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2012 Annual Compliance Obligations: What You Need To Know

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Written by: Ildiko Duckor and Peter Chess

In light of the current regulatory environment, now more than ever, it is critical for you to comply with all of the legal requirements and best practices applicable to Investment Advisers. The beginning of the year is a good time to review, consider and, if applicable, satisfy these requirements and best practices.

As the new year is upon us, there are some important annual compliance obligations Investment Advisers either registered with the Securities and Exchange Commission (the "SEC") or with a particular state ("Investment Adviser") should be aware.

First, we wanted to address three situations where Investment Advisers may need to make changes with regard to their registration. These are:

(1) SEC-registered Investment Adviser switching to State registration. SEC-registered Investment Advisers are required to withdraw registration if they have less than $90 million in Assets under Management ("AUM"). Those Investment Advisers have a June 28, 2012 deadline for state approval. These advisers should submit a state Form ADV to the relevant state by March 30, 2012 to allow at least 90 days for state approval (California in particular).

(2) State-registered Investment Adviser switching to SEC registration. A state-

registered Investment Adviser whose AUM as of December 31, 2011 was $110 million or more must register with the SEC by March 30, 2012. Going forward, state-registered Investment Advisers must apply for registration with the SEC within 90 days of becoming eligible for SEC registration and not relying on an exemption from registration. The threshold for registration with the SEC is $100 million or more in AUM, but you may stay registered with the state up to $110 million in AUM.

(3) Currently exempt Investment Adviser registering with the SEC. An Investment Adviser previously exempt from registration that is now registering with the SEC must do so by the March 30, 2012 deadline. The Form ADV should have been filed with the SEC by February 14, 2012.

The following is a summary of the primary annual or periodic compliance-related obligations that may apply to Investment Advisers. The summary section begins with what we feel are "hot" areas of compliance for 2012, and then addresses continuing compliance and other regulatory issues. The summary is not intended to be a comprehensive review of an Investment Adviser's tax, partnership, corporate or other year-end requirements, nor an exhaustive list of all of the obligations of an Investment Adviser under the Investment Advisers Act of 1940, as amended (the "Advisers Act") or applicable state law. Although many of the obligations set forth below apply only to SEC-registered Investment Advisers, state-registered Investment Advisers may be subject to similar and/or additional obligations depending on the state in which they are registered. State-registered Investment Advisers should contact us for additional information regarding their specific obligations under state law.

"Hot" Compliance Areas

Qualified Client Threshold Updated. In a Final Rule amendment recently released, the SEC clarified the calculation of the dollar amount thresholds applicable to the new qualified client standard which became effective on September 19, 2011. The changes that became effective September 19, 2011 for the "qualified client" definition under the Advisers Act involved changing the previous $750,000 AUM test to $1 million and the current net worth test to $2 million. The value of a person's primary residence and certain debt secured by the property may not be included in the net worth test. Either of these tests must be met at the time of entering into the advisory contract. Investment Advisers that impose performance fees should prepare to amend form advisory agreements to account for the new thresholds for contracts entered into after September 19, 2011. Investment Advisers that manage hedge funds, private equity funds, or other private funds that impose performance fees or incentive/carried interest allocations **should have revised subscription agreements as follow**:

- Investors first investing between September 19, 2011 and May 22, 2012 are subject to the $1 million AUM and $2 million net worth thresholds, but these are calculated by including the value of the person's primary residence.

- Investors first investing as of or after May 22, 2012 are subject to the $1 million AUM and $2 million net worth thresholds, but the calculation excludes the value of the person's primary residence.
- There are two grandfather provisions. (1) Registered Investment Advisers are permitted to continue to charge clients performance fees if the clients were considered qualified clients before the rule changes. (2) Newly registering Investment Advisers will be permitted to continue charging performance fees to those clients they were already charging performance fees.

