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HEDGE FUND ADVISER REGISTRATION AND COMPLIANCE

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Current Exemption from Registration

- Until February 1, 2006, where advice is provided to an entity only, and not individually to the investors in the entity, the entity counts as one client
- Advisers do not need to register with the SEC if they:
  - Do not hold themselves out to the public as investment advisers and
  - Have fewer than 15 clients in any 12-month period

New Rule

- On and after February 1, 2006, for purposes of this "private adviser" exception, one must count each investor in an entity that is a "private fund"
- A "private fund" is an entity that is excluded from the definition of investment company under either Sections 3(c)(1) or 3(c)(7) of the Investment Company Act if the investors have the right to redeem their interests during the first two years
  - Exceptions for extraordinary circumstances and reinvestments of distributions of capital gains or income
  - Two-year redemption test is applied to investments made on or after February 1, 2006, whether those investments are made by new or existing investors (except in extraordinary circumstances)
- A company is a "private fund" only if interests in it are offered based on the investment advisory skills, ability or expertise of the investment adviser

New Rule — Continued

- This look-through requirement generally applies even if the private fund is not organized in the United States
- Look-through applies if a private fund invests in another private fund
- Special rules for offshore advisers

New Rule — Continued

- Open questions:
  - Two years and a day?
  - Does the lock-up period apply to owners/employees?
  - Does it apply to withdrawals of incentive allocation/performance fees?
  - How does two-year holding period apply to allocated gains on income on initial contribution?
  - Must special purpose general partners/managing members register?

Why Register if You Don't Have to?

- ERISA – managing "plan assets"
- Government plan money
- Fund of funds
- Huge growth in assets
- Not that big a deal

Preparing for Registration

- Appoint a Chief Compliance Officer to manage the process
- Prepare compliance manual
- Revise and amend fund documents to reflect registration and to include provisions required under the Advisers Act
- Prepare drafts of Form ADV Part 1 and Part II
- Don’t wait until the last minute
- Compliance Review

Registration

- In order to register with the SEC, the investment adviser must still have assets under management of at least $25 million
- The adviser may exclude value of proprietary assets, as well as assets attributable to non-U.S. persons, when calculating this threshold
- Normally registration is effective within 45 days following submission

Registration Process

- Prepare and file Part 1 of Form ADV with IARD system
- Prepare Part II – not filed with SEC now
- SEC is working to make IARD system accept Part II
- SEC has said it is also working on revising Part II
- Guidance has been requested from SEC staff as to how to answer certain questions on Form ADV

Form ADV — Delivery

- A RIA must deliver to its clients and prospective clients a copy of Part II of Form ADV
- Alternatively, a RIA can deliver the client or prospective client any other written document (such as a brochure) containing whatever information the RIA wishes to include as long as that document contains the same information as in its Part II
- Part II must be delivered:
  - Not less than 48 hours prior to entering an investment advisory contract or
  - At the time of entering into the contract if client has a right to terminate the contract without penalty within five business days
- The SEC has said that a RIA must deliver its Part II to each individual investor in a private fund
- A RIA must deliver (or offer to deliver) a copy of its Part II (or equivalent brochure) to each client once a year

Form ADV — Maintenance

- RIA must update its Form ADV and file Part 1 with the SEC within 90 days after the end of its fiscal year
- Part 1 must also be updated promptly if:
  - Name, business address, business telephone or facsimile numbers, contact employee, or other identifying information in Item 1 of Part 1A change
  - Form of organization changes
  - Custody arrangements change
  - Descriptions of certain disciplinary items relevant to the RIA, its affiliates or personnel change or
  - Information provided in response to Items 4 (successions), 8 (participation or interest in client transactions) or 10 (control persons) of Part 1A becomes materially inaccurate

Compliance Procedures – Three Basic Requirements

- RIA must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules under the Advisers Act
- It's unlawful to provide advice if compliance procedures are not in place
- RIA must review these policies and procedures annually for their adequacy and the effectiveness of their implementation
- RIA must designate a CCO to be responsible for administering the policies and procedures

Compliance Procedures — Coverage

- Rule doesn't mandate particular topics, but adopting release states that compliance procedures are expected to address at least the following issues:
  - Portfolio management processes -- allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions
  - Trading practices -- procedures by which the RIA satisfies its duty to seek best execution, uses client brokerage to obtain research and other services, and allocates aggregated trades among clients
  - Proprietary trading of the RIA and personal trading activities of supervised persons
  - Accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements

Compliance Procedures — Coverage (Continued)

- Safeguarding of client assets from conversion or inappropriate use by advisory personnel
- 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
- Marketing advisory services, including the use of solicitors
- Processes to value client holdings and assess fees based on those valuations
- Safeguards for the privacy protection of client records and information and
- Business continuity plans

- Compliance procedures should be tailored to the specific business activities of the RIA

