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Practical Effects of Dodd-Frank on the Operations of Investment Fund Managers

Having historically operated largely free of federal regulatory rigors, managers of most private equity and hedge funds must now contemplate a new future. As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act, fund managers have to also start thinking of themselves as "investment advisers" required both to register with either the SEC or the state(s) in which they operate, and comply with a wide array of reporting, operational, and behavioral obligations.

The core statutory and regulatory scheme that Dodd-Frank has imposed on a fund manager is the Investment Advisers Act of 1940, and, until now, it expressly exempted most fund managers from its coverage. The scope of the Advisers Act is broad – it has always covered persons who are paid a fee to recommend securities to individual or institutional investors or to actively manage their money, and it speaks principally in terms of "investment advisers," "clients" and "accounts" rather than in the language common in the world of investment funds, i.e., "investment managers," "general partners," "investors," and "funds." The customary language of fund managers, and particularly of managers of private equity funds, does not fit easily into the terminology of the Advisers Act, and there will no doubt be a substantial amount of interpretation, rule-making and adjustment to enable managers to adapt to this new world. In reviewing this report, fund managers should recognize that regulatory references to "investment advisers" mean the fund managers.

By July 21, 2011, fund managers will at a minimum have to be registered with the SEC, or with their local state(s), and have policies and practices in place that will allow them to continue to operate in compliance with the new legal regime.

This report is designed as a guide for fund managers to help them start to think like a regulated investment adviser and to navigate through the process of registration and compliance. It is divided into three sections: 1) the process of SEC registration; 2) internal policies and procedures that a registered investment manager (which in this report means a fund manager) must adopt, implement and enforce; and 3) the change in the fund manager's relationship to the fund's investors and the investment community.

I. SEC Registration

The general rule, subject to a few esoteric exceptions, is that a fund manager must register with the SEC if: 1) it manages only the assets of investment funds (including the hedge funds or private equity funds themselves, plus pooled co-investment or alternative investment vehicles, or separately managed accounts that invest together with the hedge funds or private equity funds) that are all exempt from having to register as investment companies under the Investment Company Act of 1940 (this is typically the case with hedge funds, private equity funds, and their investors) and the total assets it manages exceeds $150,000,000; or 2) it also separately advises managed accounts for persons outside the funds who are not themselves exempt investment companies, and the total assets under management

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exceed $100,000,000 (or, as noted below, $25,000,000 for a New York fund manager). The SEC, in a recent proposed rule-making release, has sought to clarify that for purposes of determining registration eligibility, a private fund manager must include in its AUM calculation the amount of any uncalled capital commitments made to the fund. Proposed SEC rules would also require advisers to use the fair value of private fund assets in determining AUM, rather than, for instance, cost-basis, and to recalculate that amount quarterly.

For fund managers based in New York (although not for those based in Connecticut), the situation is a little more complex. Because of uncertainties concerning how New York regulates investment advisers, we currently recommend that fund managers who also permit persons outside of the funds themselves to invest in parallel with the funds, and which are not themselves investment funds, should register with the SEC if aggregate assets under management exceed $25,000,000, rather than $100,000,000.

While not the topic of this report, fund managers should note that if they are ineligible or not required to register with the SEC, they may have to register with the state(s) in which they operate. Fund managers will need to register with the SEC or the state in which their based, but not both, although the IARD process and Form ADV are usually applicable to state registrations as well. For example, Connecticut requires the Form ADV to be filed in the IARD. The SEC expects to adopt rules to prevent fund managers whose AUM periodically vacillates around the SEC registration threshold from having to repeatedly change the locus of their registration.

We are available to discuss and assess with you the various factors that will affect whether, and where, you will have to register.

