SEC-Registered Investment Advisers:

Regulatory Requirements Memorandum

February 2022

CONFIDENTIAL

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I. Introduction

This Memorandum discusses regulatory requirements imposed upon investment advisers registered with the Securities and Exchange Commission ("SEC"). Investment advisers register under and are subject to the provisions of the Investment Advisers Act of 1940, as amended (the "Advisers Act") and rules thereunder. Advisers are also subject to other laws and other regulations, certain of which are discussed in the Appendix.

II. Definition of Investment Adviser

As defined in Section 202(a)(11) of the Advisers Act, an "investment adviser" is any person who, "for compensation, engages in the business of advising others ... as to the value of securities or as to the advisability of investing in, purchasing, or selling securities…." There are certain exceptions to the definition set forth in Section 202(a)(11).[1] An investment adviser is required to register with the SEC under the Advisers Act unless otherwise exempted or excluded.[2]

Subject to certain exceptions, investment advisers with less than $25 million of regulatory assets under management may not register with the SEC, but may be required to register with the appropriate state authorities.

Investment advisers with assets under management of over $25 million must register with the SEC unless the adviser meets the definition of a "Mid-Sized Investment Adviser" or is otherwise exempted or excluded from the registration requirements of the Advisers Act.[3] A "Mid-Sized Investment Adviser" is defined as an adviser with assets under management between $25 million and $100 million that is (i) required to be registered in the state where it maintains its principal office and place of business; and (ii) if registered, would be subject to examinations by the state. The only state that does not subject investment advisory firms to examinations is New York State, and therefore, Mid-Sized Investment Advisers in New York State must register with the SEC.

Most states separately regulate investment advisers who either engage in the advisory business from, or advise clients who are residents of, their respective states. The registration procedures, qualification requirements and registration exemptions differ from state to state. SEC registered investment advisers are exclusively regulated by the SEC and therefore are not required to also register with any state. Nevertheless, (i) SEC registered investment advisers may be required to submit "notice filings" and pay fees (*see* Section III.B. below) to (a) states in which they have a place of business or (b) states in which they have no place of business but do not qualify for a *de minimis* exemption based on the number of clients in such state; (ii) state authorities may investigate and bring enforcement actions involving fraud or deceit against an adviser or persons associated with an adviser; and (iii) state authorities may require the licensing, registration or other qualification of "investment adviser representatives" who have a "place of business" in such states.[4]

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[1] For example, broker-dealers are excepted from the definition of "investment adviser" provided that their provision of any advisory services are "solely incidental" to the conduct of their brokerage business and when those incidental advisory services are provided for no special compensation. *See* SEC Release No. IA-5249 (June 2019) *available at* https://www.sec.gov/rules/interp/2019/ia-5249.pdf.

[2] Certain advisers that are not required to register with the SEC ("exempt reporting advisers") are required to complete and file with the SEC certain sections of the Form ADV Part 1A. Such exempt reporting advisers may be subject to SEC examination.

[3] The Dodd-Frank Wall Street Reform and Consumer Protection Act eliminated former Section 203(b)(3) of the Advisers Act, which exempted advisers who had fewer than 15 clients within the preceding 12 months and did not hold themselves out to the public as investment advisers. The SEC also adopted a rule exempting from the registration requirement any U.S. or non-U.S. adviser that acts as an adviser solely to private funds and manages private fund assets from the United States of less than $150 million. Effective March 12, 2018, the assets of small business investment companies (SBICs) are excluded from the definition of assets under management for purposes of the private fund adviser exemption and $150 million threshold. Investment advisers who solely advise venture capital funds (the definition of "venture capital funds", as of March 10, 2020, includes Rural Business Investment Companies) are exempt from registration with the SEC. *See* SEC Release No. IA-5454 (March 2020).

[4] Rule 203A-3 under the Advisers Act defines "investment adviser representative" to include a "supervised person" of an investment adviser (i) who has more than five clients who are natural persons other than "excepted persons" and (ii) more than 10% of whose clients are natural persons other than "excepted persons".

A "supervised person" is defined as any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an adviser, or other person who provides investment advice on behalf of the adviser and is subject to the supervision and control of the adviser. However, a supervised person will not be considered an investment adviser representative if the supervised person (i) does not on a regular basis solicit, meet with or otherwise communicate with clients of the investment adviser, or (ii) provides only impersonal investment advice.

An "excepted person" is a natural person or a company (i) that immediately after entering into the investment advisory contract with the investment adviser, has at least $1,000,000 under management with the investment adviser, or (ii) that the investment adviser reasonably believes either (a) has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2 million (excluding the value of such person's primary residence) at the time the contract is entered into, or (b) is a "Qualified Purchaser" as defined in Section 2(a)(51)(A) of the Investment Company Act, ""at the time the contract is entered into, or (iii) a natural person who immediately prior to entering into the contract is (a) an executive officer, director, trustee, general partner or person serving in a similar capacity, of the investment adviser, or (b) an employee of the investment adviser (other than one whose functions are solely clerical, secretarial or ministerial for the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such adviser, provided that such employee has been performing such functions and duties for or on behalf of the adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

For purposes of the definition of investment adviser representative, "place of business" is defined as (i) any office at which the investment adviser representative regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; or (ii) any other location that is held out to the general public as a location at which the investment adviser representative provides investment advisory services, solicits, meets with, or otherwise communicates with clients.

III. Registration with the SEC

An adviser registers with the SEC by completing Form ADV and filing it with the SEC. The Form contains several parts. Part 1A requests background information about the investment adviser, such as ownership information, disciplinary history, number of clients, assets under management, information regarding the adviser's separately managed account business, other offices, social media accounts, and whether the adviser has custody over client funds.[5] Part 1B is required for state-registered advisers. Part 2A and Part 2B request enhanced information regarding the adviser and its personnel in narrative form. In addition, Form ADV includes a Part 3 (also referred to as the "Form CRS" or the "relationship summary"), which requires advisers that have "retail investors"[6] to deliver a brief relationship summary to their retail clients and customers about the adviser and its business.

A. INITIAL REGISTRATION

To register with the SEC, an investment adviser must electronically file Part 1A and Part 2A of Form ADV and, if applicable, Part 3, via the Investment Adviser Registration Depository ("IARD"). IARD is a web-based system that provides a database of information on registered investment advisers. In order to access the IARD system, the adviser must first open an IARD account by completing the IARD "Entitlement Packet", which is *available at* https://www.iard.com/pdf/secentitlementpacket. Only persons authorized in the Entitlement Packet will have access to prepare or revise the Form ADV.

Once the Entitlement Packet is received and processed by IARD, the adviser will receive a Confirmation Package, including a password that will enable the adviser to access the IARD system and begin preparation of the Form ADV Part 1.[7] The IARD system permits the adviser to prepare the Form ADV Part 1 over a period of 120 days and to save the filing as a "draft" or "pending" filing. The Form will not be available to anyone other than the adviser's designated personnel or third-party agents until it has been filed.

The IARD also provides advisers with online access to the Part 2A and Part 3 items and instructions. Instead of completing Part 2A and Part 3 online, an adviser must draft its Part 2A brochure and Part 3, convert it to a text-searchable PDF, and attach the completed brochure and Part 3 to its filing on IARD. To update its Part 2A and Part 3, an adviser must make the necessary changes to the source file on its own system and then attach the revised versions to its IARD filing.[8]

An adviser will not be permitted to submit the electronic Form ADV filing until the appropriate funds have been deposited into the adviser's IARD financial account, either by check or wire transfer. There are two types of fees – an initial "set-up" fee and an annual amendment fee, each based on the adviser's assets under management, as updated from time to time at the following website: http://www.iard.com/fee_schedule.asp.

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[5] Additionally, Form ADV provides, subject to certain conditions, an "umbrella registration" on a single Form ADV for multiple private fund adviser entities operating a single advisory business.

[6] "Retail investor" is defined as "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes." General Instruction 11.E to Form CRS. In the SEC staff's view, investors in pooled investment vehicles such as hedge funds, private equity funds and venture capital funds would not meet the definition of "retail investor". *See* SEC Form CRS FAQs – Delivery Requirements *available at* https://www.sec.gov/investment/form-crs-faq.

[7] Prior to receiving the password, the Form ADV can be downloaded from the IARD web site.

[8] *See* General Instruction 7.A to Form CRS.

In addition, there are fees for each state's "notice filing", as described below, and additional fees for registering adviser representatives (if any) in the state(s) in which the representative has a place of business. There are no filing fees for "routine" amendments to the Form ADV.

The SEC imposes no examination requirements on registered investment advisers or their personnel. However, investment adviser representatives must comply with the examination and/or qualification requirements in the states in which they are required to be licensed.

Assuming that Part 1A and Part 2A and, if applicable, Part 3, are completed and filed satisfactorily, the SEC must either grant or deny the adviser's registration within 45 days of the filing.

Once registered, an investment adviser is subject to periodic inspections conducted by SEC staff.

B. NOTICE FILINGS

Certain advisers applying for registration with the SEC may also be required to provide state securities authorities with copies of the SEC filings. These are known as notice filings and will be sent automatically through IARD to the states checked in Item 2.B. of Part 1A of Form ADV. Payment of additional fees will be required for each state to which an adviser makes a notice filing and must be submitted to IARD before the Form ADV will be accepted. Certain states may also require receipt of a paper copy of the adviser's Form ADV. Notice filings are generally required in states in which the adviser has an office or in states where there is more than a *de minimis* number of advisory clients (which differs from state to state). To determine whether notice filings must be made and to review the filing requirements of a particular state, an adviser should analyze the relevant state investment adviser requirements.

IV. Disclosure Requirements

Part 2

Part 2 of Form ADV, which must be drafted in narrative form, is divided into two main components: Part 2A, which is known as the "Firm Brochure," and Part 2B, which is known as the "Brochure Supplement". The Firm Brochure is intended to provide advisory clients with information related to an adviser's fee arrangements, methods of analysis, investment strategies and risks, disciplinary information and conflicts of interest,[9] among other items. The Brochure Supplement is designed to provide advisory clients with more detailed information about each supervised person who either formulates investment advice for a client and has direct client contact or who makes discretionary investment decisions for client assets.

Part 2A. Part 2A of Form ADV includes 19 items (the first 18 of which apply to federally-registered investment advisers) that advisers must respond to in the following order and using the following headings:

- Cover Page
- Material Changes[10]
- Table of Contents
- Advisory Business
- Fees and Compensation[11]
- Performance-Based Fees and Side-By-Side Management
- Types of Clients
- Methods of Analysis, Investment Strategies and Risk of Loss
- Disciplinary Information
- Other Financial Industry Activities and Affiliations

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[9] The staff of the SEC's Division of Investment Management released an FAQ emphasizing that advisers should disclose conflicts of interest in their Form ADV Part 2 including the nature of the conflict and how the conflict is addressed. The FAQ reiterates that disclosure must include sufficiently specific facts to allow clients to understand the adviser's conflicts and business practices and that disclosing that the adviser "may" have a conflict is not adequate disclosure when the conflict actually exists. *See* https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation. *See also* Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation (April 18, 2019) *available at* https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation.

[10] Material Changes may alternatively be placed after the cover page or as an exhibit to the Firm Brochure.

[11] The SEC's Division of Examinations ("Division of Examinations"), formerly named the Office of Compliance and Inspections Examinations ("OCIE"), issued a Risk Alert on July 23, 2019 and observed that several advisers had undisclosed compensation arrangements, which resulted in conflicts of interests that could have impacted the impartiality of the advice the supervised persons gave to their clients. *See* https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Supervision%20Initiative.pdf.

- Code of Ethics, Participation or Interest in Client Transactions and Personal Trading
- Brokerage Practices
- Review of Accounts
- Client Referral and Other Compensation
- Custody
- Investment Discretion
- Voting Client Securities
- Financial Information
- Requirements for State-Registered Advisers

In addition, advisers that sponsor wrap fee programs must provide a separate wrap fee brochure that meets the requirements set forth in Appendix 1 of Part 2A.

Advisers must specifically disclose conflicts of interest related to particular items as well as explain how they address those conflicts of interest. The General Instructions for Part 2 recognize that, as a fiduciary, an adviser must seek to avoid conflicts of interest with its clients, and, at minimum, make full disclosure of all material conflicts of interest between the adviser and its clients that could affect the advisory relationship. This requires that the adviser provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest that the adviser has and the business practices in which the adviser is engaged, and can give informed consent to such conflicts or practices or reject them. To the extent that the items in Part 2 do not comprehensively address all of the conflicts or material disclosure that an adviser must provide to its clients, the adviser may have to disclose to clients information not specifically required by Part 2 of Form ADV or in more detail than the Firm Brochure and Brochure Supplement items might otherwise require. Several other significant disclosure items are highlighted below:

Material Changes. An adviser must create a summary of the material changes to the Firm Brochure since the last annual update. The summary may appear on the cover page of the Firm Brochure or on the page following the cover page. Alternatively, the adviser may prepare a separate document summarizing the material changes to the Firm Brochure and file the document as an exhibit to the Firm Brochure.

Performance-Based Fees and Side-By-Side Management. An adviser must disclose whether it charges performance-based fees or has supervised persons that manage accounts that pay performance fees. If an adviser also manages accounts that are not charged a performance-based fee, it must describe the conflicts of interests arising from the side-by-side management of performance-based fee accounts and the other accounts, and how the adviser addresses those conflicts.

Methods of Analysis, Investment Strategies and Risk of Loss. An adviser must describe its methods of analysis and investment strategies, and describe any material risks related to "significant" methods of analysis, strategies and certain types of securities it recommends. The adviser must provide additional details if the risks related to the foregoing items are significant or unusual. An adviser engaged in frequent trading practices must disclose how such practices may impact performance.

Adviser Disciplinary Information. An adviser must disclose any legal or disciplinary event that is material to evaluating the integrity of the adviser or its management personnel. Certain disciplinary events are presumed to be material. Firm Brochure disclosure of disciplinary information is required in addition to the disciplinary information that is currently required in Part 1 of Form ADV.

Part 2B. An adviser must create one or more Brochure Supplements that include information about each supervised person (e.g., a partner, officer, director or employee of the adviser) who: (i) formulates investment advice for a client and has direct client contact; or (ii) makes discretionary investment decisions for client assets. Each Brochure Supplement must be written using plain English, be organized in the order specified by Part 2B, utilize the same headings and provide the following information about the supervised person:

- formal educational background and business experience;
- disciplinary history that is material to a client's evaluation of the supervised person's integrity;
- other business activities;
- additional compensation paid to the supervised person by a non-client for providing advisory services; and
- how the adviser monitors the advice provided by the supervised person and the name and other information about the supervisor of that supervised person.

Part 3 Form CRS

Form CRS is a brief relationship summary intended to inform retail investors about: (i) the types of client and customer relationships and services the adviser offers; (ii) the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; (iii) whether the adviser and its financial professionals currently have reportable legal or disciplinary history; and (iv) how to obtain additional information about the adviser. The instructions to Form CRS contain specific requirements as to the preparation of the relationship summary. For example, the relationship summary should be written in a concise and direct manner and must not exceed two pages.[12]

[12] Form CRS is *available at* https://www.sec.gov/rules/final/2019/34-86032-appendix-b.pdf. On April 7, 2020, the Division of Examinations issued a risk alert that set forth examples of the areas related to Form CRS that the SEC staff may focus on in examinations, including: (i) Delivery and Filing: whether Form CRS (including any amendments) has been filed, prominently posted on the firm's website and delivered to investors in accordance with the instructions; (ii) Content: whether Form CRS includes all required information and the information is true, accurate and not misleading; (iii) Formatting: whether Form CRS is formatted in accordance with the instructions and is written in plain English; (iv) Updates: whether a firm has sufficient policies and procedures for updating Form CRS in accordance with the instructions and how the firm files and communicates the updates to investors; and (v) Recordkeeping: whether a firm has and maintains adequate records related to the delivery of Form CRS and has adequate policies and procedures related to compliance with delivery and recordkeeping requirements. *See* SEC Office of Compliance Inspection and Examinations Risk Alert, "Examinations that Focus on Compliance with Form CRS" (April 7, 2020) *available at* https://www.sec.gov/files/Risk%20Alert%20-%20Form%20CRS%20Exams.pdf.

V. Filing, Delivery and Amendment Requirements

A. INITIAL AND ANNUAL FORM ADV FILINGS

ADV Part 1 and the Firm Brochure

In order to register with the SEC, an adviser must initially file ADV Part 1 and the Firm Brochure electronically with the SEC through the IARD system. An adviser is not required to prepare the Firm Brochure if it does not have any clients that must receive it.[13]

On an annual basis no later than 90 days after the end of its fiscal year, an adviser must update its ADV Part 1 and its Firm Brochure and create a summary of material changes for Part 2A (either as part of the Firm Brochure or as an exhibit thereto) and file the updated Part 1 and Part 2A (and the attached amendments) with the SEC.

Brochure Supplement

Brochure Supplements are not required to be filed with the SEC. Instead, an adviser must retain Brochure Supplements within its records. If an adviser does not have any client to whom a Brochure Supplement would have to be delivered, it does not have to prepare a Brochure Supplement.[14]

Form CRS Relationship Summary

An adviser that is required to deliver a relationship summary to its retail investor clients must initially file its Form CRS electronically with the SEC through the IARD system.[15]

B. DELIVERY OF THE FIRM BROCHURE, BROCHURE SUPPLEMENT AND RELATIONSHIP SUMMARY

The Firm Brochure

An adviser must deliver[16] the Firm Brochure to a client[17] or a prospective client before or at the time it enters into an advisory contract with the client. On an annual basis no later than 120 days after the end of its fiscal year, an adviser must deliver to each client either: (1) an updated Firm Brochure,

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[13] An adviser does not have to deliver Firm Brochures to: clients that only receive impersonal investment advice and who will pay the adviser less than $500 per year, clients that are registered investment companies or clients that are business development companies.