Accredited Investor Definition Changes. The "accredited investor" definition has been amended to include any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million except that the person's primary residence may not be included as an asset for purposes of the calculation. Other final amendments to the relevant rules added provisions for the treatment of debt secured by the primary residence and a grandfathering provision that permits the application of the former net worth test in certain limited circumstances. **Investment Advisers should revise subscription agreements for the clarified threshold calculation** as follows:

- Any investor making a first investment or making an additional contribution on or after July 21, 2010 must exclude the value of the primary residence from the net worth calculation.
- Any investor making a first investment or making an additional contribution on or after February 27, 2012 must exclude the value of the primary residence from the net worth calculation in addition to observing the provisions added by the other final amendments described above.
- Investors must qualify under the standard in effect at the time of each new investment contribution.

Form PF. The SEC and the Commodity Futures Trading Commission ("CFTC") adopted new reporting rules on October 31, 2011. The new SEC rule under the Advisers Act requires Investment Advisers that advise one or more private funds and have at least $150 million in private fund AUM to file the Form PF with the SEC. The new CFTC rule requires commodity pool operators ("CPOs") and commodity trading advisors registered with the CFTC to satisfy specific filing requirements with respect to private funds by filing the Form PF with the SEC in certain circumstances. The Form PF has quarterly and annual filing requirements based on a number of factors, including amounts and types of assets.

- Large hedge fund advisers[1] must file the Form PF within 60 days of each fiscal quarter end, with the first filing after the end of the first fiscal quarter ending on or after June 15, 2012.
- Large liquidity fund advisers[2] must file the Form PF within 15 days of each fiscal quarter end, with the first filing after the end of the first fiscal quarter ending on or after June 15, 2012.
- All other filers[3] must file the Form PF within 120 days of each fiscal year end, as applicable, on or after December 15, 2012.
- Under initial compliance, many advisers will not need to file their first Form PF until 2013.

New CFTC Rules. In a February 9, 2012 Final Rule, the CFTC rescinded Section 4.13(a)(4), which provided private pools with an exemption from registration as a CPO with the CFTC. Investment Advisers operating 3(c)(7) private funds will no longer be able to claim exemption from CPO registration for funds offered only to institutional qualified eligible purchasers ("QEP") and natural persons that meet QEP requirements that hold more than a de minimis amount of commodity interests. The exemption under Section 4.13(a)(3) was retained, which provides exemption from CPO registration in cases where the pool trades minimal amounts of futures such that at all time either (a) the aggregate initial margin and premiums required to establish the fund's commodity interest positions may not exceed 5% of the fund's liquidation value or (b) the aggregate notional value of the fund's commodity interest positions may not exceed 100% of the fund's liquidation value. Advisers that had relied on the Section 4.13(a)(4) exemption will either need to avail themselves of the Section 4.13(a)(3) exemption or register as a CPO, i.e., both 3(c)(1) or 3(c)(7) pools will have to comply with the 4.13(a)(3) exemption or register.

Continuing Compliance Areas

Update Form ADV. An Investment Adviser must file an annual amendment to Form ADV Part 1 and Form ADV Part 2 within 90 days of the end of its fiscal year. Part 1 and Part 2A of the Form ADV must be filed with the SEC through the electronic IARD system. Accordingly, if you are SEC-registered adviser whose fiscal year ends on or after December 31, 2011, you must file Part 1A and Part 2A Brochure as part of your annual updating amendment by March 30, 2012. If you are a state-registered adviser whose fiscal year ends on or after December 31, 2011, you must also file Part 1A, Part 1B, Part 2A Brochure and 2B Brochure Supplement as part of your annual updating amendment by March 30, 2012.

New Form ADV Part 1. Part 1 of Form ADV has been amended, most importantly, with regard to the calculation of AUM and auditor information. The Form now contains a uniform method of calculating AUM, and eliminates adviser discretion in including or excluding certain assets from the AUM calculation.

Form ADV Ongoing Updates. Investment Advisers must amend Part 1 of their Form ADV promptly during the year if certain information becomes materially inaccurate. The brochure and supplement must also be updated promptly during the year if any information becomes materially inaccurate unless the material inaccuracies result solely from changes in the amount of client assets managed or changes to the fee schedule.