Registration Process

In order to register as an investment adviser, an applicant must file the investment adviser registration form, Form ADV, with the Securities and Exchange Commission. Form ADV consists of two parts: Part 1, which provides information about the investment adviser and its affiliated persons, and Part 2 (which was until recently designated “Part II”). Part 1 is divided into two sub-parts: Part 1A, which must be completed by all investment advisers registering with the SEC or with state securities authorities, and Part 1B, which must only be completed by those investment advisers registering with state securities authorities. Part 2 is also divided into two sub-parts: Part 2A, also known as a “brochure”, and Part 2B, also known as a “brochure supplement.” For investment advisers registering with the SEC, each of Part 1A and Part 2A of Form ADV must be filed electronically through the Investment Advisers Registration Depository (“IARD”). The brochure and brochure supplement must also generally be delivered to each client of an investment adviser at or prior to such time as the adviser enters into an advisory agreement with such client. While technically the “client” of a fund manager is the fund itself (and the holders of managed accounts, if applicable), we recommend that information and documents that the rules specify have to be delivered to “clients” be interpreted by fund managers as requiring delivery to the fund’s investors. As applied to private investment funds, in other words, sometimes a “client” is the fund, and sometimes it is the investor. It is a situation ripe for confusion.

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Preliminary Steps; Filing Fees

Before an investment adviser can file Form ADV on the IARD, it must establish an IARD User Account by submitting a paper copy of the IARD Entitlement Package, which must be signed by an executive officer of the adviser and returned to the Financial Industry Regulatory Authority (FINRA), which administers the IARD. This form will designate an individual as a Super Account Administrator (SAA) for the adviser, who will have "Administrator" access to all applicable applications and privileges that participate in the FINRA Entitlement Program. Upon completing the Super Account Administrator Entitlement Form, an adviser will be assigned a CRD number (an identification number), and will be given a user ID and password to access the IARD.

Once the adviser has been given access to the IARD and prior to filing Form ADV, it will need to deposit funds into an account with FINRA. The appropriate fees will then be deducted from the adviser's account when Form ADV is filed.

In connection with an adviser's initial electronic filing on the IARD, an adviser is required to pay FINRA an initial setup fee. Advisers are further required to pay an annual updating fee at the time of filing an annual updating amendment (as described below) to Form ADV. The following schedule sets forth the current fees:

Assets Under Management	Initial Set-Up Fee	Annual Fee
SEC Registrant - Under $25 Million	$40	$40
SEC Registrant - $25 Million - $100 Million	$150	$150
SEC Registrant - Over $100 Million	$225	$225

Advisers may further be required to pay fees to states with whom they are required to make notice filings, which are also calculated and remitted by the IARD.

Timing of Submission

Upon submission of Part 1 of Form ADV by an investment adviser, the SEC will examine the filing for compliance with the Advisers Act and, within 45 days after such filing, grant registration or institute a proceeding to determine whether to deny registration. Fund managers should note, however, that the SEC may grant registration substantially more quickly, since Forms ADV are not typically given detailed preliminary review. A fund manager should therefore be certain that it is fully compliant in all respects with the Advisers Act (including operationally), and be ready to file Form ADV, absolutely no later than June 6, 2011, or even earlier if the Form ADV will be disclosing the existence of current or prior regulatory disciplinary actions against persons covered by the filing, since those disclosure will likely trigger greater SEC scrutiny.

The various steps described in this Memorandum that fund managers will have to take will take time and resources. Legal, financial, and other advisors (including, for example, IT professionals to ensure that email and other electronic communications meet the record retention and availability

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requirements) will likely be working with many clients to meet the same deadline. In order to complete the process in a correct, complete and efficient manner we suggest that, at a minimum, again assuming that there are no disciplinary actions disclosed in the Form ADV, a fund manager should begin the process at least two months before the filing deadline mentioned above. If disciplinary actions will be disclosed in the filing, the preparatory processes should start now.

Information to be included in Form ADV

Part 1: In Part 1 of Form ADV, an investment adviser must provide information with respect to itself and persons associated with it.