[14] An adviser is not required to deliver Brochure Supplements to: clients to whom the adviser is not required to deliver a Firm Brochure (or wrap fee program brochure); clients who receive impersonal investment advice, even if they receive a Firm Brochure; and certain clients who are "qualified clients" on the basis of their status as executive officers, directors, trustees, general partners or persons serving in similar functions or other firm employees participating in the firm's investment activities for the past twelve months.

[15] Form CRS is not subject to an annual amendment requirement.

[16] The Firm Brochure (including the summary of material changes) and the Brochure Supplement may be delivered to a client electronically; provided, the client has consented to electronic delivery in a manner that is consistent with the SEC's published interpretive guidance on electronic delivery.

[17] It is considered best practice for a private fund adviser to deliver the Firm Brochure (and Brochure Supplements) to the underlying investors of the private fund even though the private fund (and not its investors) is considered to be the client of the adviser.

including or accompanied by the summary of material changes (if there are material changes to the Firm Brochure since the last annual updating amendment); or (2) the summary of material changes to the Firm Brochure, accompanied by (i) an offer to provide a current copy of the Firm Brochure without charge, and (ii)(A) the website address (if available), (B) an e-mail address (if available), (C) a telephone number by which a client may obtain the current Firm Brochure from the adviser, and (D) the website address for obtaining information about the adviser through the Investment Adviser Public Disclosure (IAPD) system.

Brochure Supplement

An adviser must deliver the applicable Brochure Supplements to the applicable client or prospective client at or before the time advisory services are provided to the client, but an adviser has no annual delivery obligation to its clients with respect to the Brochure Supplement.

Form CRS Relationship Summary

An adviser must deliver a relationship summary to each retail investor before or at the time the adviser enters into an investment advisory contract with the retail investor. The Adviser must deliver the relationship summary even if its agreement with the retail investor is oral.[18] An adviser must also deliver the relationship summary to a retail investor within 30 days upon a retail investor's request.

C. OTHER-THAN-ANNUAL AMENDMENTS

ADV Part 1 and the Firm Brochure

An adviser is required to amend its Form ADV[19] as follows:

- An adviser is required to "promptly" amend its Form ADV (including corresponding sections of Schedules A, B, C, D and R) by filing other-than-annual amendments if:
  - → the adviser is adding or removing a relying adviser as part of its umbrella registration;
  - → information provided in response to Items 1 (except 1.O. and Section 1.F. of Schedule D), 3, 9 (except 9.A.(2), 9.B.(2), 9.E. and 9.F.), or 11 of Part 1A or Items 1, 2.A. through 2.F., or 2.I. of Part 1B or Sections 1 or 3 of Schedule R becomes inaccurate in any way;
  - → information provided in response to Items 4, 8 or 10 of Part 1A, or Item 2.G. of Part 1B, or Section 10 of Schedule R becomes materially inaccurate; or
  - → information provided in the adviser's Firm Brochure becomes materially inaccurate.
- If an adviser is submitting an other-than-annual amendment to its Firm Brochure, it is not required to update its summary of material changes as required by Item 2 of the Firm Brochure. An adviser is not required to update its Firm Brochure between annual amendments solely because the amount of client assets it manages has changed or because its fee schedule has changed.

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[18] As of the date by which an adviser is first required to electronically file its relationship summary with the SEC (i.e., June 30, 2020), the adviser must begin to deliver its relationship summary to each new or prospective client and customer who is a retail investor before or at the time of entering into an investment advisory contract with the retail investor. Within 30 days after June 30, 2020, the adviser must deliver its relationship summary to each existing client and customer who is a retail investor.

[19] In an administrative proceeding, the SEC fined Sands Brothers Asset Management LLC, a registered investment adviser, $60,000 related to various Advisers Act violations, including violations related to material misstatements and inaccuracies in its Form ADV and failure to file required amendments to its Form ADV. *See* In the Matter of Sands Brothers Asset Management LLC, Administrative Proceeding, File No. 3-14097, Release No. 3099 (Oct. 22, 2010).

However, if it is updating its Firm Brochure for a separate reason in between annual amendments, and the amount of client assets it manages listed in response to Item 4.E. or its fee schedule listed in response to Item 5.A. has become materially inaccurate, it should update that item as part of the interim amendment.

- Other items need only be updated as part of the adviser's annual amendment.

An adviser is only required to deliver an interim amendment to the Firm Brochure to clients if the amendment relates to the addition of a disciplinary event or a material change to disciplinary history information, in which case the adviser must deliver the interim amendment promptly. The interim amendment can also be in the form of a statement describing the material facts relating to the change in disciplinary information.

Brochure Supplement

An adviser must promptly update a Brochure Supplement when information contained in the Brochure Supplement becomes materially inaccurate and is only required to deliver the updated Brochure Supplement to its clients when amending information relating to disciplinary information. The update can also be in the form of a statement describing the material facts relating to the change in disciplinary information.

Relationship Summary

An adviser is required to update its relationship summary and file the amended Form CRS with the SEC within 30 days whenever any information therein becomes materially inaccurate.

VI. Fiduciary Duty; Antifraud Provisions

An investment adviser is a fiduciary and therefore must serve the interests of its advisory clients. As a fiduciary, an investment adviser owes its clients an affirmative duty of utmost good faith and full and fair disclosure of all material facts. The investment adviser must adhere to the standard of care and diligence in conducting its advisory business activities as is required by law, and must be particularly sensitive to situations in which the interests of its advisory clients may be directly or indirectly in conflict with those of the investment adviser. In June 2019, the SEC issued an interpretation of an investment adviser's fiduciary duty to its clients and enhanced standards for investment advisers. The SEC's interpretation reaffirms and clarifies certain aspects of the fiduciary duty that an investment adviser owes to its clients. The interpretation provides that investment advisers' fiduciary duties include: (i) the duty of care, which includes the duty to provide advice that is in the client's best interest, the duty to seek best execution and the duty to act and provide advice and monitoring over the course of the relationship and (ii) the duty of loyalty, which requires investment advisers to put their clients' interests before their own, make full and fair disclosure of all material facts with respect to the advisory relationship and not favor one client over another in an unfair manner.

Sections 206(1) and 206(2) of the Advisers Act prohibit investment advisers from defrauding clients or engaging in a transaction, practice or course of business that operates as a fraud on clients. The SEC and courts have found numerous types of activities to constitute fraud, many of which are discussed elsewhere in this memorandum. In some cases, fraud occurs because an adviser has not made full and fair disclosure about a conflict of interest between the adviser and a client.

Section 206(4) of the Advisers Act prohibits investment advisers from engaging in any act, practice or course of business which is fraudulent, deceptive or manipulative. Section 206(4) also gives the SEC rulemaking authority to define and provide means reasonably designed to prevent such acts, practices and courses of business.

Rule 206(4)-8 prohibits advisers to pooled investment vehicles[20] from making false or misleading statements of material fact to current or prospective investors or engaging in any other fraudulent, deceptive or manipulative conduct with respect to a fund's investor or prospective investor. Accordingly, an adviser has an obligation to keep current all disclosure and marketing materials provided to investors in private investment funds for which the adviser provides advisory services. The SEC has stated that the standard of enforcement will be a negligence standard and will not require *scienter* on the part of the adviser.

[20] For purposes of this Rule, a "pooled investment vehicle" is any investment company as defined in Section 3(a) of the Investment Company Act (e.g., any registered investment company), and any company that would be an investment company under Section 3(a) of the Investment Company Act but for the exclusion from such status under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act (e.g., a hedge fund or a private equity fund).

VII. Compliance Programs

Rule 206(4)-7 under the Advisers Act requires every adviser registered with the SEC (i) to adopt and implement written policies and procedures designed to detect and prevent violations of the Advisers Act by the adviser and its supervised persons, (ii) to review the policies and procedures at least annually to assure their adequacy and effectiveness, and (iii) to designate a chief compliance officer with responsibility for administering and enforcing the policies and procedures. While an adviser is permitted to delegate various compliance functions to service providers, the adviser's compliance policies must provide for effective oversight of the service providers[21].

The Rule does not specify elements that must be included in an adviser's compliance policies,[22] but the SEC and its staff, in the release adopting Rule 206(4)-7, subsequent formal and informal SEC staff guidance and enforcement actions, have indicated that they expect that the policies will address the following:

- portfolio management processes (e.g., allocation of investment opportunities among clients and consistency of a portfolio with guidelines established by the client);
- trading practices (e.g., best execution, soft dollars and allocation of aggregated trades);
- allocation of expenses between the adviser and its clients and among clients;[23]
- identification and elimination, or disclosure, of conflicts of interest that might lead the adviser to render advice which is not disinterested (e.g., the adviser has an interest in recommended

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[21] Advisers should also disclose the role and compensation of service providers (i.e., operating partners) and the adviser's conflicts of interest related to arrangements with service providers including instances where (i) portfolio companies controlled by an adviser's private fund clients enter into service agreements with entities controlled by, or related to, the adviser, (ii) the adviser has other financial incentives for portfolio companies to use certain service providers, such as incentive payments from discount programs. Advisers should ensure that they adopt policies and procedures that seek to ensure that they follow their disclosed procedures related to affiliated service providers. *See* SEC Office of Compliance Inspection and Examinations Risk Alert, "Observations from Examinations of Investment Advisers Managing Private Funds" (June 23, 2020) available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert.pdf.

[22] We suggest that advisers consider adopting compliance policies to address certain areas which have been the recent focus of SEC enforcement since the adoption of Rule 206(4)-7. SEC staff views regarding compliance policies are constantly evolving, and the staff has offered additional guidance through public statements, including the Division of Examinations Risk Alerts, Division of Investment Management Guidance Updates and other mediums, which advisers should consider.

[23] *See*, e.g., In the Matter of Blackstone Management Partners L.L.C., et al., Administrative Proceeding, File No. 3-16887, Release No. IA-4219 (Oct. 7, 2015); In the Matter of Kohlberg Kravis Roberts & Co. L.P., Administrative Proceeding, File No. 3-16656, Release No. IA-4131 (June 29, 2015); In the Matter of Alpha Titans, LLC, Timothy P. McCormack, and Kelly D. Kaeser, Esq., Administrative Proceeding, File No. 3-16520, Release No. IA-4073 (April 29, 2015); In the Matter of Lincolnshire Management, Inc., Administrative Proceeding, File No. 3-16139, Release No. IA-3927 (Sept. 22, 2014). *See also* Office of Compliance Inspections and Examinations, Securities and Exchange Commission, National Exam Program Risk Alert, Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers (Apr. 12, 2018), *available at* https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf. *See also* SEC Office of Compliance Inspection and Examinations Risk Alert, "Observations from Examinations of Investment Advisers Managing Private Funds" (June 23, 2020) available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert.pdf (the SEC Staff also has observed deficiencies related to the receipt of portfolio company fees including (i) the failure to apply or calculate portfolio company fee offsets in accordance with disclosures; (ii) inadequate policies and procedures to track the receipt of portfolio company fees, and (iii) inadequate disclosure of accelerated portfolio company monitoring fees upon the sale of the portfolio company).

investments, the adviser can purchase fund interests from investors at a discount in connection with a fund restructuring).[24]

- cybersecurity;[25]
- proprietary trading of the adviser and personal trading of its employees;
- accuracy of disclosure to clients (including advertisements);[26]
- safeguarding client assets from conversion or inappropriate use by advisory personnel;
- accurate creation and appropriate maintenance of required records;
- marketing of adviser's services, including use of solicitors;
- procedures to value client holdings and assess fees;
- supervisory practices with respect to advisory personnel in branch offices;[27]
- automated advisory services;[28]
- hiring and supervision of supervised persons with certain disciplinary histories;[29]
- safeguards for the protection of client records and information;
- business continuity plans.[30]

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[24] *See* SEC Office of Compliance Inspection and Examinations Risk Alert, "Observations from Examinations of Investment Advisers Managing Private Funds" (June 23, 2020) *available at* https://www.sec.gov/files/Private%20Fund%20Risk%20Alert.pdf.

[25] *See* In the Matter of R.T. Jones Capital Equities Management, Inc., Administrative Proceeding, File No. 3-16827, Release No. IA-4202 (Sept. 22, 2015).

[26] *See* In the Matter of Catalyst Advisors, LLC and Jerry Szilagyi, Administrative Proceeding, File No. 3-19674, Release No. 5436 (January 27, 2020).

[27] *See* SEC Division of Examinations Risk Alert, "Division of Examinations Observations: Investment Advisers' Fee Calculations Advisory" (November 10, 2021) *available at* https://www.sec.gov/files/exams-risk-alert-fee-calculations.pdf and Office of Compliance Inspections and Examinations, Securities and Exchange Commission, National Examination Risk Alert Vol. 6-2, Multi-Branch Adviser Initiative (Dec. 12, 2016), *available at* https://www.sec.gov/ocie/announcement/risk-alert-multi-branch-adviser-initiative.pdf.

[28] The SEC staff issued guidance for automated advisers, colloquially referred to as "robo-advisers", suggesting three distinct areas for robo-advisers to consider: (i) the substance and presentation of disclosures to clients about the robo-adviser and the investment advisory services it offers; (ii) the obligation to obtain information from clients to support the robo-adviser's duty to provide suitable advice; and (iii) the adoption and implementation of effective compliance programs reasonably designed to address particular concerns relevant to providing automated services. *See* Investment Management Guidance Update, Robo-Advisers, No. 2017-02 (Feb 2017), *available at* https://www.sec.gov/investment/im-guidance-2017-02.pdf. *See also* SEC Division of Examinations Risk Alert "Observations from Examinations of Advisers that Provide Electronic Investment Advice" (November 9, 2021) *available at* https://www.sec.gov/files/exams-eia-risk-alert.pdf.

[29] *See* Risk Alert: Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest (July 23, 2019), *available at* https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Supervision%20Initiative.pdf.

[30] The SEC staff has stated that an investment adviser has a "fiduciary obligation to its clients that includes taking steps to protect the clients' interests from risks resulting from the adviser's inability to provide advisory services

In connection with the compliance rule, an adviser is required to keep copies of its compliance policies and procedures and any records documenting the annual review of such policies and procedures.

Advisers should conduct initial and periodic "risk assessments" to identify their compliance risks and conflicts of interest. Identified risks and conflicts should be mapped by the adviser to those compliance policies and procedures designed to address the risks and conflicts. In recent years, the SEC staff has focused on risk management and internal controls for advisers, and has specifically requested information demonstrating how an adviser has implemented and tested its compliance policies and procedures (e.g., exception reports and documentation of follow-up work, completed compliance check-lists, reconciliations, management reports, documents containing supervisory approval of overrides in various areas, warning or sanction notices to staff that violated a policy or procedure, results and related analyses of transactional and forensic testing, internal audits, etc.).[31]

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after, for example, a natural disaster" (*see* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Rel. No. 2204 (Dec. 17, 2003). *See* also Investment Management Guidance Update: Business Continuity Planning for Registered Investment Advisers; No. 2016-04 (June 2016), *available at* https://www.sec.gov/investment/im-guidance-2016-04.pdf. In addition, in the wake of COVID-19, the SEC will be particularly focused on proper disclosures to clients regarding new risks, as well as upholding their compliance and reporting obligations during the pandemic. In particular, managers should adhere to their founding documents in terms of liquidity management and reports to investors. The Division of Examinations has indicated that reliance on regulatory relief will not be a factor utilized in determining whether they conduct an exam. In future exams, The Division of Examinations will likely focus on business continuity measures taken in response to the COVID-19 pandemic, including implementation and effectiveness of continuity plans, as well as steps taken to prevent investors and market integrity. *See* OCIE Statement on Operations and Exams –Health, Safety, Investor Protection and Continued Operations are our Priorities *available at* https://www.sec.gov/ocie/announcement/ocie-statement-operations-health-safety-investor-protection-and-continued.

[31] The Division of Examinations issued a Risk Alert on July 23, 2019 that focused on oversight practices of SEC-registered advisers that previously employed, or currently employ, individuals with a history of disciplinary events. The Risk Alert is available at https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Supervision%20Initiative.pdf. The Division of Examinations issued a Risk Alert on June 18, 2020 identifying preparedness of registered investment advisers and broker-dealers for the transition away from use of the LIBOR benchmark as a focus of their 2020 exams which is available at https://www.sec.gov/files/Risk%20Alert%20-%20OCIE%20LIBOR%20Initiative_1.pdf.

VIII. Investment Management Agreements

A. WRITTEN AGREEMENTS

It is recommended that advisers enter into written agreements with all their advisory clients. In particular, for advisers to private pooled vehicles, for purposes of Section 206(1) and (2) of the Advisers Act, the SEC may not define the term "client" to include an investor in a private fund managed by an investment adviser, provided that the adviser has entered into an investment advisory contract with such private fund.

B. ASSIGNMENT CLAUSES

Section 205(a)(2) of the Advisers Act requires each investment advisory contract entered into by a registered investment adviser to provide that the contract may not be assigned without the client's consent. Section 202(a)(1) of the Advisers Act defines "assignment" generally to include any direct or indirect transfer of an investment advisory contract by an adviser or any transfer of a controlling block of an adviser's outstanding voting securities. Rule 202(a)(1)-1 under the Advisers Act, however, provides that a transaction that does not result in a change of actual control or management of the adviser would not be deemed to be an assignment for these purposes.

C. HEDGE CLAUSES

The SEC and its staff have taken the position that a provision in an advisory contract that is likely to lead a client to believe that it has waived any available right of action against the adviser may violate the antifraud provisions of the Advisers Act. As a result, hedge clauses in advisory contracts are usually accompanied by a statement indicating that nothing in the contract should be construed as a waiver of any rights that a client may have under applicable state or federal law.[32] Despite the presence of such a statement, a hedge clause may be found to violate the antifraud provisions of the Advisers Act if it is likely to lead a client to believe that he or she has waived non-waivable rights.

