



O'MELVENY & MYERS LLP

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# Registration and Regulation of Investment Advisers



# Investment Adviser Registration



# Overview

- Registering with the SEC will have a significant impact on the business and operations of investment advisers. As a result, investment advisers to funds should begin to analyze their supervisory systems and business practices in anticipation of registering with the SEC.
- This presentation provides an overview of
  - The SEC registration process and certain steps that unregistered investment advisers should consider taking in anticipation of registration; and
  - Certain regulatory requirements imposed on registered investment advisers under the Advisers Act



## Part I

# The SEC Registration Process and Steps to Take in Anticipation of Registration



# Registration of the Advisory Firm

- **Form ADV:** To register with the SEC, an investment adviser must prepare Form ADV. Form ADV consists of two parts, Part I and Part II.
  - **Part I:** Part I of Form ADV provides information about the adviser and its associated persons, including:
    - The identity of the person who controls the adviser.
    - Business activities of the adviser.
    - Conflicts of interest.
    - Amount of assets under management.
    - Whether the adviser maintains custody of assets.
    - Disciplinary history of the adviser and its related persons.
    - Type and number of advisory clients.
  - **Part II:** Part II of Form ADV is a written disclosure statement in paper format that includes information such as:
    - The types of advisory services provided by the adviser.
    - How securities are analyzed by the adviser.
    - Advisory fees charged by the adviser to its clients.
    - Whether the adviser has brokerage or investment discretion for clients.
    - Description of the adviser's education and business background.
    - Conflicts of interest.
    - Proxy voting policies implemented by the adviser.
    - A description of the adviser's code of ethics.



## Filing Part I and Part II of Form ADV

- **Part I:** Part I of Form ADV must be filed electronically with the SEC through the Investment Adviser Registration Depository (“IARD”).
  - **SEC Review Period:** The SEC Staff reviews Part I of Form ADV for completeness and any apparent problems, such as inconsistent information provided in response to different questions. The SEC has **forty-five (45) days** from the filing of Part I to approve the firm’s registration or begin the process to deny registration.
    - **OMM Note:** In our experience, it typically take several months to complete the Form ADV and to develop the firm’s compliance infrastructure, and most registrations are approved within **20 to 35 days** after filing the Form ADV.
- **Part II:** Part II of Form ADV is a written disclosure document that the SEC deems to be filed if the adviser completes the document and retains Part II in its files available for SEC inspection. However, this will likely change in the future as the SEC has proposed rule amendments that will require Part II to be filed through IARD and be made publicly available.



# Compliance Infrastructure

- **Appointing or Hiring a Chief Compliance Officer**
  - The CCO must be “competent and knowledgeable regarding the Advisers Act” and “have a position of sufficient seniority and authority within the organization” to compel others to follow the firm’s policies and procedures
- **Written Supervisory Procedures and Code of Ethics**
  - Ideally, a firm’s supervisory procedures and code of ethics **should be completed prior to the SEC granting registration** to the firm, as the firm will be responsible for complying with all applicable regulatory requirements under the Advisers Act once registered.



# Written Supervisory Procedures

- The SEC mandates that the supervisory procedures be **tailored** to the adviser's specific business. At a minimum, the policies and procedures should address
  1. Portfolio management process
  2. Trading practices
  3. Personal trading by supervised persons
  4. Accuracy of disclosures to investors, clients, and regulators
  5. Safeguarding of client assets
  6. Accurate creation and maintenance of client records
  7. Marketing advisory services
  8. Valuation of client assets
  9. Safeguarding privacy of client records
  10. Business continuity plans



# Code of Ethics

- Pursuant to Rule 204(A)-1, a registered investment adviser is required to establish, maintain and enforce a **written code of ethics** that includes, among other things:
  - Standards of business conduct outlining fiduciary duties owed to advisory clients and requiring employees to comply with the federal securities laws
  - Provisions requiring “access persons” (i.e., persons who have access to MNPI, information concerning client investments or is involved in advising clients) to periodically report personal securities transactions. A compliance officer is required to review these reports.
  - Provisions requiring supervised persons to report violations of the code of ethics to the chief compliance officer
  - Provisions requiring each supervised person to acknowledge receipt of the code of ethics
  - Provisions requiring access persons to obtain prior approval before acquiring securities in an IPO



## Steps to Take in Advance of Registration

- Unregistered adviser should begin:
  - Preparing a written supervisory procedure manual and code of ethics that is tailored to its business. Preparing the manual can take a significant amount of time and should be started in advance of registration;
  - Reviewing its business activities to identify potential conflicts of interest, such as outside business activities of firm employees, allocation policies between funds with overlapping investment objectives, and conflicts in dedicating time among the adviser's funds; and
  - Reviewing its existing compliance infrastructure to determine whether additional resources or compliance personnel are necessary to comply with the Advisers Act and related regulations.