Chief Compliance Officer

- Not required to hire a dedicated CCO
- But must designate an individual to serve as such
- SEC has stated that:
  - CCO should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the RIA
  - CCO should have a position of sufficient seniority and authority within the RIA to compel others to adhere to the compliance policies and procedures

Code of Ethics

- New Advisers Act Rule 204A-1 requires that RIAs adopt codes of ethics
- Compliance date was February 1, 2005
- Preclearance-only mandated for
  - Private placements and
  - IPOs

Code of Ethics — Continued

- Code of ethics must:
  - Set forth a standard of business conduct that the RIA requires of all its supervised persons, which must reflect their fiduciary obligations
  - Require supervised persons to comply with applicable federal securities laws (including procedures that prevent access to material, nonpublic information about the RIA's securities recommendations, and client securities holdings and transactions, by individuals who do not need the information to perform their duties) and
  - Require a RIA's "access persons" to periodically report their personal securities transactions and holdings to the RIA's CCO or other designated persons
  - Require the RIA to review those reports
  - Require reporting of violations to the CCO

Code of Ethics – Access Persons

- An “access person” is a supervised person who:
  - Has access to non-public information regarding any client’s purchase or sale of securities
  - Has access to non-public information regarding portfolio holdings of any RIC advised by the RIA
  - Is involved in making securities recommendations to clients or
  - Has access to such recommendations
- It’s a presumption
- In addition, all directors, officers and partners are presumed to be access persons if providing investment advice is the RIA’s primary business

Performance Fees

- Generally unlawful for an adviser to enter into an advisory agreement that provides for compensation to the adviser based on a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client
- Doesn't apply to arrangements with foreign persons or arrangements with "qualified clients"

Performance Fees – Qualified Client

- "Qualified client" is
  - A natural person who or a company that, immediately after entering into the contract, has at least $750,000 under the management of the RIA
  - A natural person who or a company that, immediately prior to entering into the contract, has a net worth (together with assets held jointly with a spouse) of more than $1,500,000 at the time the contract is entered into
  - A natural person who or a company that, immediately prior to entering into the contract, is a "qualified purchaser"
  - A natural person who, immediately prior to entering into the contract, is a "knowledgeable employee" of the RIA
- For purposes of the $750,000/$1,500,000 requirements, the RIA must "look through" a Section 3(c)(1) fund

Performance Fees – Grandfather Provision

- Existing investors in any fund that qualifies for the exclusion in Section 3(c)(1) may retain their investment and add to it even if they are not "qualified clients" and
- Newly-registered advisers may continue in effect advisory contracts they may have with clients that are not "qualified clients" as long as, in each case, they originally invested in the fund or entered into the advisory contract before February 10, 2005
- A private fund adviser required to register as a result of the new rule may market its performance even if it has not previously retained all of the records required under the Advisers Act
  - Such advisers should begin keeping all required performance-related records on February 10, 2005 to use such performance after registration

Custody

- A RIA has custody if it holds, "directly or indirectly, client funds or securities, or [has] any authority to obtain possession of them"
  - A RIA that advises a private fund has custody when it acts as general partner to a limited partnership (or managing member of a limited liability company)
- RIAs with custody must maintain client funds or securities with "qualified custodians" (defined to include most banks and brokers) in an account either in the client's name or in the adviser's name as agent or trustee for its clients
- RIAs with custody must generally send quarterly account statements to clients or have the qualified custodian do so
  - If the RIA sends the statements, the RIA must undergo an annual surprise audit

Custody – Private Funds

- A RIA is not required to comply with the quarterly reporting requirements with respect to its private funds if the private funds:
  - Are audited annually and
  - Distribute their audited financial statements prepared in accordance with GAAP within 120 days of the end of the private fund's fiscal year (180 days for "funds-of-funds")
  - If a private fund amortizes its organization and offering costs, is it GAAP? (Guidance has been requested.)
- A fund-of-funds is defined as a pooled investment vehicle that invests 10% or more of its total assets in other pooled investment vehicles sponsored or advised by unaffiliated entities

Advertising

- The Advisers Act prohibits a RIA and its employees from making any untrue statement of a material fact or omitting to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading
- No communications should state that the SEC or any other regulatory authority approves of or endorses the RIA
- No testimonials except in limited circumstances
- Past performance is no guarantee of future results
- No cherry-picking

Advertising — Continued

- Cannot present gross performance unless (i) in a one-on-one presentation and (ii) provide net performance information also
- Hypothetical performance only in very narrow circumstances
- Broker-dealers may only distribute sales material with the actual performance of Section 3(c)(1) funds - no back-tested performance or performance of related products (Does not apply to performance information in a PPM and does not apply at all to Section 3(c)(7) funds)