FINRA Entitlement Program. FINRA implemented changes to its Entitlement Program, which provides access to an Investment Adviser's IARD account. Every adviser firm (new and existing) is now required to designate an individual as its Super Account Administrator (SAA). The SAA must be an authorized employee or officer of the adviser firm.

Fund IARD Account. An Investment Adviser must ensure that its IARD account is adequately funded to cover payment of all applicable registration renewal fees and notice filing fees.

State Notice Filings/Investment Adviser Representatives. An Investment Adviser should review its advisory activities in the various states in which it conducts business and confirm that all applicable notice filings are made on IARD. In addition, an Investment Adviser should confirm whether any of its personnel need to be registered as "investment adviser representatives" in any state and, if so, register such persons or renew their registrations with the applicable states.

Brochure Rule. On an annual basis, an Investment Adviser must provide its clients and separate account client(s) with a copy of its updated Form ADV Part 2A, or provide a summary of material changes and offer to provide an updated Form ADV Part 2A. An adviser could meet its delivery obligation to a hedge fund client by delivering its brochure to a legal representative of the fund, such as the fund's general partner. Delivery is required within 120 days of the end of the adviser's fiscal year.

Annual Assessment of Compliance Program. At least annually, an Investment Adviser must review its compliance policies and procedures to assess their effectiveness. The annual assessment process should be documented and such document(s) should be presented to the Investment Adviser's chief executive officer or executive committee, as applicable, and maintained in the Investment Adviser's files. At a minimum, the annual assessment process should entail a detailed review of:

- (1) the compliance issues and any violations of the policies and procedures that arose during the year, changes in the Investment Adviser's business activities and the effect that changes in applicable law, if any, have had on the Investment Adviser's policies and procedures;

- (2) the Investment Adviser's Code of Ethics, including an assessment of the effectiveness of its implementation and determination of whether they should be enhanced in light of the Investment Adviser's current business practices;
- (3) the business continuity/disaster recovery plan, which should be "stress tested" and adjusted as necessary;
- (4) the Social Media policies and procedures, which the SEC recommends all Investment Advisers should adopt as part of their compliance policies and procedures; Investment Advisers should consider adding such policies and procedures if they have not already done so;
- (5) review compliance with side letters and other special terms policies and procedures; and,
- (6) the Whistleblower policies and procedures, which Investment Advisers should consider adopting or reviewing in light of recent SEC rules that implemented the whistleblower program that became effective in August 2011. Under the new rules, persons who provide information to the SEC about a violation of any securities law may be eligible in certain situations to receive 10 to 30 percent of amounts recovered by the SEC. Advisers should consider internal policies that promote employee reporting of violations.

Custody; Annual/Surprise Audit. Private fund Investment Advisers should have their funds audited by a PCAOB registered independent account and provide audited financial statements of their fund(s), prepared in accordance with U.S. generally accepted accounting principles, to the fund(s)' investors within 120 days of the end of the fund(s)' fiscal year. Investment Advisers that do not have their private funds audited should determine whether they are deemed to have custody of those funds' assets and therefore are subject to an annual surprise audit and other requirements.

Annual Privacy Notice. Under SEC Regulation S-P, an Investment Adviser must provide its fund investors or client(s) who are natural persons with a copy of the Investment Adviser's privacy policy on an annual basis, even if there are no changes to the privacy policy.

New Issues. Compliance should now address FINRA Rule 5131, which became effective in May 2011 and prohibits quid pro quo and "spinning" allocations of new issues of securities and addresses the book-builiding, new issue pricing, penalty bids, trading and waivers of lock-up agreements by member firms and associated persons. This new rule must be observed in addition to Rule 5130, whereby an Investment Adviser that acquires "new issue" IPOs for a fund or separately managed client account must obtain written representations every 12 months from the fund or account's beneficial owners confirming their continued eligibility to participate in new issues. This annual representation may be obtained through "negative consent" letters.

