CLEARY GOTTLIEB

Alert Memo

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Financial Regulatory Reform - Hedge Fund and Private Equity Provisions

The Administration's sweeping recommendations for financial regulatory reform, issued June 17, 2009, impose only limited requirements on hedge and private equity funds.

Advisors Act registration required. Above a *de minimus* threshold, hedge fund and PE managers will be required to register with the SEC under the Investment Advisors Act. For some PE and hedge funds, the requirement to register under the Advisors Act will impose both expense and the need for substantial administrative changes. Depending upon the size of the firm and the state of its compliance, the cost of registration could be as high as $500,000, and the requirement to document compliance procedures in detail may be a significant drain on management resources.

On the other hand, many hedge and PE firms had been moving toward Advisors Act registration over the last years, so the universe of firms for whom this provision will be a problem has shrunk notably.

Key elements of being a registered advisor are (1) detailed initial and continuing disclosure to the SEC (including new requirements to help the SEC measure the risk elements of assets and liabilities); (2) detailed and documented compliance policies; (3) record retention requirements; and (4) regular and surprise SEC exams. (A detailed outline of Advisors Act requirements is attached.)

No capital, leverage or other financial requirements. The Administration's recommendations do not impose any explicit capital, leverage or similar financial requirements on hedge funds or PE firms. On the other hand, an interagency committee will name financial holding companies whose size or other factors make them systemically significant. Thus, it is at least imaginable that a particularly large hedge fund might be designated. The effect of being named a significant financial holding company is to be subject to "robust", "strict" supervision.

Please feel free to call any of your regular contacts at the firm or any of the partners and counsel listed under Private Equity in the Practices section of our website (www.cgsh.com) if you have any questions.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

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This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

Annex I

Summary of U.S. Investment Advisers Act Requirements[1]
I. Initial Registration Process
A. **Disclosure to Regulator** (*Part I of Form ADV)*[2] • Part I of Form ADV provides information to the Securities and Exchange Commission ("SEC") regarding the investment adviser ("Adviser") and its employees, fee arrangements, assets under management, advisory activities, financial industry affiliations, direct and indirect owners and control persons and affiliates (including any disciplinary information regarding all such persons over the past 10 years).
B. **Required Disclosure to Clients** (*Part II of Form ADV)*[3] • Part II of Form ADV is not filed with the SEC but requires the Adviser to disclose to clients (either by providing clients with Part II or the information required in Part II, as discussed in Section II.C below) certain information, including: o the nature of the Adviser's business, including services offered and fees charged, types of clients advised, methods of analysis used, investment strategies employed, and sources of information used by the investment adviser in formulating recommendations; o description of any educational and business standards applicable to persons associated with the Adviser and the actual educational background and business activities of such persons; o biographical details for each officer, director or other person who either controls the investment adviser directly or indirectly or who determines general client advice.[4] • Advisers must also disclose to clients all material financial, legal or disciplinary events. Many Advisers use Part II of their Form ADV for this purpose (see Section II.G.3.iii below).

[1] This chart contains a brief summary of certain provisions of the Advisers Act and does not purport to address all provisions of the Advisers Act, nor all requirements imposed on investment advisers generally.

[2] In order to register with the SEC as an investment adviser, an adviser must file an application on Form ADV. Form ADV consists of two parts. Currently, only Part I is required to be filed with the SEC. However, the Adviser must retain a copy of Part II, and must provide a copy of Part II to investors as part of the "brochure" requirement (as described in Section II.C below).

[3] An Adviser to a fund, who is also the general partner (or an entity serving in a similar capacity) to the fund, is required to deliver a copy of its brochure to each investor in or beneficial owner of the fund, in addition to delivering a copy of the brochure to the fund itself. In addition, it is market practice even for Advisers who are not also the general partners of their fund clients to deliver a brochure and make certain other disclosures (e.g., Regulation S-P privacy notice) to the investors in or beneficial owners of the fund.

