Investment Advisers Act Compliance Developments in 2013

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Introduction

For the investment adviser industry, the dust is finally starting to settle five years after the global financial crisis hit in 2007 and the Madoff scandal came to light in 2008, but more remains to be done. In response to those events and others, Congress and the U.S. Securities and Exchange Commission have expanded and globalized U.S. investment advisory regulation. Many advisers registered for the first time by early 2012 and became subject to regulation under the U.S. Investment Advisers Act of 1940 (or claiming exemptions and, in some cases, becoming subject to SEC filing obligations). As advisers assess next steps in meeting their compliance obligations, they must remain forward-looking and plan for, rather than react to, the regulatory developments that 2013 will bring.

Developments to come will be broadly shaped by the events of 2012's fourth quarter, including the re-election of President Obama, the designation of Elisse B. Walter to replace Mary L. Schapiro as SEC Chairman, the four-Commissioner (rather than five) SEC that leaves the potential for 2-2 votes (and resulting standstill), and change at the head of the SEC's Enforcement Division. Despite some uncertainty, advisers may find it fruitful to align their compliance processes with various recent indications of regulators' Advisers Act agenda.

Key compliance developments for the coming year include:

Compliance self-assessments and keeping track of SEC priorities. For the first time, newly registered investment advisers will be conducting an annual review of the adequacy of their Advisers Act compliance policies and procedures. Even seasoned registrants should heed the signals that the SEC staff has provided about its regulatory agenda for 2013 – compliance matters that the SEC and its staff recently highlighted in announcing the new "Presence Exams" initiative, in highlighting the "Aberrational Performance Inquiry," in speeches to the industry, and by virtue of the enforcement actions the SEC has chosen to bring. Even unregistered advisers, such as "exempt reporting advisers," may find it useful to consider whether certain practices should be enhanced.

New government filings. Most Form PF filers' initial filings are due in early 2013. What are the first steps in preparing this form, as well as its sister forms that U.S. Commodity Futures Trading Commission registrants must file with the CFTC? What's new for Form ADV, the Advisers Act registration statement?

Amended investor eligibility standards. Many advisers are finding it necessary to update their investor applications and subscription agreements to address new regulatory developments.

The intersection of the JOBS Act and Advisers Act compliance. The Jumpstart Our Business Startups Act (JOBS Act) opens up the prospect, for the first time, of general advertising by private funds. Regardless of any new regulatory guidance that may come in 2013, fund managers must comply with existing advertising content restrictions under the Advisers Act and other regulations.

Looking beyond the Advisers Act. Outside of the four corners of the Advisers Act, 2013 is sure to offer many more challenges for the typical investment advisory compliance professional. This article will conclude by identifying a few of these.

What 2013's Compliance Self-Assessment Holds in Store for Advisers

For a registered investment adviser, Advisers Act Rule 206(4)-7 requires an annual review of the adequacy and effective implementation of its compliance program. The SEC has said that the review should also assess the need to revise the compliance program as a result of any compliance matters that arose during the past year, changes in the business activities of the adviser, and – the subject of this part of the article – relevant regulatory developments.

An adviser's business, and its compliance requirements, could be viewed as falling into three broad categories:

- Seeking clients
- Providing investment advice
- Administering the advisory business

For each category, what signals have the SEC and its staff given about their anticipated regulatory priorities looking into 2013? Some of the answers can be found in the October 2012 letter in which the SEC's Office of Compliance Inspections and Examinations ("OCIE") introduced its Presence Exams initiative (the "Presence Exams Letter").

Seeking clients

Marketing materials introduce an adviser to prospective investors. Given the importance of such materials, the SEC routinely targets such materials when it inspects an adviser's business. Underscoring the centrality of marketing materials, those new SEC registrants that received the Presence Exams Letter came across "Marketing" as its first substantive subject. That letter said that OCIE would consider whether an adviser:

> has made false or misleading statements about its business or performance record; made any untrue statement of a material fact; omitted material facts; made any statement that is otherwise misleading; or engaged in any manipulative, fraudulent, or deceptive activities.

With that in mind, it is worth revisiting the main elements of the SEC's regulation of adviser marketing, while noting recent actions that the SEC has taken.