D. TERMINATION PENALTIES

If an advisory agreement is terminated, the adviser must refund the portion of any prepaid fees attributable to periods after the termination of the agreement.[33]

E. NOTIFICATION OF CHANGE IN PARTNERSHIP

Section 205(a)(3) requires an investment advisory agreement used by an investment adviser that is organized as a partnership to provide that the adviser will notify its clients of any change in the membership of the partnership within a reasonable time after such change. An investment adviser organized as a limited partnership, however, need not notify its clients of changes in limited partners.

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[32] *See* Release No. IA-58 (Apr. 10, 1951); Auchincloss & Lawrence Inc., (pub. avail. Feb. 8, 1974). The SEC staff re-affirmed this position in 2007 when it said that an adviser's use of a hedge clause and non-waiver disclosure would not violate Sections 206(1) and 206(2) of the Advisers Act. *See* Heitman Capital Management, LLC (pub. avail. Feb. 12, 2007). *See also* SEC Release No. IA-5248 (June 2019).

[33] *See* Jason Baker Tuttle, Sr., Initial Decision Release No. 13 (Jan. 8, 1990).

IX. Performance-Based Fees and Incentive Compensation

The Advisers Act generally prohibits registered investment advisers from entering into agreements providing for advisory fees based on a share of the capital gains or appreciation of the client's assets ("incentive compensation"). The Advisers Act contains exceptions from this prohibition for contracts with (i) "qualified clients"; (ii) registered investment companies or clients having more than $1 million in managed assets, if specific conditions are met (*see* Paragraph B. "Fulcrum Fees", below for further discussion); (iii) private investment companies excepted from the Investment Company Act of 1940, as amended ("Investment Company Act") under Section 3(c)(7) of such Act; and (iv) clients that are not U.S. residents. Rule 205-3 under the Advisers Act provides a further exception.

A. RULE 205-3

Rule 205-3 under the Advisers Act permits registered advisers to charge incentive compensation to clients who invest at least $1,100,000 with the adviser, who have a net worth (together, in the case of a natural person, with assets held jointly with a spouse) exceeding $2.2 million,[34] or who, with certain exceptions, are "Qualified Purchasers" as defined in Section 2(a)(51) of the Investment Company Act ("Qualified Clients").[35] Clients that are private investment companies relying on Section 3(c)(1) of the Investment Company Act or investment companies registered under the Investment Company Act may be charged incentive compensation only if each of their equity owners meets one of those tests. There is also an exception for certain "knowledgeable employees" of the adviser.

B. FULCRUM FEES

Section 205(b)(2) of the Advisers Act permits a registered adviser to charge "fulcrum fees" to certain clients whereby the compensation is proportionately based on an account's investment performance in relation to "an appropriate index of securities" (i.e., the base advisory fee moves upward or downward in equal proportions in relation to the performance of the account compared to the performance of the index). A fulcrum fee may only be charged to registered investment companies or to other clients who have invested at least $1 million with the adviser (other than certain pension vehicles excluded in the statute).

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[34] Pursuant to Rule 205-3, for purposes of calculating a natural person's net worth: (1) the person's primary residence must not be included as an asset; (2) indebtedness secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time the investment advisory contract is entered into may not be included as a liability (except that if the amount of such indebtedness outstanding at the time of calculation exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess must be included as a liability); and (3) indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the residence must be included as a liability.

[35] The SEC adopted amendments to the dollar amount thresholds in the definition of qualified client under Rule 205-3 effective on November 10, 2021. *See* Investment Advisers Act of 1940 Release No. IA-5904 (November 4, 2021) *available at* https://www.sec.gov/files/exams-risk-alert-fee-calculationsrules/final/2021/ia-5904.pdf.

X. Trading and Allocation Practices

Investment advisers placing client trades must comply with a number of SEC rules and interpretations. The discussion set forth in sections A. and B. below focuses on principal and agency cross transactions as well as transactions between discretionary client accounts or "cross transactions". The discussion set forth in section C. focuses on the allocation of securities among clients and aggregation of orders.

A. PRINCIPAL AND AGENCY CROSS TRANSACTIONS

Section 206(3) of the Advisers Act prohibits an investment adviser from knowingly (i) selling any security to or purchasing any security from a client while acting as a principal for its own account (a "principal transaction") or (ii) effecting any sale or purchase of any security for the account of an advisory client while acting as broker for a person other than such client (an "agency cross transaction") without, in each case, disclosing to the client prior to completion of the transaction, the capacity in which the adviser is acting and obtaining the consent of the client to the transaction prior to its completion. Although the Advisers Act and the regulations adopted thereunder do not mandate the specific disclosures to be provided to clients in connection with obtaining their consent, based on SEC staff interpretations, an investment adviser is required to disclose all material information concerning a principal or agency cross transaction (including the adviser's purchase price for any security it proposes to sell and the best price at which the transaction could be effected elsewhere, if more advantageous, as well as all facts necessary to be disclosed to alert the client to the adviser's potential conflicts of interest in the transaction) so that the client is fully informed when determining whether to consent to the transaction. Consent for principal transactions must be obtained separately for each transaction (i.e., blanket disclosure and consent is not sufficient).

Rule 206(3)-2 defines "an agency cross transaction for an advisory client" as a transaction in which a person acts as an investment adviser in relation to a transaction in which such investment adviser, or any person controlling, controlled by or under common control with such investment adviser, acts as broker for both the advisory client and for another person on the other side of the transaction. In contrast to principal transactions, the adviser-broker need not obtain consent for each agency cross transaction it enters into for clients; provided that it complies with the following conditions of the Rule:

- the client prospectively consents in writing to agency cross transactions, and the consent is based on full disclosure of the adviser's role in the transactions as well as its potentially conflicting loyalties and responsibilities;
- the adviser sends a written confirmation of each agency cross transaction that includes, among other things, a statement on the nature of the transaction and the source and amount of any other remuneration received by the adviser;
- the adviser sends an annual statement of the number of agency cross transactions effected and amount of remuneration received by the adviser since the last statement;
- all client statements include a prominent statement that the client's prospective consent may be revoked at any time by written notice to the adviser; and
- no agency cross transaction is effected in which the adviser advises both the purchaser and the seller.[36]

[36] The Division of Examinations issued a Risk Alert on September 4, 2019 that provided an overview of the most common compliance issues identified by the Division of Examinations related to principal trading and agency cross transactions under Section 206(3) of the Advisers Act. The Risk Alert is available at https://www.sec.gov/files/OCIE%20Risk%20Alert%20-

B. TRANSACTIONS BETWEEN CLIENT ACCOUNTS

A "cross transaction" is a transaction between two different client accounts that are managed on a discretionary basis by the same adviser. Cross transactions between client accounts are not permitted if they would constitute principal trades[37] or trades for which the adviser or its affiliates are compensated as brokers ("agency cross transactions") unless client consent has been obtained or, in the case of agency cross transactions, the conditions of Rule 206(3)-2 are met.[38] The SEC has determined that an investment adviser will not be deemed to be "acting as broker" for purposes of Section 206(3) if the adviser receives no compensation (other than its advisory fee), directly or indirectly.[39]

Cross transactions are subject to the anti-fraud provisions of the Advisers Act and involve potential conflicts of interest. Engaging in cross transactions may require disclosure of any relevant conditions or restrictions and any related conflicts of interest[40] in the following documents: (i) the Firm Brochure, (ii) any offering documents (for investment vehicles), and (iii) any investment management agreements (for separately managed accounts). Cross trades should be conducted with a client that is registered as an investment company only in accordance with the policies and procedures duly adopted by such investment company client (e.g., Rule 17a-7 procedures).

C. ALLOCATION OF SECURITIES AMONG CLIENTS AND AGGREGATION OF ORDERS

As noted above, an adviser has a duty of loyalty, which requires it to eliminate or at least expose through full and fair disclosure the conflicts associated with its allocation policies, including how it will allocate investment opportunities, such that a client can provide informed consent.[41] This duty includes

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%20Principal%20and%20Agency%20Cross%20Trading.pdf. The Division of Examinations issued a follow-up Risk Alert on July 21, 2021 as a supplement to the staff's observations made in the Principal Transactions Risk Alert by providing greater detail on certain compliance issues. The Division's observations were derived from an examination initiative that focused on SEC-registered investment advisers that engaged in cross trades, principal trades, or both, involving fixed income securities. The Division encouraged advisers to review their written policies and procedures regarding principal and cross trades, including the implementation of those policies and procedures, to ensure that they are consistent with the Advisers Act and the rules thereunder. The Risk Alert is available at https://www.sec.gov/exams/announcement/risk-alert-fixed-income-principal-cross-trades.

[37] Cross trades involving an account or fund of which the adviser (or its affiliates) owns 25% or more will be considered "principal transactions" and will be subject to the consent requirement under Section 206(3) of the Advisers Act. *See* Gardner Russo & Gardner, (pub. avail. June 7, 2006).

[38] Such trades are also generally prohibited by ERISA, and should not be conducted with an ERISA account (including a private investment vehicle that has substantial benefit plan investors and is subject to ERISA) unless it has been determined that an exemption is available.

[39] *See* Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Release No. IA-1732 (July 17, 1998).

[40] In a June 2020 Division of Examinations Risk Alert, the SEC Staff observed that, conflicts of interest related to cross-transactions were inadequately disclosed, including disclosure of cross-transactions in which advisers established the price at which securities would be transferred between client accounts in a way that disadvantaged either the selling or purchasing client. *See* SEC Office of Compliance Inspection and Examinations Risk Alert, "Observations from Examinations of Investment Advisers Managing Private Funds" (June 23, 2020) available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert.pdf.

[41] See SEC Release No. IA-5248 (June 2019). The SEC Staff has also observed that conflicts of interest related to allocations of investments among clients were inadequately disclosed. For example, the Staff observed private fund advisers that preferentially allocated limited investment opportunities to new clients, higher-fee paying clients, proprietary accounts, or proprietary-controlled clients, and allocated securities at different prices or in apparently inequitable amounts among clients.

The Staff also observed that conflicts of interest related to the following matters were inadequately disclosed: (i) clients investing in different levels of the capital structure of the same portfolio company and (ii) agreements to provide co-investment opportunities to certain investors (or the failure to follow their disclosed process for allocating co-investment opportunities among investors). *See* SEC Office of Compliance Inspection and Examinations Risk

establishing procedures, applied on a consistent and equitable basis, for allocating securities (and securities recommendations) among clients (discretionary and nondiscretionary). The issue of treating clients fairly with respect to allocations is of particular concern when the security is scarce or may be purchased at an unusually favorable price (i.e., "new issue" securities). Whether any given allocation is unfair depends on the facts and circumstances involved and the needs and financial objectives of the adviser's various clients. At a minimum, however, the SEC staff has indicated that an adviser must have a procedure for allocating securities and recommendations among clients (e.g., a pro rata allocation based on average price, subject to certain exceptions, or a rotational system) and that the adviser's allocation practices must be disclosed to its clients.

The SEC staff has not required the use of any specific formula nor any specific procedures, although it has taken the position that allocations of securities should be made before transactions are effected. The SEC has selectively brought enforcement proceedings against advisers and their personnel for perceived abuses (such as failing to allocate securities to client accounts for two to nine business days)[42] or for failing to allocate securities equitably among its clients.[43] In particular, with respect to "new issues", the SEC has made clear that an adviser may not allocate securities to favored clients or to improve the performance of poorly performing accounts without disclosing that allocation practice to clients.[44]

In directing orders for the purchase or sale of securities to a broker-dealer for execution, an adviser may aggregate or "bunch" those orders on behalf of two or more of its accounts, so long as the aggregation is done for purposes of achieving best execution, and no client is systematically advantaged or disadvantaged by the aggregation. An adviser may include in a bunched order accounts in which it or its officers or employees have an interest. The SEC staff has stated in a no-action letter[45] that such aggregation of client orders is permitted when the following conditions are met:

- aggregation policies are fully disclosed in the adviser's Form ADV and separately to each existing client and to the broker-dealers through which aggregated orders are placed;
- no advisory client will be favored over any other client;

Alert, "Observations from Examinations of Investment Advisers Managing Private Funds" (June 23, 2020) available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert.pdf.

[42] *See* In the Matter of Melhado, Flynn & Associates, Inc., George M. Motz and Jeanne McCarthy, Release No. IA-2593 (Feb. 26, 2007) (the SEC instituted cease-and-desist proceedings against a registered investment adviser who delayed allocation of trades and then allocated the most profitable trades to one advisory client at the expense of other advisory clients); In the Matter of Gerson Asset Management, Inc. and Seth Gerson, Release No. IA-27176 (Dec. 2, 2005) (the SEC instituted cease-and-desist proceedings against a registered investment adviser that delayed trade allocation and then unfairly allocated profitable trades to its own accounts and unprofitable trades to its clients' accounts); In re Michael L. Smirlock, Release No. IA-1393 (Nov. 29, 1993); In the Matter of Kemper Financial Services, Inc., Release No. IA-1387 (Oct. 20, 1993).

[43] *See*, inter alia, In re F.W. Thompson Co., Ltd. et al., Release No. IA-1895 (Sept. 7, 2000) (the SEC instituted cease-and-desist proceedings against a registered investment adviser who preferentially allocated shares of "hot IPOs" to clients with whom the adviser had performance based fee arrangements without disclosing this practice to clients); In re Dreyfus Corp. et al., Release No. IA-1870 (May 10, 2000) (the SEC instituted cease-and-desist proceedings against a registered investment adviser who preferentially allocated shares of "hot IPOs" to a particular fund despite prospectus disclosure indicating that investment opportunities would be allocated equitably among the adviser's funds); In re Account Mgmt. Corp., et al., Release No. IA-1529 (Sept. 29, 1995) (the SEC instituted cease-and-desist proceedings against a registered investment adviser who preferentially allocated shares of "hot IPOs" to clients who were close friends of the adviser without adequately disclosing this practice to clients).

[44] *See* In re F. W. Thompson Company, Ltd., Release No. IA-1895 (Sept. 7, 2000).

[45] *See* SMC Capital, Inc. (pub. avail. Sept. 5, 1995). The SEC staff noted in the no-action position that there may be other allocation methods that investment advisers can use without violating the Investment Company Act and the Advisers Act.

- each client will participate in an aggregated order at the average share price for all of the adviser's transactions in that security on any given day, with transaction costs shared pro rata based on participation[46];
- prior to entering an aggregated order, a written allocation statement will be prepared, specifying the participating client accounts and method of allocation among accounts;
- partially filled orders will be allocated pro rata based on the written allocation statement;
- if an order must be allocated in a manner different from that in the written allocation statement, all clients must receive fair and equitable treatment and the written rationale for the departure must be approved by the adviser's compliance officer;
- the adviser will receive no additional compensation as a result of the aggregation;
- the adviser's books and records will separately reflect securities held by, or bought or sold for, client accounts that participate in the aggregation; and
- client funds and securities are deposited with custodians and will not be held collectively any longer than is necessary to settle the purchase or sale.

To the extent that an adviser does not aggregate trades but has the opportunity to do so, the adviser must explain in Form ADV Part 2A that clients may therefore pay higher brokerage costs.

[46] The SEC staff expanded its position taken in SMC Capital, Inc. (pub. avail. Sept. 5, 1995) in a no-action letter to the Investment Company Institute (October 26, 2017) to permit an adviser subject to the European Union's revised Markets in Financial Instruments Directive ("MiFID II") to continue to aggregate orders for purchases and sales of securities on behalf of its clients (which may include registered investment companies), where some clients may pay different amounts for research because of MiFID II requirements, but all clients will continue to receive the same average price for the security and execution costs. The SEC staff conditioned its relief on an adviser adopting and implementing policies and procedures reasonably designed to ensure that (1) each client in an aggregated order pays the average price for the security and the same cost of execution (measured by rate); (2) the payment for research in connection with the aggregated order would be consistent with each applicable jurisdiction's regulatory requirements and disclosures to the client; and (3) subsequent allocation of such trade will conform to the adviser's allocation statement (i.e., a pre-trade written statement specifying the participating client accounts and the intended allocation among them) and/or the adviser's allocation procedures. The SEC staff noted that the relief does not apply to an investment adviser that is not subject to MiFID II (either directly or contractually). MiFID II generally applies to investment firms that have a physical presence in Europe. Non-EU investment advisers may become subject to certain MiFID II requirements under various circumstances, such as having an EU-regulated office; providing sub-advisory services to a MiFID firm; or, as required by individual EU member states, providing advisory services to clients domiciled in that state.

XI. Brokerage Practices and Soft Dollars

A. BEST EXECUTION

An adviser has a duty to seek the most favorable terms reasonably available under the circumstances for the execution of its clients' securities transactions. This duty to seek "best execution" for clients' securities transactions is similar to a broker's duty to seek best execution.[47] An adviser fulfills this duty by seeking to obtain the execution of securities transactions on behalf of a client with the goal of maximizing value for the client under the particular circumstances occurring at the time of the transaction. Maximizing value encompasses more than just minimizing cost. When seeking best execution, an adviser should consider the full range and quality of a broker's services.[48] An adviser must periodically review and document its evaluation of its brokerage practices, including the brokers it uses to execute client transactions, to determine whether they are consistent with the adviser's obligation to seek "best execution" for its clients.[49] The SEC staff has, at times, requested written documentation of the adviser's best execution review.

The Division of Examinations issued a Risk Alert in July 2018 on the most common deficiencies cited in examinations of advisers' compliance with their best execution obligations under the Advisers Act. Those deficiencies included not performing best execution reviews, not considering materially relevant factors during best execution reviews, not seeking comparisons from other broker-dealers, not fully disclosing best execution practices, not disclosing soft dollar arrangements (*see* Section XI.B. below), not properly administering mixed use allocations, inadequate policies and procedures relating to best execution, and not following best execution policies and procedures.[50]

B. SOFT DOLLARS

Advisers' use of "soft dollars" refers to the practice of using client commissions to pay for research and for brokerage services in addition to routine executions. The use of client commissions by an adviser for those purposes creates a conflict of interest that may incentivize the adviser when directing orders to disregard its best execution obligations in favor of generating commissions.

