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VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Consequences of Registration Under the Investment Advisers Act of 1940

This article discusses, in summary form, various disclosure, reporting, and other obligations imposed upon registered investment advisers under the Investment Advisers Act of 1940 (Advisers Act) and related federal securities law. It does not describe every requirement to which a registered adviser may be subject, such as fiduciary duties under the Investment Company Act of 1940.

Disclosure and Filings

Disclosures in Form ADV

The registration form for advisers, Form ADV, requires disclosure of, among other things, (1) the ownership of the adviser (by percentage range, not by exact amount of ownership interest); (2) the disciplinary history of the adviser, certain affiliates of the adviser, and the adviser's officers, directors, and employees; and (3) the adviser's management and trading practices, including any conflicts of interest. Currently, Part 1A of Form ADV is filed electronically through the Investment Adviser Registration Depository (IARD) and these forms are publicly available over the Internet. Part II of Form ADV, which is given to prospective clients, is completed in paper and is not filed with the SEC, and the SEC has proposed to amend it and require it to be filed electronically.

Disclosure of Material Financial and Disciplinary Information

Rule 206(4)-4 under the Advisers Act requires all advisers to disclose certain material financial and disciplinary information to their clients, such as a financial condition of the adviser that is reasonably likely to impair the adviser's ability to meet its contractual commitments to clients, or any legal or disciplinary event that is material to an evaluation of the adviser's integrity or ability to meet contractual commitments to clients. Certain defined legal or disciplinary events involving the adviser or any management person of the adviser are presumed material; the presumption is rebuttable. The SEC has proposed to delete this rule and incorporate its substance into Form ADV, but has not taken action on this proposal.

State Filings

SEC-registered advisers generally must make notice filings in states where they have a place of business and clients. Notice filings are made through the IARD using Form ADV. Advisory employees who provide advice to "retail" clients must register as "investment advisory representatives" (IARs) in the state where they have an office. The state in which an adviser makes a notice filing retains the right to inspect the adviser only for allegations of actions that would violate the state's adviser antifraud statutes and rules.

Form ADV Distribution

Registered advisers must furnish each present and prospective advisory client with a copy of a written disclosure document, the adviser's "brochure," which consists of Part II of the adviser's Form ADV and Schedule F of Form ADV.

Privacy Policy

Registered advisers are covered by Regulation S-P, the SEC's privacy rules, and must provide a statement of their privacy policies to new clients and to current clients at least annually.

Section 13 Filings

A registered adviser can file Schedule 13G to report significant (5% or greater) ownership of a company, instead of the more onerous Schedule 13D, assuming that the registered adviser does not have a control purpose. Form 13F reporting is the same for registered advisers as it is for unregistered advisers.

Antifraud

Antifraud Provision

Section 206 of the Advisers Act generally makes it unlawful for an investment adviser to engage in fraudulent, deceptive, or manipulative conduct. Section 206 is broader than the antifraud provisions in the federal securities laws. Unlike Rule 10b-5 under the the Securities Exchange Act of 1934 (1934 Act), Section 206 is not limited to situations involving the purchase or sale of a security, but can be applied in other circumstances. Section 206 applies to all advisers, whether required to be registered or not. The SEC may bring an enforcement action under Section 206 even if there is no actual injury to a client. Generally, there is no private right of action under Section 206.

Sections 206(1) and 206(2) generally prohibit an adviser from employing a "device, scheme or artifice" to defraud clients or engaging in a "transaction, practice or course of business" that operates as a "fraud or deceit" on clients. While these provisions are often construed together, there are some differences, the most notable being that *scienter* is generally required to find a violation of Section 206(1) while it is not required to find a violation of Section 206(2).

Among the many types of activities that have been found or alleged to violate Sections 206(1) or 206(2) are front-running; misrepresenting pricing methodology or failing to follow disclosed valuation methods; favoring certain clients or proprietary accounts in allocating initial public offerings or other trades without adequately disclosing this practice; taking advantage of investment opportunities belonging to the client; and failing to disclose the following: (a) commission-splitting arrangements, (b) soft-dollar practices, (c) a personal financial interest in securities recommended to clients or related conflicts of interest, (d) "double fees" received from clients' assets invested in a fund the adviser manages, (e) that clients paid materially different commissions due to directed brokerage arrangements, and (f) that the prices obtained for clients were not the most favorable under the circumstances.

Sections 206(1) and 206(2) require an adviser to make full and adequate disclosure to clients on matters that may affect the adviser's independence and judgment. Section 206 is intended to bring conflicts of interest to the attention of clients to permit fully informed decisions regarding the adviser. While the amount and nature of the disclosure required depend on the facts and circumstances of each case, the duty of disclosure in situations involving a potential conflict of interest has generally been construed to be broader than under normal circumstances (i.e., more extensive and detailed disclosures are required). Examples of potential conflicts of interest, and the high standard of disclosure to which they are subject, include:

- Where an adviser receives compensation, directly or indirectly, from a source other than the client for recommending a security, the nature and extent of the compensation must be set forth.
- Where an adviser owns or is affiliated with a broker through which clients' transactions will be traded, the nature and extent of the adviser's interest or affiliation and the fact that the adviser may benefit from the transactions should be disclosed.