More specifically, Part 1A and the Schedules thereto require information such as:

- basic identifying information, including the adviser's legal name and other names under which it conducts business, web addresses, as well as other contact information;

- the adviser's basis for registering with the SEC;

- basic corporate organization, including the adviser's form and jurisdiction of organization and fiscal year;

- information regarding the adviser's advisory business, including the number and functions of employees, the number and types of clients, a description (in check-the-box form) of how the adviser is compensated and the adviser's AUM;

- information regarding the adviser's financial industry affiliations and activities, including information with respect to each private fund advised by the adviser or of which an affiliate of the adviser is a general partner;

- the identity of persons that control the adviser; and

- the disciplinary history of the adviser, its employees, officers, directors, owners and other related persons, such as:

    - criminal or civil actions, where the adviser or a management person of the adviser was convicted, pleaded guilty or "no contest," or was subject to certain disciplinary actions with respect to conduct involving investment-related businesses, statutes, regulations, or activities; fraud, false statements, or omissions; wrongful taking of property; or bribery, forgery, counterfeiting, or extortion;

    - administrative proceedings before the SEC, other federal regulatory agencies, or any state agency where the adviser's or a management person's activities were found to have caused an investment-related business to lose its authorization to do business or where such person was involved in a violation of an investment-

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related statute or regulation and was the subject of specific disciplinary actions taken by the agency; and

- self-regulatory organization (SRO) proceedings in which the adviser or a management person of the fund manager was found to have caused an investment-related business to lose its authorization to do business; or was found to have been involved in a violation of the SRO's rules and was the subject of specific disciplinary actions taken by the organization.

For advisers using Form ADV to register with state securities authorities, Part 1B requires additional information, including information regarding any bond required to be posted by, and compliance with capital requirements of, the adviser's home state, as well as additional information regarding disciplinary history.

The SEC has, additionally, recently proposed to require specifically that fund managers include in Part 1A expanded information regarding their managed funds, including information concerning organizational, operational, and investment characteristics of the fund, the nature of the fund's investors, and the identities of certain providers of goods and services to the fund.

Part 2: Part 2A of Form ADV, typically called the "brochure," requires an adviser to provide certain information that is typically found in a fund's offering memorandum. The disclosure in the Form ADV, however, must be presented in succinct narrative form and in "plain English" and includes the following:

- a description of its advisory business and services, and a statement of the amounts of assets the adviser manages;
- a description of how the adviser is compensated;
- a description of expenses clients are required to bear;
- disclosure concerning performance based fees;
- a description of the types of clients to whom the adviser provides investment advice;
- a description of the methods of analysis and investment strategies the adviser employs; and
- disclosure of disciplinary events that would be material to the evaluation of the adviser's business or integrity.

Part 2B of Form ADV, referred to as the "brochure supplement," requires an adviser to disclose information regarding its "supervised persons" who formulate investment advice for clients of the adviser or who have discretionary authority over an adviser's client's assets. In the case of a private investment fund, where direct advisory contact with investors is not the norm, these persons are typically the key members of the fund's investment committee. The information required to be included

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in a brochure supplement includes information regarding the supervised person's educational background and business experience, disciplinary information, and other business activities.

Ongoing Registration Requirements

Annual Amendments: Advisers are required to file an annual updating amendment to Form ADV, updating responses to all items, within 90 days after the end of the adviser's fiscal year. For SEC registered advisers, amendments to Part 1A and Part 2A must be submitted electronically. Amendments to the brochure supplement (Part 2B) do not need to be filed electronically on an annual basis, but must be maintained in the adviser's files. In addition, an adviser must deliver a summary of material changes to the brochure (as well as a current brochure itself) or must offer to provide the current brochure, to clients within 120 days after the end of the adviser's fiscal year.

Interim Amendments: If responses to certain items of Part 1 of Form ADV become inaccurate (or depending on the item, materially inaccurate), or any of the information in Part 2A (the brochure) becomes materially inaccurate, the adviser must promptly file an amendment to Form ADV electronically; however, an adviser is not required to update its brochure on an interim basis solely because the amount of client assets it manages has changed. In addition, an adviser must update Part 2B (the brochure supplement) when information therein becomes materially inaccurate. Interim updates to the brochure and brochure supplement must only be delivered to clients if they update certain items related to disciplinary information.