Section 28(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), provides a safe harbor from claims of breach of fiduciary duty for discretionary advisers who obtain

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[47] Although the SEC has never specifically defined "best execution," it has stated that an investment adviser must execute each transaction so that a client's total cost is the most favorable under the circumstances and has taken action against advisers for failure to obtain best execution. Factors that may be considered in choosing a broker-dealer to execute a transaction include execution capability, the value of the research provided, commission rate, financial responsibility and responsiveness to the investment adviser. The best qualitative execution for the account, not cost, is the determinative factor. It should be noted that an adviser's duty to seek best execution applies to transactions in equity as well as fixed income securities.

[48] *See* SEC Release No. 34-86031 (June 2019).

[49] *See* SEC Release No. IA-5248 (June 2019). *A*n adviser to a registered open-end investment company should ensure that it considers the company's obligations under Rule 12b-1(h) of the Investment Company Act, if applicable, when directing brokerage to broker-dealers that also sell shares of the company.

[50] *See* Office of Compliance Inspections and Examinations, Securities and Exchange Commission, National Exam Program Risk Alert, Compliance Issues Related to Best Execution by Investment Advisers (Jul. 11, 2018), *available at* https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf.

"research and brokerage services" from broker-dealers who execute securities transactions for clients[51] at commission rates higher than the lowest commission rates available.[52] To be eligible for this safe harbor, the adviser must make a good faith determination that the amount of a commission is reasonable in relation to the value of the research and brokerage services provided, viewed in terms of either that particular transaction or the adviser's overall responsibilities for all of its discretionary accounts. The SEC has stated that Section 28(e)'s safe harbor applies if the service provided constitutes "lawful and appropriate assistance to the money manager in carrying out its decision-making responsibilities".[53]

In July 2006, the SEC published an Interpretive Release ("2006 Release") with respect to Section 28(e) in order to clarify the scope of the brokerage and research services in light of developing technology. The 2006 Release sets forth a 3-step analysis for an adviser to determine whether a particular service is eligible for the safe harbor protection: (i) does the product or service constitute eligible research or brokerage under Section 28(e); (ii) does the product or service provide lawful and appropriate assistance in the investment decision making process; and (iii) is the amount of commission paid reasonable in light of the products received?

To qualify as "research," a product must reflect the "expression of reasoning or knowledge" either through (i) advice relating to the value of securities, the advisability of investing in securities and the availability of securities or their buyers or sellers or (ii) analyses or reports about issuers, industries, economic factors and trends, portfolio strategy and the performance of accounts. The form of the research may be electronic, paper or oral.

To qualify as "brokerage," a service must be provided to effect securities transactions during the period beginning when orders are first transmitted to broker-dealers and ending at the conclusion of clearance and settlement of the transactions.

When the product or service provided by the broker-dealer also has mixed-use (i.e., non-research uses such as software that can be used for research purposes and can also be used for administrative purposes), the adviser must proportionately allocate, and pay for in "hard dollars", the non-research component of the product or service. The SEC requires advisers to demonstrate a good faith attempt in making this allocation and to maintain adequate records concerning allocations.

Another issue that arises under Section 28(e) occurs when research services or products are provided by parties other than the executing broker-dealer, referred to as "third party research". The

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[51] The SEC staff has taken the position that the safe harbor afforded by Section 28(e) is not available for transactions in futures and principal transactions, except for certain "riskless principal" trades in equities. Riskless principal transactions are generally described as trades in which, after receiving an order to buy (or sell) from a customer, the broker-dealer purchases (or sells) the security from (or to) another person in a contemporaneous offsetting transaction. Such transactions may be eligible for the Section 28(e) safe harbor where the fee paid to the broker-dealer and the transaction price are fully disclosed on the confirmation and the transaction is reported in the same manner as an agency transaction.

[52] Commissions generated by trading in other types of investments (e.g., futures, forwards, currencies) do not qualify for the Section 28(e) safe harbor.

[53] In a no-action letter to the Securities Industry and Financial Markets Association ("SIFMA"), the SEC staff stated that it would not recommend enforcement action against an investment adviser seeking to operate in reliance on Section 28(e) if it pays for research through the use of a research payment account ("RPA") in connection with a client commission arrangement, as described in SIFMA's no-action request letter and conforming to the requirements for RPAs in MiFID II, provided that all other applicable conditions of Section 28(e) are met. The SEC staff limited its relief to the following circumstances: (1) the adviser makes payments to the executing broker-dealer out of client assets for research alongside payments to that executing broker-dealer for execution; (2) the research payments are for research services that are eligible for the safe harbor under Section 28(e); (3) the executing broker-dealer effects the securities transaction for purposes of Section 28(e); and (4) the executing broker-dealer is legally obligated by contract with the adviser to pay for research through the use of an RPA in connection with a client commission arrangement. *See* Securities Industry and Financial Markets Association, Asset Management Group, SEC No-Action Letter (October 26, 2017).

SEC has stated that a broker-dealer receiving a commission used to provide research must be involved in "effecting" the transaction for which the commission is paid and the research must be "provided by" the broker-dealer. Broker-dealers are involved in "effecting" a trade if they execute, clear or settle the trade or perform at least one of the following four functions: (i) take financial responsibility for customer trades until the clearing broker-dealer has received payment or securities; (ii) make and/or maintain records relating to customer trades, including blotters and memoranda of orders; (iii) monitor and respond to customer comments concerning the trading process; or (iv) monitor trades and settlement. The 2006 Release modified the interpretation of "provided by" to include both (i) an arrangement under which the broker-dealer is legally obligated to pay for research, and (ii) an arrangement under which the broker-dealer uses client commissions to pay for eligible research for which such broker-dealer is not directly obligated to pay if the broker-dealer pays the research preparer directly and takes steps to assure itself that the client commissions that the manager directs it to use to pay for such services are used only for eligible research.

The following attributes help determine whether the broker-dealer that is effecting transactions for the advised accounts but is not legally obligated to pay for the research has satisfied the "provided by" element: (i) the broker-dealer pays the research preparer directly; (ii) the broker-dealer reviews the description of the services to be paid for with client commissions under the safe harbor for red flags that indicate the services are not within Section 28(e) and agrees with the money manager to use client commissions only to pay for those items that reasonably fall within the safe harbor; and (iii) the broker-dealer develops and maintains procedures so that research payments are documented and paid for promptly.

An adviser using client commissions to acquire products or services that are not eligible services under Section 28(e) must disclose the practices with specificity in the adviser's Form ADV and obtain client consent prior to engaging in the practices.

C. FORM ADV DISCLOSURE REQUIREMENTS ADDRESSING BROKERAGE PRACTICES

A registered investment adviser must adequately disclose its brokerage practices to advisory clients. Item 12 of Part 2 of Form ADV requires an adviser to make the following disclosure to clients regarding brokerage and soft dollar arrangements:

Research and Other Soft Dollar Benefits:

If an adviser receives research[54] or other products or services, other than execution from a broker-dealer or a third-party in connection with client securities transactions, the adviser must disclose its practices and discuss the conflicts of interest that are created. An adviser must also disclose the following:

- the fact that when it uses client brokerage commissions (or markups or markdowns) to obtain research or other products or services, it receives a benefit because it does not have to produce or pay for the research, products or services.
- it may have an incentive to select or recommend a broker-dealer based on its interest in receiving the research or other products or services, rather than on its clients' interest in receiving most favorable execution.
- whether it may cause clients to pay commissions (or markups or markdowns) higher than those charged by other broker-dealers in return for soft dollar benefits (known as paying-up).

[54] In the case of research, both proprietary research (created or developed by the broker-dealer) and research created or developed by a third party.

- whether it uses soft dollar benefits to service all of its clients' accounts or only those that paid for the benefits.

- whether it seeks to allocate soft dollar benefits to client accounts proportionately to the soft dollar credits the accounts generate.

- a description of the types of products and services[55] it or any of its related persons acquired with client brokerage commissions (or markups or markdowns) within its last fiscal year.

- an explanation of the procedures it used during its last fiscal year to direct client transactions to a particular broker-dealer in return for soft dollar benefits it received.

Brokerage for Client Referrals.

If an adviser considers, in selecting or recommending broker-dealers, whether it or a related person receives client referrals from a broker-dealer or third party, it must disclose this practice and discuss the conflicts of interest it creates. Specifically, the adviser must:

- disclose that it may have an incentive to select or recommend a broker-dealer based on its interest in receiving client referrals, rather than on its clients' interest in receiving most favorable execution.

- provide an explanation of the procedures it used during its last fiscal year to direct client transactions to a particular broker-dealer in return for client referrals. [56]

Directed Brokerage.

- If an adviser routinely recommends, requests or requires that a client direct the adviser to execute transactions through a specified broker-dealer, the adviser must describe its practice or policy. An adviser must explain that not all advisers require their clients to direct brokerage. If an adviser and the broker-dealer are affiliates or have another economic relationship that creates a material conflict of interest, the adviser must describe the relationship and discuss the conflicts of interest it presents. It must explain that by directing brokerage it may be unable to achieve most favorable execution of client transactions, and that this practice may cost clients more money.

- If an adviser permits a client to direct brokerage, it must describe its practice. If applicable, an adviser must explain that it may be unable to achieve most favorable execution of client transactions. An adviser must explain that directing brokerage may cost clients more money. For example, in a directed brokerage account, the client may pay higher brokerage commissions because the adviser may not be able to aggregate orders to reduce transaction costs, or the client may receive less favorable prices.

As noted above, an adviser must discuss in its Firm Brochure whether and under what conditions it aggregates the purchase or sale of securities for various client accounts, and if the adviser

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[55] This description must be specific enough for the adviser's clients to understand the types of products or services that the adviser is acquiring and to permit them to evaluate possible conflicts of interest. The description must be more detailed for products or services that do not qualify for the safe harbor in section 28(e) of the Exchange Act, such as those services that do not aid in investment decision-making or trade execution. Merely disclosing that the adviser obtains various research reports and products is not specific enough.

[56] The SEC has instituted cease-and-desist proceedings against advisers who fail to disclose arrangements with broker-dealers under which the adviser directs clients' trades through a particular broker in exchange for client referrals from such broker. *See* Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Release No. 34-54165 (July 18, 2006); In the Matter of Folger Nolan Fleming Douglas Capital Management, Inc. Neil C. Folger and David M. Brown, Release No. IA-2639 (August 23, 2007).

does not aggregate orders when it has the opportunity to do so, it must explain its practice and describe the costs to clients of not aggregating.

XII. Insider Trading Policies; Codes of Ethics; Political Contributions and Third Party Solicitors; Foreign Corrupt Practices Act; and Whistleblower Rules

A. INSIDER TRADING POLICY

Section 204A requires registered investment advisers to establish, maintain, and enforce written policies reasonably designed to prevent the misuse of material, non-public information by the adviser or persons associated with the adviser.[57] Although Section 204A does not specify what the procedures should contain, an adviser should take into consideration its operations, organizational structure, and the scope and nature of its business in developing such procedures.

The SEC staff has stressed the importance of maintaining adequate insider trading policies and procedures. The SEC staff has focused, for example, in its inspections on whether an adviser's insider trading policies and procedures address certain heightened risk situations in which the adviser or one of its employees may obtain material, non-public information.[58] [59]

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[57] The Insider Trading and Securities Fraud Enforcement Act of 1988 (the "Insider Trading Act"), among other things, amended the Advisers Act to impose additional compliance obligations on investment advisers. In particular, the Insider Trading Act expanded the potential exposure of civil penalties to investment advisers and their "controlling persons" who knowingly or recklessly fail to take appropriate measures to prevent insider trading violations by their employees. The SEC Staff has observed Section 204A violations whereby advisers failed to address the MNPI risks posed by their employees (i) interacting with: (a) insiders of publicly-traded companies, (b) outside consultants arranged by "expert network" firms, or (c) "value added investors" (e.g., corporate executives or financial professional investors that have information about investments); (ii) who could obtain MNPI through their ability to access office space or systems of the adviser or its affiliates that possessed MNPI; and (iii) who periodically had access to MNPI about issuers of public securities, for example, in coNAnnection with a private investment in public equity *See* SEC Office of Compliance Inspection and Examinations Risk Alert, "Observations from Examinations of Investment Advisers Managing Private Funds" (June 23, 2020) available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert.pdf.

[58] Such situations include, for example, those in which a member of the adviser's personnel serves as director of a publicly traded company or on a creditors committee or a private fund advised by the adviser has an investor that is an officer or director of a publicly-traded company. Additionally, advisers should adopt and implement written policies and procedures designed to identify third parties providing services to them, such as outside consultants, temporary employees and interns, and assessing whether, based on their functional roles and access to nonpublic client information, such third parties should be subject to some or all of the adviser's compliance policies and procedures, including its code of ethics. Advisers should also consider adopting policies and procedures designed to prevent the misuse of material, nonpublic information received from expert network firms and other research firms (e.g., political intelligence analysts).

[59] *See* In the Matter of Ares Management LLC, Release No. 5510 (May 26, 2020) (inadequate policies and procedures to monitor MNPI where an employee of the adviser serves on the board of a portfolio company and continues to be involved in investment decisions involving that company). See also In the Matter of Cannell Capital, LLC, Release No. 5441 (February 4, 2020) (failure to follow written policies and procedures by not maintaining a

B. CODE OF ETHICS

(i) *Adopting a Code of Ethics*

Rule 204A-1 requires a registered investment adviser to adopt a code of ethics.[60] An adviser's code of ethics must include, at minimum, the following:

- a standard of business conduct expected of supervised persons that establishes ideals for ethical conduct, reflects the adviser's fiduciary duty to clients and requires supervised persons to comply with applicable federal securities laws;
- provisions requiring access persons[61] to report their personal securities transactions and holdings to the adviser and for the adviser to review such reports (as further discussed below);
- provisions requiring supervised persons to report violations of the code to designated persons, including the chief compliance officer; and
- provisions requiring the adviser to provide supervised persons with a copy of the code of ethics and obtain a written acknowledgement of receipt from each such person.

An adviser is required to describe its code of ethics in Part 2 of Form ADV and to offer to provide a copy of the code to clients or prospective clients.

(ii) *Reporting Requirements*

An adviser's code of ethics must require all access persons to submit periodic reports to the compliance officer (or other designated person), as follows:

Holdings Reports. Within ten days of becoming an access person and once a year thereafter, each such person must provide the adviser with a holdings report, current as of a date not more than 45 days prior to the individual becoming an access person (with respect to the first report) or the date the report is submitted (with respect to subsequent reports). The holdings report must contain at least the following information:

- the title and type of security, the ticker symbol or CUSIP number, as applicable, and the number of shares and principal amount of each reportable security[62] in which the access person has any direct or indirect beneficial ownership;

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reasonably designed list of securities that firm personnel and their family household members were prohibited from trading after the firm came into possession of potential material nonpublic information).

60 Most of the requirements of Rule 204A-1 mirror those contained in Rule 17j-1 under the Investment Company Act, which apply to registered investment companies and certain of their service providers.

61 "Access persons" include any supervised person who has access to nonpublic information regarding client transactions or the portfolio holdings of any reportable fund, and anyone involved in making recommendations to clients or who has access to nonpublic recommendations. If the adviser's primary business is providing investment advice, all directors, officers and partners are presumed to be access persons.

62 A "reportable security" includes all securities other than direct obligations of the U.S. government, money market instruments (e.g., bank certificates of deposit, commercial paper, repurchase agreements, etc.), shares of money market funds and other types of mutual funds (other than affiliated mutual funds) and unit investment trusts, if the trust is invested exclusively in unaffiliated mutual funds. The staff of the SEC recommended that all ETFs be treated as reportable securities regardless of form (unit investment trust or open-ended) and be reported. *See* National Compliance Service, SEC No-Action Letter (pub. avail. Nov. 30, 2005).

- the name of the broker, dealer or bank with which the access person maintains an account in which any securities are held for the access person's direct or indirect benefit; and
- the date the report is submitted.

Transaction Reports. Access persons must provide the adviser with transaction reports within 30 days after the end of each calendar quarter, covering all their securities transactions during the quarter. The report must contain at least the following information with respect to each reportable security in which the access person had, or acquired, any direct or indirect beneficial ownership:

- the title and amount of the security acquired or disposed;
- the date and nature of the transaction (that is, purchase, sale or other acquisition or disposition);
- the ticker symbol or CUSIP number, as applicable;
- the execution price, interest rate and maturity date, as applicable;
- the bank, broker or dealer by or through which the trade was executed; and
- the date of the report.

Exceptions from Reporting. Access persons are not required to submit reports with respect to securities held in accounts over which the access person has no direct or indirect influence or control (each, a "non-control account"), transactions that are effected pursuant to an automatic investment plan or if the report would duplicate information contained in broker confirmations or account statements that are received within 30 days after the end of the applicable quarter. Prior to permitting an employee to rely on the reporting exception for a non-control account, an adviser should take steps to establish a reasonable belief that the account qualifies as a non-control account. The SEC staff has suggested that the adviser may consider, for example, (i) obtaining information about the relationship between the trustee or manager of the account and the access person; (ii) obtaining periodic certifications by access persons and their trustee or manager regarding the access person's influence or control over the non-control account; and (iii) on a sample basis, requesting reports on holdings and/or transactions made in the non-control account to identify transactions that would have been prohibited pursuant to the code of ethics, absent reliance on this reporting exception.[63]

(iii) *Pre-approval of Certain Transactions*

The code of ethics must require access persons to obtain the adviser's approval before effecting transactions in initial public offerings or limited offerings. In accordance with the books and records rule, the adviser is also required to maintain records of its decision to approve these transactions and the reasons supporting such decision. (*See* Section XX. – "Recordkeeping Requirements" below).