Anti-fraud. The fiduciary duty that applies under U.S. law imposes on an investment adviser "an affirmative duty of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading his clients."[1] Among other things, an investment adviser must not misrepresent its experience, capabilities, or past performance.

While the general antifraud prohibitions described above apply to any investment adviser, including exempt reporting advisers and those that are otherwise exempt from registration, the following SEC requirements pertain only to SEC-registered advisers.

One-on-one presentations. If tailored and presented to only one person, a marketing piece may fall outside the Advisers Act's definition of "advertisement," thus leaving it free of certain technical requirements discussed below. Because the Advisers Act's advertising rule is premised on antifraud principles, however, certain concepts under that rule may be relevant even to one-on-one presentations.[2] As an example of the need to be vigilant in preparing one-on-one materials, the SEC staff has brought claims in connection with the accuracy of an adviser's responses to a request-for-proposal (RFP).[3]

Advertisements. For many communications to more than one person, including on an adviser's publicly-accessible web site, the Advisers Act's advertising rule and related SEC staff guidance impose certain requirements, some general and some specific, including the following:

- *Accuracy and full disclosure*. Could some portion of a firm's marketing materials be considered false or misleading, or benefit from explanations about assumptions and sources of data? For new registrants, the "target" audience has expanded beyond investors (who may be sufficiently sophisticated to draw on other information or ask questions) to include the SEC staff, which has investor protection as one of its missions.
- *Investment performance*. False or misleading performance information is a hot topic for the SEC. In October 2012, the SEC's Enforcement Division's Asset Management Unit announced that it had recently brought a total of seven cases under its Aberrational Performance Inquiry initiative. That Unit describes the initiative as applying proprietary risk analytics to a private fund's returns and screening for inconsistency between those returns and the fund's investment strategy or other benchmarks. Also relating to investment returns, some newly-registered firms feel that showing their performance on a gross basis, rather than net of fees and expenses, more accurately demonstrates their skill and is consistent with their investors' expectations. Nevertheless, the SEC staff's position is that, with limited exceptions, net rather than gross performance is the rule because it best shows the returns an investor may have actually achieved.
- *Past specific recommendations*. Identifying particular investments made for other advisory clients is generally prohibited, absent certain procedural steps (such as listing all of the year's recommendations, or basing the list on a certain objective standard and offering to provide the full year's list upon request). Marketing materials that include case studies, attribution analysis, or illustrations of investment process can all raise questions from the SEC's examination staff.
- *Testimonials*. Testimonials are generally prohibited as well. These include not only the classic testimonial – a quotation from a satisfied customer – but also, potentially, customer

Note about an adviser's advertisement review process

Sample topics an investment adviser's personnel might consider when preparing a checklist for reviewing marketing materials include the following, among others that the adviser views as relevant:

- Is the document an "advertisement"? Who is its audience?
- Is it accurate? Does the adviser have appropriate back-up to support its facts and data?
- Are its assumptions clear, or is further explanation needed? Are sources cited?
- Is the presentation of investment performance consistent with SEC staff positions?
  - Is performance net or gross of fees and expenses?
  - Are the investment objectives and the effects of market conditions disclosed?
  - Is the benchmark relevant; what are key differences from the adviser's strategy?
  - How did the adviser choose the accounts for which performance is shown?
- Is SEC staff guidance (or, for funds, any Financial Industry Regulatory Authority (FINRA) restrictions) applicable concerning model, hypothetical, backtested, or related performance (performance of other accounts)?
- Does the adviser claim to comply with a third party standard, such as the CFA Institute's Global Investment Performance Standards (GIPS), when presenting performance?
- Does the document include target or projected returns?
- Does it include "past specific recommendations"? Any testimonial?
- Does it include "puffery"?
  - Examples include "best," "brilliant" – exaggerated or unsupportable claims
- Could the document be deemed inadvertently to "offer" a fund's securities?
- Does it include standard disclaimers?
  - Past performance is not necessarily indicative of future performance
  - SEC registration does not imply any particular training or competence
  - Reflects (or does not reflect) reinvestment of dividends and other earnings
  - Possibility of loss and other materials risks

satisfaction rankings or even "likes" and similar social media ratings, according to a National Examination Risk Alert issued by OCIE in January 2012.

