COVINGTON

COVINGTON & BURLING LLP

ADVISORY | Private Fund Advisers

January 8, 2013

13 FOR '13

KEY AREAS OF FOCUS FOR PRIVATE FUND ADVISERS IN 2013

The elimination of the exemption from registration under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), for advisers with fewer than 15 clients resulted in the registration of approximately 1,500 additional investment advisory firms, many of which are advisers to one or more private funds.[1] With registration behind them, many private fund advisers are ringing in 2013 by expanding their knowledge of existing Advisers Act requirements and familiarizing themselves with a host of new regulatory requirements, both in the United States and abroad. Set forth below are several items that should be on every registered private fund adviser's radar early in the new year.

1) Form PF. Although Form PF will not be new for advisers to larger liquidity funds and hedge funds,[2] all other private fund advisers must make their first Form PF filing following the end of their first fiscal year or fiscal quarter, as applicable, ending on or after December 15, 2012. The amount of information and frequency of an adviser's Form PF filing depends on the size and types of private funds it manages; for example, most advisers to private equity funds must file Form PF within 120 days after their fiscal year end.[3] Form PF is filed electronically with the Securities and Exchange Commission (the "SEC"), but unlike Form ADV, is not publicly available. New Form PF filers should consider collecting the information required by the form early in 2013 to ensure that they are ready for the upcoming filing deadline.

2) CFTC Reaffirmation Filing. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") amended the Commodity Exchange Act to include swaps among the commodity interests that will cause a pooled investment vehicle to be considered a "commodity pool." Accordingly, funds engaging in any swap activities may now be considered commodity pools, with managers of such funds required to register as commodity pool operators ("CPOs") by December 31, 2012, unless an exemption applied. Many fund managers that use swaps solely for hedging purposes may have relied on one of the *de minimis* exemptions to the CPO registration

---

[1] "Dodd-Frank Act Changes to Investment Adviser Registration Requirements," *available at* <http://www.sec.gov/divisions/investment/imissues/df-iaregistration.pdf> (Oct. 1, 2012). A private fund is a fund that would be an investment company but for the exemptions provided under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, as amended.

[2] Advisers with at least $5 billion in regulatory assets under management attributable to either (i) hedge funds or (ii) liquidity and registered money market funds, as of the end of the calendar year or quarter ending after June 15, 2012, were subject to an earlier filing deadline for Form PF.

[3] Advisers need not file Form PF if they are (i) exempt from registration under the Advisers Act (including exempt reporting advisers), (ii) do not advise any private funds, or (iii) have less than $150 million in regulatory assets under management as of their most recently completed fiscal year end.

requirements.[4] Any manager choosing to rely on such an exemption was required to file a notice of exemption by December 31, 2012 with the National Futures Association ("NFA"). This notice, once filed, must be reaffirmed annually, within 60 days after the end of the calendar year. Under recently issued NFA guidance, this means that fund managers that filed for a *de minimis* exemption on or before December 31, 2012 must reaffirm the exemption by March 1, 2013, or it will be considered withdrawn.

3) Form ADV Annual Updating Amendment. Federally registered advisers and exempt reporting advisers must file updates to their Forms ADV at least annually, within 90 days after their fiscal year end (i.e., March 31, 2013 for a calendar year end adviser). The annual updating amendment must update the adviser's responses to all items on Form ADV, including changes in ownership structure, the firm's code of ethics, custody arrangements and conflicts of interest. Any material changes to the adviser's last annual update must be described in Part 2 of Form ADV. The filing fee for an annual updating amendment varies based on the adviser's assets under management.[5]

4) State Updates. Many states require SEC-registered advisers to make notice filings if the adviser does business in the state. Typically, these notice filings must be updated annually, and usually the update can be accomplished by checking a box on the adviser's Form ADV. Most states require an adviser to pay an annual fee in connection with the updated notice filing. Generally, states also require annual updating filings and filing fees for any "investment adviser representatives"[6] who are registered under state law.

5) Annual Compliance Review. The Advisers Act requires each adviser to review the adequacy of its policies and procedures no less than annually to determine their effectiveness. The chief compliance officer should examine the results of this review and update the adviser's compliance manual to address changes or developments in the legal or regulatory landscape and the adviser's business as well as changes that may affect the appropriateness of certain policies and procedures. An adviser must maintain for five years any records or evidence generated in connection with the annual compliance review, as well as copies of its policies and procedures that were in effect during the past five years.