(iv) *Exceptions for Small Advisers*

Advisers with only one access person are not required to submit reports to themselves or to obtain approval for trades, provided that they maintain records of holdings and transactions, as required by the Rule.

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[63] *See* Investment Management Guidance Update, Personal Securities Transactions Reports by Registered Investment Advisers: Securities Held in Accounts Over Which Reporting Persons Had No Influence or Control, No. 2015-03 (June 2015), *available at* https://www.sec.gov/investment/im-guidance-2015-03.pdf.

C. POLITICAL CONTRIBUTIONS; THIRD PARTY SOLICITORS

(i) *Political Contributions*

Rule 206(4)-5 under the Advisers Act prohibits an adviser from receiving compensation for providing advisory services to a government entity for two years following any contribution, other than certain *de minimis* contributions, by the adviser or its covered associates to an official of the government entity who is or will be in a position to influence the award of advisory business.[64] In addition, an adviser is prohibited from coordinating, or soliciting others to make, contributions for an official of a government entity to which the adviser is providing or seeking to provide advisory services.

(ii) *Payments to Third Party Solicitors*

Rule 206(4)-5 prohibits an adviser from providing, or agreeing to provide, directly or indirectly, payments to third parties to solicit government entities for advisory business on the adviser's behalf, unless such third parties are regulated persons, which include certain broker-dealers and registered investment advisers that are themselves subject to similar pay to play restrictions.

For a discussion of the requirements for Rule 206(4)-3 with respect to cash payments to solicitors for client referrals, *see* Section XVI below.

(iii) *Recordkeeping Requirements*

Rule 204-2 requires an adviser that has government clients or that provides advisory services to a covered investment pool in which a government entity investor invests to keep detailed information regarding its covered associates, the government entities to which the adviser provides or seeks to provide advisory services and political contributions made by the adviser and its covered associates to certain officials, political parties and political action committees. In addition, an adviser, regardless of whether it has government clients, must, following a date to be determined by the SEC, keep a list of the name and business address of each regulated person to whom the adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity on its behalf.

D. GIFTS AND ENTERTAINMENT

Investment advisers and their employees sometimes engage in the practices of giving gifts and entertaining others for purposes of marketing and other reasons. In addition, investment advisers and their employees may also receive gifts from and be entertained by broker-dealers and other companies that provide services to the advisers or their clients. These practices create conflicts of interest between an adviser and its clients.

Neither Rule 204A-1 under the Advisers Act, the rule that requires investment advisers to maintain codes of ethics, nor any other rule or provision under the Advisers Act regulates gifts and entertainment or requires procedures governing gifts and entertainment practices. The adopting release of Rule 204A-1 noted, however, that many advisers have procedures in their codes of ethics that are in addition to those required by the Rule, including limitations on acceptance of gifts (*i.e.*, a gifts and entertainment policy). The SEC staff has also issued guidance stating that the receipt of gifts or entertainment by investment advisers and their employees may implicate Section 17(e)(1) of the Investment Company Act, which prohibits an affiliated person of a fund (e.g., an adviser and its employees) from accepting from any source any compensation (other than regular salary or wages from the fund) for the purchase and sale of any property to or for the fund. Accordingly, the SEC staff has indicated in such

[64] In January 2017, the SEC announced settlements with ten investment advisory firms charged with violating Rule 206(4)-5. *See* Press Release, Sec. & Exch. Comm'n, 10 Firms Violated Pay-to-Play Rule By Accepting Pension Fund Fees Following Campaign Contributions, (Jan. 17, 2017).

guidance that the receipt of gifts or entertainment by investment advisers should be addressed in the fund's compliance manual.[65]

The SEC has brought enforcement actions against investment advisers engaged in abusive gift and entertainment practices. These actions provide guidance regarding the boundaries of what constitutes permissible gift and entertainment practices.[66]

E. FOREIGN CORRUPT PRACTICES ACT

The Foreign Corrupt Practices Act ("FCPA") prohibits payments intended to improperly influence foreign officials. Persons subject to the FCPA may not pay, offer to pay, promise to pay or authorize the payment directly or indirectly through a third-party of anything of value to any "foreign official" in an attempt to influence any act or decision of the foreign official in his or her official capacity or to secure an improper advantage in order to obtain or retain business.

Congress enacted the FCPA in 1977 in response to scandals involving bribes by U.S. public companies to illegally influence decisions made by foreign governments. The FCPA applies beyond U.S. public companies to, among other persons, U.S. investment advisers and their business partners seeking investments from government entities located outside the U.S. The SEC in a sweep letter issued in 2013 focused on "pay to play" activities outside the U.S. As a result, investment advisers have implemented procedures designed to ensure that their employees and third-parties comply with the FCPA.[67]

In addition to the FCPA, investment advisers must potentially comply with other corruption, bribery or ethics laws in countries where investments are sought. In addition, such countries may have licensing requirements.

F. WHISTLEBLOWER RULES

The SEC, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, adopted whistleblower rules ("Whistleblower Rules") designed to create incentives for employees at investment advisers (and other SEC-regulated entities) to report possible violations of the federal securities laws to the SEC by rewarding individuals for credible tips that lead to successful enforcement actions.[68] The Whistleblower Rules also protect reporting employees from retaliatory actions taken by their investment adviser employers.[69]

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[65] *See* Investment Management Guidance Update, Acceptance of Gifts or Entertainment by Fund Advisory Personnel – Section 17(e)(1) of the Investment Company Act, No. 2015-01 (February 2015), *available at* https://www.sec.gov/investment/im-guidance-2015-01.pdf.

[66] *See*, e.g., Fidelity Management & Research Company and FRM Co., Inc. (Investment Advisers Act Rel. 2713 (March 5, 2008)).

[67] *See* In the Matter of Legg Mason, Release No. 3961 (August 2018); In the Matter of Och-Ziff Capital Management Group LLC, Release No. 4540 (September 2016); In the Matter of Garth Ronald Peterson, Release No. 3501 (November 2012).

[68] *See* Section 21F of the Exchange Act and Rules 21F-1 through 21F-17 thereunder.

[69] In this regard, an adviser should ensure that its policies and its agreements with employees do not prohibit or otherwise disincentivize an employee from reporting potential federal securities law violations. The SEC brought an enforcement action against an investment adviser in April 2015 for requiring employees to sign confidentiality statements containing "improperly restrictive language" that could be read to discourage employees from reporting potential violations of the federal securities laws. *See*, e.g., In the Matter of KBR, Inc., Administrative Proceeding, File No. 3-16466, Release No. 34-74619 (Apr. 1, 2015). In October 2016, the Division of Examinations also released a Risk Alert regarding compliance with whistleblower rules, with particular attention to examining employment agreements and severance agreements to determine whether they contain confidentiality and other

provisions that would impede employees and former employees from communicating with the SEC concerning possible securities law violations. *See* Office of Compliance Inspections and Examinations, Securities and Exchange Commission, National Examination Risk Alert Vol. 6-1, Examining Whistleblower Rule Compliance (Oct. 24, 2016), *available at* https://www.sec.gov/ocie/announcement/ocie-2016-risk-alert-examining-whistleblower-rule-compliance.pdf.

XIII. Custody

Rule 206(4)-2 governs the custody of advisory client assets.

A. DEFINITION OF CUSTODY

A registered investment adviser (or a related person of a registered investment adviser in connection with advisory services the registered investment adviser provides to clients) has "custody" of client funds or securities ("client assets") if the adviser holds, directly or indirectly, client assets or has authority to obtain possession of them. The adviser has custody if a related person holds, directly or indirectly, client assets or has authority to obtain possession of them, in connection with advisory services provided by the adviser.[70] Examples of circumstances in which a registered investment adviser will have custody include the following:

- the registered investment adviser has possession of client assets, unless received inadvertently and returned promptly (within three business days);
- the registered investment adviser or any related person is authorized or permitted (including by general power of attorney or the custodial agreement between the client and the custodian) to withdraw client assets maintained with a custodian upon the adviser's instruction to the custodian other than for authorized trading (e.g., authority to write checks, pay bills, pay taxes, etc.) [71];
- a registered investment adviser or any related person acts in any legal capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle) that gives it legal ownership of or access to client assets;
- the registered investment adviser or any related person is a (i) trustee of a trust for the benefit of a client or (ii) a trustee of a participant-directed defined contribution plan established for the adviser's employees and the adviser acts as investment adviser to the plan or any investment plan option;[72] and

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[70] In February 2017, the SEC staff issued guidance on additional scenarios in which a registered investment adviser is deemed to have custody of client assets, including (i) standing letters of instruction established by a client with a qualified custodian that grant the adviser the authority to disburse client assets to one or more third parties specifically designated by the client (*see* Investment Adviser Association, SEC No-Action Letter (Feb. 21, 2017), *available at* https://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm, (ii) arrangements that grant the investment adviser the authority to transfer a client's assets between the client's accounts maintained at one or more qualified custodians (Staff Responses to Questions About the Custody Rule, Question II.4, U.S. Sec. & Exc. Comm'n, *available at* https://www.sec.gov/divisions/investment/custody_faq_030510.htm (posted Feb. 21, 2017)), and (iii) provisions in a custodial agreement that grant the adviser access to client assets even though the adviser did not otherwise intend to have such access (U.S. Sec. & Exc. Comm'n Div. of Inv. Mgmt., Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority, Investment Management Guidance Update (Feb. 2017), *available at* https://www.sec.gov/investment/im-guidance-2017-01.pdf). The SEC staff subsequently clarified in June 2018 that an adviser that does not have a copy of a client's custodian agreement and does not know, or have reason to know whether the agreement would give the adviser inadvertent custody need not comply with the custody rule with respect to that client's account if inadvertent custody would be the sole basis for custody (Staff Responses to Questions About the Custody Rule, Question II.11, U.S. Sec. & Exc. Comm'n, *available at* https://www.sec.gov/divisions/investment/custody_faq_030510.htm (posted June 5, 2018)).

[71] The SEC has clarified that authority to trade is not considered custody.

[72] When a supervised person of the adviser serves as executor, conservator or trustee for an estate, conservatorship or trust solely because the supervised person has been appointed in these capacities as a result of a family or

- the registered investment adviser deducts fees from client accounts (through arrangements with clients and the qualified custodian).

B. CUSTODY REQUIREMENTS

A registered investment adviser with custody is required to:

- Maintain client assets with a "qualified custodian" which includes banks, registered broker-dealers, registered futures commissions merchants and foreign financial institutions (provided certain conditions are met).[73] Client assets must be held in an account under the client's name or under the adviser's name as agent or trustee for its client. Shares of mutual funds and certain "privately offered securities" (described below) are not required to be maintained with a qualified custodian.

- Promptly notify clients in writing of the qualified custodian's name, address and manner in which the assets are maintained. Clients should also be notified following any changes in this information.

- Arrange for account statements to be sent to clients at least quarterly by the qualified custodian.[74] The account statement must state: (i) the amount of funds; (ii) each security in custody at the end of such quarter; and (iii) all transactions for the quarter, including fees deducted. The account statement is not required, however, to disclose the market value of the securities.

- The adviser must have a reasonable belief after due inquiry that the qualified custodian has satisfied the account statement requirement. The qualified custodian is permitted to use a service provider to deliver the statements provided that the statements are sent to the client directly and not through the adviser.

- If the adviser has arranged for the qualified custodian to send quarterly account statements to clients that are pooled investment vehicles, the account statements must be sent to each limited partner (or other comparable underlying owner).

- If the adviser elects to send quarterly statements directly to clients (in addition to those sent by the qualified custodian) and the adviser is required to send notice to clients because the adviser has opened a custodial account, following any changes to the information required in that notification and in any subsequent quarterly account statements delivered to clients, the adviser must also include a legend urging clients to compare quarterly statements they receive from the custodian with those received from the adviser.

- Undergo an annual surprise examination by an independent public accountant of those client assets for which the adviser has custody unless one of the following exceptions is applicable: (i) the client is a pooled investment vehicle in compliance with the annual audit provision (*see* "Special

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personal relationship with the decedent, beneficiary or grantor (not as the result of employment with the adviser), the adviser is not deemed to have custody of the funds or securities of the estate, conservatorship or trust.

[73] *See* Rule 206(4)-2(d) for a complete list of "qualified custodians". In order to be a "qualified custodian", a foreign financial institution that customarily holds financial assets for its customers must keep a client's funds and securities segregated from its own proprietary assets. The SEC has stated that in selecting a foreign financial institution to hold client assets, an adviser must either have "a reasonable basis for believing that the foreign institution will provide a level of safety for client assets similar to that which would be provided by a 'qualified custodian' in the United States" or disclose to clients any material risks of maintaining the assets with the foreign custodian. *See* also Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2176 (Nov. 5, 2003).

[74] A client may designate another party to receive the quarterly account statements. The Rule refers to such persons as "Independent Representatives". An Independent Representative is a person that (a) acts as agent for an advisory client and by law or contract is obligated to act in the best interest of the advisory client; (b) does not control, is not controlled by, and is not under common control with the adviser; and (c) does not, and has not had within the past two years, a material business relationship with the adviser.

Circumstances" below); (ii) the adviser has custody of client assets solely as a consequence of its authority to deduct advisory fees from client accounts; or (iii) the adviser is deemed to have custody solely as a result of certain of its related persons holding client assets and a determination has been made that the adviser is "operationally independent" of the affiliated custodian.

- Obtain, or receive from its related person, a written internal control report ("ICR") with respect to those clients for which a registered investment adviser or a related person, rather than an independent custodian, serves as the qualified custodian of client assets in connection with advisory services provided by the adviser. The ICR must be prepared by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB-Registered") as of the commencement of the engagement and as of each calendar year-end.

C. SPECIAL CIRCUMSTANCES

(i) *Pooled Investment Vehicles Subject to Annual Audits*

With respect to pooled investment vehicles, an adviser with custody is exempt from the account statement delivery and the surprise exam requirements discussed above provided that: (i) the pooled investment vehicle is subject to an annual audit; (ii) the audited financial statements are prepared in accordance with U.S. generally accepted accounting principles ("GAAP")[75]; (iii) the audited financial statements are distributed to all underlying owners of the pooled investment vehicle within 120 days[76] of the end of the pooled investment vehicle's fiscal year; (iv) the annual audit is conducted by an independent public accountant that is PCAOB-Registered as of the commencement of the engagement and as of the calendar year-end; and (v) upon liquidation the pooled investment vehicle must have a final liquidation audit and distribute audited financial statements prepared in accordance with GAAP to its investors promptly after completion of such audit. If an adviser is not able to rely on this exception, the adviser will be required to comply with the quarterly account statement and surprise examination requirements discussed above.[77]

(ii) *Privately Offered Securities*

An adviser with custody is exempt from the requirement to maintain client assets with a qualified custodian, if: (i) the securities were not acquired through a public offering; (ii) ownership of the securities is uncertificated and recorded only on the books of the issuer or its transfer agent in the name of the client; and (iii) transfer of ownership is subject to the prior consent of the issuer or the holders of the issuer's outstanding securities.

(iii) *Special Purpose Vehicles and Escrows*

An adviser to private funds may form special purpose vehicles ("SPVs") to facilitate investments in certain securities by one or more pooled investment vehicles managed by the adviser. The SEC staff has issued guidance in the form of a series of examples as to when an adviser must treat an SPV as a separate client for purposes of the custody requirements, which would require the adviser to obtain a separate audit of the SPV and deliver audited financial statements of the SPV to the beneficial owners of

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[75] With respect to a pooled investment vehicle that is organized outside of the U.S. or has a general partner or other manager with a principal place of business outside the U.S., the financial statements can be prepared in accordance with accounting standards other than GAAP, provided that (i) the financial statements contain information substantially similar to financial statements prepared in accordance with GAAP, and (ii) the financial statements reconcile any material variations between the accounting standard used and GAAP.

[76] For advisers to funds-of-funds, the period in which the adviser must distribute audited financial statements is 180 days. To be eligible for the extended deadline, the fund-of-funds must invest at least 10% of its assets in other unrelated pooled vehicles.

[77] The SEC staff has provided no-action relief in narrow circumstances in which an audit is not required. *See* 16th Amendment Advisors LLC, SEC No-Action Letter (pub. avail. Mar. 23, 2015).

the pooled investment vehicle(s) invested in the SPV.[78] The guidance states that an adviser must treat an SPV as a separate client when the SPV has owners other than private fund clients of the adviser and related persons of the adviser.

[78] *See* Investment Management Guidance Update, Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows, No. 2014-07 (June 2014), *available at* https://www.sec.gov/investment/im-guidance-2014-07.pdf.

XIV. Valuation

The price, or fair value, that an investment adviser determines for securities held in its client accounts significantly impacts its relationship with its clients. This includes direct impacts on (i) the compensation paid to the investment adviser; (ii) the performance reported for the accounts and related marketing activities; and (iii) the relative ownership interests held by investors in pooled investment vehicles (*e.g.*, investors in a private fund purchase and redeem their interests at net asset value per share which is determined based on the value of portfolio assets). As a result, an investment adviser faces significant conflicts of interest when valuing any security held in client accounts. The adviser receives compensation based on the value of assets under management and, in some cases, the performance of an account. These compensation arrangements create an incentive for the adviser to ascribe higher values to portfolio securities and assets to generate greater asset-based and performance-based advisory fees for itself (*e.g.*, asset-based fees are often equal to a percentage of the accounts net asset value), or to enhance its ability to attract new clients and retain existing clients by showing better performance.