# Part 2: Investment Adviser Regulation Under the Advisers Act



## Advisers Act

- The following is a brief summary of certain select requirements imposed on registered advisers by the Advisers Act



# SEC Inspections

- **Scope of Inspection:**
  - Newly registered advisers should anticipate an SEC inspection within the first year.
  - The SEC conducts inspections to ensure that the adviser complies with the Advisers Act and other securities laws, and otherwise conducts its business in accordance with the disclosures in its Form ADV. SEC inspections generally consist of (1) **routine** examinations, (2) **sweep** examinations, and (3) examinations for **cause**.
- **Possible Outcome of SEC Inspection:** An SEC inspection may have one of several outcomes.
  - “No further action”
  - “Deficiency letter” which requires the adviser to respond within a stated time to correct the deficiencies
  - Enforcement referral



# Advertising

- Rule 206(4)-1 governs advertisements and marketing by advisers of their advisory services. Examples may include:
  - Flip Books
  - Emails
  - Brochures
  - News Letters
- Rule 206(4)-1 bars advertisements that directly or indirectly include:
  - Misstatements and omissions
  - Testimonials
  - Cherry picking



# Past-Specific Recommendations

## NO CHERRY PICKING

- Rule 206(4)-1 prohibits any fund manager from using advertisements that refer directly or indirectly to the manager's **past specific profitable recommendations** unless the advertisement sets out a list of **ALL** recommendations made by the manager within at least the **prior one-year period**.
- The SEC has taken the position that a manager may NOT provide a partial list of past specific recommendations accompanied by an offer to provide a complete list. See Franklin Mgmt., Inc., SEC No Action Letter (pub. avail. Dec 10, 1998).
- Case studies that focus on one or more past transactions or deals may be viewed as cherry picking unless all transactions or deals are disclosed.



# Performance Results

- The SEC has determined that it is **misleading** to present prospective investors with “**model**” or “**actual**” performance results that:
  1. Fail to disclose the effect of material economic conditions on the results portrayed
  2. Fail to reflect the deduction of advisory fees, brokerage commissions or other expenses the client would have paid
  3. Fail to disclose whether performance results reflect reinvestment of dividends
  4. Suggest potential profits without disclosing probability of loss
  5. Compare results to an index without disclosing all material factors relevant to the comparison
- **Net of Fees Requirement:** The SEC takes the view that performance advertising is misleading if it fails to reflect the deduction of advisory fees, brokerage commissions, and other expenses that a client or fund would have paid.
- **Disclosure is not a substitute** for showing performance “net of fees.” Disclosure of the existence of fees or a range of fees is not sufficient.



## Predecessor Performance

- A portfolio manager may advertise the performance results it achieved at a prior investment advisory firm only if:
  - The accounts managed at the prior firm have **substantially similar investment objectives** to the accounts currently managed by the portfolio manager;
  - The portfolio manager managed **no other comparable funds** or accounts at the prior manager;
  - No other person played a **significant part in achieving the funds or account's performance** at the prior firm and the portfolio manager is **principally responsible** for managing the accounts at the new firm; and
  - The performance of the prior funds or accounts is **not presented in a misleading manner**.



# Custody of Client Assets

- **Custody:** Registered advisers with **actual or constructive custody** (e.g., holding or having access to client funds) of client assets are generally required to maintain client funds and securities with a “**qualified custodian**” (e.g., a bank or broker dealer).
- Key Points:
  - Quarterly Account Statements
  - Surprise Examination
  - Internal Controls Report
  - Annual Audit
  - Layering
  - Privately Offer Securities Exemption



## Books and Records

- **Books and Record Retention:** The SEC imposes stringent recordkeeping requirements on registered advisers. These requirements are largely designed to aid regulators in monitoring the firm's compliance with securities regulations.
- **Document Retention:** Registered investment advisers are generally required to maintain and preserve records in an easily accessible place for five (5) years; for the first two (2) years they must maintain and preserve the records in the adviser's office.
- **Electronic Preservation:** If the registered adviser preserves the records electronically, the system used to preserve the records must meet certain standards established by the SEC.