During its annual compliance assessment, or on an ongoing basis, it is common for a compliance department to use a checklist as a starting point when reviewing marketing materials.

As advisers assess next steps in meeting their compliance obligations, they must remain forward-looking and plan for, rather than react to, the regulatory developments that 2013 will bring.

Solicitors and placement agents. Registered investment advisers are subject to the Advisers Act's cash solicitation rule, which requires certain disclosures to clients about compensation paid to a solicitor of investment advisory business, and certain terms of an agreement between the adviser and solicitor. Compliance personnel may wish to determine whether internal and external compensation arrangements are being handled consistent with this rule. This Advisers Act rule does not apply to the sale of fund interests, but the Presence Exams Letter stated that the use of placement agents to solicit investors for private funds would be part of the new Presence Exams. Broker-dealer implications also may arise in connection with the payment of compensation for selling fund interests.

Providing Investment Advice

In connection with an adviser's core business purpose – providing investment advice – the Presence Exams Letter included a "Portfolio Management" heading that specifically identified the following as being of concern:

- Conflicts of interest between the adviser and its clients
- Allocation of investment opportunities among clients
- Whether an adviser's practices are consistent with disclosures provided to clients or fund investors

"Exempt reporting advisers" or those otherwise not registered also may find it useful to consider the following, despite not being subject to Presence Exams, as these topics tend to be relevant to investment advisers generally.

Conflicts of interest. The Presence Exams Letter actually referred to conflicts of interest both under the "Portfolio Management" heading and under a separate "Conflicts of Interest" heading wholly dedicated to the subject. The letter affirms that an investment adviser has an obligation to identify, mitigate, disclose, and manage certain conflicts of interest. Among other topics, the exam staff said it intends to examine transactions by advisers with affiliated parties – which is the kind of topic that can keep a compliance department busy on a day-to-day basis, depending on the nature of its business and affiliations.

Investment allocation. Investment advisers face a challenge when managing multiple investment portfolios for which the same trades may be suitable. The challenge increases when trades are made frequently, orders cannot be completely filled, or assets cannot easily be broken into manageable pieces. The SEC has not imposed specific requirements on how an adviser must allocate investment opportunities, but in its original rulemaking release that accompanied the Advisers Act compliance program rule, the SEC noted its expectation that any registered adviser will, if relevant to its business, adopt written policies and procedures on this topic. An adviser conducting a self-assessment should consider whether its disclosures, policies, and practices are synchronized.

For compliance personnel, key questions include whether allocations are being made:

- Equitably over time, as a matter of fair treatment of investors
- Consistently with the firm's policies
- In a manner that could suggest that an employee intentionally favors one account over another due to a conflict of interest

As hindsight is 20/20, many advisers prophylactically adopt an ongoing routine of monitoring trade allocations for compliance with the firm's policies and for unusual variations (inadvertently or not) in the relative performance of accounts that trade in the same securities. As part of their annual or ongoing trade allocation assessment, some advisers review samples of trades,

Note about conflicts of interest in investment allocation

Conflicts of interest in allocating investment opportunities among accounts may arise with respect to, for example:
- Accounts having higher vs. lower management fees
- Accounts subject to performance fees vs. none
- Strategic relationship with adviser vs. client that is not significant to firm's strength
- Proprietary account vs. unaffiliated investor
- Fund in which the adviser has an investment vs. none
- Fund whose success is important to firm's reputation vs. less public client

conduct other forensic reviews, supplement their automated systems, or, on occasion, engage outside consultants for recommendations.