As discussed in Section VI, an investment adviser, as a fiduciary, must fully and fairly disclose to its clients all material facts pertaining to its services, including those relating to potential conflicts of interest. In order to address conflicts related to valuations when it is responsible for determining such valuations, an investment adviser should adopt and consistently apply policies and procedures reasonably designed to value the holdings in their client accounts in a fair and consistent manner.[79] The exact valuation methods and related policies and procedures will vary from investment adviser to investment adviser based on the types of securities they invest in, the types of clients they service, their internal organizational structures, and other relevant factors. The potential for conflicts of interests and improper valuations also varies depending on the particular securities involved.

[79] On June 4, 2019, Deer Park Road Management Company, LP ("Deer Park") agreed to settle SEC charges stemming from Deer Park's violation of Section 206(4) and Rule 206(4)-7 of the Advisers Act by agreeing to an SEC order imposing a $5 million penalty and other relief. The SEC found that Deer Park had (i) insufficient valuation policies and procedures (i.e., with respect to safeguards against inconsistent approaches to valuation and conflicts of interest present when traders set the values of securities in the portfolios they manage) and (ii) deficient implementation of policies and procedures (i.e., valuing securities using internal models although Deer Park's policies and procedures required trades to prioritize the use of observable inputs such as market information). In re Deer Park Road Management Company, LP, and Scott E. Burg, Administrative Proceeding File No. 3-19190 (June 4, 2019), *available at* https://www.sec.gov/litigation/admin/2019/ia-5245.pdf. *See also* SEC Office of Compliance Inspection and Examinations Risk Alert, "Observations from Examinations of Investment Advisers Managing Private Funds" (June 23, 2020) available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert.pdf.

XV. Marketing

[NOTE: In December 2020, the SEC adopted amendments to Rule 206(4)-1 (the "Advertising Rule") and rescinded Rule 206(4)-3 (the "Cash Solicitation Rule"). The amendments merge the requirements of the Advertising Rule and the Cash Solicitation Rule into new Rule 206(4)-1, which covers investment adviser marketing (the "Marketing Rule"). The Marketing Rule became effective on May 4, 2021 and has a compliance date of November 4, 2022. An adviser may choose to comply with the Marketing Rule in its entirety any time starting on May 4, 2021. Until an adviser transitions to the Marketing Rule, the adviser must continue to comply with the Advertising Rule and Cash Solicitation Rule and the SEC staff's positions thereunder.[80]The Advertising Rule and Cash Solicitation Rule, and the SEC staff's positions thereunder, are discussed in Sections V and VI of the Appendix hereto. The Marketing Rule is discussed in this Section XV.

On October 21, 2021, the Staff of the Division of Investment Management released additional guidance through an IM Information Update[81] announcing the withdrawal and modification of certain staff statements and no-action letters relating to the Advertising Rule and Cash Solicitation Rule. The staff identified a number of no-action letters and previously issued guidance in Appendix A of this update that will be modified or withdrawn as part of the adoption of the Marketing Rule. These updates announced as part of this Information Update will become effective on November 4th, 2022, the same date as the Marketing Rule compliance date.]

Under the Marketing Rule (Rule 206(4)-1), the term "advertisement" is broadly defined and includes two prongs, the first covering "traditional" advertising and the second covering testimonials and endorsements.

First Prong. The first prong includes any direct or indirect communication an adviser makes to more than one person that offers the adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the adviser, or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the adviser.

The first prong does not include:

- extemporaneous, live, oral communications;[82]
- information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing, or other required communication; or
- a communication that includes hypothetical performance[83] that is provided (i) in response to an unsolicited request for such information from a prospective or current client or investor in a private

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80 *See* Marketing Compliance Frequently Asked Questions (April 14, 2021), *available at* https://www.sec.gov/investment/marketing-faq.

81 *See* IM Information Update IM – Info – 2021 - 10 (October 2021), available at https://www.sec.gov/files/2021-10-information-update.pdf.

82 "Extemporaneous" communications do not include prepared remarks or speeches (such as those delivered from scripts). Slides or other written materials that are distributed or presented to an audience would be deemed advertisements if they meet the definition. Investment Adviser Marketing, SEC Release No. IA-5653 (Dec. 22, 2020), at 39-40: https://www.sec.gov/rules/final/2020/ia-5653.pdf (referred to as "Marketing Rule Adopting Release" throughout the rest of this section).

83 "Hypothetical performance" means performance results that were not actually achieved by any portfolio of the adviser, and includes model performance, back-tested performance and target or projected performance returns. Final rule 206(4)-1(e)(8). See Section D(5) below (discussing hypothetical performance).

fund advised by the adviser or (ii) to a prospective or current investor in a private fund advised by the adviser in a one-on-one communication.

Second Prong. The second prong includes any testimonial or endorsement for which an adviser directly or indirectly provides compensation, including cash and non-cash forms of compensation.[84]

- A "testimonial" is a statement by a current client or investor in a private fund advised by the adviser about the client or investor's experience with the adviser or its supervised persons.

- An "endorsement" is a statement by a person other than a current client or investor in a private fund advised by the adviser that indicates approval, support or recommendation of the adviser or its supervised persons or describes that person's experience with the adviser or its supervised persons.

Both testimonials and endorsements also capture statements that (i) directly or indirectly solicit any current or prospective client or investor to be a client of the adviser or an investor in a private fund advised by the adviser; or (ii) refer any current or prospective client or investor to be a client of the adviser or an investor in a private fund advised by the adviser.

A. GENERAL PROHIBITIONS

The Marketing Rule sets forth seven principles-based general prohibitions that apply to all advertisements. Specifically, an adviser may not, directly or indirectly, disseminate any advertisement that:

- includes any untrue statement of a material fact, or omits to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading;

- includes a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC;

- includes information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the adviser;

- discusses any potential benefits to clients or investors connected with or resulting from the adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits;

- includes a reference to specific investment advice provided by the adviser where such investment advice is not presented in a manner that is fair and balanced;

- includes or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or

- otherwise is materially misleading.

[84] Such compensation may include, for example, fees based on a percentage of assets under management or amounts invested, flat fees, retainers, hourly fees, reduced advisory fees, fee waivers, and any other methods of cash compensation, and cash or non-cash rewards, such as directed brokerage, sales awards and other prizes, gifts and entertainment (e.g., outings, tours or other forms of entertainment). Marketing Rule Adopting Release at 48; *See also,* 2019 Proposing Release, supra footnote 7, at nn.357 and 358 and accompanying text (discussing, for example, refer-a-friend programs).

B. CONDITIONS APPLICABLE TO TESTIMONIALS AND ENDORSEMENTS, INCLUDING SOLICITATIONS

An adviser may use advertisements that include a testimonial or endorsement, and may provide compensation (directly or indirectly) for a testimonial or endorsement, if the adviser complies with the following three conditions: (i) the Disclosure Requirement; (ii) the Adviser Oversight and Compliance Requirement; and (iii) the Disqualification Provision, each of which is described below.

(i) *Disclosure Requirement*

The adviser must disclose, or reasonably believe that the person giving the testimonial or endorsement (such person, a "promoter") discloses, the following at the time the testimonial or endorsement is disseminated:

The following must be *clearly and prominently*[85] disclosed:

- if a testimonial, that it was given by a current client or investor, or if an endorsement, that it was given by a person other than a current client or investor;
- if applicable, that cash or non-cash compensation was provided for the testimonial or endorsement; and
- a brief statement of any material conflicts of interest on the part of the promoter resulting from the adviser's relationship with such person.

The following must also be disclosed:

- the *material terms* of any compensation arrangement, including a description of the compensation provided or to be provided, directly or indirectly, to the promoter;[86] and
- the *material conflicts of interest* on the part of the promoter resulting from (i) the adviser's relationship with the promoter and/or (ii) any compensation arrangement must be disclosed.

(ii) *Adviser Oversight and Compliance Provision*

The Oversight and Compliance Provision includes two separate requirements:

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[85] To be clear and prominent, the disclosures must be at least as prominent as the testimonial or endorsement. The "clear and prominent" standard requires that the disclosures be included within the testimonial or endorsement, or in the case of an oral testimonial or endorsement, provided at the same time. such disclosures should appear close to the associated statement such that the statement and disclosures are read at the same time, rather than referring the reader somewhere else to obtain the disclosures. Where an oral testimonial or endorsement is provided, it would be consistent with the clear and prominent standard if the disclosures are provided in a written format, so long as they are provided at the time of the testimonial or endorsement. The requirement to provide the disclosures clearly and prominently may necessitate formatting and tailoring based on the form of the communication. *See* Marketing Rule Adopting Release at 90-91; *See* final rule 206(4)-1(b)(1)(i)(A) through (C).

[86] The SEC has further clarified that certain aspects of compensation should be disclosed (if applicable) including: specific amounts of cash compensation paid, the percentage and time period if compensation takes the form of a percentage of the total advisory fee over a period of time, the value of non-cash compensation if readily ascertainable, as well as whether compensation, cash or non-cash, is payable upon dissemination of the testimonial or endorsement or is deferred or contingent on a certain future event (i.e. an investor's continuation or renewal of the advisory relationship, agreement or investment). *See* Marketing Rule Adopting Release at 96.

- *Reasonable Basis*. The adviser must have a reasonable basis for believing that any testimonial or endorsement complies with the requirements of the Marketing Rule.[87]

- *Written Agreement*. The adviser must have a written agreement with any person giving a compensated testimonial or endorsement that describes the scope of the agreed upon activities and the terms of the compensation for those activities.[88]

(iii) *Disqualification Provision*

The adviser may not compensate certain "bad actors" and other ineligible persons for a testimonial or endorsement (the "Disqualification Provision"). In particular, the adviser is prohibited from compensating a person, directly or indirectly, for a testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should know, that the person giving the testimonial or endorsement is an *ineligible person* at the time of solicitation.[89]

(iv) *Exemptions*

The Marketing Rule contains exemptions from certain of the above-mentioned requirements for testimonials and endorsements that are disseminated:

- for no compensation or *de minimis* compensation;[90]

- by a partner, officer, director or employee of the adviser or its affiliates;[91]

- by an SEC-registered broker-dealer;[92] or

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[87] What constitutes a "reasonable basis" depends on the facts and circumstances. Examples of what could constitute a "reasonable basis" for believing that the testimonial or endorsement complies with the requirements of final rule include: periodically making inquiries of a sample of investors solicited or referred by the promoter in order to assess whether the promoter's statements comply with the rule, an adviser's implementation of policies and procedures as a means to form a reasonable basis for believing that the testimonial or endorsement complies with the rule; and an adviser including terms in a written agreement with a promoter. *See* Marketing Rule Adopting Release at 110.

[88] There are two exemptions from this written agreement Requirement: (i) testimonials and endorsements disseminated for no compensation or *de minimis* compensation ($1,000 or less during the preceding 12 months), and (ii) testimonials and endorsements by an adviser's affiliates. *See* Marketing Rule Adopting Release at 135-136.

[89] An "ineligible person" is a person who is subject to either a "disqualifying Commission action" or to any "disqualifying event" (as defined in Rule 206(4)-1(e)), and certain of that person's employees and other persons associated with an ineligible person. *See* Marketing Rule Adopting Release at 309.

[90] "*De minimis* compensation" means a total of $1,000 or less (or the equivalent value in non-cash compensation) paid during the preceding 12 months. Final rule 206(4)-1(e)(2); *See* Marketing Rule Adopting Release at 146.

[91] Testimonials and endorsements by certain affiliates of an adviser are exempt from the Disclosure Requirements if (a) the affiliation between the adviser and the affiliate is "readily apparent" to or is disclosed to the client or investor at the time the testimonial or endorsement is disseminated, and (b) the adviser documents the affiliate's status at the time the testimonial or endorsement is disseminated. *See* Marketing Rule Adopting Release at 136-138.

[92] A testimonial or endorsement by a SEC-registered broker-dealer is exempt from the following requirements that would otherwise apply to a testimonial or endorsement: (i) the Disclosure Requirement, provided, that the testimonial or endorsement is a recommendation subject to Regulation Best Interest under the Securities Exchange Act of 1934, as amended (the "Exchange Act"); (ii) the disclosure of the material terms of any compensation arrangement and any material conflicts of interest requirement of the Disclosure Requirement, provided, that the testimonial or endorsement is provided to a person that is not a "retail customer" as defined under Regulation Best Interest; and (iii) the Disqualification Provision, provided, that the broker or dealer is not

- by a person that is covered by Rule 506(d) under the Securities Act of 1933 with respect to a Rule 506 securities offering and whose involvement would not disqualify the offering under Rule 506.

(v) *Third-Party Ratings*

A "third-party rating" is a rating or ranking of an adviser provided by a person who is not a "related person" of the adviser, and the person provides such ratings or rankings in the ordinary course of its business. An advertisement may not include any third-party ratings unless the adviser:

- has a reasonable basis for believing that any questionnaire or survey used in the preparation of the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result; and

- clearly and prominently discloses, or the adviser reasonably believes that the third-party rating clearly and prominently discloses: (i) the date on which the rating was given and the period of time upon which the rating was based; (ii) the identity of the third party that created and tabulated the rating; and (iii) if applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.

(vi) *Performance Advertising*

The Marketing Rule imposes tailored requirements on the use of the following types of performance results in advertisements: gross performance; related performance; extracted performance; hypothetical performance; and predecessor performance.

1. *Net Performance Requirement*

An adviser may include a presentation of gross performance in an advertisement provided that the advertisement also presents net performance that: (i) is presented with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance; and (ii) is calculated over the same time period, and using the same return methodology, as the gross performance.[93]

2. *Prescribed Time Periods*

An adviser may not include in any advertisement the performance results of any portfolio or any composite aggregation of related portfolios, unless:

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subject to statutory disqualification, as defined in Section 3(a)(39) of the Exchange Act. *See* Marketing Rule Adopting Release at 50 & 146-150.

[93] "Gross performance" means the performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable) before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services to the relevant portfolio. *See* Marketing Rule Adopting Release at 169-170.

"Net performance" means the performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable) after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services to the relevant portfolio, including, if applicable, advisory fees, advisory fees paid to underlying investment vehicles, and payments by the adviser for which the client or investor reimburses the adviser. Net performance: (i) may reflect the exclusion of custodian fees paid to a bank or other third-party organization for safekeeping funds and securities; and/or (ii) if using a model fee, must reflect one of the following: (A) the deduction of a model fee when doing so would result in performance figures that are no higher than if the actual fee had been deducted; or (B) the deduction of a model fee that is equal to the highest fee charged to the intended audience to whom the advertisement is disseminated. *See* Marketing Rule Adopting Release at 171-174.

- the advertisement includes performance results of the same portfolio or composite aggregation for one-, five- and ten- year time periods; except that if the relevant portfolio did not exist for any such period, then the life of the portfolio must be substituted for that period (all such required time periods are referred to herein as "prescribed time periods"); and

- the results are presented with equal prominence and end on a date that is no less recent than the most recent calendar year-end.

The prescribed time periods requirement, however, does not apply to the presentation in advertisements of the performance results of private funds.

3. *Related Performance*

An adviser may use "related performance" results in an advertisement provided that the performance results of all "related portfolios" are included. Notwithstanding the foregoing, the performance of any related portfolios can be excluded if:

- the advertised performance results are not materially higher than if all related portfolios had been included; and

- the exclusion of any related portfolio does not alter the presentation of any applicable prescribed time period.

Related performance means the performance results of one or more related portfolios, either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios falling within stated criteria and a "related portfolio" as a portfolio with substantially similar investment policies, objectives, and strategies as those of the services being offered in the advertisement.

4. *Extracted Performance*

An adviser may include "extracted performance" results in an advertisement only if the advertisement provides, or offers to provide promptly, the performance results of the total portfolio. Extracted performance means the performance results of a subset of investments extracted from a portfolio.

5. *Hypothetical Performance*

The Marketing Rule permits the use of "hypothetical performance" in advertisements subject to certain requirements described below. Hypothetical performance means performance results that were not actually achieved by any portfolio of the adviser, and it includes, but is not limited to:

- performance derived from model portfolios;

- performance that is backtested by the application of a strategy to data from prior time periods when the strategy was not actually used during those time periods; and

- targeted or projected performance returns with respect to any portfolio or to the investment advisory services with regard to securities offered in the advertisement.

An adviser may include hypothetical performance in an advertisement only if the adviser:

- adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement;

- provides sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance; and

- provides (or, if the intended audience is an investor in a private fund provides, or offers to provide promptly) sufficient information to enable the intended audience to understand the risks and limitations of using such hypothetical performance in making investment decisions.

6. *Predecessor Performance (Portability of Performance)*

An adviser may advertise performance results achieved by a portfolio manager while working for another adviser (called "predecessor performance")[94], provided that the following requirements are satisfied:

- the person or persons who were primarily responsible for achieving the prior performance results manage accounts at the advertising adviser;

- the accounts managed at the predecessor adviser are sufficiently similar to the accounts managed at the advertising adviser that the performance results would provide relevant information to clients or investors;

- all accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of any prescribed time periods; and

- the advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.

[94] "Predecessor performance" means investment performance achieved by a group of investments consisting of an account or a private fund that was not advised at all times during the period shown by the adviser that is advertising the performance. final rule 206(4)-1(e).

XVI. [RESERVED]

XVII. Consumer Protection Regulations

A. REGULATION S-P

Regulation S-P, or the "Privacy Rule," requires registered investment advisers to provide their clients who are individuals with an initial and annual privacy notice describing the adviser's policies regarding the disclosure of clients' nonpublic personal information. An adviser is not required to provide the annual privacy notice if the adviser (1) does not share non-public personal information with non-affiliated third parties (other than as permitted under certain enumerated exceptions under the Gramm-Leach-Bliley Act, *e.g.*, to service providers who perform services on behalf of the adviser, or as necessary to administer a transaction requested by a client), and (2) has not changed its policies and practices regarding disclosure of non-public personal information since the most recent privacy notice provided to its clients.[95]

The privacy notice must disclose the types of information the adviser collects and shares with others and the procedures the adviser has implemented to safeguard that information.[96] If the adviser discloses nonpublic personal information about clients to third parties (other than to affiliates, third parties who effect or process client transactions, the adviser's attorneys, accountants and auditors and to otherwise comply with government requests for information), the adviser must also provide an "opt-out" notice giving the client the opportunity to request that the information not be disclosed to third parties.