II. Ongoing Compliance Requirements

A. **Updated Filings**

- Under the Advisers Act, an Adviser must comply with certain on-going filing requirements, including the requirement to:
  - file an annual updating amendment to its Form ADV.
  - promptly file an amendment to its Form ADV in the event of any change to the Adviser's identifying information, SEC registration, custody of client assets, disciplinary disclosure history, state registration or bond, judgments and lien information.
  - promptly file an amendment to its Form ADV in the event of any material change to its control persons, ownership, business activities or participation or interest in client transactions.
  - promptly amend, maintain and provide to the SEC upon request its "brochure" (as described in Section II.C below), which will be Part II of its Form ADV, in the event of any material change to the information contained therein.

B. **Recordkeeping**

- The Adviser must maintain all records relating to its advisory business specified by Rule 204-2(a) and (c) under the Advisers Act;[5]
- Records must be preserved in an easily accessible place in the United States for at least five years from the end of the fiscal year during which the last entry was made, and in the first two years, such records must be maintained in an office of the Adviser;
- The Adviser's corporate records must be maintained at its principal office and preserved for at least three years after the termination of its investment advisory business;
- If any of the Adviser's officers, managers or employees engage in personal securities transactions, the Adviser must promptly obtain records of their securities holdings and reports of any transactions in a security in which the Adviser or any advisory representative has or acquires any direct or indirect beneficial ownership and keep certain related records.[6]

C. **The "Brochure Rule"**

- The Adviser must deliver to each existing or prospective advisory client a written disclosure statement (a "brochure") either
  - (i) at least 48 hours prior to entering into a written or oral investment advisory contract with such client, or
  - (ii) at the time such contract is entered into, in which case the client has the right to terminate the contract without penalty

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[4] Biographical information must also be provided for any person, other than a clerical or administrative employee, who has been convicted of violating securities or other criminal laws or subject to certain other disciplinary actions.

[5] Rule 204-2(a) and (c) generally refers to the business books and records as well as records of client securities purchased and sold.

[6] Rule 204-2(a)(13) under the Advisers Act.

within five business days.

- A brochure may take either of two forms:
    - (i) it may be a copy of Part II of the Adviser's Form ADV, or
    - (ii) it may be a written document that contains at least the information required by Part II.
- Subsequent reportable events must be communicated promptly to all existing clients.
- The Adviser must annually either deliver a current brochure to its clients or offer in writing to deliver a brochure without charge upon written request.

D. **Custody**

- If the Adviser has custody or possession of client funds or securities, the Adviser must maintain such funds or securities with a "qualified custodian"[7] in a separate account for each client in such client's name, or in one or more accounts containing only funds and securities of the client in the name of the Adviser as agent for such client.[8]
- "Qualified custodians" include the types of financial institutions that clients and advisers ordinarily use for custodial services, such as banks, savings associations and registered broker dealers.
    - The term also includes non-U.S. financial institutions that customarily hold customer assets, so long as the customer assets are held in segregated customer reserve accounts.
- In addition, the Adviser must either
    - (i) have a reasonable belief that the qualified custodian provides account statements at least quarterly to clients whose funds and securities the custodian holds, or
    - (ii) send a quarterly account statement to each client for whom it has custody of funds and securities, in which case the Adviser must also undergo an annual surprise inspection by an independent public accountant.[9]
- Upon opening an account with a qualified custodian, the Adviser must notify each client in writing of the qualified custodian's name

[7] Currently, an Adviser or an Adviser's affiliate, who meets the definition of "qualified custodian" can act as a qualified custodian for client funds and securities pursuant to the custody rule under the Advisers Act. However, under proposed amendments to the custody rules may prohibit such arrangements and instead require the qualified custodian be an independent institution.

[8] For purposes of the Advisers Act, custody is defined in Rule 206(4)-2 as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them," and includes (i) possession of client funds or securities, (ii) any arrangement under which an adviser is authorized or permitted to withdraw client funds or securities held by a custodian upon instruction to the custodian, and (iii) access to client funds by virtue of an adviser's dual role as both general partner and investment adviser to a limited partnership or other such capacity.