Consistent practices and disclosures. Whether registered or not, an investment adviser's practices must be consistent with its disclosures and client agreements. For example, the SEC recently brought an enforcement action against an investment adviser of collateralized debt obligations (CDOs) that allegedly informed prospective investors that it would invest alongside them in the CDOs but did not.[4] The SEC also recently charged a mutual fund adviser with the failure to disclose risky derivatives strategies that contributed to fund losses.[5]

An investment adviser also must be sure that its brokerage practices, such as with respect to best execution and soft dollars, conform to the disclosures that it makes to its clients. When seeking best execution, an investment adviser should consider the full range and quality of the counterparty's services in placing trades, including, among other things, execution capability, commission rate, financial responsibility, and responsiveness to the adviser, as well as the value of research provided – which may fall within formal or informal soft dollar arrangements, subject to appropriate disclosures. In a recent enforcement action, the SEC claimed that an adviser failed to consider the full list of best execution factors that it undertook in its Form ADV to consider.[6]

Administering an investment advisory business

Finally, the adviser exercises various administrative functions that may fall outside of its client-facing roles but in many ways are equally important, and may be relevant as chief compliance officers prepare their annual compliance assessment.

Valuation and the Calculation of Fees. Many investment advisers calculate their fees based on the value of their assets under management, or based on increases in such valuation, and thus have an incentive to overstate the value of portfolio assets. It thus makes sense that an adviser's valuation of the assets it manages for clients is another important target of the SEC. In recent speeches, the Director of the SEC's Division of Investment Management and the Chief of the SEC Enforcement Division's Asset Management Unit each highlighted valuation among their key priorities for 2013.[7] The Presence Exams Letter noted valuation as a key compliance issue, alerting advisers that the SEC

Note about problematic investment conduct

The SEC places few substantive restrictions on an adviser's portfolio management. For example, the Advisers Act does not place any particular limit on the use of leverage, the kinds of assets or instruments placed in a portfolio, or the extent of risks. Disclosures cannot, however, excuse all types of conduct. Two examples:
- *Insider trading.* The SEC has brought, and in 2013 surely will continue to bring, numerous claims against investment advisers (both in the United States and globally) for trading on the basis on material nonpublic information in violation of law.[1]
- *"Window dressing" or "portfolio pumping."* A recent news article highlighted evidence of a quarter-end practice in which a private fund manager bids up the price of securities its fund client owns, presumably to inflate the fund's performance as of quarter-end. Such conduct theoretically would increase performance-based and asset-based fees that are calculated as of quarter-end, and would help the fund with marketing its "as-of-quarter-end" performance.[2]

In seeking to improve its compliance program, an adviser may find it prudent to watch not only for enforcement actions brought by the SEC, but news articles as well, as the SEC enforcement staff uses a combination of news stories, regulatory examinations, and "TCR" – tips, complaints and referrals – among other resources, in determining which cases to investigate.

Endnotes

1 See, e.g., SEC v. Tiger Asia Management, LLC, et al., Litigation Release No. 22569 (Dec. 13, 2012), and any number of other recent cases and administrative actions.

2 Jason Zweig and Tom McGinty, "Fund Managers Lift Results With Timely Trading Sprees," Wall Street Journal (Dec. 6, 2012).

staff "will review advisers' valuation policies and procedures, including their methodology for fair valuing illiquid or difficult to value instruments." The Presence Exams Letter goes on to say that the exam staff "will review advisers' procedures for calculating management and performance fees, and allocation of expenses to private funds." Highlighting the SEC's current focus on valuation is a recent enforcement action that took the rare step of naming as respondents the board members of an SEC-registered mutual fund, alleging deficiencies in the board's valuation processes.[8]

Despite some uncertainty, advisers may find it fruitful to align their compliance processes with various recent indications of regulators' Advisers Act agenda.

Custody of client assets. Many newly-registered advisers have found that the complexity and specific requirements of the Advisers Act's custody rule take time and effort to master and implement. ("Exempt reporting advisers" and other unregistered firms are not required to comply with that rule.) After the Madoff era (which still produces news such as the December 2012 Federal sentencing of Bernard Madoff's brother, Peter), a chief concern of the SEC has been the safekeeping of client assets and verification that accounts hold what an adviser says they hold. Visitors from the SEC's examination staff often put verification of assets, and custody rule compliance, at the front-and-center of their agenda.

Business continuity plans. In fall 2012, Hurricane Sandy, which left Wall Street underwater and much of the East Coast temporarily closed for business, brought disaster recovery back to the forefront. Compliance personnel should assess what would happen if their firm's offices became inaccessible.