ERISA. An Investment Adviser may wish to reconfirm whether its fund(s)' investors are "benefit plan investors" and whether investments by benefit plan investors result in fund assets being characterized as "plan assets" for purposes of reconfirming its fund(s)' compliance with the 25% "significant participation" exemption under ERISA. This is particularly important if a significant amount of a fund's assets have been withdrawn or redeemed, and some Investment Advisers may need to check compliance procedures with each investment or withdrawal. The reconfirmation may be obtained through "negative consent" letters.

Anti-Money Laundering. FinCEN may consider a new round of proposed anti-money laundering regulations for unregistered investment companies, certain investment advisers and commodity trading advisors. An Investment Adviser is still subject to the economic sanctions programs administered by OFAC and should have an anti-money laundering program in place. An Investment Adviser should review its anti-money laundering program on an annual basis to determine whether the program is reasonably designed to ensure compliance with applicable law given the business, customer base and geographic footprint of the Investment Adviser.

FBAR Reporting. A U.S. person is required to file a Report of Foreign Bank and Financial Accounts ("FBAR") if they have a financial interest in or signature authority over a foreign bank, securities or other financial account (e.g., a prime brokerage account) in another country. Failure to file this form when required can result in significant penalties. Financial accounts that may be subject to FBAR reporting include accounts of a mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions. Private offshore funds, such as hedge funds and private equity funds (e.g., a Cayman Island "mutual fund") are *not deemed* to be a foreign financial account, and therefore investment advisers are not required to file an FBAR with respect to these funds. However, if these private funds have either a foreign bank account, foreign prime brokerage account, or other foreign financial account, and the adviser has signature authority over those accounts, then the adviser may have to file an FBAR with respect to those accounts.

"Pay-to-Play". The SEC adopted two measures on June 30, 2010 to prevent "pay-to-play" practices by Investment Advisers seeking to manage funds for state and local governments. The SEC adopted amendments to these rules in 2011. The amendments cover a multitude of topics, including the prohibition of soliciting or coordinating campaign contributions from others for elected officials in a position to influence the selection of the adviser. With regard to California, generally employees of "external managers" fall under the definition of "placement agent" requiring lobbyist registration. There are exceptions. Employees (i.e., partners, members, etc.) who spend at least 1/3 of their time during a calendar year managing assets (i.e., securities) will not fall under the "placement agent" definition and may solicit from California state public plans. This would require a portfolio manager-type to be involved in marketing to covered entities. The second exception, a 3-prong test requires that the manager be selected through a competitive bidding process, which is rare, so this exception may not be helpful.

Special Purpose Vehicles of Investment Advisers. In January 2012, the SEC confirmed that, subject to certain conditions, it would not recommend enforcement action to the SEC under the Advisers Act against an Investment Adviser or a related Special Purpose Vehicle established to act as the general partner or managing member of a private fund managed by the Investment Adviser if the Special Purpose Vehicle does not separately register as an Investment Adviser.

Amend Schedule 13G or 13D. An Investment Adviser whose client or proprietary accounts, separately or in the aggregate are beneficial owners of 5% or more of a registered voting equity security, and who have reported these positions on Schedule 13G, must update these filings annually within 45 days of the end of the calendar year, unless there is no change to any of the information reported in the previous filing (other than the holder's percentage ownership due solely to a change in the number of outstanding shares). An Investment Adviser reporting on Schedule 13D is required to amend its filings "promptly" upon the occurrence of any "material changes." In addition, an Investment Adviser whose client or proprietary accounts are beneficial owners of 10% or more of a registered voting equity security must determine whether it is subject to any reporting obligations, or potential "short-swing" profit liability or other restrictions, under Section 16 of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Section 16 Filings. Individuals or entities that hold a beneficial ownership of ten percent of any class of equity securities registered under Section 12 of the Exchange Act, if an officer or director of such issuer, may be required to file Form 3, 4, or 5 regarding crossing certain thresholds, reporting certain sales, and making certain annual reports.