## Principal Transactions & Cross Trades

- A **principal transaction** is a transaction in which the investment adviser (or an owner or affiliate) sells or purchases securities from an advisory client
- Section 206(3) of the Advisers Act permits advisers to engage in certain principal transactions if the adviser:
  - Provides **written disclosure** to the client of the capacity in which it is acting; and
  - Obtains the client's **consent** to the transaction
- **Client consent may be obtained either before execution of the transaction or before the settlement of the transaction.**



# Agency Cross Transactions

- An **agency cross transaction** is a transaction in which the investment adviser (or an associated person of the investment adviser) acts as a broker for both an advisory client and for another person on the other side of the transaction.
- **Rule 206(3)-2:** The SEC promulgated Rule 206(3)-2 to allow Agency Cross Transactions without needing to provide disclosure and consent on a per trade basis if the following conditions are satisfied:
  1. Client must prospectively authorize agency cross transactions in writing;
  2. Adviser must disclose to the client in writing the capacities in which it will act and the possible conflicts of interest it may face;
  3. Each Agency Cross Trade must be confirmed in writing;
  4. Adviser must provide the client with an annual summary of all agency cross trades; and
  5. All client statements must disclose that the client may terminate the authority to engage in agency cross trades at any time.



## Cross Trades

- Investment advisers engage in **cross trades** by arranging the purchase or sale of securities between the accounts or funds managed by the adviser
- **Notice / Consent:** Cross Trades do **NOT** require notice or consent so long as the **adviser receives no compensation other than its advisory fee** for effecting the transaction (unless the cross trade is deemed to be a principal transaction)



## Cross Trades May Be Deemed a Principal Transaction

- The SEC generally considers cross trades involving an account or fund controlled by the adviser (or its owners, employees or affiliates) to be Principal Transactions.
- The mere holding of an interest in a client account by an adviser will not render such an account a principal account for the purpose of Section 206(3).
- The SEC staff considers two factors in determining whether a client account is a principal account: (i) the nature of the relationship of the account owners to the investment adviser; and (ii) the extent of the ownership interest of the investment adviser and its affiliates in the account.
- Section 206(3) applies to a cross trade between a client account and an account of which the investment adviser and/or its controlling persons, in the aggregate, own(s) more than 25% of ownership interests. It would not apply to a cross trade between a client account and an account of which the adviser and/or its controlling persons hold ownership interests, in aggregate, of 25% or less.



# Solicitors

- If the adviser uses third party “solicitors” or “finders” to solicit new clients for the investment adviser, the adviser must make certain disclosures to the client

## **Rule 206(4)-3: Requirements of Cash Solicitation Rule**

- A cash referral fee must be paid pursuant to a written agreement to which the adviser is a party. The written agreement must:
  - Describe solicitor’s activities and compensation for such activities
  - Contain solicitor’s undertaking to perform those duties under the agreement consistent with the adviser’s instructions
  - Require the solicitor to provide the client with a copy of the adviser’s brochure and disclosure document
- In addition, the solicitor must also receive from a prospective client a signed and dated acknowledgment that it has received the disclosure document. Finally, the adviser must ensure that the solicitor is not statutorily disqualified
- **The Cash Solicitation Rule applies only to clients (funds), not investors in funds**



## The “Brochure Rule” – Rule 204-3

- **Rule 204-3:** Rule 204-3 requires a registered adviser to provide certain written disclosures to prospective and existing clients at specified times. For most clients, such disclosure may take either of two forms:
  - a copy of **Part II** of the adviser’s **Form ADV**; or
  - a written document containing at least the information contained in the Form ADV.
- The adviser’s brochure must be furnished to the prospective client:
  - at least **48 Hours prior** to entering into an advisory contract; or
  - **at the time of entering into an advisory contract**, provided that the client can terminate the contract without penalty within **5 business days**.



## Assignment of Investment Management Agreements

- **Client Consent:** Section 205(a)(2) of the Advisers Act prohibits a registered adviser from entering into an IMA with a client that fails to provide that the advisory agreement **cannot be assigned by the registered adviser to another party without the consent of the client.**
- **“Assignment”** is defined very broadly under Section 202(a)(1) to include a traditional assignment as well as *any transfer of control of the registered adviser*. As a result, a change in control of a registered adviser could be deemed an assignment of all advisory contracts that such registered adviser is a party to, and would require prior consent for each assignment.



## Rule 202(a)(1)-1 Exception

- The broad assignment definition encompasses many types of transactions that **may not alter the actual control or management of an adviser**, such as a corporate reorganization. Since obtaining client consent in these situations would serve no useful purpose, the SEC adopted Rule 202(a)(1)-1.
- **Rule 202(a)(1)-1** – Deems transactions that **do not result in a change of actual control or management** of an adviser not to be an assignment under the Advisers Act. The determination of whether a particular transaction involves a change in control is inherently factual.



**Thank you**