The initial notice must be given to the client at the time the advisory relationship is established (usually when the client signs the advisory agreement). The adviser must then give those individuals a privacy notice every calendar year. The notice must be given even if the adviser does not disclose nonpublic information about its clients to third parties.

The adviser must also provide a privacy notice and opt-out notice to individuals who are not regular clients, but to whom the adviser provides an occasional financial product or service. If the adviser generally does not disclose information about such persons to third parties, no opt-out notice is required.

In addition, the adviser must adopt written policies and procedures that protect client records and "consumer report information"[97], including the proper disposal of such information in a reasonable manner, to protect against unauthorized access or use of the information.[98] The policies and procedures must be reasonably designed to ensure the security and confidentiality of client records and information and protect those records and information from threats, hazards and unauthorized use. [99]

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95 *See* Fixing America's Surface Transportation Act (*see* Title LXXV, Section 75001. Eliminate Privacy Notice Confusion).

96 In 2009, the SEC, together with seven other federal agencies, adopted a model privacy form, which is available at http://www.sec.gov/divisions/marketreg/tmcompliance/modelprivacyform-secg.htm.

97 "Consumer report information" means any record about an individual, whether in paper, electronic or other form, that is a consumer report or is derived from a consumer report, including a compilation of such records. It does not include information that does not identify individuals, such as aggregate information or blind data.

98 Certain advisers may be subject to additional information security requirements required by state law.

99 The staff of the Division of Examinations issued a Risk Alert on April 16, 2019 that provided a list of compliance issues related to Regulation S-P that were identified in SEC exams. The staff noted that it observed registrants that (i) failed to provide privacy notices and opt-out notices, (ii) did not have written policies and procedures as required under the Safeguards Rule and (iii) had written policies and procedures that did not appear implemented or reasonably designed to (1) ensure the security and confidentiality of customer records and information, (2) protect against anticipated threats or hazards to the security or integrity of customer records and information, and (3)protect against unauthorized access to or use of customer records or information that could result in substantial

B. REGULATION S-AM

Regulation S-AM prohibits registered investment advisers from using eligibility information (i.e., certain financial information, such as information regarding the client's transactions or experiences) about clients[100] received from an affiliate of such adviser for marketing purposes unless the client is provided with a clear and conspicuous notice that the adviser may use such information, the client is granted a reasonable opportunity to opt-out of such use, and the client does not in fact opt-out of such use. The opt-out notice must be provided by the affiliate with whom the client had or has a pre-existing business relationship. Such notice must be in writing and must (i) identify the affiliate providing the notice; (ii) disclose that the individual may elect to opt-out; (iii) provide the duration of the individual's election (which must be at least five years for both initial and renewal opt-out periods) and (iv) describe a reasonable and simple method for the individual to elect to opt-out.

The adviser may make marketing solicitations to the client 30 days after the affiliate has provided the notice to the client by mail, by e-mail, or electronically (such as by posting the notice on a website); provided that the client has not elected to opt-out. If a client has previously opted out of receiving marketing solicitations, the adviser may make marketing solicitations to the client after the expiration of the opt-out period if, 30 days after the affiliate has provided a renewal notice to the client by mail, by e-mail, or electronically (such as by posting the notice on a website), the client has not elected to opt-out again.

The adviser need not comply with the requirements if the eligibility information received from the affiliate is used to:

- Make a marketing solicitation to a client with which the adviser has a pre-existing business relationship;
- Perform certain services on behalf of an affiliate;
- Respond to a communication about the adviser's products or services initiated by the individual; or
- Respond to an authorization or request by the individual to receive solicitations.

The adviser's chief compliance officer must review periodically, but at least annually the information made available to the adviser by its affiliates, the adviser's use of such information for marketing purposes and the information included in the opt-out notices. The compliance officer must also, on a

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harm or inconvenience to customers. The Risk Alert is available at https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Network%20Storage.pdf.

Additionally, the Division of Examinations staff issued a Risk Alert on May 23, 2019 that identified security risks associated with the storage of electronic customer information including cloud-based storage, that may raise compliance issues under Regulation S-P and Regulation S-ID. The staff noted that it observed (i) firms that did not adequately configure the security settings on their network storage solution to protect against unauthorized access or have policies and procedures addressing the security configuration of their network storage solutions, (ii) advisers that did not ensure that the security settings on vendor-provided network storage solutions were configured in accordance with the adviser's standards and (iii) certain advisers' policies and procedures did not identify the different types of data stored electronically by the adviser and the appropriate controls for each type of data. The staff of the Division of Examinations provided examples of features of effective configuration management programs, data classification procedures and vendor management programs, and encouraged advisers to review their practices, policies and procedures with respect to the storage of electronic customer information to consider whether any improvements are necessary. The Risk Alert is available at https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Network%20Storage.pdf.

[100] For consistency and for the avoidance of confusion, the term "client" is used throughout this subsection in place of the word "consumer" which is used throughout Regulation S-AM. Regulation S-AM defines consumer as "an individual who obtains or has obtained a financial product or service from you that is to be used primarily for personal, family or household purposes, or that individual's legal representative."

periodic basis, confirm delivery of the required notices and the adviser's compliance with the opt-out periods.

The adviser must retain records of each opt-out (both initial and renewal, if applicable) sent or provided to each client, along with the date of such delivery. Additionally, the adviser must retain a record of each client who elects to opt-out and the period for which such opt-out is effective.

C. REGULATION S-ID

Regulation S-ID, or the "Red Flags Rule", requires investment advisers that meet the definition of "financial institution" or "creditor" under the rule ("Qualifying Advisers") to adopt a written identity theft prevention program that is designed to detect, prevent and mitigate identity theft in connection with the opening of a covered account or any existing covered account. Such a program must include policies and procedures designed to identify relevant types of identity theft red flags; detect the occurrence of those red flags; respond appropriately to detected red flags; and periodically update the identity theft program to reflect changes in risks to customers, and to the safety and soundness of the financial institution or creditor, from identity theft. A red flag is a pattern, practice, or specific activity that indicates the possible existence of identity theft.

A Qualifying Adviser that is required to adopt an identity theft program must also provide for the proper administration of the program, including (i) obtaining approval of the initial written program from either its board of directors or an appropriate committee of the board of directors (or, if an entity does not have a board, from a senior management employee); (ii) involving the board of directors, an appropriate committee thereof, or a designated employee at the level of senior management in the oversight, development, implementation and administration of the program;[101] (iii) training staff, as necessary, to effectively implement the program; and (iv) exercising appropriate and effective oversight of service provider arrangements. In addition, when developing its program, a Qualifying Adviser should consider the guidelines attached to Regulation S-ID relating to risk factors, sources and categories of red flags.

D. CYBERSECURITY AND INFORMATION SECURITY

The SEC staff has indicated that, in its investment adviser examinations, it intends to focus on an adviser's cybersecurity governance, identification and assessment of cybersecurity risks, protection of networks and information, risks associated with remote customer access and funds transfer requests, risks associated with vendors and other third parties, detection of unauthorized activity, and experiences with certain cybersecurity threats.

The SEC staff has issued guidance identifying those cybersecurity measures that should be considered by advisers. The guidance recommends that advisers (1) conduct periodic assessments to identify cybersecurity threats and areas of vulnerability in order to prioritize and mitigate risks, (2) create a strategy designed to prevent, detect and respond to cybersecurity threats and (3) adopt written policies and procedures to implement the strategy.[102] Investment advisers should maintain written information security policies providing measures to protect an adviser's information technology assets, including the policies and procedures addressing cybersecurity risks posed by third party vendors or business partners with access to firm networks, customer data or other sensitive information. The Division of Examinations has also released a Risk Alert summarizing its observations from cybersecurity examinations since the SEC's 2014 Division of Examinations Cybersecurity I Initiative, noting that cybersecurity remains one of the top security risks for investment advisers and as such the Division of Examinations will continue to examine for

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[101] The designated senior management employee responsible for the oversight, development, implementation and administration of an adviser's program may be the adviser's chief compliance officer.

[102] *See* Investment Management Guidance Update, Cybersecurity Guidance, No. 2015-02 (April 2015), *available at* https://www.sec.gov/investment/im-guidance-2015-02.pdf.

cybersecurity compliance procedures and controls, including testing the implementation of those procedures and controls at firms.[103]

In January 2020, the Division of Examinations issued examination observations related to cybersecurity and operational resiliency practices to assist market participants in their consideration of how to enhance cybersecurity preparedness and operational resiliency. The observations highlight certain approaches taken by market participants to potentially safeguard against threats and respond in the event of an incident in the areas of governance and risk management, access rights and controls, data loss prevention, mobile security, incident response and resiliency, vendor management, and training and awareness. [104] In July 2020, the Division of Examinations issued a Risk Alert that emphasized the Division of Examinations' commitment to working with financial services market participants to monitor cybersecurity developments, improve operational resiliency, and effectively respond to cyber threats, and the Division of Examinations provided the following examples of measures for market participants to enhance cybersecurity preparedness: (i) incident response and resiliency policies, procedures and plans, (ii) operational resiliency, (iii) awareness and training programs, (iv) vulnerability scanning and patch management, (v) access management and (vi) perimeter security.[105] In September 2020, the Division of Examinations issued a Risk Alert that noted that the Division of Examinations has observed in recent examinations, an increase in the number of cyber-attacks against SEC-registered investment advisers and brokers and dealers using credential stuffing, a method of cyber-attack to client accounts that uses compromised client login credentials, resulting in the possible loss of customer assets and unauthorized disclosure of sensitive personal information.[106]

E. OTHER APPLICABLE PRIVACY LAWS

Depending on its business, an adviser may be subject to additional privacy laws, including state and international privacy laws. For example, the California Consumer Privacy Act, enacted in 2018, is a comprehensive state law governing the collection and use of consumer data and requires an adviser subject to the act to, among other things, (1) provide to a customer a description of the personal information about the customer in the adviser's possession, (2) delete that personal information upon the customer's request, and (3) give the customer a right to prevent the company from selling the personal information to third parties.

An adviser should consider whether any such additional laws apply and, if so, whether to implement policies and procedures to ensure compliance therewith.

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[103] *See* Office of Compliance Inspections and Examinations, Securities and Exchange Commission, National Examination Risk Alert Vol. 6-5, Observations from Cybersecurity Examinations (Aug. 7, 2017) *available at* https://www.sec.gov/files/observations-from-cybersecurity-examinations.pdf.

[104] *See* Cybersecurity and Resiliency Observations (January 2020), *available at* https://www.sec.gov/files/OCIE%20Cybersecurity%20and%20Resiliency%20Observations.pdf.

[105] *See* SEC Office of Compliance Inspection and Examinations Risk Alert (July 10, 2020), available at https://www.sec.gov/files/Risk%20Alert%20-%20Ransomware.pdf.

[106] *See* SEC Office of Compliance Inspection and Examinations Risk Alert (September 15, 2020), available at https://www.sec.gov/ocie/announcement/risk-alert-credential-compromise.

XVIII. Proxy Voting Procedures

Rule 206(4)-6 under the Advisers Act requires a registered investment adviser with voting authority over client proxies to adopt proxy voting policies and procedures, including procedures to address material conflicts of interest, and to disclose such procedures and its specific voting history to clients.[107] The Rule does not apply to advisers whose clients retain voting authority, smaller investment advisers who are registered with state securities authorities, or investment advisers who are not required to register under the Advisers Act.

An adviser subject to the Rule is required to:

- adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interests of its clients;
- describe such procedures to clients and, upon request, provide a summary of the procedures to clients;
- disclose to clients how they may obtain information on how the adviser voted their proxies; and
- retain certain written records about its proxy voting. (*See* Section XX. – "Recordkeeping Requirements" below for a more complete description.)

The Rule applies to all advisers that have explicit or implicit proxy voting authority over client securities. The SEC has clarified that an overall delegation of discretionary authority to an adviser constitutes implicit proxy voting authority, even though an advisory contract may be silent on this point. The Rule does not apply to advisers who do not have authority to vote the proxies themselves but provide advice to clients about voting proxies.

The SEC did not mandate specific proxy voting policies and procedures. However, the SEC encouraged the design of policies and procedures that address:

- how an adviser votes its proxies on behalf of its clients; and
- the particular factors that an adviser takes into consideration when voting on particular matters.

In additional guidance issued by the SEC on an adviser's obligations regarding proxy voting, the SEC clarified that while an adviser and its client may shape the voting authority through full and fair disclosure and informed consent, in all cases, an adviser that assumes proxy voting authority must make voting determinations consistent with its fiduciary duty and in compliance with the Rule.[108] To the extent an adviser has multiple clients, an adviser should consider whether voting proxies for its clients in

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[107] The SEC has issued a Staff Legal Bulletin providing guidance on investment advisers' proxy voting responsibilities and use of outside proxy advisory firms. The bulletin noted that when considering the retention (or continuation of an existing retention) of a proxy advisory firm to provide voting recommendations, an adviser should assess such firm's ability to competently and adequately analyze proxy issues. The bulletin also highlighted the importance of policies and procedures designed to ensure (a) adequate oversight of an outside proxy advisory firm; (b) that the investment adviser is apprised of any applicable changes to the proxy firm's business or any new potential conflicts of interest; and (c) that proxies are being voted in the best interest of clients (*see* Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, June 30, 2014).

[108] *See* Commission Guidance Regarding Proxy Responsibilities of Investment Advisers, SEC Release Nos. IA-5325; IC-33605 (Aug. 2019), *available at* https://www.sec.gov/rules/interp/2019/ia-5325.pdf.

accordance with a uniform voting policy would be in the best interest of each of its clients, or whether it should have different voting policies for some or all of its clients.

In July 2020, the SEC issued guidance regarding policies and procedures and disclosure requirements for advisers that use the electronic vote management systems of third-party proxy advisory firms.[109] The guidance provides that an adviser should consider whether its policies and procedures with respect to automated voting are reasonably designed to ensure that the adviser exercises voting authority in its client's best interest. In particular, an adviser should consider whether its policies and procedures address circumstances where an adviser has become aware that an issuer intends to file or has filed additional solicitation materials with the SEC after the adviser has received the proxy advisory firm's voting recommendation, but before the proxy submission deadline. In such instances, if an issuer files such additional information sufficiently in advance of the submission deadline and the additional information would reasonably be expected to affect the adviser's voting determination, the adviser would likely need to consider the additional information prior to exercising voting authority to demonstrate that it is voting in its client's best interest. The adviser should also consider reviewing its agreements with proxy advisory firms to determine whether the proxy advisory firms are permitted to utilize non-public information regarding how the adviser intends to vote (i.e., due to the pre-population of voting recommendations and automated voting) in a manner that would not be in the best interest of the adviser's client, such as whether the proxy advisory firm is permitted to share this information (including information on aggregated voting intentions of the firm's clients) with third parties.

The July 2020 guidance provides that an adviser has an obligation, as a result of its duty of loyalty to clients, to make full and fair disclosure of all material facts relating to the advisory relationship, including material facts relating to the exercise of voting authority with respect to client securities. Advisers using automated voting systems should consider disclosing (i) the extent of and circumstances under which the adviser uses automated voting, and (ii) how the adviser's policies and procedures address the use of automated voting in cases where the adviser becomes aware of additional information prior to the proxy submission deadline.

The Rule also specifically requires that the procedures address material conflicts that may arise between an adviser or its affiliates and its clients (such as when the adviser has business or personal relationships with participants in proxy contests, corporate directors or candidates for directorship). The SEC noted that a policy of disclosing conflicts to a client and obtaining direction from the client on how to vote would satisfy the requirement of the Rule (although certain additional consideration should be given to this alternative in the case of employee benefit plan clients). Otherwise, the adviser must be able to demonstrate that its vote was based on the client's best interest and not on the interests of the adviser.

The SEC staff has also issued guidance on an investment adviser's responsibilities in retaining proxy advisory firms.[110] The guidance suggests that advisers have an ongoing duty to monitor proxy advisory firms to ensure that the firms have the capacity and competency to adequately analyze proxy issues and obtain current and accurate information relevant to matters with respect to which they make voting recommendations. The SEC staff has indicated that an adviser should take reasonable steps to verify that a proxy advisory firm is independent and can make proxy voting recommendations in an impartial manner and in the best interests of the adviser's clients.

An adviser that retains a proxy advisory firm to provide voting recommendations or voting execution services also should consider adopting policies and procedures that provide for consideration of additional information that may be relevant to a particular proposal, and should take additional steps to evaluate whether the adviser's voting determinations are consistent with its voting policies and procedures and in the client's best interest before the votes are cast. If an adviser were to become aware of a potential

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[109] *See* Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, IA-Release 5547 (July 22, 2020), *available at* https://www.sec.gov/rules/policy/2020/ia-5547.pdf.

[110] Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014).

error or weakness in the firm's voting analysis, an adviser should conduct a reasonable investigation into them.

XIX. Wrap Fee Programs

A wrap fee program is any advisory program under which a specified fee or fees not based directly upon transactions in a client's account, but based on the size of the client's account, is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of client transactions. Therefore, the investment management fee and brokerage commission are "wrapped" together into a single asset-based fee. More specifically, program "wrapped" services include portfolio management, asset allocation, custodial services, execution of transactions, and preparation of quarterly performance reports.

Investment advisers participating in wrap fee programs as advisers or portfolio managers must disclose such participation in Form ADV. Investment advisers that sponsor wrap fee programs must complete, file and deliver Appendix 1 of Part 2A[111].