[9] Currently, the SEC has proposed amendments to the custody rule under the Advisers Act that would eliminate this option. In addition, under the proposed amendments, the Adviser must undergo an annual surprise audit from an independent accountant. SEC Release IA-2876.

and address and the manner in which the funds or securities will be maintained.

E. **Antifraud Provisions**

- The Advisers Act and the rules promulgated thereunder contain both general and specific provisions intended to prevent fraudulent, deceptive or manipulative practices.
- Investment advisers have an affirmative obligation to fully and fairly disclose material facts to their clients and prospective clients.
- If the Adviser is an adviser to a pooled investment vehicle, the Adviser is prohibited from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in the pooled investment vehicle.

1. **Disclosure**

- The Adviser is prohibited generally from employing a "device, scheme or artifice" to defraud clients or from engaging in a "transaction, practice or course of business" that operates as a "fraud or deceit" on clients.[10]
- As a result, the Adviser must make full and adequate disclosure to its clients regarding various issues that may present a conflict of interest or otherwise may impact its independence or judgment.

2. **Principal and Agency Cross Transactions**

- The Adviser (and each of its affiliates) is prohibited from engaging in certain transactions with its clients without disclosure to and consent from the client.
- Unless the facts are adequately disclosed and the client consents, the Adviser will be prohibited from:
  - (i) effecting a securities transaction for an advised client while the Adviser or an affiliate is acting as a broker for a third party (an "agency cross transaction"), or
  - (ii) acting as principal in a transaction with an advised account (a "principal transaction").

3. **Fraudulent Practices**

- An Adviser may not engage in "any act, practice, or course of business which is fraudulent, deceptive, or manipulative."
- This provision has been interpreted to prohibit investment advisers from trading based on investment advice that has not yet been, but is about to be, disclosed to advisory clients (a practice known as "front-running").
- The SEC has promulgated a variety of rules proscribing other specific fraudulent practices, including the following:

i. **Limitation on Advertisements**

[10] Under Rule 206(4)-8, if the Adviser is an adviser to a pooled investment vehicle, the Adviser is prohibited from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in the pooled investment vehicle.

- The Adviser is generally prohibited from advertising in any fashion that refers directly or indirectly to its past specific recommendations, including by providing any client testimonials.[11]
- Advertisements that offer to furnish a list of all recommendations made by the Adviser within the immediately preceding period of not less than one year are not prohibited, provided
  - that such a list states the names of the security recommended,
  - the date and nature of each recommendation,
  - the security's market price at the time of recommendation and at the present time,
  - and a cautionary statement as to the fact that the success of future advice cannot be assured.
  - the Adviser is prohibited from disclosing performance data or model performance results, unless such information is presented fairly and complies with certain other requirements.[12]

ii. **Client Solicitation**

- The Adviser is prohibited from paying a cash fee for client solicitations or referrals, except upon compliance with various disclosure and supervisory obligations.

iii. **Disclosure of Disciplinary History**

- The Adviser is required to inform its clients of material financial, legal or disciplinary events.
  - disclosure must be made at least 48 hours prior to entering into an advisory contract,
  - or at the time the contract is entered so long as the client can terminate the contract without penalty within five business days.
  - any subsequent reportable events must be communicated promptly to all existing clients.

iv. **Misuse of Nonpublic Information**

- The Adviser must establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by itself or any person "associated" with the Adviser.

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[11] For purposes of the Advisers Act, an "advertisement" includes any written communication addressed to more than one person (including published, broadcast, televised or electronically-transmitted notices or announcements) that offers any analysis, report or publication regarding securities, any graph, chart, formula or other device for making securities decisions or any other investment advisory services regarding securities. This broad definition generally covers materials prepared for prospective clients or existing clients, as well as the "brochure" described in Section II.C above.

[12] The SEC has focused significant enforcement attention on the misleading use of performance data in the past. While SEC rules do not specifically address performance advertising, Rule 206(4)-1(a)(5) under the Advisers Act prohibits an adviser from distributing any advertisement that contains any untrue statement of a material fact or that is otherwise false or misleading.

