sup>

It is common for private equity funds to have quite complex structures, with multiple investment and acquisition vehicles serving various tax- and liability-related and other functions positioned between or alongside the fund and the ultimate portfolio company. In this context, it may be challenging to determine the vehicles the holdings of which may be subject to the Advisers Act's requirements regarding custody (*e.g.*, whether the securities held by a special purpose vehicle owned or co-owned by the fund are subject to custody requirements). Additionally, if a private equity fund does not meet the requirements of the audit exemption, the private equity adviser faces issues determining what evidence of private investments must be held by a qualified custodian (*e.g.*, investments made in a partnership for which there was no subscription agreement), how to custody investments that cannot be held by a qualified custodian (*e.g.*, certain foreign investments or pledged securities), and how to explain to investors receiving statements directly from custodians the various investment and acquisition vehicles that do not otherwise appear on the fund's financial statements. Although the risks to investors relating to custody of private equity investments may be relatively low (in light of the limited ability of private equity advisers to misappropriate portfolio company investments and the limited ability to create and report false investments in portfolio companies), compliance costs for private equity firms with respect to custody can be substantial.

### **Compliance Policies and Procedures**

All registered investment advisers must adopt written compliance policies and procedures reasonably designed to prevent violation of the Advisers Act and must review the adequacy and effectiveness of such policies and procedures at least annually.<sup>83</sup> The SEC staff has stated its expectation that an adviser's policies and procedures, at a minimum, should include the following:

- Accuracy of Disclosures in Account Statements and Advertisements
- Brokerage Allocation and Soft Dollar Policy
- Business Continuity Plan

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<sup>74</sup> *Id.* Rule 206(4)-2(d)(2)(iii).

<sup>75</sup> *Id.* Rule 206(4)-2(b)(2). Privately offered securities are defined as securities that are: (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (ii) uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client; and (iii) transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer. *Id.*

<sup>76</sup> *Id.* Rule 206(4)-2(a)(1).

<sup>77</sup> *See generally* Advisers Act Rule 206(4)-2(d)(6).

<sup>78</sup> Some accountants do not consider themselves independent of a private equity fund for such purpose if they provide certain services to a portfolio company of the fund.

<sup>79</sup> Advisers Act Rule 206(4)-2(b)(4) (180 days in the case of a fund of funds, *ABA Subcommittee on Private Inv. Entities*, Dec. 8, 2005).

<sup>80</sup> Advisers Act Rule 206(4)-2(b)(2)(ii).

<sup>81</sup> *Id.* Rules 206(4)-2(a)(3) and 206(4)-2(a)(5).

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<sup>82</sup> *Id.* Rule 206(4)-2(a)(4).

<sup>83</sup> *Id.* Rule 206(4)-7.

- Cash Payment for Client Solicitations Policy
- Code of Ethics
- Custody Policy
- Electronic Communications Retention Policy
- Fee Calculation Policy
- Insider Trading and Market Manipulation Policy
- Investment Opportunity and Trade Allocation Procedures
- Liquidity and Valuation Procedures
- Portfolio Compliance with Investment Restrictions Policy
- Privacy and Data Security Policy
- Proxy Voting Policies and Procedures
- Recordkeeping Policy<sup>84</sup>

Because this recommended list was not crafted with private equity advisers in mind, a private equity adviser will need to consider carefully how to tailor its compliance manual to its business and operations. For example, a typical private equity adviser is unlikely to need substantial policies relating to brokerage allocation, soft dollars, liquidity, or cash payments for client solicitations (as the adviser will not be placing ordinary course transactions with brokers, its investments are generally illiquid, and the adviser will not use solicitors to find “clients”). Similarly, as most private equity firms do not receive compensation based on the interim valuation of portfolio companies, valuation procedures would focus on the valuation of such companies generally only for purposes of marketing materials and other reports. In addition, a private equity firm will need to craft its policies in light of its contractual requirements set forth in the limited partnership agreements for its funds or other applicable agreements (e.g., such documents typically address the allocation of investment opportunities among funds). Finally, depending on the nature of a private equity adviser’s business and operations, other policies in addition to

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<sup>84</sup> See generally Adv. Act Rel. No. IA-2204 (2004). This list was issued before the adoption of certain recent SEC rules applicable to investment advisers, such as the “pay-to-play” rule described above, and a comprehensive compliance program should include policies and procedures reasonably designed to achieve compliance with those new rules as well.

those set forth above may be necessary or advisable (for example, to address gifts and entertainment matters).