Cash Solicitation Rule

- A RIA may enter into referral agreements with and make payments to independent parties ("solicitors") for purposes of referring clients to the RIA in compliance with Rule 206(4)-3
  - The rule applies to prospective private fund investors under the *Dana* no-action letter
- Rule 206(4)-3 requires that the solicitor not be subject to a statutory disqualification and that the solicitation agreement be in writing
- The solicitation agreement must require the solicitor, at the time of initial client contact, to provide the client with:
  - Part II of the RIA's Form ADV and
  - A written disclosure statement describing the solicitation arrangement (which must be signed by the client and returned to the RIA)
- There are relaxed requirements for affiliated solicitors

Cash Solicitation Rule and "Finders"

- If the solicitor is soliciting the purchase of shares of or interests in a private fund and receiving "transaction-based compensation," the solicitor is also likely to be required to register as a broker-dealer under the Securities Exchange Act of 1934 and comparable state laws

Proxy Voting

- Rule 206(4)-6 requires a RIA to adopt proxy voting procedures
- Procedures must include how the RIA addresses material conflicts that may arise between the interests of the RIA and the interests of clients
- RIAs must describe their proxy voting policies and procedures and, upon request, provide a copy of the policies and procedures to clients
- Advisers to fund-of-funds and other RIAs that may seldom be asked to vote proxies are still required to have proxy voting procedures

Records

- Section 204 and Rule 204-2 require RIAs to keep specific books and records
- Required records must be kept for five years in an easily accessible place, the first two years in an appropriate office of the adviser (ERISA requires six years)
  - Electronic recordkeeping is permissible under certain circumstances
  - Guidance has been requested regarding having the administrator retain these records
- E-mail and other electronic records are analyzed no differently than written materials (although more SEC guidance may be forthcoming)

Preparing for an SEC Examination

- Dos and Don’ts
  - Establish one contact person
  - Give staff a separate work room
  - Extend common courtesies
  - Don’t intentionally mislead the staff
  - Maintain records of what you give the staff
  - Keep all original documents
  - Do not alter documents
  - Prepare your “witnesses”
  - Advise employees of SEC’s presence and these guidelines
  - Document what you have told the staff
  - Consult with legal counsel
  - Do not make premature admissions
  - Ask staff to rethink burdensome requests or emails
  - Don’t panic

EVERYTHING A PRIVATE FUND MANAGER REALLY WANTS (NEEDS) TO KNOW ABOUT ERISA …..

William P. Wade
September 19, 2005

Employee Retirement Income Security Act of 1974

. . . OR, 5 STEPS TO MANAGING "PLAN ASSETS"

STEP ONE: DOES ERISA APPLY?

- ERISA governs conduct of plan "fiduciaries"
- "Fiduciary" status depends on functions performed with respect to "plan assets," including –
  - Investment discretion
  - Investment advice
- DOL "plan asset" regulations

STEP ONE: DOES ERISA APPLY? (cont.)

ERISA does *not* apply to fund that is –

- Registered under Investment Company Act of 1940
- A “venture capital operating company”
- A “real estate operating company”

STEP ONE: DOES ERISA APPLY? (cont.)

- The “25% Test”: Fund assets are “plan assets” (and manager is a “fiduciary”) if –
  - an ERISA plan acquires an “equity interest” in the fund, and
  - “benefit plan investors” in the aggregate hold 25% or more of the value of any class of equity interests in the fund

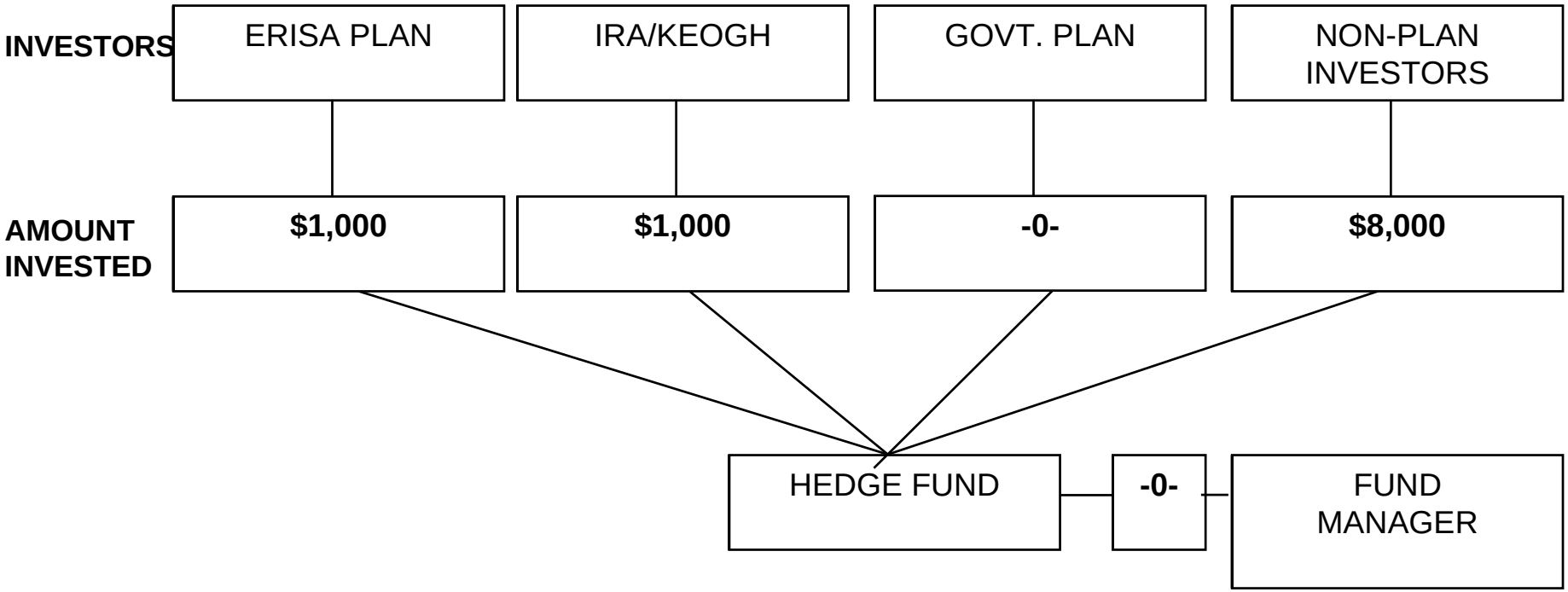
STEP ONE: DOES ERISA APPLY? (cont.)