Personal trading. The technical Code of Ethics reporting requirements – which apply only to SEC-registered advisers -- and the breadth of their reach within an organization tend to require ongoing vigilance by a firm's compliance department to confirm that reports are being made on a timely basis. In addition, from a conflicts of interest standpoint, the Presence Exams Letter warns that the SEC staff will review personal securities trading.

Privacy. As information technology continues into mobile communications, "going paperless," cloud computing, and outsourced IT functions, client data becomes ever more subject to breach – particularly in this era of whistleblowing, Wikileaks, and Anonymous. Registered investment advisers are obligated by the SEC's Regulation S-P and Regulation S-AM to take measures to protect the privacy of their clients, no matter the challenge. Exempt reporting advisers and other unregistered firms are generally subject to parallel privacy-related rules (such as those administered by the U.S. Federal Trade Commission). Global firms often find themselves subject to even more stringent privacy directives overseas.

Recordkeeping. Emails, text messages, social media, and other forms of electronic communication continue to balloon. As the SEC's exam staff expects prompt production of responsive records, SEC-registered advisers should consider their electronic communications policies and recordkeeping practices. Exempt reporting advisers are not subject to specific recordkeeping rules but could become so in the future.

New Government Filings

Form PF

Registered investment advisers must file the new Form PF if they exceed certain thresholds of private fund regulatory assets under management. (Exempt reporting advisers and other unregistered advisers are not required to file on Form PF.) Some of the largest private fund advisers made their first Form PF filing in summer 2012, and most others will file within the first several months of 2013.

The relevant regulatory AUM is calculated with reference to the firm's private funds, as well as certain of the firm's separate accounts that are managed parallel to those funds, and certain of the funds and accounts managed by the adviser's affiliates. Special instructions are given for such calculations by managers of funds that invest in other funds, including for fund-of-funds managers.

In some cases, Form PF will require a filer to provide a significant amount of data about its business. For example, for a "large" hedge fund adviser (generally, $1.5 billion attributable to hedge funds and certain other accounts), the form asks about long and short positions in several dozen different types of equities, fixed income securities, derivatives, commodities and structured products (by security type and not at a CUSIP level). For each $500 million hedge fund managed by that adviser, the form requires reporting of certain additional fund-by-fund information including on portfolio liquidity, large individual positions, posting of collateral by counterparties, borrowings, and results of internal formal risk assessments. The form includes numerous other detailed questions. Different items of information will be reported by advisers of liquidity funds, private equity funds, and several other categories of fund.

Form PF preparation will require planning and input from various levels within an organization and, in some cases, its service providers and other third parties.

Form CPO-PQR and Form CTA-PR

The CFTC adopted Form CPO-PQR for registered commodity pool operators and Form CPO-PR for registered commodity trading advisors. These new forms are more relevant to advisers than they would have been in years past, as many firms have found it necessary to register with the CFTC this year due to recent rule changes. These forms must be filed by a CFTC registrant even if the firm also files Form PF, although in that case the CFTC filings may be abbreviated. Despite the partial coordination by the SEC and CFTC in establishing the forms, advisers are cautioned as to potentially different initial reporting deadlines, timing of periodic filings, assets-under-management thresholds, and questions or instructions among the forms.

Form ADV

Advisers who registered with the SEC just ahead of the spring 2012 deadline – as well as exempt reporting advisers – will be making their first annual update of Form ADV in spring 2013. This update represents an opportunity to carefully review the form's data and disclosures, and to continue to enhance the process by which the firm populates and verifies its responses. In fact, as the 2012 filing season involved a wholly re-formatted Form ADV, even long-registered investment advisers may wish to revisit the significant re-drafting done a year ago, to confirm it continues to reflect their business.

Of particular note, Item 2 "Material Changes" is an area of Form ADV Part 2 that many advisers will complete for the first time. This is because in 2012 advisers either became newly-registered or made many disclosures for the first time, at least in Part 2's new format, and so generally had little or nothing to report in response to that Item 2.

