Compliance Corner

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Special Considerations for Private Fund Advisers under the Advisers Act

Introduction

As the investment adviser community is well aware, one of the key provisions of last year's Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") is the removal of the so-called private adviser exemption. Because of that change, most investment advisers to private funds will be required to register under the Investment Advisers Act of 1940 (the "Advisers Act"), if they are not already registered with the Securities and Exchange Commission (the "SEC"). Applying the Advisers Act to private fund managers poses some unique and challenging issues, and there is little guidance on many of these issues. We highlight in this article key challenges unique to registered private fund advisers, including (i) completing Form ADV, (ii) complying with certain substantive provisions of the Advisers Act, and (iii) new compliance requirements arising from the Dodd-Frank Act. Although advisers to various categories of private funds, such as hedge funds, private equity funds and real estate funds, will face different compliance issues due to the asset class managed, this article will focus on the issues common to private fund advisers generally.

Form ADV

A threshold question faced by private fund advisers is which entities need to register. The reason this is problematic for most private fund advisers is that private funds are usually organized as limited partnerships, and the actions of the private fund adviser are subject to the control and supervision of an entity affiliated with the adviser that acts as the general partner of the fund. According to 2005 guidance from the SEC staff (the "Staff"), where an adviser and affiliated general partner both make investment recommendations and decisions for a fund, the general partner would not be required to register, provided that it is subject to examination by the SEC and that all of its investment advisory activities are subject to the Advisers Act rules (such as recordkeeping rules and requirements relating to performance-based compensation). However, private fund advisory organizations often present more complicated fact patterns, such as multiple affiliated advisory entities with substantially overlapping employees and management or a structure in which the entity that is paid the management fee is not the same as the entity at which portfolio management employees are housed. Due to the dearth of more specific guidance, private fund advisers will have to analogize their particular structures to the guidance available.

Once it is determined which entity (or entities) will register, private fund advisers will have to grapple with the question of how much disclosure to include in their Form ADV brochure. For example, certain items in Form ADV call for information that has already been given to investors in a fund in a private placement memorandum, such as investment strategies and related risks. A private fund adviser will need to consider whether such information should be repeated verbatim in Form ADV or summarized (*i.e.,* the adviser will need to weigh the risks of having two sets of disclosure on the same topic against the requirement in Form ADV to use "plain English" and "concise and direct" language). Recent Staff guidance permits a cross-reference in Form ADV to an offering document, but still requires a brief explanation of the relevant strategy or risk in Form ADV (raising the same issue regarding consistency of disclosure). Similarly, private fund advisers will need to consider whether to harmonize disclosure regarding conflicts of interest in the offering documents and Form ADV and the benefits and detriments of inconsistent disclosure.

Additionally, because the Form ADV filed by advisers will be available to the public through the SEC's Investment Adviser Public Disclosure website, private fund advisers are sensitive to the disclosure in Form ADV. For example, disclosure that is too fulsome may provide a roadmap to competitors of an adviser's different investment strategies or techniques. In addition, of particular concern for private fund advisers is the requirement to disclose fees charged to investors in their funds. It should be noted that the instructions to Form ADV permit advisers to exclude fee schedules from a Form ADV delivered to clients that are "qualified purchasers" (presumably the exception requires the fund to be a qualified purchaser, rather than the fund investors, but there is no guidance on this point). Although many private funds will satisfy the qualified purchaser standard,

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a private fund adviser may also advise smaller funds, separate accounts or funds established for "friends and family" that do not meet this standard. The private fund adviser must then consider whether the Form ADV delivered to a non-qualified purchaser client (and therefore a Form ADV posted to the SEC's public website) must contain a fee schedule for a qualified purchaser client.

Beyond those bigger picture issues, there remain other disclosure items on Form ADV that private fund advisers may find ill-suited to their structure. For example, if a fund is deemed to control a company (by having more than a 25% voting stake in a class of securities or otherwise), then that company may become a "related person" of the adviser to that fund. In such a case, the adviser would need to include significant disclosures regarding such company, including the company's disciplinary history, even though the company may be uninvolved in the securities/investment business. Another example is Part 2B of Form ADV, which requires disclosure regarding the supervision of investment personnel. For many private fund advisers, investment decisions are made by a committee of equals for which there is no supervision, complicating the required disclosure.

Finally, a private fund adviser must determine whether the Form ADV should be delivered to investors in a fund. The SEC has recently suggested that such delivery is not required, and that the Form ADV can be delivered to the general partner of the fund. Nonetheless, some private fund advisers may find it useful to deliver the Form ADV to investors in a fund voluntarily, based on the view that it is a way to satisfy any potential fiduciary disclosure obligations that may exist (since offering memoranda are not updated on a regular basis for all funds).

