September 14, 2010

SUBSTANTIVE PROVISIONS FOR NEWLY REGISTERING INVESTMENT ADVISERS

*This is one of a series of memos issued by the Investment Funds Practice Group of Gibson Dunn to investment advisers to "private funds" that may be required to register under the Investment Advisers Act of 1940 as a result of amendments included in the Dodd-Frank Wall Street Reform and Consumer Protection Act. **Click here** to access the other memos.*

Once registered with the SEC, investment advisers become generally subject to the substantive provisions of the Advisers Act, which require registered advisers to adopt certain policies and procedures, and to take (or refrain from taking) various actions.

Code of Ethics and Personal Trading; Insider Trading Proxy Voting

Code of Ethics; Reports of Personal Trading. Rule 204A-1 requires registered advisers to establish, maintain and enforce a written code of ethics setting forth a standard of business conduct required of the adviser's supervised persons that reflects the adviser's and its supervised persons' fiduciary obligations and that requires, among other things, such persons to comply with applicable U.S. federal securities laws. A copy of the code of ethics must be provided to clients and prospective clients upon request.

The code of ethics must also require an adviser's "access persons" (i.e., the adviser's supervised persons who (a) have access to nonpublic information regarding any clients' purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund; or (b) are involved in making securities recommendations to clients, or have access to such recommendations that are nonpublic)[1], to periodically submit reports to the adviser (and for the adviser to review) regarding their personal and familial holdings and transactions of "reportable securities"[2], including:

- an initial (and thereafter, an annual) holdings report disclosing beneficial ownership in securities and related information, including the number and principal amount of the securities and the broker, dealer or bank with which such person has an account; and

[1] If an adviser's primary business is providing investment advice, there is a presumption that its directors, officers and partners are access persons. Administrative, technical and clerical personnel may also be access persons if they have access to nonpublic information in the course of their duties.

[2] All securities are generally deemed "reportable securities" except for: (a) U.S. government obligations; (b) bankers' acceptances, bank certificates of deposit, commercial paper and high-quality short-term debt instruments, including repurchase agreements; (c) shares issued by money market funds, (d) shares issued by open-end funds other than reportable funds; and (e) shares issued by unit investment trusts that are invested exclusively in one or more open-end funds, none of which are reportable funds.

- quarterly reports of securities transactions since the last quarterly report, unless, as is most often the case, the adviser requires that access persons' broker-dealers provide the adviser with duplicate confirmations and account statements.

Pre-Clearance of Investments in IPOs and Limited Offerings. The Code of Ethics must require an adviser's access persons to obtain the adviser's approval prior to acquiring (directly or indirectly) beneficial ownership of any security in an initial public offering or "limited offering"[3].

Personal Trading Policies. Advisers should be careful in establishing a personal trading policy to ensure that the policy complies with the requirements of the law, facilitates demonstration of compliance, avoids placing the firm in a potential conflict of interest position, and is properly tailored to the investment strategy and profile of the particular firm. For example, some advisers have adopted policies that include: (a) requiring all personal trades to be pre-cleared by the compliance officer, (b) requiring copies of all personal trade confirmations to be provided to the compliance officer on a monthly or quarterly basis, (c) requiring all personal trades to be made through a single broker pre-approved by the adviser, (d) restricting trading during certain blackout periods, and (e) establishing information barriers, restricted lists and watch lists.

Insider Trading Policies and Procedures. Section 204A of the Advisers Act requires registered advisers to establish, maintain and enforce written policies and procedures reasonably designed (taking into account the nature of the adviser's business) to prevent the misuse of material, nonpublic information by the adviser and any person associated with the adviser. The SEC has interpreted the misuse of material, nonpublic information to include the misuse of material, nonpublic information about the adviser's securities recommendations, as well as securities transactions and holdings of clients. Advisers should consider the use of restricted lists and watch lists, as well as information barriers as part of its policies and procedures.

Additional Policies. The policies and procedures that an adviser establishes should reflect the compliance risks involved in the adviser's particular business. While not expressly required by the Advisers Act, many advisers have adopted additional restrictions on the acceptance of gifts, outside business activities and political activities in order to reinforce the adviser's fiduciary obligations to clients.