Notes about an adviser's Form PF filing process

In preparing to file Form PF for the first time, advisers may find the following steps useful:

- Assemble personnel responsible for managing the data compilation and filing process
- Determine whether the firm is a "large" filer
  - This will affect the firm's initial deadline, frequency of filings, and extent of reporting
  - If the firm manages funds in more than one of the main reporting categories (hedge fund, private equity fund, liquidity fund), the firm should determine whether it meets particular reporting thresholds for each category of fund
  - Note that many advisers are finding the definition of "hedge fund" to be sufficiently broad that it encompasses certain funds that the adviser would otherwise consider to be, for example, private equity funds
- Determine the initial filing deadline
- Determine the portions of the form that the firm must complete
- Plan for efficient data compilation
  - Coordinate among financial staff and outside service providers as appropriate
  - For sub-advised funds, coordinate with the other involved advisers
- For non-U.S. firms, determine the effect of reduced reporting requirements for such a firm
- If the firm is near a particular threshold, determine any transition timing and processes for the near-future

Note that the SEC staff has posted a number of frequently-asked-questions on the SEC's web site. An adviser may find it useful to review these FAQs as it plans its reporting process or compiles data.

Staying Current with Investor Eligibility Standards

Investment advisers have been updating their investor applications and fund subscription documents to account for certain new eligibility standards and data collection, including:

Accredited investors. For a private fund that relies on Regulation D under the US Securities Act of 1933 for a safe harbor from the registration of its securities with the SEC, its investors generally must be "accredited investors" – regardless of the regulatory status of its investment manager. With the enactment of the Dodd-Frank Wall

Street Reform and Consumer Protection Act (Dodd-Frank Act), Congress changed the net worth portion of the accredited investor standard to exclude the value of a person's primary residence. The SEC subsequently amended Regulation D to more specifically exclude any positive equity investors may have in their primary residence, but to include (as reducing net worth) any mortgage debt that exceeds the estimated fair market value of the residence. A private fund should be sure that its fund offering materials include this updated standard.

Qualified clients. Under the Advisers Act, performance-based compensation generally may be charged by a registered adviser only to "qualified clients" – whether they are fund investors or separate account clients. Effective mid-2012, the SEC changed the qualified client definition, raising the net worth standard from $1.5 million to $2 million. That net worth standard was changed in the same way as was done for accredited investors to exclude the value of the primary residence. The SEC also raised the alternative standard, concerning assets the client holds with the adviser, from $750,000 to $1 million. Then-existing investors were grandfathered in, generally with respect to previous but not future investments. Again, where there is a performance fee or allocation, offering materials should be reviewed to be sure this new investor eligibility standard is enforced.

Form PF categories of investors. To facilitate their Form PF reporting, some private fund managers that are registered with the SEC have been revising their subscription documents to add category-of-investor information (U.S. individuals, non-U.S. individuals, private funds, non-profits, pension plans, etc.) required by the form.

CFTC compliance. Many advisory firms, newly registered with the CFTC, are adding certain CFTC-specific representations to the certifications they seek from investors, including:

- NFA Bylaw 1101 compliance questions, as Bylaw 1101 generally prohibits an NFA member from doing business with (including making investments for) persons who should be, but are not, CFTC-registered
- In some cases, for purposes of certain exemptions, representations attesting to an investor's status as a non-U.S. person based on the CFTC-specific definition which varies from, for example, the definition of U.S. person for purposes of Regulation S under the Securities Act

It is appropriate under certain circumstances to seek similar representations even from existing investors. When CFTC registrants address the foregoing changes, make newly-required updates to older claims of exemption (generally beginning in the first quarter of 2013), and claim exemptions that are now more stringent than before, they would be well-served to consider whether they have systems in place to assure compliance over time.

Foreign private adviser compliance. Investment advisers relying on the "foreign private adviser" exemption from Advisers Act registration may find it useful to add non-U.S. person representations to their investor applications. Such representations would facilitate counting the number or asset value of investors who are U.S. persons for purposes of determining ongoing eligibility for that Advisers Act exemption.

JOBS Act and Investment Adviser Advertising Compliance

When the Jumpstart Our Business Startups Act (JOBS Act) was enacted in April 2012, the new law instructed the SEC to relax the longstanding prohibition on general solicitation and advertising in connection with unregistered securities offerings made under Rule 506 of Regulation D. The accredited investor standard would still apply to *sales*, perhaps even more strictly than before. However, subject to SEC rulemaking, *offers* – including of interests in private funds – could be made using general advertising. This development has brought visions of private funds using the internet, television, yellow pages, and billboards to solicit private fund investors.