Complying with the Advisers Act Substantive Requirements

Once registered, an adviser becomes subject to the Advisers Act's substantive requirements, which may prove to be uniquely challenging in their application to private fund advisers. A threshold issue for a private fund adviser is to distinguish between their "clients" (*i.e.,* the funds) and the investors in those funds. This bifurcation will affect the application of a number of requirements for registered investment advisers, including:

- Delivery of Form ADV, as discussed above.
- The rules regulating payments to entities that solicit "clients" for the adviser. An arrangement whereby a placement agent finds investors for a private fund would not be subject to this rule, as the agent is not soliciting "clients" for the adviser. Although there was some doubt regarding this position for many years, SEC guidance in 2008 confirmed this interpretation.
- Regulation S-P and Regulation S-AM concerning privacy and the use of personal consumer information. As the fund, rather than the investors in the fund, is the adviser's client, the adviser does not have any obligations to investors under these regulations. It is important to note, however, that other privacy and data security rules may apply to the adviser and/or the fund (*e.g.,* Federal Trade Commission rules and Massachusetts data security rules).
- Required client consent for principal transactions (*i.e.*, transactions between the fund and the adviser) or assignment of advisory contracts. A literal reading of the requirements would suggest that the general partner of the fund could give such consent on behalf of the fund. However, although there is no clear SEC guidance in this area, many practitioners are uncomfortable giving the consent right to an affiliated general partner, and instead require an investor vote (or at least consent of certain independent limited partners, such as an advisory board).

For some private fund advisers, it may, however, be difficult to identify which pooled investment vehicles should be considered "clients" for purposes of the Advisers Act. For example, some private fund advisers have organized funds in which only employees invest or have organized special purpose "co-investment" vehicles that invest alongside a private fund in a particular transaction.

Private fund advisers should also note that certain Advisers Act requirements specifically require a "look through" to the underlying investors in a fund. A few examples are:

- Registered investment advisers are only allowed to charge performance-based compensation fees to "qualified clients" that are sophisticated or non-U.S. investors. However, for purposes of charging a performance fee to a fund, the applicable investors must be qualified clients, even if the fund itself is a qualified client.
- Under the custody rules, there are circumstances in which required account statements from a fund's qualified custodian must be sent directly to the investors in the fund, rather than the general partner or the fund itself. Additionally, delivery of such account statements to investors in a private fund (as well as the surprise exam and custody of privately offered securities with a qualified custodian) are not required so long as the fund is audited annually by an independent public accountant meeting certain requirements and the fund's financial statements are delivered to investors shortly following year-end. The custody rules also clarify that it is not sufficient to send account statements or financial statements solely to limited partners of a fund that are themselves limited partnerships and related persons of the adviser (*e.g.*, if a fund holds an interest in a special purpose vehicle through which an underlying investment is made).

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- Advisers to most private funds are prohibited from making material misstatements or omissions to investors or prospective investors in a fund, as well as engaging in fraudulent activities with respect to investors or prospective investors in a fund.
- The SEC's recent pay-to-play rule (addressing political contributions made to certain officials of advisory clients that are government entities) is applied to an adviser that manages the assets of a government entity through certain private funds.

New Compliance Requirements under the Dodd-Frank Act

The Dodd-Frank Act itself (and rules adopted pursuant to the Dodd-Frank Act) will add additional requirements for private fund advisers. For example, the SEC has the power to define "client" for most purposes of the Advisers Act and, notwithstanding the distinction noted above, may make changes that treat investors as clients for certain provisions. Additionally, under the Dodd-Frank 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.

Perhaps the most significant change is that the Dodd-Frank Act requires the SEC to collect certain information regarding each private fund an adviser manages, including assets under management, use of leverage, trading and investment positions, counterparty credit risk exposure, and side letter arrangements granting certain investors more favorable rights or benefits. In January 2011, the SEC proposed the new Form PF in order to collect such information from advisers. As currently proposed, all private fund advisers would be required to provide extensive disclosure on an annual basis, including their monthly and quarterly fund performance, certain borrowing information, and the number of beneficial owners of each advised fund. Certain types of private fund advisers will have to provide even more information. Hedge funds would be subject to as much as 24 additional pages of disclosure, including risk metrics, a breakdown by asset class of all fund securities, details on counterparties, and information on the redemption rights of investors. Advisers to many private equity funds would have to disclose details on portfolio company borrowing, defaults and debt-to-equity ratios, as well as the industry and geographic focus of their investments. Finally, "large" private fund advisers, with assets under management over a given threshold (currently proposed at $1 billion), would have to file this information and other specific information, within 15 days of each quarter-end. As the SEC has received comments criticizing the proposed scope and frequency of disclosure in Form PF, the final form may have substantial changes.

Conclusion

These are just a few of the issues private fund advisers face, whether they are new or existing registrants. In many instances, there are a variety of approaches taken by industry participants, all of which may be reasonable or acceptable, and in other instances, industry best practices will begin to evolve, either due to consensus among practitioners or because of regulatory guidance, whether formal or informal. Even for advisers who have until the first quarter of 2012 to register, as the SEC indicated current unregistered advisers will, proactively thinking about how your firm will approach these issues will be beneficial.

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