6) United States Foreign Account Tax Compliance Act ("FATCA"). Under FATCA, certain foreign financial institutions ("FFIs"), including foreign private equity funds, foreign hedge funds, foreign parallel entities of U.S. funds, foreign blockers, and even foreign holding companies used by funds to acquire portfolio companies, will be required in the near future to enter into an information-reporting and withholding agreement with the U.S. Internal Revenue Service (the "IRS"). Under this agreement, covered FFIs will be required to perform due diligence on account holders (*e.g.*, the investors in the funds) to determine if the accounts are held by U.S. or foreign owners, and report on U.S.-owned accounts to the IRS. A 30% withholding tax will apply to payments received by FFIs that are required

---

[4] The *de minimis* exemptions are described in the following Covington E-Alert: Exemptions and No-Action Relief Help Funds Navigate Year-End CFTC Registration Requirements" (Dec. 19, 2012).

[5] The SEC's annual updating fee for an adviser with more than $100 million in regulatory assets under management is $225. An adviser must have sufficient funds deposited in its FINRA account to cover all fees associated with its Form ADV filing. Advisers should consider depositing sufficient funds several days in advance of their anticipated filing date as payment processing may take up to 48 hours.

[6] Rule 203A-3(a) under the Advisers Act defines an "investment adviser representative" as a supervised person who has (i) more than five clients and (ii) more than 10% of which are natural persons. The Advisers Act permits states to impose licensing, registration, qualification or examination requirements on investment adviser representatives, and the definition of an investment adviser representative varies from state to state.

to enter into the IRS agreement but fail to do so, and to certain payments made by compliant FFIs to account holders that cannot be verified as FATCA-compliant. It is expected that the withholding tax will begin to apply to payments made on or after January 1, 2014, but the requirements to begin collecting account information may commence as early as 2013. Private fund advisers should monitor the implementation of final FATCA regulations (which are anticipated to be released at any time) and consider revisions to subscription documents to require investors to provide the information necessary to comply with FATCA.

7) European Union Alternative Investment Fund Managers Directive (the "AIFM Directive"). The AIFM Directive is due to be implemented in EU member states by July 22, 2013. The AIFM Directive introduces a new regulatory regime for managers of investment funds that are not UCITS (Undertakings for Collective Investment in Transferable Securities) funds (*i.e.*, EU-established authorized retail funds). Accordingly, the AIFM Directive will apply to managers of all other fund types, including hedge funds, private equity funds, real estate funds, commodity funds, infrastructure funds and funds of funds. From July 22, 2013, U.S. and other non-E.U. managers marketing covered funds to investors in the European Union will be subject to certain minimum mandatory disclosure, reporting, filing and other requirements which will need to be met in relation to such marketing and on a continuing basis. In addition, no marketing in an EU member state by, or at the initiative of, a non-EU fund manager will be permitted unless a cooperation arrangement for the purpose of systematic risk oversight in line with international standards is in place between the regulator in that member state and the supervisory authorities in both the non-EU manager's home jurisdiction and the fund's jurisdiction of organization, if different. It is expected that, from 2015, U.S. and other non-EU managers managing covered funds which are established in the EU will be required to become authorized under the AIFM Directive (and become subject to EU regulatory supervision) and that, from 2018, authorization under the AIFM Directive also will be required for U.S. and other non-EU managers to market covered funds to investors in the European Union. Private fund advisers that are contemplating marketing fund interests to EU investors after July 22, 2013 will need to confirm that the applicable cooperation arrangements are in place and consider at an early stage how they will comply with the mandatory disclosure, reporting, filing and other requirements.

8) Office of Compliance Inspections and Examinations ("OCIE") Presence Examinations. The SEC staff has announced a new initiative to conduct risk-based examinations of advisers to private funds that recently registered with the SEC.[7] The SEC staff has indicated it will release guidance on any broad issues encountered during these private fund adviser examinations after the first two years of presence examinations.[8] Advisers should endeavor to complete any compliance housekeeping early in 2013 so that they are ready well in advance of receiving a notice of examination from OCIE.