Proxy Voting. Rule 206(4)-6 requires registered advisers to (a) adopt and implement written policies and procedures that are reasonably designed to ensure that advisers vote client securities in the best interests of clients and address how advisers will resolve material conflicts of interest that may arise with respect to proxy voting; (b) describe their proxy voting policies and procedures to clients and, upon request, furnish a copy of the policies and procedures to the requesting client; and (c) disclose to clients how to obtain information about how the investment

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[3] A limited offering is an offering that is exempt from registration under the Securities Act of 1933, as amended, pursuant to Sections 4(2) or 4(6) or Regulation D (a private placement).

adviser voted their securities. The SEC has not prescribed specific policies and procedures; rather, policies and procedures should be established that are appropriate for a particular adviser's business.

Brokerage Arrangements and Transactions

Best Execution and Soft Dollars. As fiduciaries, advisers are required to provide, or select brokers who provide, "best execution" for client transactions. Best execution means executing securities transactions for clients with the best qualitative execution, considering the full range and quality of a broker's services, and not necessarily simply the best price.

"Soft dollar" arrangements (i.e., arrangements under which products or services other than execution of securities transactions are obtained by an adviser in exchange for directing client brokerage transactions to the broker) create potential conflicts of interests in meeting an adviser's obligation of best execution. The SEC takes the position that soft dollar arrangements could violate an adviser's fiduciary duties unless the arrangements fall within the safe harbor created by Section 28(e) of the Securities Exchange Act of 1934, as amended. The safe harbor allows an adviser to cause a client account to pay more than the lowest available commission if the adviser determines in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by the broker, viewed in terms of either that particular transaction or the adviser's overall responsibilities with respect to the accounts as to which the adviser exercises investment discretion.

Principal Transactions and Agency Cross Transactions. Section 206(3) of the Advisers Act prohibits an investment adviser from knowingly acting as principal in any securities transaction with a client without disclosing to the client in writing before the completion of the transaction the capacity in which the adviser is acting and obtaining the written consent of the client to the transaction. This prohibition also applies where an affiliate or controlling person of the adviser is acting as a principal in any securities transaction with a client of the adviser. In the private fund context, if the adviser (and/or its controlling persons) owns more than 25% of a fund that is a counterparty to the client in a transaction, the transaction may be treated as a principal transaction and subject to Section 206(3).

Blanket pre-approval of principal transactions is generally not effective. However, clients may pre-approve agency cross transactions, where the adviser or its affiliate (typically an affiliated broker-dealer) effects transactions between one of its advisory clients and a third party and receives compensation as agent. For agency cross transactions, specific reporting is mandated by Rule 206(3)-2.

Allocation of Securities and Investment Recommendations. The SEC takes the position that an adviser may violate the Advisers Act if it does not allocate securities and investment recommendations among clients in a fair and equitable manner. What is fair and equitable depends upon the facts and circumstances of each situation. To comply, registered advisers must adopt written policies and procedures that address investment opportunity allocations among clients. At a minimum, advisers should have a robust policy in place and provide clients with complete and accurate disclosure of the policy. Regardless of the allocation policy adopted, it should be fair and equitable and should be applied on a consistent basis. The SEC's staff often

scrutinizes trade allocation practices during examinations because of the potential for abuse of clients

Trade Aggregation. The SEC recognizes that aggregation of trades for multiple client accounts may be beneficial to clients in various circumstances (e.g. by resulting in lower brokerage commissions). However, when aggregating client trades, an investment adviser must fully disclose its aggregation policies in Form ADV and must aggregate the trades in a fair, equitable and consistent manner.

Trade Errors. Investment advisers are required to correct trade errors arising in the course of managing client assets in a manner that is consistent with their fiduciary obligations to clients. It is recommended that an adviser have a written policy for correcting trade errors and to consistently follow the policy. In examinations, the SEC's staff typically reviews trade error data.

Custody of Client Assets

Registered advisers with custody of client assets are required under Rule 206(4)-2 to maintain client assets with a "qualified custodian" (which generally includes regulated banks and savings associations, registered broker-dealers and registered futures commission merchants, and may include the adviser itself or an affiliate thereof). "Custody" is broadly defined as holding directly or indirectly client funds or securities, or having the authority to obtain possession thereof. Under this broad definition, advisers who merely have authority to deduct their fees from the clients' accounts and a general partner of a limited partnership would be deemed to have "custody."