"Benefit plan investors" include –

- Plans of all kinds – whether or not subject to ERISA –
- Other private investment funds whose assets are treated as "plan assets"

STEP ONE: DOES ERISA APPLY? (cont.)

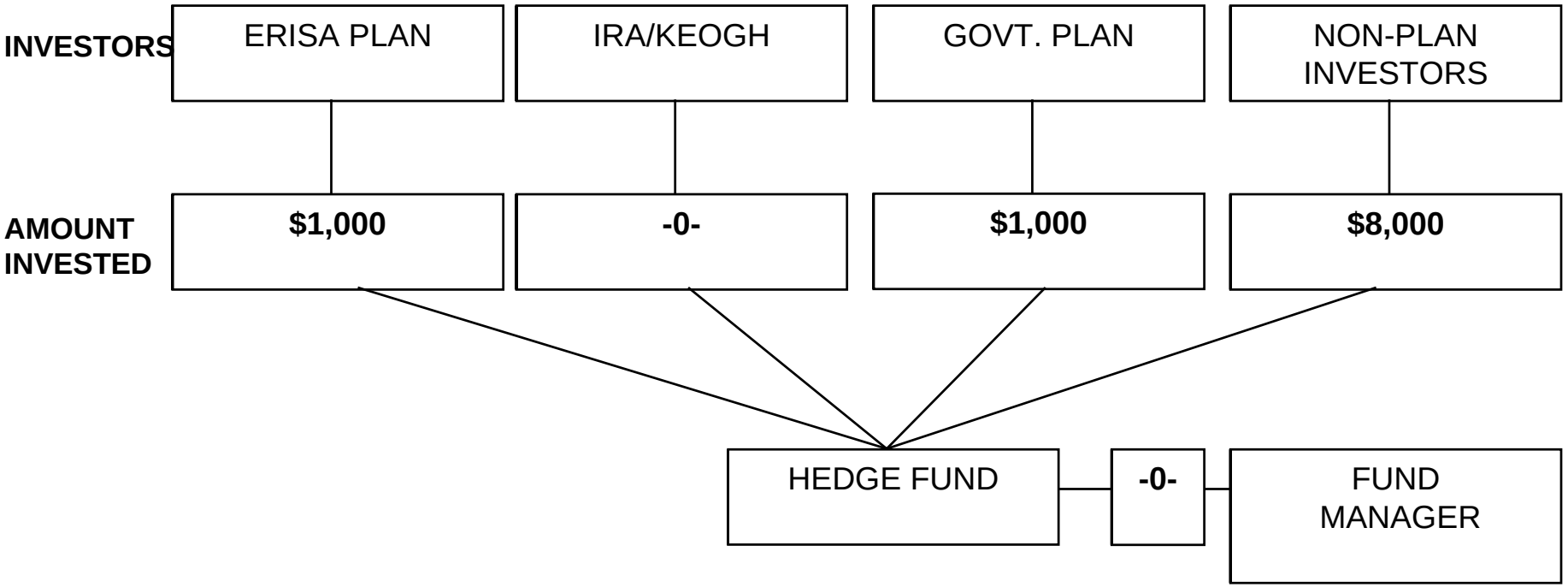
Example One:



PLAN ASSETS ? No

STEP ONE: DOES ERISA APPLY? (cont.)