F. **Duty to Supervise**

- The Adviser must supervise the activities of persons who act on its behalf.[13]
- Supervisors must act decisively to detect and prevent violations of the U.S. federal securities laws.
- The Adviser's officers and employees may be sanctioned for failure to supervise others.
    - The Adviser's establishment of reasonable compliance procedures and the reasonable discharge by supervisory persons of the duties and obligations incumbent upon a supervisory person by reason of such procedures, are an affirmative defense to a failure to supervise allegation.

G. **SEC Inspections**

- Advisers are subject to regular, on-site inspections by the SEC, at the expense of the Adviser.
- Inspections are intended to determine if the Adviser is operating in conformity with the Advisers Act and other applicable law and the information disclosed in the Adviser's Form ADV.
- Generally, the inspection is conducted on a "surprise" basis and will involve a review of the Adviser's books and records and other documents (including sales and advertising materials, compliance procedures, inter-company agreements and agreements with clients).
- Inspection may also involve interviews with the Adviser's employees.
- The SEC may also conduct a "for cause" inspection if it believes an adviser may be violating U.S. securities laws.
- From time to time, SEC staff will conduct "sweep" inspections that are typically focused on Advisers in a particular geographic area or that are engaged in certain activities.

H. **Compliance Program, Chief Compliance Officer and the Code of Ethics**

- Advisers are required to create and maintain a compliance program and review such program annually.[14] In general, the compliance program must take into account the nature of the Adviser's business and the resulting risk exposure of such business, and must be reasonably designed to prevent a violation of the Advisers Act, as well as to detect and correct any violations that have occurred. The SEC has indicated that the following topics should be covered in the compliance program, (if applicable to the Adviser's business):
    - portfolio management processes, including, among other things, how the Adviser allocates opportunities among clients;
    - trading practices, including, among other things, best execution and soft dollar arrangements;
    - proprietary and personal trading;

[13] Section 203(e)(6) of the Advisers Act.

[14] Rule 206(4)-7 under the Advisers Act and SEC Release No. IA-2204 (Dec. 17, 2003).

- accuracy of disclosures to clients, investors and regulators;
  - safeguarding client assets;
  - accurate creation and protective storage of records;
  - marketing advisory services;
  - processes used to value client holdings and assess client fees;
  - safeguarding client privacy; and business continuity plans.
- The compliance program must be reviewed annually and records of such review must be maintained under the recordkeeping rule (see Section II.B above).
- The Adviser must appoint a Chief Compliance Officer ("CCO") to implement the compliance program, ensure that the compliance program is maintained and reviewed and address any issues that arise with respect to compliance with the Advisers Act.[15]
- The Adviser must adopt and enforce a Code of Ethics detailing standards of conduct for advisory personnel.[16]
- The Code of Ethics must include the following minimum provisions:
  - standards of business conduct that reflect the fiduciary obligations of the Adviser and its supervised employees;
  - requirements to comply with federal securities laws;
  - reporting of personal securities transactions conducted by access persons[17] and review of such transactions;
  - safeguards for material non-public information about client transactions;
  - pre-approval of certain transactions;
  - reporting of code violations; and
  - review and enforcement of the code by the CCO, to whom personal securities transaction reports will be submitted.
- Receipt of the Code of Ethics by supervised employees of the Adviser must be acknowledged in writing, and a summary of the Adviser's Code of Ethics must be disclosed in Part II of its Form ADV and provided to clients upon request.

I. Capital Requirements and Minimum Assets Under Management

- An Adviser is not subject to any minimum capital requirements under the Advisers Act.

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[15] *Id.*

[16] Rule 204A-1 under the Advisers Act and SEC Release No. IA 2256 (July 2, 2004).

[17] An "access person" is defined as a supervised person who has access to non-public information regarding clients' purchase or sale of securities, is involved in making securities recommendations to clients or who has access to such recommendations that are non-public.

- However, an Adviser must have at least $25 million in assets under management to qualify for SEC registration. If it has less than 25 million it may be regulated under the laws of the state in which it maintains its principal office and place of business.

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