9) Social Media. The use of social media by advisers and their supervised persons may implicate the Advisers Act rules on advertising and potentially create liability under the anti-fraud provisions of the Advisers Act and the federal securities laws. Retaining copies of social media posts also may present practical compliance challenges under the Advisers Act recordkeeping rules. Advisers should adopt, and periodically review the effectiveness of, specific policies and procedures on social

---

[7] OCIE, "Letter regarding National Exam Program," *available at* <http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf> (Oct. 9, 2012) (the "OCIE Letter"). The SEC staff has indicated that it currently does not anticipate examining exempt reporting advisers on a regular basis, but will do so if there are indications of wrongdoing, such as from tips or complaints. "Rules Implementing Amendments to the Investment Advisers Act of 1940," Release No. IA-3221 (June 22, 2011).

[8] OCIE Letter.

media, and may consider pre-approval requirements and usage guidelines to address the work-related use by their supervised persons of social media sites and any content to be posted thereon.

10) Valuation and Fees. Advisers to private funds may encounter challenges in valuing private fund investments, given that many such investments are illiquid or otherwise difficult to value. An adviser should assess the effectiveness of, and its disclosure relating to, valuation policies and procedures, the use of a fund's valuation to calculate management fees and performance fees and the allocation of fees and expenses to private funds. An adviser's approach to valuation and fees likely will be an area of focus during any presence examination by OCIE. [9]

11) Advertising. Advertisements must not be false or misleading or contain any untrue statements of material fact. An "advertisement" is defined broadly under the Advisers Act and may include offering memoranda, slides used in marketing presentations and emails sent to multiple parties. Although the SEC staff has not released any new guidance on advertising, they have indicated it is an area of focus during presence examinations.[10] Accordingly, advisers that use prior performance data in their advertisements should confirm that the information is not presented in a misleading manner and provides meaningful information to investors. Additionally, an adviser would be well advised to ensure that it is not inadvertently distributing a prohibited testimonial through social media, such as a statement of a client's favorable investment experience or an endorsement of the adviser (i.e., "liking" on Facebook or a recommendation on LinkedIn).

12) Conflicts of Interest. The SEC staff has identified conflicts of interest as a key area of interest during OCIE compliance exams, including conflicts associated with compensation, portfolio management, valuation and an adviser's interactions with its affiliates.[11] Advisers should take care to identify the material potential conflicts presented by their operations, including the provision of investment advice to private funds, and ensure that such conflicts are properly managed and disclosed. Advisers also should review their conflicts practices at least annually, if not more frequently, to ensure that their policies and procedures are responsive to new conflicts that emerge as their business evolves and throughout the life cycle of the private funds they advise.

13) Insider Trading. An adviser should confirm that its insider trading policy is appropriate for its size and business model and that it has provided adequate training to its employees on the perils of insider trading. In addition to increased enforcement activity relating to insider trading more generally, the SEC has sanctioned advisers for failing to maintain effective insider trading polices without any underlying misuse of material nonpublic information or other wrong-doing.[12]

---

[9] OCIE Letter.

[10] *See id.*

[11] Carlo V. di Florio, "Conflicts of Interest and Risk Governance," National Society of Compliance Professionals, *available at* <http://www.sec.gov/news/speech/2012/spch103112cvd.htm> (October 22, 2012).

[12] Examples of such enforcement actions include *In re Janney Montgomery Scott LLC*, Release No. 34-64855, Administrative Proceeding File No. 3-14459 (July 11, 2011), and *In re Morgan Stanley & Co.*, Release No. 34-54047 (June 27, 2006).

If you have any questions concerning the material discussed in this client advisory, please contact the following members of our corporate practice group:

Kerry Burke (co-author)	+1.202.662.5297	kburke@cov.com
Simon Currie	+44.(0)20.7067.2011	scurrie@cov.com
Julian Hammar	+1.202.662.5628	jhammar@cov.com
Lisa Koff	+1.212.841.1053	lkoff@cov.com
Loretta Shaw-Lorello	+1.212.841.1073	lshawlorello@cov.com
Dirk Suringa	+1.202.662.5436	dsuringa@cov.com
Cory Levine (co-author)	+1.202.662.5277	clevine@cov.com