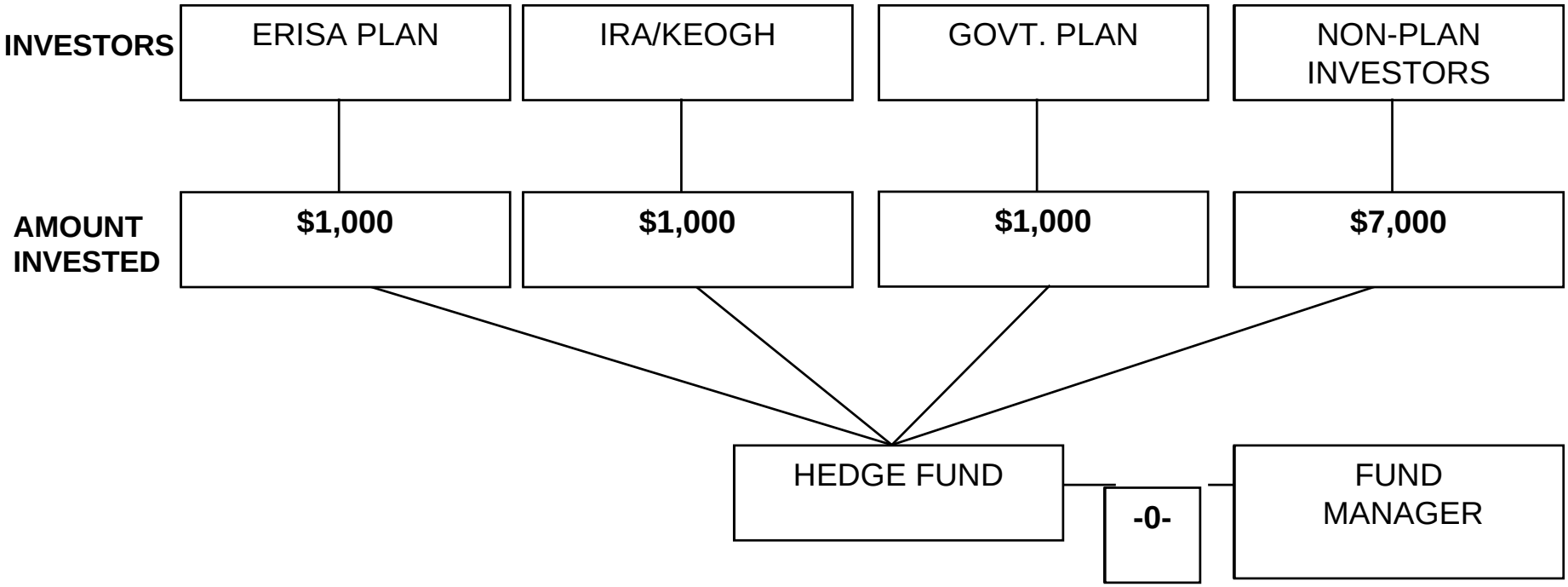
Example Two:



PLAN ASSETS ? No

STEP ONE: DOES ERISA APPLY? (cont.)

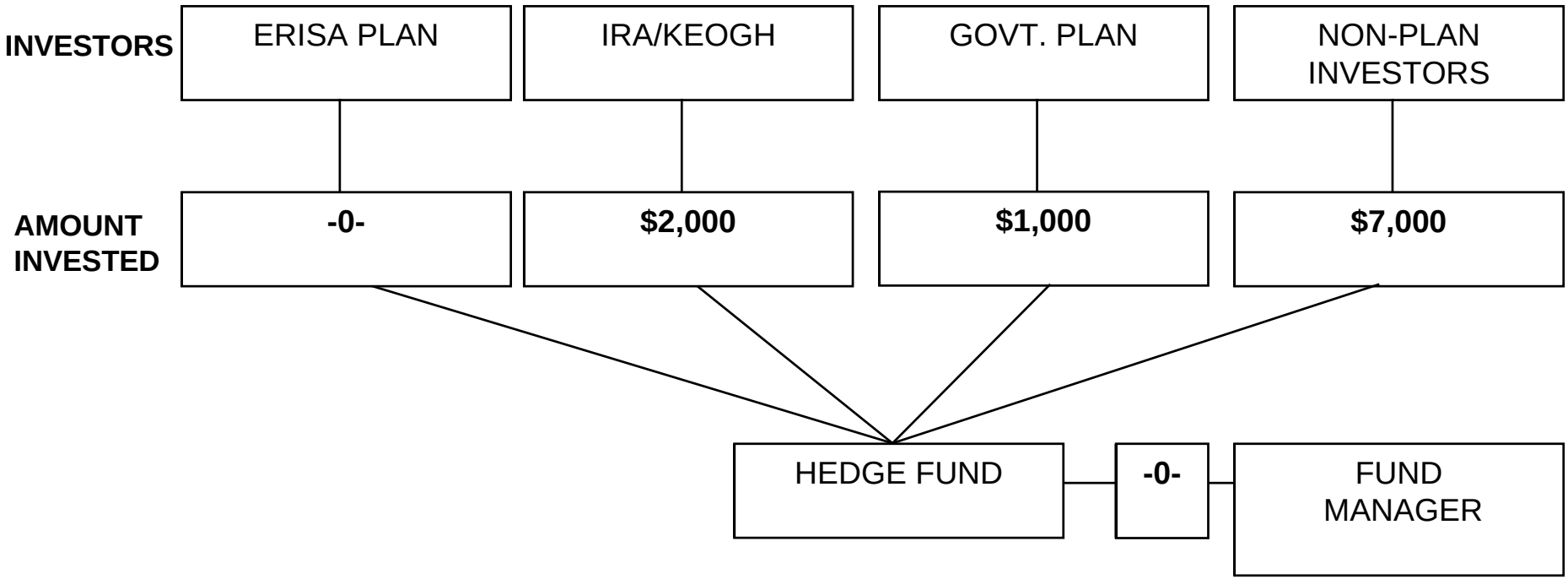
Example Three:



PLAN ASSETS ? Yes

STEP ONE: DOES ERISA APPLY? (cont.)

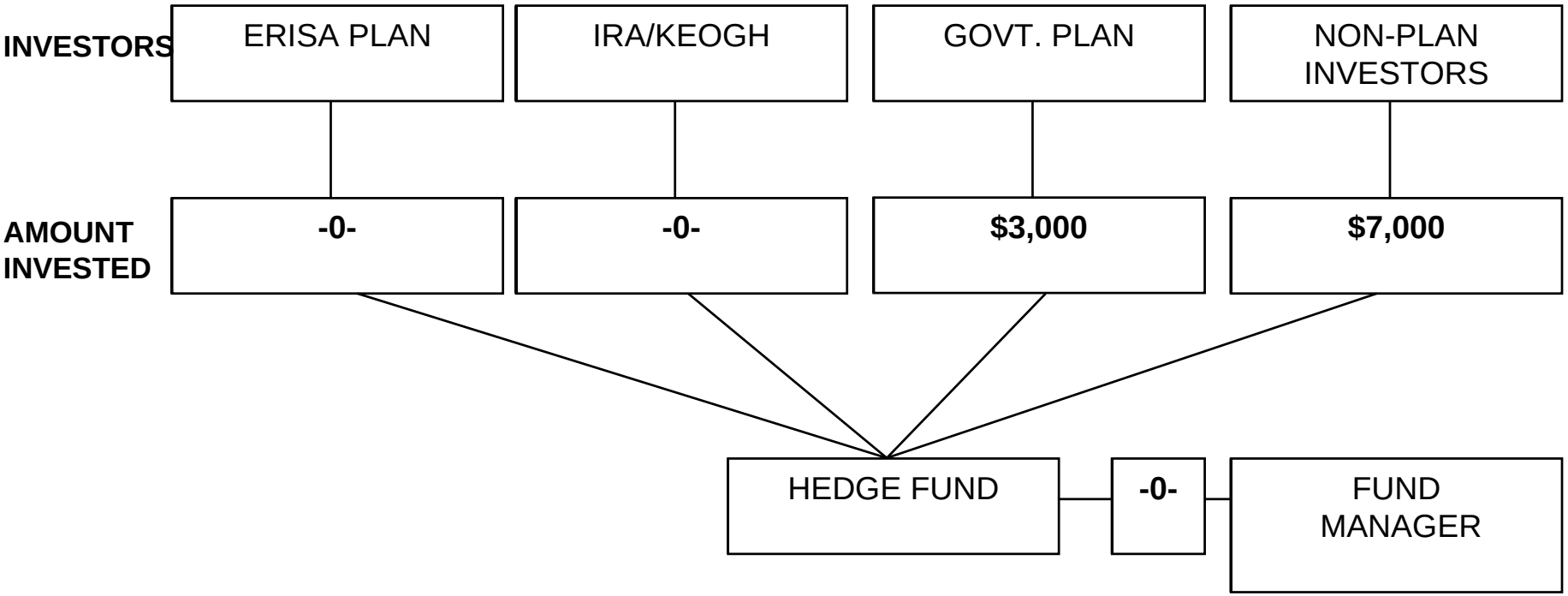
Example Four:



PLAN ASSETS ? Yes

STEP ONE: DOES ERISA APPLY? (cont.)