II. Ongoing Operational Compliance

Introduction

Every fund manager registered with the SEC is required to establish and maintain policies and procedures reasonably designed to prevent violations of the Advisers Act of and rules and regulations related to that Act as well as to detect and correct violations that occur. Since the adviser's Act is for the first time being made applicable to managers of private equity funds, many of the practices that are common to investment advisers and fund managers in the public securities markets will have only limited relevance to a private equity fund manager. Nevertheless, the "culture of compliance" that all investments advisers are expected to inculcate in their operations is of crucial importance to the SEC, and a private equity fund manager should consider ways to implement all of the policies described below, rather than seeking reasons to avoid adopting them. Since the SEC has the authority to conduct a compliance audit of the books, records and operations of every registered adviser, it is strongly advised that all fund managers, in adopting appropriate policies and procedures, keep in the forefront of their planning how these policies are documented, how their records are maintained, and how easily it will be to demonstrate to an SEC auditor that the fund operates in compliance with the Advisers Act.

The compliance policies and procedures should address the practices and risks present at each adviser. No one standard set of policies and procedures will address the requirements of the SEC for all advisers because each adviser is different, has different business relationships and affiliations, and, therefore, has different conflicts of interest. Because the facts and circumstances (i.e., activities, arrangements, affiliations, client base, service providers, conflicts of interest, and other business factors that may cause violations of the Advisers Act or the appearance of impropriety) that can give rise to

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violations of the Advisers Act are unique for each adviser, each adviser should identify its unique set of risks, both as the starting point for developing its compliance policies and procedures and as part of its periodic assessment of the continued effectiveness of these policies and procedures. This process of assessing factors that may cause violations of the Advisers Act is often called a "Risk Assessment," a "Gap Analysis," or the compilation of a "Risk Inventory." Counsel can certainly assist in this process.

It is important that the risk analysis be conducted while initially establishing compliance policies and procedures and periodically thereafter to make sure that the policies and procedures are sufficiently comprehensive and robust to address all areas in which an adviser is at risk of violating the Advisers Act.

Chief Compliance Officer

Every registered investment adivser must designate one person as the Chief Compliance Officer ("CCO"). In organizations that do not want to hire a person just for this purpose, this title and responsibilities are typically given to the existing Chief Financial Officer. The CCO must be senior enough to enforce the fund manager's policies and procedures, must have access to all relevant information and, ideally, should be as separate as possible from the conflicts of interest that the manager's policies are designed to detect. If the CCO does have both compliance and organizational (operational) positions, the resulting conflicts of interest must be appropriately identified and managed.

The CCO must be reasonably trained regarding the Advisers Act and other relevant regulations and the methods to detect and enforce the adviser's policies and procedures. The CCO is also responsible to ensure that the adviser's employees are appropriately trained regarding the relevant regulations, the adviser's policies and procedures, and to ensure compliance.

Part-time CCOs often find the breadth and importance of their new role intimidating, particularly in the preparatory stages, but also during ongoing operations. Counsel and others routinely work with the CCO to manage the new responsibilities including, for example, with respect to specific compliance issues that arise from time to time, maintenance of policies and procedures and preparation for SEC examinations.

Compliance Manual

Every registered adviser must establish and maintain written policies and procedures reasonably designed to prevent violations of the Advisers Act and of rules and regulations related to that Act (the "Compliance Rule"). These policies and procedures must be reviewed at least annually to confirm the adequacy of these policies and procedures and the effectiveness of their implementation. Counsel, as well as others, are frequently called on to assist in the establishment of these policies and procedures based on the Risk Assessment mentioned earlier.

The SEC has stated that it expects the policies and procedures, at a minimum, to address the following issues to the extent that they are relevant to the adviser's business:

- Portfolio management processes, including allocation of investment opportunities among funds and managed accounts and the consistency of portfolios with their respective

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investment objectives, and disclosures to the funds (and to their investors, by implication), and applicable regulatory restrictions;

- The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements;
- Proprietary trading by the adviser and the personal trading activities of the adviser's supervised persons;
- Safeguarding of fund and other client assets from conversion or inappropriate use by the adviser or its personnel;
- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
- Safeguards for the privacy protection of client records and information;
- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services (referred to as "soft dollar arrangements"), and allocates aggregated trades among clients;
- Marketing advisory services, including the use of solicitors;
- Processes to value client holdings and assess fees based on those valuations; and
- Business continuity plans.

Instituting Compliance Policies

Code of Ethics

Each registered investment adviser is required to adopt a code of ethics (under the "Code of Ethics Rule" — Rule 204A-1 under the Advisers Act). The code of ethics should set forth the standards of business conduct expected of supervised persons (i.e., employees, officers, directors and other people that the adviser is required to supervise), and it must address personal securities trading by these people.