- Where an adviser (or an affiliate) will be buying or selling the same securities as a client, the client should be informed as to whether the adviser may recommend a security it also owns, or whether the adviser (or an affiliate) may take the position inconsistent with the client's position.
- Where an adviser or related party compensates a third party for referring a client, the material terms of the arrangement should be disclosed to the client.

An adviser is also subject to the antifraud provisions of the other federal securities laws, such as Section 17(a) of the 1933 Act and Rule 10b-5 under the 1934 Act, and may be subject to state fiduciary provisions.

In addition to the specific prohibitions in Section 206, the Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.* held that Section 206 imposes a fiduciary duty on advisers by operation of law. The purpose of this duty is to eliminate conflicts of interest and to prevent an adviser from overreaching or taking unfair advantage of a client's trust. As a fiduciary, an adviser owes its clients more than honesty and good faith alone. Rather, an adviser has an affirmative duty of "utmost good faith to act solely in the best interests of the client and to make full and fair disclosure of all material facts, particularly where the adviser's interests may conflict with the client's. Pursuant to this duty, an adviser must at all times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions." Among the specific obligations that the SEC has indicated flow from an adviser's fiduciary duty are the following:

- A duty to have a reasonable, independent basis for its investment advice
- A duty to obtain best execution for clients' securities transactions when the adviser has brokerage discretion
- A duty to ensure that its investment advice is suitable to the client's objectives, needs, and circumstances
- A duty to refrain from effecting personal securities transactions inconsistent with client interests
- A duty to be loyal to clients.

Compliance Policies and Procedures; Chief Compliance Officer

A registered adviser must (a) adopt and implement written policies and procedures reasonably designed to prevent violation, by the adviser and its supervised persons, of the Advisers Act and the rules thereunder; (b) review, at least annually, the adequacy of the policies and procedures and the effectiveness of their implementation; and (c) designate an individual (who is a supervised person) as the Chief Compliance Officer responsible for administering the policies and procedures, all pursuant to Rule 206(4)-7.

Advertising and Referrals

Advertising

A registered adviser's advertising is regulated primarily under Rule 206(4)-1 under the Advisers Act. An "advertisement" includes any notice, circular, letter, or other written communication addressed to more than one person (or any notice or other announcement in any publication or by radio or television) that offers, among other things, "any investment advisory service with regard to securities." Among other things, the Rule prohibits the use of client testimonials, restricts the use of past specific recommendations, and contains an antifraud provision. Numerous SEC staff no-action and interpretive letters have set out advertising guidance on the use of past performance, model portfolios, the effect of fees on performance, and comparisons of performance to indices. Whether any particular advertisement is false or misleading will depend on the particular facts and circumstances surrounding its use, including (1) the form and content of the advertisement, (2) the implications or inferences construed from the advertisement in its total context, and (3) the sophistication of the prospective client. The burden of

determining what is "false or misleading" is therefore placed squarely on the adviser itself. Except in one-on-one situations, the SEC requires that any performance advertising include net performance as well as gross performance.

Payments for Referrals

Rule 206(4)-3 allows a registered adviser to pay a fee to a third-party solicitor who has obtained clients for the adviser if certain conditions are met. In general, a solicitor must provide any potential client with copies of (1) the adviser's current brochure and (2) a disclosure statement describing the terms of the solicitation agreement between the adviser and the solicitor (including information as to fees paid to the solicitor). The adviser must keep a signed, written confirmation that the client has received the disclosure materials.

Custody

Custody or Possession of Client Funds or Securities

An adviser who has custody or possession of any client funds or securities (including the ability to deduct fees from an account) must comply with certain asset "safekeeping" requirements in Rule 206(4)-2. The SEC has proposed to amend the custody rule to require, among other things, that advisers with custody (including the ability to deduct fees) undergo an annual surprise verification of client assets in their custody, and that advisers that self-custody or use a related person as custodian obtain an internal controls report (SAS 70) performed by an independent accountant licensed with and regulated by the Public Company Accounting Oversight Board. Comments on the proposed amendments were due July 28, 2009.

Trading Practices

Portfolio Management Practices

A number of portfolio management practices, while not specifically barred by the Advisers Act, may be found to violate the antifraud provisions of the Act. The following rules apply generally to an adviser's portfolio management practices:

1. Brokerage must be allocated generally on the basis of "best execution" of the client's trade orders.

2. Purchases of securities for clients must be "suitable" for client needs and meet any and all requirements set out in the relevant advisory contract.

3. Advisers must not engage in excess trading in accounts (churning).

4. If the adviser receives goods or services from broker-dealers in return for brokerage placed, and the adviser pays more than the lowest available commission (soft-dollar arrangement), either the services must be "research" within the meaning and intent of Section 28(e) of the 1934 Act, or the contract must specifically disclose the types of nonresearch goods and services the adviser will receive. To qualify under Section 28(e), the research must assist the adviser in its investment decision-making functions. Registered funds and ERISA plans can "pay up" only for products and services within the safe harbor.