### **Chief Compliance Officer**

A registered investment adviser must designate a supervised person as its chief compliance officer, who is responsible for administering the adviser’s compliance policies and procedures.<sup>85</sup> It can, but need not, be the adviser’s general counsel or chief financial officer. The chief compliance officer should have both the knowledge and the authority to develop and to enforce the adviser’s compliance policies and procedures.<sup>86</sup> Consequently, a private equity firm would want its chief compliance officer to have significant familiarity with the private equity business, in light of the unique compliance issues that it raises.

### **Proxy Voting**

A registered investment adviser must adopt and implement procedures reasonably designed to ensure that it votes proxies on behalf of its clients in the best interests of its clients.<sup>87</sup> Such procedures must address the resolution of material conflicts between the interests of the adviser and the interests of its clients.<sup>88</sup> A registered adviser must disclose to clients how they can obtain information about how the adviser voted their securities.<sup>89</sup> A registered adviser also must describe its proxy voting procedures to its clients and offer to furnish a copy thereof to them upon request.<sup>90</sup> Although the applicable rule is called “Proxy Voting,” and private equity advisers are unlikely to vote proxies or be sent proxy statements regularly (as private equity funds will not hold many publicly traded securities), the terms of the rule refer to exercising “voting authority with respect to client securities.”<sup>91</sup> Consequently, a private equity firm should consider whether it needs to adopt procedures to address the voting of portfolio company securities (e.g., a shareholder consent required to approve a portfolio company transaction).

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<sup>85</sup> Advisers Act Rule 206(4)-7(c).

<sup>86</sup> Adv. Act Rel. No. IA-2204 (2004).

<sup>87</sup> Advisers Act Rule 206(4)-6(a).

<sup>88</sup> *Id.*

<sup>89</sup> *Id.* Rule 206(4)-6(b).

<sup>90</sup> *Id.* Rule 206(4)-6(c).

<sup>91</sup> *Id.* Rule 206(4)-6.

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## Code of Ethics

A registered investment adviser must adopt a written code of ethics that, at a minimum:

- (i) reflects the adviser's fiduciary obligations and those of its supervised persons, and requires its supervised persons to comply with applicable federal securities laws;
- (ii) requires the adviser's access persons (generally, advisory personnel, directors, officers, and partners) to provide, and requires the adviser to review, reports regarding such access persons' transactions in and holdings of securities;
- (iii) requires prompt internal reporting of any violations of the code of ethics to the adviser's chief compliance officer; and
- (iv) requires the adviser to provide each of its supervised persons with a copy of its code of ethics and any amendments thereto, and requires each such supervised person to acknowledge, in writing, his receipt of such copies.<sup>92</sup>

Registered advisers are also required to maintain and enforce the provisions of their codes of ethics and pre-clear access persons' investments in initial public offerings and private placements (including investments by advisory personnel in private equity funds managed by the adviser).<sup>93</sup>

Special issues faced by many private equity advisers regarding the code of ethics include whether certain paid consultants with access to the adviser's recommendations must comply with the code of ethics and whether pre-clearance of personal securities transactions (often considered a "best practice," but not

required by applicable law for most transactions) should be adopted in light of the nature of a private equity fund's investments.

## Insider Trading

An adviser must establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the adviser's business, to prevent the misuse of material non-public information by the adviser or by any person associated with the adviser.<sup>94</sup> As private equity firms do not generally engage in transactions in publicly traded securities, the issues associated with insider trading may be less prominent.<sup>95</sup> However, these requirements take on heightened significance for private equity advisers to the extent they may receive such information in connection with potential going-private transactions or may exchange information with an affiliate that does buy or sell publicly traded securities or otherwise owes a duty to an issuer.

## CONCLUSION

Registration under the Advisers Act will necessitate changes to a number of the practices of a private equity adviser, and the full extent of the changes will not be known unless and until the SEC provides further guidance on a number of interpretive issues arising from the application of the Advisers Act to the private equity business model. In the meantime, a private equity adviser will need to examine its business in light of the requirements of the Advisers Act; conform its practices to those requirements that clearly apply; and, with respect to those requirements that raise unresolved questions, make a determination regarding its approach based on its unique situation and risk tolerance. ■

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<sup>94</sup> See Advisers Act § 204A.

<sup>95</sup> Although private equity advisers regularly purchase and sell portfolio companies based on inside information, generally insider trading laws are not violated unless such purchase or sale is based on such information in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of the relevant security or the shareholders of that issuer, or to any other person who is the source of the material non-public information. In a typical negotiated private equity transaction with shareholders of an issuer, there would not be such a breach.

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<sup>92</sup> *Id.* Advisers Act Rule 204A-1(a).

<sup>93</sup> *Id.*; see also Rules 204A-1(c) and 204A-1(e)(7).

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