The adviser's code of ethics should encourage an honest, open, and ethical compliance culture and an ethical environment that is consistent with the description in the code of ethics. The adviser's compliance culture should handle conflicts of interest and compliance issues in ways that are consistent with the adviser's disclosures, given the adviser's fiduciary responsibilities to its funds and managed accounts, and must include periodic training of staff with respect to expectations regarding ethical conduct and a written acknowledgement from all employees regarding their knowledge of the code of ethics. Using specific factors (e.g., the number of compliance issues that occur) may be a good way to measure the effectiveness of the ethical environment.

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Violations of the code of ethics should be handled appropriately and consistently across all staff, including the imposition of fines or similar sanctions for repeated violations of code provisions. The CCO or another designated senior level person must be responsible for administering the code of ethics.

The code of ethics must satisfy the following requirements:

- "Access persons" must report their personal securities transactions to the CCO or to another designated person each quarter. "Access persons" are any supervised persons who have access to non-public information regarding client transactions or holdings, make securities recommendations to clients or have access to such recommendations, and, for most advisers, all officers, directors and partners.

- Access persons must submit a complete report of the securities that they hold at the time they first become an access person, and then at least once each year after that.

- Access persons must obtain approval prior to investing in initial public offerings or private placements or other limited offerings, including pooled investment vehicles.

- The CCO or another designated person in addition to the CCO must review these personal securities transaction reports.

- Supervised persons must promptly report violations of the code of ethics (i.e., including violations of the federal securities laws) to the CCO or to another designated person (provided the CCO also receives a report on such issues). The adviser must also maintain a record of these breaches.

Also, registered investment advisers are required to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the misuse of material non-public information (under Section 204A of the Advisers Act). These policies and procedures must encompass the activities of the adviser and of all supervised persons. Advisers often include this prohibition on insider trading in their code of ethics.

The code of ethics must be disclosed in Form ADV, Part 2, Item 11 and be provided to advisory clients (including, by implication, a fund's investors), if they request it.

Creating and Maintaining Books and Records

Each registered adviser must make and keep true, accurate and current certain books and records, including information that may be contained in e-mails and instant messages, relating to the adviser's business (under "the Books and Records Rule" -- Rule 204-2). The books and records that must be made and kept are quite specific, and include:

- advisory business financial and accounting records, including: cash receipts and disbursements journals; income and expense account ledgers; checkbooks; bank account statements; advisory business bills; and financial statements;

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- a memorandum of each order given by the investment adviser for the purchase or sale of any security, of any instruction received by the investment adviser from the client concerning the purchase, sale, receipt or delivery of a particular security, and of any modification or cancellation of any such order or instruction (showing among other things, the terms and conditions of the order, instruction, modification or cancellation, the identity of the person connected to the investment adviser who recommended the transaction to the client and the person who placed the order, the account for which entered, the date of entry and the bank, broker or dealer by or through whom executed, where appropriate);

- all check books, bank statements, cancelled checks and cash reconciliations of the investment adviser;

- all trial balances, financial statements and internal audit working papers relating to the business of the investment adviser;

- records that document the adviser's authority to conduct business in client accounts, including: a list of accounts in which the adviser has discretionary authority; documentation granting the adviser discretionary authority; and written agreements with clients, such as advisory contracts;

- advertising and performance records, including: newsletters; articles; and computational worksheets demonstrating performance returns;

- records related to the Code of Ethics Rule, including those addressing personal securities transaction reporting by access persons;

- records regarding the maintenance and delivery of written disclosure documents and disclosure documents provided by certain solicitors who seek clients on behalf of the adviser;

- a copy of each brochure and brochure supplement and each amendment or revision to the brochure and brochure supplement, that satisfies the requirements of Part 2 of Form ADV, and any summary of material changes that satisfies the requirement of Part 2 of Form ADV but is not contained in the brochure;

- books and records pertaining to political contributions by the investment advisor and its covered persons; and

- policies and procedures adopted and implemented under the Compliance Rule, including any documentation prepared in the course of the adviser's annual review.