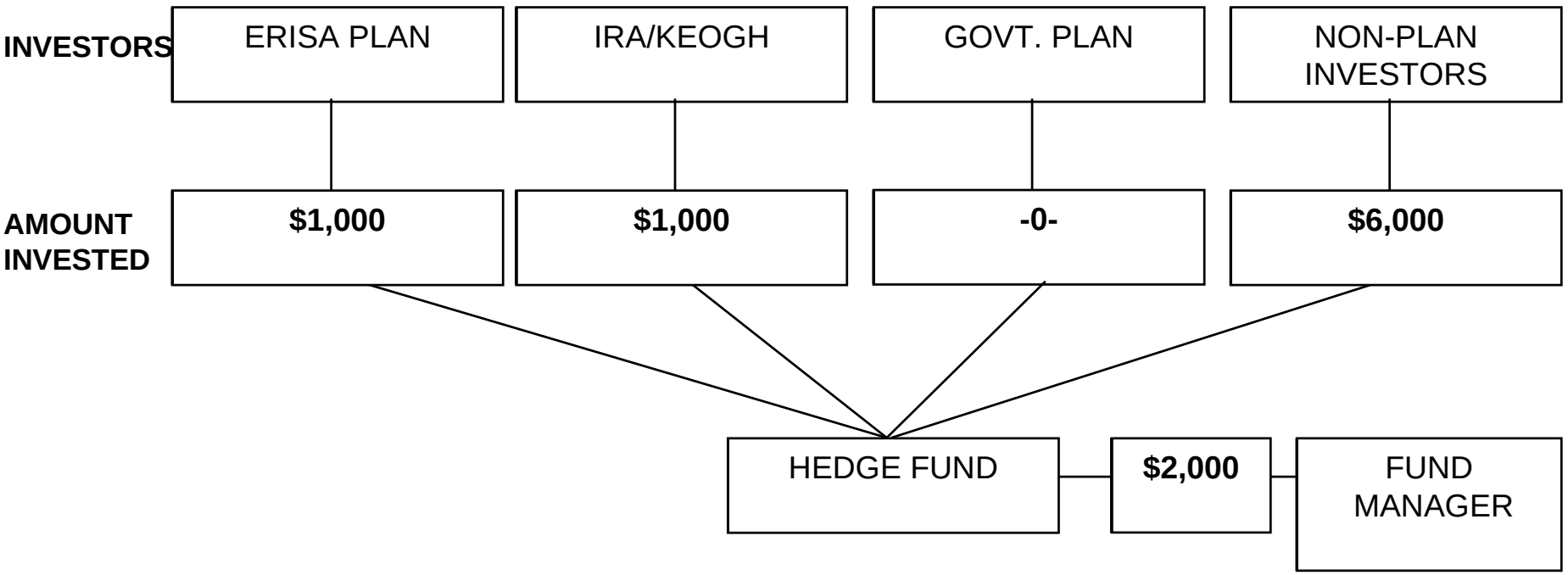
Example Five:



PLAN ASSETS ? No

STEP ONE: DOES ERISA APPLY? (cont.)

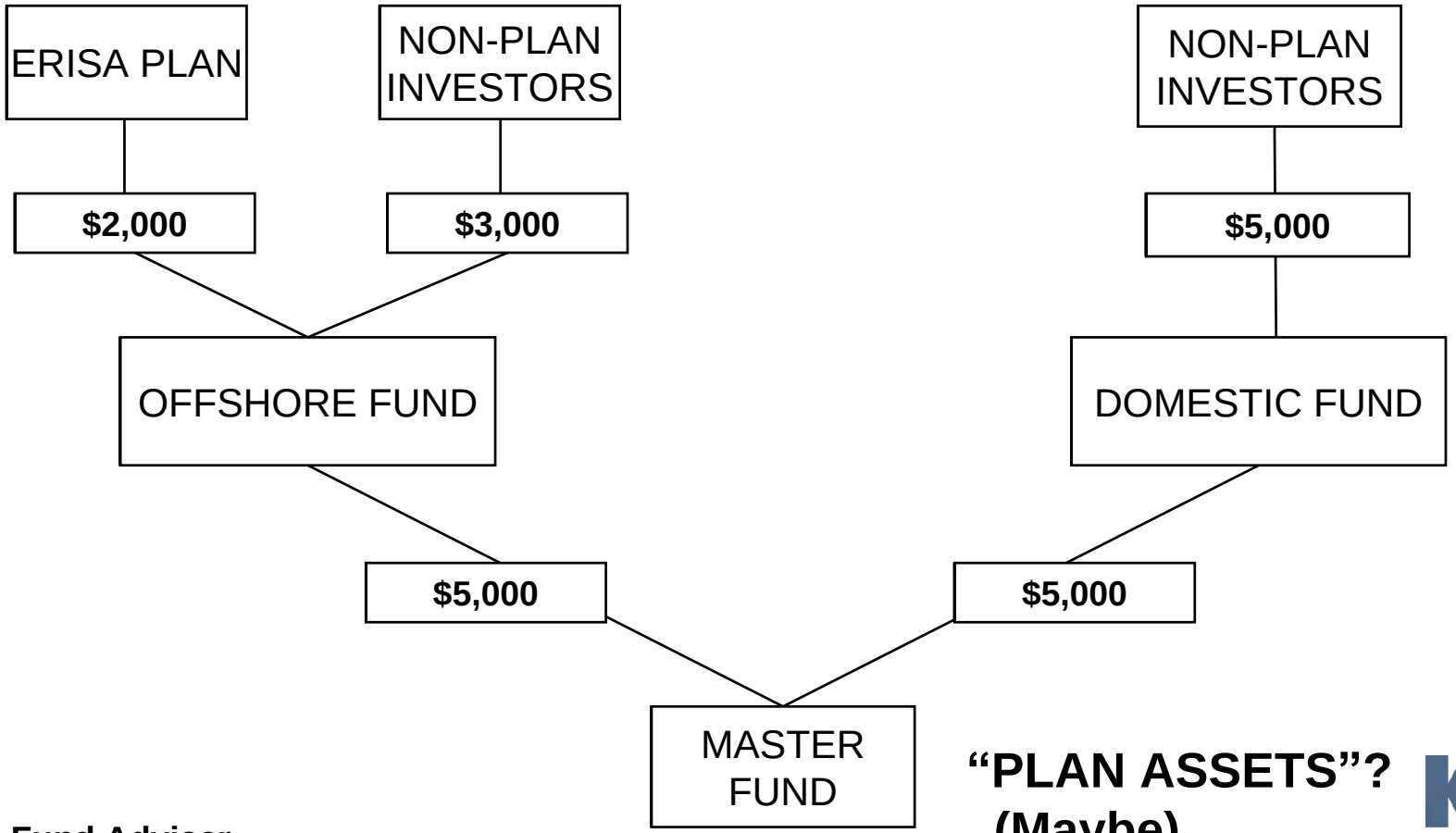
Example Six:



