Registration and Compliance Report

Registration Under the Investment Advisers Act of 1940: Process and Consequences

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), signed by President Obama on July 21, 2010, requires many investment advisers that are currently exempt from registration to register with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940 (the "Advisers Act") by removing the "fewer than 15-client" exemption on which many managers rely. The Dodd-Frank Act, however, adds exemptions for, or requires the SEC to promulgate rules exempting, the following investment advisers from registration: (1) investment advisers whose sole clients are venture capital funds (as such term will be defined by the SEC), (2) investment advisers whose sole clients are private funds and will have total assets under management in the United States of less than $150 million, (3) investment advisers who provide investment advice solely to licensed small business investment companies (unless registered as a business development company) and (4) family offices. These new registration requirements will be effective July 21, 2011.

Investment advisers must satisfy minimum requirements with respect to assets under management to be permitted to register with the SEC. If an adviser's principal place of business is located in a state that requires the adviser to be registered and subject to inspection, the adviser would not be permitted to register with the SEC unless it has assets under management (AUM) of at least $100 million (or such higher amount as the SEC will set by rule). For any other adviser to be permitted to register with the SEC, the adviser must have at least $25 million in assets under management.[1]

As a result of this increased asset threshold for SEC registration and the removal of the 15-client exemption, many advisers who are currently registered with the SEC will be required to transition to state registration, and many advisers that are not currently registered will be required to register with the SEC. The registration process itself is not protracted, but a registered investment adviser is subject to specified disclosure obligations, rules regarding codes of ethics, compliance procedures and other antifraud rules, books and records requirements, limitations on charging performance fees for certain clients and the assignment of advisory contracts, in addition to regular inspections by SEC staff.

Registration

The SEC registration process is conducted through the Investment Adviser Registration Depository (IARD) system operated by the Financial Industry Regulatory Authority Inc. (FINRA). To be admitted to the IARD system, an investment adviser has to submit an SEC Registrant Entitlement Packet to FINRA and fund its IARD account with the de minimis SEC registration fee (currently $40 to $200, depending on the AUM of the investment adviser) and state notice filing fees, if any.

An investment adviser registers with the SEC by filing Part 1A of a Form ADV through the IARD system. Part 1A of Form ADV requires disclosure of, among other things, information regarding the principals of the investment adviser (including any disciplinary history), the organization of the investment adviser, types of clients, types of compensation, conflicts of interest and other affiliations.

Investment advisers registering with the SEC are required to file Part 2A (the "Brochure") (together with Part 1A) with the SEC as part of their registration application if they are registering after January 1, 2011. The Brochure, which was newly adopted as of October 12, 2010, includes 18 disclosure items about the adviser's business that must be addressed in a narrative format using "plain English" to describe various aspects of an adviser's business. The Brochure must follow a prescribed order in presenting disclosure items and be electronically filed with the SEC through the IARD system. In addition, there is a supplement to the Brochure in Part 2B of Form ADV that contains six disclosure items relating to persons providing investment advice or contacting clients or prospective clients (the "Supplement"). The Supplement must be provided to the relevant clients, subject to certain exceptions, but is not filed with the SEC. Rather, advisers are required to maintain copies of all Supplements and amendments in their files.

The SEC is required to act within 45 days of submission of the application to grant registration or institute a proceeding to determine whether registration should be denied. As a practical matter, the SEC staff can also request further information. Any request for further information suspends the 45-day deadline until the registration staff is satisfied with the information submitted.

Registration must be denied if the SEC finds certain disqualifying behavior as set out in Section 203(e) of the Advisers Act. This section includes conviction in the last 10 years of any felony, conviction of certain misdemeanors under U.S. or foreign law involving sales of securities, and findings in civil or administrative proceedings of certain violations of securities or financial services laws.

1 *See* Instruction 5F to Form ADV for a definition of assets under management.