Since general partners of investment funds are presumed to have custody of their investors' funds and discretion over how the fund invests its capital, fund managers must also make and keep additional records that are described in the Books and Records Rule (Rule 204-2, paragraph (b)), including the following:

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- a journal or other record showing all purchases, sales, receipts and deliveries of securities (including certificate numbers) for each fund or managed account and all other debits and credits to such accounts;

- a separate ledger account for each such "client" showing all purchases, sales, receipts and deliveries of securities, the date and price of each such purchase and sale, and all debits and credits;

- copies of confirmations of all transactions effected by or for each client account; and

- a record for each security in which any the client has a position, which record must show the name of each client having any interest in the security, the amount or interest of the client, and the location of each such security.

Private equity fund managers should also maintain detailed records regarding the selection, due diligence, investment committee approvals and all other matters relating to investment opportunities.

Records must be kept for specified periods of time. Generally, most books and records must be kept for five years from the last day of the fiscal year in which the last entry was made on the document or the document was disseminated. The adviser may be required to keep certain records for longer periods, such as records that support performance calculations used in advertisements (as described in Rule 204-2, paragraph (e)).

Records must be kept in an easily accessible location. In addition, for the first two of these years, the records must be kept in the adviser's office(s). If the adviser maintains some of its original books and records somewhere other than its principal office and place of business, it must note this practice and identify the alternative location on Form ADV (in Section 1K of Schedule D). Many advisers store duplicate copies of their advisory records in a location separate from their principal office in order to ensure the continuity of their business in the case of a disaster.

Original books and records may be stored by using either micrographic media or electronic media. These media generally include microfilm or digital formats (e.g., electronic text, digital images, proprietary and off-the-shelf software, and email). If the fund manager uses email or instant messaging to make and keep the records that are required under the Advisers Act, the email, including all attachments that are required records, should be kept as SEC examiners may request a copy of the complete record. In dealing with electronic records, the adviser must also take precautions to ensure that they are secure from unauthorized access and theft or unintended destruction (similar safeguarding provisions regarding client information obtained by the adviser is required by Regulation S-P under the Gramm-Leach-Bliley Act). In general, an adviser should be able to promptly (generally within 24 hours) produce required electronic records that may be requested by the SEC staff, including email. In order to do so, the Advisers Act requires that each adviser to arrange and index required electronic records in a way that permits easy location, access, and retrieval of any particular electronic record.

Section 204(b) of the Advisers Act, registered fund managers, specifically, are required under Dodd-Frank to maintain additional records and reports which are subject to inspection by the SEC, including:

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- the amount of assets under management and the 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, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors;
- trading practices; and
- such other information as the SEC, in consultation with the Financial Stability Oversight Council, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

Custody

Registered investment advisers that have "custody" or "possession" of client assets must take specific measures to protect client assets from loss or theft (under "the Custody Rule" — Rule 206(4)-2 under the Advisers Act).

The first step is to determine whether the adviser has custody or possession of client assets. "Custody" is defined as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." This includes situations in which the adviser:

- has physical possession of client funds or securities, even temporarily;
- enters into arrangements (including a general power of attorney) authorizing the adviser to withdraw funds or securities from the client's account (note that if the adviser is authorized to deduct its advisory fees or other expenses directly from clients' accounts, the adviser has custody); and
- any capacity (such as general partner of a limited partnership or managing member of a limited liability company) that gives the investment adviser (or a person supervised by the investment adviser) legal ownership of or access to client funds or securities.

If an adviser has custody, with limited exceptions, it must maintain these client funds and securities at a "qualified custodian." Generally, qualified custodians include most banks and insured savings associations, SEC-registered broker-dealers, Commodity Exchange Act-registered futures commission merchants, and certain foreign financial institutions. With a limited exception, for client

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accounts over which the adviser has custody, it must have a reasonable basis, after due inquiry, for believing that the client (or a designated representative) receives periodic reports directly from the custodian that contain specific information with respect to the funds and securities in custody. With respect to pooled investment vehicles over which an adviser has custody, the qualified custodian must send account statements for the pooled vehicle directly to each investor.