Advisers with custody of client assets, whether such assets are held by an unaffiliated qualified custodian or not, are required to engage an independent public accountant to conduct surprise examinations annually to verify client funds and securities. Advisers to private funds are deemed to have complied with this examination requirement with respect to a fund if that fund is subject to an audit: (a) at least annually (and upon liquidation) and distributes its audited financial statements, prepared in accordance with generally accepted accounting principles, to the fund's investors within 120 days of the end of the fund's fiscal year (or within 180 days for funds of funds); and (b) conducted by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (the "PCAOB"). In addition, advisers (or related persons) serving as qualified custodians will generally be required to obtain at least once each calendar year an internal control report from a PCAOB-registered accountant regarding the suitability of the controls that are in place with respect to custody of client assets.

Recordkeeping

Registered advisers are required under Rule 204-2 to maintain true, accurate and current books and records, generally for a five year period. The list of records to be maintained is extensive and includes, among other things, records on the adviser's finances and accounting, investment advice and transactions, compliance policies and procedures, trading activity and practices, counterparty credit risk exposure, use of leverage, assets and liabilities, advertising,

marketing and performance, advisory contracts, side letters, proxy voting, political activities, custodial activities and any additional records that the SEC determines. Records to be retained include information in electronic form, such as email.

The records of registered advisers are subject to periodic SEC examination to confirm compliance with the Advisers Act and certain information reviewed as part of the examination process, including client identities, may be shared with various other regulatory bodies and the U.S. Congress.

Advisory Agreements

Section 205 of the Advisers Act imposes various restrictions on the terms of contracts between the adviser and its clients. For example: (a) the adviser may not assign the contract without client consent[4], and (b) the contract may not provide for performance compensation (subject to various exceptions, including for contracts with 3(c)(7) funds (see Section 205(b)(4) of the Advisers Act) and contracts with "qualified clients" (i.e., clients satisfying certain net worth and sophistication tests) (see Rule 205-3)). Further, Section 215 of the Advisers Act provides that no provision of a contract may purport to waive compliance with the Advisers Act.

Anti-fraud Provisions

Advisers (whether registered or not) are subject to the anti-fraud provisions of the Advisers Act, which generally make it unlawful for advisers to engage in fraudulent, deceptive or manipulative conduct, and impose upon investment advisers fiduciary duties toward their clients.

Sales Materials. Rule 206(4)-1 prohibits fraudulent advertising by advisers. Advertising is broadly defined and includes "flip books," marketing presentations, letters to investors, due diligence questionnaires, websites, press releases and similar communications with investors and prospective investors. When seeking to comply with the advertising rules, advisers need to pay particular attention to the disclosure of actual or model performance information to their clients. As with all disclosure, advisers must take care to ensure the disclosure is truthful, complete and not misleading, including by generally disclosing performance information net of all applicable fees and expenses (and not just on a gross basis). Advisers that will be required to register as a result of the Act should carefully review their marketing materials, including in particular any disclosure regarding past performance. In its examinations, the SEC's staff routinely scrutinizes an adviser's performance claims, calculations and supporting documents.

Additional Anti-Fraud Rule for Advisers to Pooled Investment Vehicles. Advisers (whether registered or not) to pooled investment vehicles, which includes most private funds, are prohibited under Rule 206(4)-8 (whether or not in the context of a securities offering) from (a) making false or misleading statements to investors or prospective investors in those pools or (b)

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[4] Assignment is broadly defined under Section 202(a)(1) of the Advisers Act to include any direct or indirect transfer of a controlling block of the adviser's outstanding voting securities.

otherwise defrauding those investors or prospective investors. Thus, advisers must carefully consider each on-going communication with prospective and existing investors to ensure compliance with the anti-fraud provisions.

Political Contributions ("Pay-to-Play")

The SEC recently adopted Rule 206(4)-5, which will (a) ban investment advisers (whether registered or not) from receiving compensation for providing advisory services to a state or local government entity for two years if it (or certain of its executives or employees) makes a political contribution (subject to certain *de minimis* exceptions) to an official of that government entity or a candidate for such office in a position to influence award of advisory business; (b) prohibit investment advisers from paying or agreeing to pay third parties, such as placement agents, to solicit government entities for advisory business, unless the third parties are registered investment advisers or registered broker-dealers and are subject to this rule or similar "play-to-play" rules; and (c) prohibit investment advisers from soliciting or coordinating political contributions to an official of a government entity to which the adviser is providing or seeking to provide advisory services, or to a state or local political party located in the jurisdiction of the government entity. Therefore, advisers must adopt policies and procedures to ensure that the political activities of the adviser and its executives and employees do not violate the rule or cause the adviser to be banned from providing advisory services to a government entity.[5] In addition to Rule 206(4)-5, advisers may also be subject to state laws or regulations designed to prohibit "play-to-play" practices.