PLAN ASSETS ? Yes

STEP ONE: DOES ERISA APPLY? (cont.)

Example Seven:



"PLAN ASSETS"? (Maybe)

STEP TWO: UNDERSTAND FIDUCIARY DUTIES

- Fund Manager is an ERISA "fiduciary" of investing ERISA plans
- Plan investors generally will expect Manager to qualify and act as ERISA "investment manager" (state or federal registration as adviser required)
- Selected basic requirements:
  - "Solely in the interest" / "exclusive purpose"
  - Prudent "expert" standard
  - Bonding
  - Indicia of ownership of plan assets within the U.S.
  - Avoid "prohibited transactions"

STEP TWO: UNDERSTAND FIDUCIARY DUTIES (cont.)

Everyone has a personal interest in ERISA compliance:

- Fund Manager personally liable for breach of duty:
  - Restore "losses" suffered by plan
  - Disgorge "profits" realized by fiduciary
  - Equitable relief (e.g., barred from plan business)
  - Department of Labor penalties
- Plan Sponsors may have co-fiduciary liability
- Counterparties/service providers may be subject to prohibited transaction excise taxes

STEP THREE: ISSUE SPOTTING – PART I

Identify / avoid "fiduciary prohibited transactions"

- Basic Principle – Fiduciary cannot use authority to benefit self (or others in whom fiduciary has an "interest")

- Typical examples of:
  - Use of affiliates
  - Soft dollars
  - Cross trades
  - Fee arrangements

STEP FOUR: ISSUE SPOTTING – PART II

Address "party in interest" prohibited transactions –

- What is prohibited?
  - Transactions between fund and "parties in interest" of investing plans
- Who is a "party in interest"?
  - Plan sponsor
  - Labor union (members covered by plan)
  - Plan fiduciaries (e.g., trustee)
  - Plan service provider (e.g., prime broker)
  - Certain affiliates of the above

STEP FIVE – LIFE GOES ON . . . WITH EXEMPTIONS

Exemptions Useful to Fund Managers – Examples

- "Blind" equity trades on open market
- Basic "services" exemption
- "Principal" transactions with registered brokers
- "Margin" credit from registered brokers
- "QPAM" exemption

STEP FIVE – QPAM EXEMPTION

QPAM Status requires:

- Registration under Advisers Act
- More than $750,000 equity ($1 million in 2006)
- More than $50 million AUM at FYE ($85 million in 2006)
- Written acknowledgment of fiduciary status
- 10-year “clean” rap sheet

STEP FIVE – QPAM EXEMPTION (cont.)

Exemption *Does Not* Cover Certain Transactions–

- With QPAM itself or "related" party in interest
- "20% client plan"
- "Power of appointment" over QPAM
- Securities loans; certain mortgage financing arrangements; mortgage pools

STEP FIVE – QPAM EXEMPTION (cont.)

Other Conditions:

- QPAM must negotiate (or direct negotiation of) terms of transaction
- QPAM must make decision to enter into transaction
- Transaction must not be designed to benefit a party in interest
- Transaction terms must satisfy “arm’s length” test

CONCLUSION

- Questions and Answers
- Memorandum:

  "ERISA Considerations for Advisers of Private Investment Funds"