If an adviser has custody of client funds or securities that are held at an unrelated, independent qualified custodian, then the adviser must have a "surprise verification" by an independent public accountant. The independent public accountant must verify the funds and securities in the adviser's custody or possession at least once each calendar year, and must then promptly file a "certificate of accounting" with Form ADV-E electronically through the IARD.

If an adviser has custody of client funds or securities that the adviser or a related person maintains as a qualified custodian, then it must also have an internal control report completed by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board.

Proxy Voting

Because fund managers have voting authority over proxies for securities held by their funds and managed accounts, under Rule 206(4)-6 they must adopt and retain copies of policies and procedures reasonably designed to ensure that the adviser: votes proxies in the best interests of clients; discloses information to clients about those policies and procedures; and describes to clients how they may obtain information about how the adviser has voted their securities.

Under Rule 204-2(c)(2) the fund manager must also retain certain voting-related records including: the proxy statements the adviser received regarding the voted securities (the Rule provides some alternative arrangements); records of the votes cast by the adviser on behalf of its clients; records of client requests for proxy voting information; and any documents prepared by the adviser that were material to making a decision as to how to vote or that memorialized the basis for the adviser's decision.

Valuation and Pricing

Registered advisers must establish and maintain pricing policies and procedures to value their assets and liabilities. These policies and procedures should be communicated to investors and all valuations should be consistent with these policies. The adviser should perform adequate and on-going due diligence on the methodologies used by the adviser and all service providers, such as pricing services, that provide pricing information used to value clients' assets or positions.

The prices used to value clients' assets should consistently reflect the price(s) that would be paid or received in a transaction with a knowledgeable and willing counter party at the time the pricing is performed. Also the value of all other assets (e.g., cash, receivables and prepaid items) and liabilities (e.g., payables) used in determining the gross and net value of clients' accounts must consistently reflect the current value of these items at the time of the calculation.

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As part of these policies and procedures the adviser should be in a position to identify if an error is made when calculating the gross or net value of clients' positions or the net asset value ("NAV") of pooled accounts, and to correct such errors in a way that is consistent with the adviser's disclosures and its fiduciary relationship with clients.

The process for calculating the NAV of pooled clients' accounts and allocating the NAV of pooled vehicles among investors must be consistent with the pooled vehicles' policies, disclosures, and the adviser's fiduciary relationship with its clients.

In addition to the foregoing, pricing policies and procedures should:

- provide for the identification and recording of corporate actions, such as dividends and stock splits that impact clients' positions, and timely and accurate inclusion of these items;

- provide for monitoring pending corporate actions to ensure that appropriate follow-up is taken so that stale receivable items, such as recapture of taxes withheld, do not accumulate in clients' accounts;

- taking into account the volume and timing of transactions in pooled vehicles that the adviser advises, the valuations that make up the NAV must fairly represent each participant's ownership interest;

- ensure that clients are fully and fairly informed of the process for valuing clients' positions, including possible exceptions, and provide a methodology for them to give their informed consent to all material conflicts of interest that arise from such processes; and

- all documentation and other output generated in connection with the pricing and valuation process, including the calculation of NAV for pooled vehicles, should be sufficient to substantiate that all appropriate information was included in a timely, accurate, and complete manner, and all such records are preserved for the required period of time and protected from unplanned or inappropriate destruction, loss, alteration, compromise, or use.

III. Interactions with the Investor Community

Marketing and Advertising

To protect investors, the SEC prohibits certain types of advertising practices by advisers. An "advertisement" includes any communication addressed to more than one person that offers any investment advisory service with regard to securities (under "the Advertising Rule" — Rule 206(4)-1). An advertisement could include both a written publication (such as a website, newsletter or marketing brochure) as well as oral communications (such as an announcement made on radio or television). Managers should assume that the rule also applies to the offering memoranda distributed to prospective investors.

Advertising must not be false or misleading and must not contain any untrue statement of a material fact. Advertising, like all statements made to advisory clients and prospective clients, is subject

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to the general prohibition on fraud (Section 206 as well as other anti-fraud provisions under the federal securities laws). Specifically prohibited are: testimonials; the use of past specific recommendations that were profitable, unless the adviser includes a list of all recommendations made during the past year; a representation that any graph, chart, or formula can in and of itself be used to determine which securities to buy or sell; and advertisements stating that any report, analysis, or service is free, unless it really is free.