Rules for Registered Investment Advisers

Annual Update

Registered investment advisers are required to amend their Form ADV (including Part 1A, the Brochure and the Supplement) annually within 90 days after the end of their fiscal years. Registered investment advisers must file their Form ADV Part 1A and the Brochure (Part 2A) electronically through the IARD system. Advisers that are currently registered with the SEC and that have fiscal years ending on or after December 31, 2010, will be required to electronically file their Brochure with the SEC no later than March 31, 2011. In addition to the above annual amendment requirements, registered investment advisers must promptly amend their Forms ADV if specified information changes or the Brochure becomes materially inaccurate (other than due to changes to AUM).

Brochure Rule

Registered investment advisers are required to deliver their Brochures to clients at or prior to the time that they enter into investment advisory contracts and deliver their Supplement at or prior to the time that the persons described in the Supplement begin to provide advice. Annually, within 120 days of the end of their fiscal year, advisers are also required to deliver either: (1) an updated Brochure and Supplement that include a summary of any material changes or (2) a summary of any material changes, along with an offer to provide an updated Brochure and Supplement. Investment advisers may deliver the Brochure, summary of material changes and Supplement electronically with client consent, in accordance with SEC guidance. Interim updates to the Brochure or Supplement are required when a material change occurs, such as a change with respect to disciplinary information.

In the adopting release to the new Form ADV Part 2, the SEC noted the decision by the Court of Appeals for the D.C. Circuit in *Goldstein v. SEC* with respect to hedge funds, which clarifies that the "client" of an investment adviser to a hedge fund is the fund itself and not an investor in the fund. Thus, investment advisers are not required to deliver the Brochure or the Supplement to prospective fund investors. However, as a matter of practice, many fund advisers will likely choose to do so in order to comply with their fiduciary duty to disclose conflicts of interest.

Compliance Procedures and Codes of Ethics

A registered investment adviser is required to develop compliance procedures to prevent violations of the Advisers Act and to develop a code of ethics to ensure compliance with federal securities laws. A registered investment adviser's compliance program should at least cover (1) portfolio management processes, (2) disclosures to clients and potential clients, (3) personal trading, (4) safeguarding of client assets, (5) maintenance of required books and records, (6) protection of client information, (7) best execution, (8) use of third-party solicitors, (9) valuation procedures and (10) business contingency plans. The compliance procedures must be reviewed at least on an annual basis. The program must be in writing and must be tailored to the risks of an adviser's business. The use of a form compliance manual without tailoring it to the adviser's risks and procedures does not satisfy the requirements of the compliance rule. A registered investment adviser is required to appoint a chief compliance officer (CCO) to administer its compliance procedures.

A code of ethics sets forth standards of business conduct that an investment adviser requires of its supervised persons, including policies to ensure supervised persons follow federal securities laws. In addition, supervised persons who have access to nonpublic information regarding portfolio holdings or who are involved in making, or have access to, securities recommendations to clients are required to report personal holdings at the inception of their employment and thereafter on an annual basis, to report personal trades on a quarterly basis and to preclear certain trades with the CCO.

Anti-Fraud Rules

In addition to the general prohibitions against (1) fraudulent schemes and practices, (2) principal trades between the adviser and client accounts and certain client account cross trades where the adviser or an affiliate is paid a commission and (3) untrue statements related to pooled investment vehicles that apply to all investment advisers (whether or not they are registered with the SEC), registered investment advisers are subject to several additional rules promulgated by the SEC under its antifraud authority, including rules relating to advertising, custody of client assets, solicitation of clients, proxy voting policies, codes of ethics and compliance procedures.

Advertising Rule. A registered investment adviser is deemed to be engaged in a fraudulent practice if it publishes or distributes a prohibited "advertisement," which, for fund managers, covers all fund-related marketing materials and presentations to prospective investors other than "one on one" presentation materials. In particular, registered investment advisers are prohibited from, among other things, referring to any testimonial, referring to any past recommendation unless in compliance with certain requirements, making any untrue or misleading statement of material fact or omitting any material fact. In addition, "no-action" or interpretive letters from the SEC staff strictly limit which past recommendations may be referred to and prescribe a certain manner of presenting past performance. The advertising rules also apply to periodic letters to investors to the extent that they are also sent to prospective investors.