5. Advisers must have fair and equitable formulas for determining (a) the allocation of securities and (b) the dissemination of recommendations among diverse clients, and apply these formulas consistently.

Principal Transactions

No adviser may engage in any principal transaction unless the adviser discloses to the client, prior to the completion of the trade and in writing, that the adviser will be acting as principal, the cost to the adviser of any security that he or she proposes to sell to the client, or the resale price of any security that he or she proposes to buy from the client, and the best price at which the transaction could be effected by or for the client elsewhere if that price is more advantageous to the client than the actual purchase or sale price. The client must consent to each such transaction; blanket disclosure and consent is not permitted. The principal trade restrictions extend to client trades executed by an affiliate of the adviser acting as principal.

Agency Cross-Transactions

Advisers may effect agency cross-transactions (when the adviser also acts directly or through an affiliate as broker for both the client and a person on the other side of the transaction) under certain conditions. These transactions are not permissible if the adviser, acting alone or with an affiliated broker-dealer, recommends the transaction to both the purchaser *and* seller. However, in other cases these transactions are permissible provided the adviser makes certain disclosures to the client and the client consents (blanket disclosures and consents are allowed) and the adviser sends the client periodic information about agency cross-trades.

Books and Records

Recordkeeping Rule

Registered advisers must make and keep certain records listed in Rule 204-2, the recordkeeping rule. These records are subject to SEC inspection at any time. In addition to the usual records relating to client trades and the adviser's business, an adviser also must keep copies of materials that back up its claims of performance and copies of employee reports of personal trading (which could include duplicate confirmations and accounts statements). All records required to be kept pursuant to Rule 204-2 must be kept for not less than five years from the end of the fiscal year during which the last record entry was made. Records relating to the most recent two years must be kept at the adviser's office; records for the remaining time may be kept in any "easily accessible place," and may be preserved on microfilm or computer provided they are safeguarded, easily accessible, and reproducible.

Supervision

Insider Trading Policy

Section 204A requires every registered adviser to adopt, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by the adviser or any of its affiliates or employees. The SEC is authorized to bring a court action against a person who, at the time of the violation, directly or indirectly controlled the person who committed the alleged violation. An adviser or controlling person that violates this provision faces a civil penalty of up to $1,000,000 or three times the amount of profit gained or loss avoided by the controlled person's violation.

Supervisory Policies

An adviser should incorporate supervisory policies as part of its compliance policies and procedures. In addition, there is a safe harbor in Section 203(e)(6) that exculpates an adviser from liability for failure to supervise an employee if the adviser adopted and followed policies that would reasonably have been expected to prevent and detect an employee's bad acts.

Contract Provisions

Assignment of Advisory Contract

A registered adviser's advisory contract must state that the adviser may not assign the contract without the consent of the client. "Assignment" includes any indirect transfer or hypothecation of an investment advisory contract, or any transfer of a "controlling" block of the assignor's outstanding voting securities. "Control" means the power to exercise a controlling influence over the management or policies of the adviser, unless the power is solely the result of an official position with the adviser (e.g., a portfolio manager who has no ownership interest in the firm). Ownership of 25% or more of an adviser's outstanding voting securities is generally presumed to be "control."

Performance Fees

Section 205(a)(1) prohibits a registered adviser from charging a performance fee to a client. Rule 205-3 under the Advisers Act conditionally exempts from Section 205(a)(1) performance fees charged to certain "sophisticated" clients who have at least $750,000 under the adviser's management, or a net worth of more than $1.5 million, including assets held jointly with a spouse.

Retirement Plans

ERISA Plans

Only a registered investment adviser, a bank, or an insurance company can serve as an "investment manager" to an ERISA plan, thus allowing the plan's sponsor to shift liability for investment decisions to the investment manager.

SEC Examinations and Enforcement Power

Examinations

The SEC can examine unregistered advisers, but only Section 206 of the Advisers Act applies to an unregistered adviser. The SEC's examination power over a registered adviser extends to all records required to be kept under the Advisers Act and the rules thereunder.

Enforcement

The SEC is empowered under Section 203 to censure an adviser; to limit its activities, functions, or operations; or to suspend (for a period not exceeding 12 months) or revoke the registration of any adviser (or any associate of the adviser) if it finds certain specified violations and the sanction is "in the public interest." In addition, the SEC may impose civil money penalties in administrative proceedings of up to $100,000 for any individual and up to $500,000 for any entity. Further, the SEC may issue cease-and-desist orders against any person who is violating, has violated, or is about to violate a securities law, or who causes a securities law violation, by negligence or failure to act. The SEC has authority to order accounting and disgorgement of profits resulting from securities law violations. Sanctions applicable to advisers also may apply to individuals associated with or seeking to be associated with an adviser. Finally, Section 217 of the Advisers Act provides courts with the authority to impose a fine of up to $10,000 and imprisonment of up to five years.

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This article is a summary of the consequences of registration under the Advisers Act. We can provide you with more information on any of the topics in this article. Morgan Lewis has published articles on, among others, such topics as custody and recordkeeping.

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For more information on the issues discussed here, please contact your Morgan Lewis [Private Investment Funds Practice] attorney.

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