The SEC staff has said that, if an adviser advertises its past investment performance record, the adviser should disclose all material facts necessary to avoid any unwarranted inference. For example, the staff has indicated that it may view performance data to be misleading if it:

- does not disclose prominently that the results portrayed relate only to a select group of the adviser's clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material;

- does not disclose the effect of material market or economic conditions on the results portrayed (e.g., an advertisement stating that the accounts of the adviser's clients appreciated in value 25% without disclosing that the market generally appreciated 40% during the same period);

- does not reflect the deduction of advisory fees (e.g., management fees and carried interest or performance fees), brokerage or other commissions, and any other expenses that accounts would have or actually paid or been charged against investors' capital accounts;

- does not disclose whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings;

- suggests or makes claims about the potential for profit without also disclosing the possibility of loss; or

- compares actual results to an index without disclosing all material facts relevant to the comparison (e.g., an advertisement that compares results to an index without disclosing that the volatility of the index is materially different from that of the portfolio).

Fund Solicitations

Registered investment advisers may pay cash compensation to others to seek out new clients on their behalf, commonly called "solicitors" or "finders," if they meet certain conditions (under Rule 206(4)-3 of the Advisers Act):

- The solicitor is not subject to certain disciplinary actions;

- The fee is paid pursuant to a written agreement to which the adviser is a party and (with limited exceptions) the agreement must: describe the solicitor's activities and compensation arrangement; require that the solicitor perform the duties assigned and in compliance with the Advisers Act; require the solicitor to provide clients with a current copy of the adviser's

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disclosure document; and, if seeking clients for personalized advisory services, require the solicitor to provide clients with a separate written disclosure document containing specific information;

- The adviser receives from the solicited client, prior to or at the time they enter into an agreement, a signed and dated notice confirming that he/she was provided with the adviser's disclosure document and, if required, the solicitor's disclosure document; and

- The adviser has a reasonable basis for believing that the solicitor has complied with the terms of the agreement between the Solicitor and the adviser.

However, "pay-to-play" rules recently adopted by the SEC and most states severely circumscribes a fund manager's ability to engage third party solicitors from public pension plans.

Side Letters

The terms and conditions of all side letters must be consistent with disclosures to clients and the fiduciary relationship with clients and pooled vehicle participants. Managers should take care in preparing their offering memoranda, for example, to explain the risks to prospective investors' capital accounts if other investors are the beneficiary of more favorable economic terms, such as lower management fees or performance fees, or if an investor has obtained an investment approval right that might limit the flexibility of the fund manager.

Anti-Money Laundering

The anti-money laundering ("AML") regulations, which are administered through the Financial Crimes Enforcement Network (FinCEN), are applicable to open-end mutual funds. To date, investment advisers have not been identified as entities that must comply with the AML regulations, although best practices strongly suggest that fund managers adopt comprehensive "Know Your Customer" and AML procedures with respect to the investors admitted to their funds or managed accounts. Moreover, investment advisers may be delegated to perform certain AML responsibilities on the behalf of other entities and/or may be required to comply with certain related regulations (e.g., U.S. Treasury Office of Foreign Assets Control ("OFAC") reporting requirement and Internal Revenue Code/Bank Secrecy Act reporting procedures for cash transactions).

Conclusion

Dodd-Frank has unquestionably expanded the pool of hedge fund managers who will now have to operate under either federal or state registration, thereby imposing significant administrative burdens and costs. The rules regulating the operations of hedge fund managers are, at least, fairly well established. The expansion of adviser registration to private equity fund managers, however, creates substantial opportunities for confusion, since the Advisers Act and its rules largely contemplate operations focused on the public trading markets, rather than the historically less-regulated private equity markets. Nonetheless, both hedge fund and private equity fund managers must, to varying degrees, recalibrate their modes of operations, and take steps now to operate under a registration regime.

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If you have any questions about the foregoing or would like to discuss the process to contact your Morrison Cohen lawyer, or any of the Morrison Cohen lawyers listed below.

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