Form 13F. An "institutional investment manager," whether or not an Investment Adviser, must file a Form 13F with the SEC if it exercises investment discretion with respect to $100 million or more in securities subject to Section 13(f) of the Exchange Act (e.g., exchange-traded securities, shares of closed-end investment companies and certain convertible debt securities), which discloses certain information about such its holdings. The first filing must occur within 45 days after the end of the calendar year in which the Investment Adviser reaches the $100 million filing threshold and within 45 days of the end of each calendar quarter thereafter, as long as the Investment Adviser meets the $100 million filing threshold.

Form 13H. The SEC adopted Rule 13h-1 under the Exchange Act which requires "Large Traders" meeting certain definitional thresholds in transactions in NMS securities to identify themselves to the SEC and make certain disclosures to the SEC on Form 13H, effective October 3, 2011. "Large Traders" are defined as any person that exercises investment discretion over one or more accounts and effects transactions of NMS securities for or on behalf of such accounts, in an aggregate amount of at least $20 million in a day or $200 million in a month. In addition to an initial filing, all large traders must submit an annual filing on Form 13H within 45 days after the end of the calendar year and submit any amendments promptly after the end of any calendar quarter where information in the form becomes materially inaccurate.

Treasury International Capital System ("TIC") Forms:

- TIC Form SLT. Adopted in 2011, the Form SLT is required to be submitted by entities with consolidated reportable holdings and issuances with a fair market value of at least $1 billion as of the last day of any month. The first filing was required to be submitted by January 23, 2012 for consolidated data as of December 31, 2011.
- TIC Form SHC. The Form SHC is a mandatory survey of the ownership of foreign securities, including selected money market instruments, by U.S. residents as of December 31, 2011. The form must be submitted by fund managers and other entities required to do so no later than March 2, 2012.

Offering Materials. As a general securities law disclosure matter, and for purposes of U.S. federal and state anti-fraud laws, including Rule 206(4)-8 of the Advisers Act, an Investment Adviser must continually ensure that each of its fund offering documents is kept up to date, consistent with its other fund offering documents and contains all material disclosures that may be required in order for the fund investor to be able to make an informed investment decision.

Full and accurate disclosure is particularly important in light of *Sergeants Benevolent Assn. Annuity Fund v. Renck*, 2005 NY Slip op. 04460, a recent New York Appellate Court decision, where the court held that officers of an investment adviser could be personally liable for the losses suffered by a fund that they advised if they breached their implied fiduciary duties to the fund. The fiduciary nature of an investment advisory relationship and the standard for fiduciaries under the Advisers Act includes an affirmative duty of utmost good faith, and full and fair disclosure of all material facts, and an affirmative obligation to use reasonable care to avoid misleading clients.

Accordingly, it may be an appropriate time for an Investment Adviser to review its offering materials and confirm whether or not any updates or amendments are necessary. In particular, an Investment Adviser should take into account the impact of the recent turbulent market conditions on its fund(s) and review its fund(s)' current investment objectives and strategies, valuation practices, performance statistics, redemption or withdrawal policies and risk factors (including disclosures regarding market volatility and counterparty risk), its current personnel, service providers and any relevant legal or regulatory developments.

Blue Sky Filings/Form D. Many state securities "blue sky" filings expire on a periodic basis and must be renewed. Accordingly, now may be a good time for an Investment Adviser to review the blue-sky filings for its fund(s) to determine whether any updated filings or additional filings are necessary. We note that all Form D filings for continuous offerings will need to be amended with the SEC on an annual basis.

Liability Insurance. Due to an environment of increasing investor lawsuits and regulatory scrutiny of fund managers, an Investment Adviser may want to consider obtaining management liability insurance or review the adequacy of any existing coverage, as applicable.

If you have any questions regarding the summary above, please feel free to contact us.

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[1] Large hedge fund advisers are advisers with at least $1.5 billion under management attributable to hedge funds.

[2] Large liquidity fund advisers are advisers with at least $1 billion in combined AUM attributable to liquidity funds and registered money market funds.

[3] This group includes smaller private fund advisers and large private equity fund advisers, which are advisers with at least $2 billion in AUM attributable to private equity funds. All advisers with at least $150 million in AUM that are not considered large hedge fund advisers, large liquidity fund advisers, or large private equity fund advisers are considered smaller private fund advisers.

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