Additional Compliance Policies; Compliance Officer

Written Policies and Procedures

Under Rule 206(4)-7, registered advisers are required to (a) adopt and implement written policies and procedures that address their fiduciary and regulatory obligations under the Advisers Act and that are reasonably designed to prevent violations of the Advisers Act, detect violations that have occurred and promptly correct any such violations; and (b) review these policies and procedures at least annually (or in the case of the first annual review, no later than 18 months after their adoption).

The specific compliance policies and procedures to be adopted by an adviser depend on the nature of that particular adviser's business. However, at a minimum, each adviser must adopt compliance policies and procedures with respect to the disclosure and substantive provisions of the Advisers Act described above, as well as with respect to the following: portfolio management processes; trading practices; proprietary trading; processes to value client holdings and fee assessments based on such valuations; privacy safeguards; business continuity plans.

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[5] Advisers generally are required to be in compliance with the rule by March 14, 2011. However, advisers are not required to be in compliance with the provision regarding the use of third parties to solicit government business until September 13, 2011.

The SEC recommends that particular attention be given to controls in those areas of an adviser's activities that pose the greatest potential for creating conflicts of interest or other results that can harm clients, such as policies and procedures with respect to the safeguarding of client assets. During an examination, examiners will carefully evaluate the advisers policies and procedures and whether they are strictly adhered to and consistently applied.

In addition to policies and procedures designed to ensure compliance with the Advisers Act, advisers will also need to adopt policies and procedures to ensure compliance with other laws and regulations applicable to them, for example, anti-money laundering laws and regulations.

A primary responsibility of an adviser is the supervision of its employees, to ensure that they strictly comply with the adviser's policies and procedures, the disclosures made to clients and the provisions of applicable securities laws. Having proper compliance policies and procedures in place may be relevant to the SEC when considering bringing an action against an adviser alleging the failure by senior members of the adviser to supervise their employees who committed violations of the Advisers Act. As a means of ensuring the effectiveness of its policies and procedures, the adviser should implement and document a robust, on-going training program to educate its personnel about its compliance policies and procedures and to foster a culture of compliance.

Compliance Officer. Registered investment advisers are required under Rule 206(4)-7 to identify and designate a suitable chief compliance officer responsible for administering its compliance policies and procedures. The compliance officer must be competent and knowledgeable regarding the Advisers Act and of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures. Advisers that will be required to register as a result of the Act should identify and designate a qualified chief compliance officer well in advance of the registration deadline.

To assist chief compliance officers in meeting their compliance responsibilities and to help enhance compliance in the securities industry, the SEC has established the "CCOutreach Program." This program includes regional and national seminars on compliance issues of concern to chief compliance officers. Information about CCOutreach is available at http://www.sec.gov/info/ccoutreach.htm.

SEC Examination

Under Section 204 of the Advisers Act, the books and records of registered investment advisers are subject to both periodic or "for cause" examination by the SEC's inspection staff.[6] During a periodic examination the staff (a) evaluates compliance with the Advisers Act and adherence to disclosures filed with the SEC and provided to clients and (b) closely reviews the actions that advisers have taken to remedy deficiencies cited during past examinations. Failure

6 In the future, a self-regulatory organization for investment advisers may be formed, which would likely have its own rules as well as examination and enforcement authority.

to comply with the Advisers Act or to correct past deficiencies could result in enforcement action staff. To prepare for examinations, an adviser should consider engaging a third party firm specializing in SEC examinations to conduct "practice examinations" with the adviser.

The SEC provides information on the examination process in the brochure, "Examination Information for Broker-Dealers, Transfer Agents, Clearing Agencies, Investment Advisers and Investment Companies," available at http://www.sec.gov/info/cco/ccons2006exambrochure.pdf. The SEC also highlights the most common violations discovered during examinations at www.sec.gov/division/ocie/advltr.htm.

__Click here__ for a discussion of the requirement for investment advisers to register with the SEC and the limited set of exemptions from registration.

__Click here__ for information on the SEC registration process and the recently amended Form ADV.

__Click here__ for a summary checklist of some of the key compliance obligations of SEC-registered investment advisers.

Gibson Dunn lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact any of the following, or the Gibson Dunn lawyer with whom you work:

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