Custody Rule. A registered investment adviser that has "custody" of its clients' funds (i.e., it has possession of, or access to, client funds, including the ability to withdraw advisory fees) is required to maintain its clients' assets with a qualified custodian, such as a regulated bank, a registered broker-dealer, a futures commission merchant or an equivalent foreign financial institution, and notify its clients of the institution having custody. A registered investment adviser must arrange for its qualified custodian to send quarterly account statements to each of its clients for which it has custody of funds and to notify its clients if it opens an account with a new qualified custodian. The custody rule also requires that an independent public accountant perform an annual surprise examination of the funds and securities over which a registered investment adviser maintains custody. Investment advisers are exempt, however, from the custody notification requirement, surprise examination requirement and the account statement delivery requirement for any account of a limited partnership, a limited liability company or other pooled investment vehicle that is subject to an annual audit and distributes audited financial statements within 120 days of the end of the fiscal year.

Solicitation. A registered investment adviser is prohibited from making a cash payment to a solicitor in connection with the solicitation of investment advisory clients unless the solicitor enters into a written agreement that contains certain specified undertakings and provides prospective clients with the registered investment adviser's Brochure and a written disclosure document. A recent no-action letter from the SEC staff clarified that the cash solicitation rule does not apply if a solicitor is solely soliciting persons to invest in a pooled investment vehicle managed or advised by a registered investment adviser, but many advisers continue to comply with the cash solicitation rule in order to make full disclosure in accordance with their fiduciary duties.

Proxy Voting Policies. While all investment advisers are required to consider their fiduciary duties when they vote proxies, a registered investment adviser is deemed to be engaged in a fraudulent practice if it does not develop policies and procedures designed to ensure that proxies are voted in the clients' best interests and that conflicts of interest are managed. A registered investment adviser is required to describe the policies and furnish them to its clients on request. In addition, an investment adviser is required to inform clients as to how they can obtain the adviser's proxy voting record.

Pay to Play Rule. Beginning on March 14, 2011[2], a new rule (the "Pay to Play Rule") will prohibit registered investment advisers and advisers exempt from registration under the fewer than 15-client exemption from providing, directly or indirectly through any covered pooled investment vehicle, investment advisory services for compensation to any (1) agency of a state or subdivision of a state, (2) plan or pool sponsored or established by a state or political subdivision thereof or (3) official of any of the above, acting in his or her official capacity (each, a "Government Entity"), if that investment adviser or any of its Covered Associates[3] made a contribution of value (above certain modest de minimis thresholds) within the past two years to an official of such Government Entity that has direct or indirect influence over which adviser will be retained (an "Applicable Official"). The Pay to Play Rule will also prohibit registered investment advisers from coordinating or soliciting those contributions or making payments to a political party of a state or locality in which the investment adviser is providing or seeking to provide investment advisory services to a Government Entity.

The Pay to Play Rule will also prohibit the use of third parties to solicit any Government Entity unless the third party is either (1) an SEC-registered investment adviser that has neither made a contribution to an Applicable Official nor solicited or coordinated any person or political action committee to make any contribution or payment that will be prohibited under the Pay to Play Rule or (2) a broker-dealer registered with the SEC and subject to similar rules of FINRA.

Books and Records

Registered investment advisers are required to keep true, accurate and current books and records. Advisers are required to maintain business records, including accounting records and bank statements; trading records, including order tickets, and trade confirmations; all written agreements; certain written communications; advertisements; performance records; compliance records; Brochures, Supplements and summaries of material changes distributed to clients and prospective clients; privacy records; and records relating to compliance with the various substantive rules applicable to registered advisers. Most of the books and records that are required to be maintained must be retained for at least five years. In addition, advisers are required to implement systems to retain e-mails and instant messages that constitute records.

Limitations on Performance-Based Fees

Registered investment advisers are prohibited from charging fees based on a share of capital gains or the capital appreciation of client funds. An SEC rule, however, provides an exemption for advisers that provide advice to persons that are "qualified clients" or investment funds owned exclusively

[2] The restrictions on placement agents in the Pay to Play Rule will be effective on September 13, 2011.