In August 2012, the SEC issued its proposed rulemaking in response to that mandate. The proposed rule changes would, among other things:

- Eliminate the prohibition on general solicitation in Rule 506 private placements so long as all purchasers are accredited investors or the issuer reasonably believes they are accredited investors at the time of sale

- Require issuers that use general solicitation in Rule 506 offerings to take reasonable steps to verify that the purchasers are accredited investors
- Not affect traditional "quiet" Rule 506 offerings
- Not impose substantive requirements on the content of advertisements

On that last point, a policy debate has arisen on whether additional advertising restrictions should be imposed on private funds. Whatever the final form of the SEC's final rulemaking in 2013, investment advisers should keep in mind that numerous restrictions already pertain to the content of their advertisements and fund offering materials.

Congress provided that offerings under the SEC's JOBS Act rulemaking with respect to Regulation D will not be considered "public offerings" for purposes of the Federal securities laws. The Commodity Exchange Act and the CFTC's rules under that Act, however, are not commonly considered part of the securities laws. For this reason, certain CFTC exemptions that are conditioned upon the absence of a public offering are not clearly available to a fund that engages in a general solicitation after the SEC's JOBS Act rulemaking takes effect.

Note about existing regulatory restrictions on private fund advertisements

Whatever the SEC's final rules implementing the JOBS Act, private funds are subject to numerous regulatory restrictions on the content of their marketing materials. For example:

- *Advisers Act*. The Adviser's Act's antifraud provisions (for all investment advisers) and advertising rule (for SEC-registered advisers), described above in this article, may apply to fund marketing materials. In addition, Rule 206(4)-8 under the Advisers Act specifically applies antifraud principles (for all investment advisers) with respect to fund offering materials.
- *FINRA Rules.* When a FINRA member is involved in marketing an investment fund, that member is subject to certain rules that govern the materials it uses in its marketing activities. For example:
  - Rule 2210 – fair and balanced public communications
  - "Prior review" requirements – FINRA may pre-clear certain materials
- *CFTC and National Futures Association Rules.* As advisers register with the CFTC and become members of the NFA, CFTC and NFA rules may apply to the marketing materials for the funds managed by the advisers. For example:
  - CFTC Part 4 Rules – set certain timing and content requirements for fund disclosures
  - "Prior review" requirements – NFA may pre-clear broadcast advertisements and certain voluntarily-filed materials
  - NFA Rule 2-29 – NFA may regulate certain promotional material

Beyond the Advisers Act

The year 2013 is sure to hold much more in store for compliance personnel of investment advisers, even outside of the Advisers Act.

Alternative Investment Fund Managers Directive (AIFMD). 2013 presents a busy period for dealing with Europe's broadly (and globally) applicable regulations under the AIFMD. Any advisory firm that either has staff in the European Union or markets into the European Union should consider the impact of the terms of AIFMD well before the July 2013 deadline for implementation. The first action items include to inventory European Union contacts, be they the physical locations of the organization's offices, marketing plans involving European investors, or funds organized in European locations. Firms should consider the effect of the European Commission's newly-published implementing measures, and remain alert for the various Member States' implementing legislation.

Marketing developments. A number of other current hot topics relate to marketing:

- Lobbyist registration requirements, or prohibitions on the use of placement agents, imposed by states, localities and particular retirement plans (notably in New York City and the state of California)
- Domestic and overseas anti-corruption and anti-bribery statutes (notably the US Foreign Corrupt Practices Act and the UK Bribery Act)
- Anti-money laundering measures, anti-terrorist financing lists, and economic sanctions (as seen in the recent HSBC settlements)

FATCA. Many advisers are preparing and bracing for the significant due diligence and reporting obligations potentially imposed by the so-called Foreign Account Tax Compliance Act, which is affecting a broad range of non-U.S. entities, both financial and non-financial, that want to avoid withholding on certain U.S. source payments starting in 2014, and U.S. withholding agents. Among others, any manager of a non- U.S. investment vehicle (such as a Cayman Islands exempted company or limited partnership) that receives U.S.

source payments must consider its obligations and other implications under FATCA if it wants to avoid potential withholding from such payments.