[3] "Covered Associates" will include an investment advisers' general partners, managing members, executive officers, any employee that solicits from a Government Entity for the investment adviser and any persons who supervise such persons or any political action committee controlled by the investment adviser or other Covered Associates.

by"qualified clients." A qualified client is defined as any of the following: (1) a "qualified purchaser," as defined in Section 2(a)(51) of the Investment Company Act of 1940, (2) a natural person that has at least $750,000 under management with the adviser or (3) a person that has a net worth of more than $1,500,000.

Other Limitations on Advisory Contracts

In addition to the limitation on performance-based fees, registered investment advisers are subject to certain special requirements regarding the content of their investment advisory agreements. For example, such agreements must prohibit any "assignment" by the adviser (which includes a constructive assignment deemed to result from a change of control of the adviser) without the consent of the client.

Privacy Rule

Registered investment advisers are subject to Regulation S-P, the SEC's privacy rules. Regulation S-P requires registered investment advisers and other regulated persons to provide notice to clients about nonpublic information regarding that client that may be disclosed and how to opt out of such disclosure limits disclosure of such information to nonaffiliated third parties and requires advisers' written procedures to protect customer records and information.

New Reporting Rules for Private Fund Advisers

Starting the later of (1) July 21, 2011 and (2) the effectiveness of SEC rules, a registered investment adviser to a private fund will be subject to additional reporting, recordkeeping and disclosure requirements to the SEC and other third parties. The Dodd-Frank Act provides the SEC with broad authority to require registered advisers to maintain records, which will be subject to inspection, and file reports with the SEC as are "necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the Financial Stability Oversight Council …" (the "Council") and to provide the contents of those reports to the Council and other entities that have responsibility for systemic risk. Those records and reports required to be maintained or filed with the SEC will include a description of (1) the amount of assets under management, (2) the use of leverage (including off-balance sheet leverage), (3) counterparty credit risk exposure, (4) trading and investment positions, (5) valuation policies and practices of the fund, (6) types of assets held, (7) side arrangements or side letters, whereby certain clients receive more favorable rights or entitlements, (8) trading practices and (9) any other information that the SEC in consultation with the Council deems to be "necessary or appropriate in the public interest for the protection of investors or for the assessment of systemic risk…" The SEC will also be allowed to require different reports for different classes of private fund advisers. The SEC will be permitted to share the information it collects with the Council, but the SEC will not be compelled to disclose any report or information in the Dodd-Frank Act to the public.

SEC Examination

Registered investment advisers are subject to examination by the SEC's Office of Compliance Inspections and Examinations. These examinations are designed to discover violations of the Advisers Act or other applicable rules or regulations and violations of the duties and prohibitions to which all investment advisers are subject (e.g., breaches of fiduciary duties to clients or prohibitions on provision of materially false statements to investors in pooled vehicles managed by the investment adviser, trading-related fraud or use of unregistered broker-dealers to sell interests in a fund managed by an investment adviser).

The SEC commonly conducts three types of examinations: routine, for-cause and sweep. Routine examinations are conducted on a cycle determined by the SEC, depending on the assessment of the risk from the investment adviser's business. For-cause examinations are conducted when the SEC suspects that an investment adviser has violated the federal securities laws. Finally, the SEC staff conducts sweep examinations when it is investigating an industrywide issue.

Regardless of the form of examination, the examination process can be time-consuming and costly. Recently, the SEC has become more intrusive in its examination process by contacting an examined adviser's clients and custodian to confirm the information that the SEC has obtained from the adviser during its examination process.

Conclusion

Unless the SEC provides regulatory relief, non-exempt investment advisers will be required to be registered with the SEC when the transition period under the Dodd-Frank Act ends on July 21, 2011. Advisers contemplating SEC registration should begin preparing for the registration process as soon as possible in order to complete it on or before that date. For further information regarding the obligations of registered investment advisers, see the guidance published by the SEC's Division of Investment Management entitled "Information for Newly Registered Investment Advisers."

Contact Information

Additional information on these and other topics relevant to your business is available at www.akingump.com/communicationscenter.

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