Volcker Rule. Developments in the full reach and effect of the Volcker Rule, which (among other things) will remove certain bank-affiliated entities from the investor base of private funds or from sponsoring or managing private funds, continue to be assessed by the investment adviser industry.

Central clearing. Firms that advise on swaps and other derivative transactions are finding it increasingly necessary to familiarize themselves with central clearing processes and documentation. The post-Dodd-Frank Act global regulation of such instruments – and of certain users, particularly those of size – means that compliance personnel must stay on top of this rapidly developing area for both regulatory and commercial reasons.

Uniform standard of conduct for broker-dealers and investment advisers. Although investment advisers are subject to a fiduciary duty, broker-dealers historically have been subject to such a duty only under limited circumstances, and more often are subject to standards such as a requirement that a recommended security must be "suitable" for the broker-dealer's customer. In December 2012, the SEC's Investment Management Division Director announced that Division staff will continue to consider harmonization of the standard of care applicable to broker-dealers and advisers.

Conclusion

As registered investment advisers prepare for their next annual compliance program assessments, they will be well-served to take account of the developing regulatory landscape. In doing so, they may benefit from the roadmap that the SEC and its staff have provided by signaling many of the areas of regulatory focus for 2013. In addition, upcoming deadlines such as those relating to Form PF, Form ADV, FATCA, and AIFMD will surely demand the attention of advisory compliance departments. By the end of the coming year, however, it is conceivable that the pace of new regulatory developments could slow, leaving advisory compliance departments the chance to catch their breath and shore up existing policies.

ENDNOTES

Note: This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. The authors would be pleased to provide additional details or advice about specific situations if desired.

* Jesse P. Kanach represents financial institutions, including registered and private funds and investment advisers, on a variety of regulatory, corporate and transactional matters. His practice ranges from the formation and offering of hedge funds and registered open- and closed-end investment companies, to the representation of independent directors and trustees, to acquisitions of investment advisory firms.

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1 *SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963) (internal quotation marks and footnotes omitted).

2 For example, the SEC staff has identified certain advertisement content as being at odds with the advertising rule's prohibition on "any untrue statement of a material fact, or which is otherwise false or misleading." *See, e.g., Clover Capital Management, Inc.,* SEC Staff No-Action Letter (Oct. 28, 1986). The SEC staff later partially relaxed that position for certain one-on-one presentations, subject to the presentations still meeting certain conditions. *See Investment Company Institute,* SEC Staff No-Action Letter (Sept. 23, 1988).

3 *In the Matter of Aletheia Research and Mgmt., Inc. et al.,* Investment Advisers Act Release No. 3197 (May 9, 2011) (Order Instituting Proceedings) (citing general antifraud provision rather than advertising rule).

4 *In the Matter of Aladdin Capital Management, LLC et al.,* Investment Advisers Act Release No. 3514 (Dec. 17, 2012).

5 In the Matter of Claymore Advisors, LLC, Investment Advisers Act Release No. 3519 (Dec. 19, 2012).

6 *See, e.g., In the Matter of Tilden Louks & Woodnorth, LLC, et al.,* Investment Advisers Act Release No. 3494 (Oct. 29, 2012).

7 *See* Norm Champ, Director, SEC Investment Management Division, *Remarks to the ALI CLE 2012 Conference on Investment Adviser Regulation: Legal and Compliance Forum on Institutional Advisory Services* (Dec. 6, 2012) (also identifying as priorities Dodd-Frank implementation, Form PF filings, JOBS Act rulemaking, registered funds' use of derivatives, compliance by newly-registered advisers, and harmonization of the standard of care for broker-dealers and investment advisers); Bruce Karpati, Chief, SEC Enforcement Division's Asset Management Unit, *Enforcement Priorities in the Alternative Space* (Dec. 18, 2012) (also identifying conflicts of interest and misconduct in reporting investment returns).

8 *In the Matter of J. Kenneth Alderman et al.*, Investment Company Act Release No. 30300 (Dec. 10, 2012) (Order Instituting Proceedings).