Since the creation of wrap fee programs, there has been an issue as to whether the collection of client accounts in such programs are the functional equivalent of an investment company. Rule 3a-4, which was adopted in 1997, provides a safe harbor from the definition of investment company for investment advisory programs, such as wrap fee programs,[112] that are organized and operated in a manner consistent with the Rule's conditions. The conditions are designed to ensure that clients receive individualized treatment. In proposing and adopting the Rule, the SEC expressed the view that when an investment adviser provides each client with individualized treatment, the likelihood of a common enterprise existing among a group of advisory clients is substantially reduced and no investment company is created.

The Division of Examinations focused on wrap fee programs in a July 2021 Risk Alert, because of the continued growth of investor assets participating in such programs and the conflicts and disclosure practices observed during previous examinations.[113] This Risk Alert discussed the most frequently cited deficiencies and other staff observations from the Division's Wrap Fee Initiative examinations.

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[111] In light of two 2016 SEC settlement orders, advisory firms with wrap fee programs should consider implementing procedures for monitoring the costs associated with, and the frequency of, subadvisors' trading away practices, including periodic review of trading information received from subadvisors in wrap fee programs and the dissemination of such information to clients and their financial advisers. *See* In the Matter of Robert W. Baird & Co. Incorporated, (Order Instituting Cease-And-Desist Proceedings and Imposing Cease-And-Desist Order; Invest. Adv. Act Rel. No. 4526; Admin. Proc. File No 3-17532 / September 8, 2016); In the Matter of Raymond James & Associates, Inc., (Order Instituting Cease-And-Desist Proceedings and Imposing Cease-And-Desist Order; Invest. Adv. Act Rel. No. 4525; Admin. Proc. File No 3-17531 / September 8, 2016). *See also* In the Matter of Morgan Stanley Smith Barney LLC, Release No. 5499 (May 2020).

[112] The SEC noted that a nondiscretionary program (i.e., one in which the client has the authority to accept or reject each recommendation to purchase or sell a security made by the portfolio manager, and exercises judgment with respect to such recommendations), generally will not meet the definition of investment company under the Investment Company Act nor be deemed to issue securities that are required to be registered under Section 5 of the Securities Act, regardless of whether the program is operated in accordance with the provisions of Rule 3a-4. *See* Status of Investment Advisory Programs under the Investment Company Act, Release No. IC-22579 (March 24, 1997).

[113] *See* SEC Office of Compliance Inspection and Examinations Risk Alert (July 21, 2021), available at https://www.sec.gov/exams/announcement/risk-alert-wrap-fee-programs.

XX. Recordkeeping Requirements

Rule 204-2 under the Advisers Act requires a registered investment adviser to make, maintain, and preserve certain books and records covering its own activities including investment advisory activities and those activities in connection with client accounts.

The SEC staff has made clear that an adviser must retain all records, including e-mails and instant messages containing information or communications covered by the requirements of the Rule. The substance of a communication, not its form, governs whether a communication must be retained under Rule 204-2. All such records are subject to inspection and examination by the SEC and include the following:

- partnership articles and any amendments thereto, articles of incorporation, charters, minute books and stock certificate books of the adviser and any predecessor;
- journals including cash receipts and disbursement records;
- ledgers reflecting asset, liability, reserve, capital, income, and expense accounts;
- a memorandum of each order given by the adviser for the purchase or sale of a security (i.e., an "order ticket"), including (i) any client instructions to the adviser (including any modification or cancellation of such instructions), (ii) terms and conditions of the order, (iii) the person connected with the adviser who recommended the transaction, (iv) the person who placed the order, (v) the account for which entered, (vi) the date of entry, (vii) the bank, broker or dealer by or through whom executed, and (viii) whether the order was made pursuant to the exercise of discretionary power;
- checkbooks, bank statements, canceled checks, and cash reconciliations;
- bills or statements, paid or unpaid, relating to the business of the adviser;
- trial balances, financial statements, and internal audit working papers relating to the business of the adviser;
- original records of written correspondence received from and copies of written correspondence sent to clients (including e-mails) relating to advice or recommendations given; any receipt, disbursement or delivery of funds or securities; placements or execution of orders to purchase or sell any securities; or the performance or rate of return of any or all managed accounts or securities recommendations;
- a list or record of all accounts in which the adviser has discretionary power with respect to client funds or securities;
- copies of all powers of attorney and other documents from the client granting discretion to the adviser;
- copies of all written agreements with clients or otherwise relating to the business of the adviser (including agreements to pay cash referral fees to solicitors);
- copies of publications distributed to ten or more persons, and memoranda indicating the reasons for any recommendations made in the publication if not already stated;
- copies of all written statements and any amendments or revisions thereof sent to any client or prospective client in compliance with the "brochure rule" along with a record of the dates that each written statement, and each amendment or revision thereof, was given, or offered to be given, to

any client or prospective client who subsequently becomes a client and including (i) documentation describing the method used to compute managed assets for purposes of Item 4.E of the adviser's Firm Brochure if the method differs from the method used to calculate regulatory assets under management under Item 5.F of the adviser's Form ADV Part 1 and (ii) a memorandum describing any legal or disciplinary event listed in Item 9 of the Firm Brochure and presumed to be material, if the event involved the adviser or any of its staff and is not disclosed in the Firm Brochure or any Brochure Supplement, explaining the adviser's determination that the presumption of materiality has been overcome and discussing the factors described in Item 9 of the Firm Brochure or Item 3 of the Brochure Supplement;

- copies of all written acknowledgments of receipt obtained from clients confirming delivery of required materials from a paid solicitor (for the adviser);

- copies of all accounts, books and records needed to demonstrate the calculation of the performance or rate of return of all managed accounts or securities recommendations in any communication circulated by the adviser to any person (other than persons connected with the adviser) (the "Performance Records");

- copies of written policies and procedures reasonably designed to prevent misuse by the investment adviser or its supervised persons of inside information by the adviser or persons associated with the adviser;

- copies of the adviser's current code of ethics and any prior codes in effect within the past five years, records of code violations and resulting action taken by the adviser and records of all written acknowledgments of receipt of the code from persons who are, or within the past five years were, supervised persons of the adviser;

- a list of all persons who currently are, or in the past five years were, access persons;

- records relating to the periodic reports of security transactions and holdings of access persons;

- records documenting the decision to approve the purchase or sale of IPOs and limited offerings by an access person and the reasons supporting such decision (*see* Section XII. – "Insider Trading Policies; Codes of Ethics; Political Contributions and Third Party Solicitors; Foreign Corrupt Practices Act; and Whistleblower Rules" for further discussion of the requirements relating to insider trading policies and the code of ethics);

- records relating to the adviser's proxy voting, including proxy voting procedures, proxy statements received regarding client securities, votes it cast on behalf of clients, client requests for proxy voting information and the respective responses, and copies of any documents prepared by the adviser that were material to making a decision on how to vote, or that memorialized the basis for that voting decision (*see* Section XVIII. – "Proxy Voting Procedures" above for further discussion); and

- a copy of the adviser's compliance policies and procedures that are, or were, in effect at any time for the most recent five years and records documenting the annual review of such procedures (*see* Section VII. - "Compliance Programs" above for further discussion).

If an adviser has custody or possession of client funds or securities, it must also retain the following records with respect to such "custodied" accounts:

- a journal or other record showing all transactions (including receipts and deliveries) of securities (including certificate numbers) for such accounts and all other debits and credits thereto;

- a separate ledger account for each such client showing all transactions of securities, the date and price of each transaction and all debits and credits;

- copies of confirmations of all transactions effected by or for the account;
- a copy of any internal control report obtained or received pursuant to Rule 206(4)-2(a)(6)(ii);
- a memorandum describing the basis upon which the compliance officer and/or its delegates have determined that the presumption that any related person is not operationally independent under Rule 206(4)-2(d)(5) has been overcome; and
- a record for each security in which any such client has a position, showing (i) the name of each such client having any interest in each security, (ii) the amount or interest of each such client, and (iii) the location of each such security.

If an adviser renders any investment supervisory or management service to any client, it must also retain the following records with respect to such supervised or managed accounts:

- records showing separately for each such client (i) the securities purchased and sold, and (ii) the date, price and amount of each such purchase and sale; and
- for each security in which any such client has a current position, a listing of the current amount or interest of each such client.

If an adviser has any government entity clients or provides advisory services to a covered investment pool in which a government entity investor invests, it must also retain books and records including a description of the following:

- the names, titles and business and residence addresses of all covered associates of the adviser;
- all government entities to which the adviser provides or has provided investment advisory services, or which are or were investors in any covered investment pool to which the adviser provides or has provided investment advisory services, as applicable, in the past five years;
- all direct or indirect contributions made by the adviser or any of its covered associates to an official of a government entity, or direct or indirect payments to a political party of a state or political subdivision thereof, or a political action committee. These must be listed in chronological order and they must indicate (a) the name and title of each contributor, (b) the name and title (including any city/county/state or other political subdivision) of each recipient of a contribution or payment, (c) the amounts and date of each contribution or payment, and (d) whether any such contribution was the subject of the exception for certain returned contributions; and
- the name and business address of each regulated person to whom the adviser provided or agreed to provide, directly or indirectly, payment to solicit a government entity for investment advisory services on its behalf.

Generally, the books and records required to be maintained by the Advisers Act must be maintained and preserved in an easily accessible place and manner for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the adviser.[114] Records relating to advertisements (and substantiation of the information contained therein) must be retained by the adviser for the foregoing periods from the end of the fiscal year during which the adviser last disseminated the advertisement. The adviser generally must

[114] An adviser that was exempt from registration in reliance on Section 203(b)(3) prior to July 21, 2011 is not required to maintain books and records pertaining to any period prior to such adviser's registration; provided, however, that the adviser should continue to preserve any books and records in its possession that pertain to the performance or rate of return of private funds or other accounts under its management.

maintain partnership agreements, incorporation documents and related records at its principal office until at least three years after termination of the business.

Registered investment advisers may store all records on electronic[115] media. The records must be arranged and indexed so as to permit easy location, access and retrieval of any particular record. In addition, the adviser must:

- establish and maintain procedures to safeguard the records from loss, alteration or destruction;
- limit access to the records to authorized persons, the SEC and (in the case of mutual funds) fund directors; and
- ensure that electronic copies of non-electronic originals are complete, true and legible.

The adviser must be able to produce "promptly", upon request by the SEC, true and complete copies of the records in the medium in which they are stored and a means to print the records, and must separately store, for the relevant time period, a duplicate copy of the record.

Registered investment advisers should be aware that the SEC staff may also request that the adviser produce any records kept by the adviser, not just those that are required to be kept.

In addition, investment advisers are required to maintain certain records regarding the private funds that they advise, including a description of the following:

- the amount of assets under management and use of leverage, including off-balance sheet leverage;
- counterparty credit risk exposure;
- trading and investment positions;
- trading practices;
- valuation policies and practices of the fund;
- types of assets held;
- side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors;[116] and
- such other information as the SEC deems necessary and appropriate.

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[115] Electronic media may include microfilm, microfiche or other micrographic media or electronic storage media such as digital storage.

[116] Conflicts of interest related to (i) the financial relationship between investors, or clients, and the adviser should be adequately disclosed, including with respect to initial seed investors in private funds and investors who provide credit facilities or other financing to the adviser or its private funds and (ii) granting preferential liquidity rights to select investors or select accounts that trade side-by-side with accounts with less favorable liquidity. *See* SEC Office of Compliance Inspection and Examinations Risk Alert, "Observations from Examinations of Investment Advisers Managing Private Funds" (June 23, 2020) available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert.pdf.

XXI. Form PF

Pursuant to Rule 204(b)-1, registered investment advisers with at least $150 million in regulatory assets under management attributable to private funds (for purposes of the Advisers Act, issuers that would be an investment company as defined in section 3 of the Investment Company Act, but for sections 3(c)(1) or 3(c)(7), are classified as private funds) must submit regular reports on Form PF. Advisers must file Form PF electronically on a confidential basis. Form PF filing requirements are generally based on (i) the types of private funds advised (i.e., hedge funds, private equity, liquidity funds, etc.) and (ii) the amount of regulatory assets under the investment adviser's management.

Generally, investment advisers are required to file Form PF 120 days after the end of their fiscal year. However, investment advisers with at least $1.5 billion in regulatory assets under management attributable to hedge funds are required to file Form PF on a quarterly basis, 60 days after the end of each quarter. Different thresholds may apply to investment advisers with regulatory assets under management attributable to different types of private funds.

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If you have any questions concerning any of the regulatory requirements described in this memorandum, please contact an attorney in the Investment Management Group.

Seward & Kissel LLP

Appendix

This Appendix is not meant to be exhaustive but to highlight several areas of federal and state law that may be applicable to SEC-registered investment advisers and to their institutional clients.

I. USA PATRIOT ACT

The "Patriot Act", which is intended to combat terrorism and money laundering activity, imposes anti-money laundering ("AML") compliance obligations on "financial institutions", including broker-dealers, investment companies and certain other financial services firms.[117]

The Patriot Act states that all "financial institutions" shall establish an AML program that includes, at a minimum, the following:

Development of Internal Policies, Procedures and Controls. Given the Patriot Act's objective of preventing the unknowing assistance of terrorist financing or money laundering, the focus of AML procedures should be directed at "knowing your customer" and should be applied to both existing and prospective clients.

Designation of a Compliance Officer. The compliance officer should have thorough knowledge and understanding of the AML procedures adopted by the firm and have the necessary authority to enforce the procedures (including the ability to contact clients to elicit more AML-related information). The compliance officer should periodically review and, to the extent necessary, update the firm's AML procedures.

Establishment of an Ongoing Employee Training Program. The compliance officer should supervise the training of employees and educate them on issues such as the recognition of money laundering activity, the firm's AML procedures, legal obligations and industry developments.

Arrangement of an Independent Audit Function to Ensure Compliance. The audit function should be conducted by a person who is not involved on a day-to-day basis with the firm's AML program, but who has an understanding of the firm's activities, AML procedures and relevant legal issues. The Patriot Act does not specify whether such person needs to be an auditor or simply a disinterested person.

The Patriot Act requires the Secretary of the Treasury to prescribe regulations that consider the extent to which the AML requirements are commensurate with the size, location and activities of the financial institutions to which such regulations apply. It is unclear whether such regulations will provide more specificity as to the implementation of the AML program requirements or how compliance with such requirements will be regulated.

II. BANK SECRECY ACT

In August 2015 the Financial Crimes Enforcement Network ("FinCEN") proposed a rule requiring certain investment advisers to establish AML programs and report certain suspicious activity to FinCEN pursuant to the Bank Secrecy Act ("BSA"). FinCEN also proposed to include investment advisers

[117] Investment advisers were not originally included in the definition of "financial institution". In 2003, the Secretary of the Treasury proposed rules that would include both registered investment advisers and certain unregistered investment advisers within the scope of the definition. In October 2008, the proposed rules were withdrawn. *See* section II of this Appendix for a discussion of the Financial Crimes Enforcement Network's ("FinCEN") proposed rule in August 2015 requiring certain investment advisers to establish AML programs and report certain suspicious activity to FinCEN pursuant to the Bank Secrecy Act.

in the general definition of "financial institution," which, among other things, would require advisers to file Currency Transaction Reports ("CTRs") and keep records relating to the transmittal of funds. The proposed rule would apply to registered investment advisers, and FinCEN would delegate its authority to examine investment advisers for compliance with the proposed rule to the SEC.

III. ERISA

ERISA requires that a fiduciary act prudently and for the exclusive benefit of the plan's participants. ERISA also prohibits broad categories of transactions ("prohibited transactions") between the plan and its "parties in interest", and then exempts various transactions from these prohibitions. Exemptions are both statutory and granted by the United States Department of Labor (the "DOL"). The principal exemption that registered investment advisers rely upon is Prohibited Transaction Class Exemption 84-14 (the "QPAM Exemption"). ERISA imposes personal liability on a fiduciary for breaches of its fiduciary duties.

An adviser can become a fiduciary to a plan under ERISA in two ways.

- Advice fiduciary: a person who for a fee (direct or indirect) provides a recommendation to a plan, plan fiduciary, or plan participant regarding the advisability of acquiring, holding or disposing of plan assets is an ERISA fiduciary; unless (i) the plan has $50 million in assets, (ii) the plan fiduciary is a bank, insurance company, registered investment adviser or broker/dealer, or (iii) the plan participant is relying on an independent fiduciary that is a bank, insurance company, registered investment adviser or broker/dealer.

- Discretionary fiduciary: a person is an ERISA fiduciary to a plan to the extent it has authority or control over the plan's assets. Discretionary authority can be direct, under a separate account agreement, or indirect, because a private investment fund is deemed to hold plan assets under the 25% test imposed by the DOL's "plan assets regulation".

In addition, the prohibited transaction rules also apply to any person that is a fiduciary to (i) an Individual Retirement Account, or (ii) a public fund subject to prohibited transaction rules by applicable law or by inclusion in such public fund's management contract of a requirement that the adviser treat the public fund entirely or in part as an ERISA account.

IV. OTHER REQUIREMENTS

Registered investment advisers may also be subject to other filing requirements and limitations relating to their beneficial ownership of securities on behalf of clients or their own accounts. These filing requirements and limitations, include, but are not limited to, the following:

- **Definition of Beneficial Ownership** – Section 13 of the Exchange Act imposes certain filing obligations on "beneficial owners" of securities. For purposes of Section 13, a "beneficial owner" is any person who directly or indirectly has or shares (i) voting power, including the power to vote or direct the voting of such security; and/or (ii) investment power, which includes the power to dispose of or direct the disposition of such security.

- **Schedule 13D** – Section 13(d) requires beneficial owners of more than 5% of a class of equity securities to file a report on Schedule 13D within 10 days of the transaction that resulted in their beneficial ownership exceeding 5%. Amendments must be filed to reflect certain changes in status. In certain circumstances, such as where the investment is passive or where the investor qualifies as an "institutional investor", beneficial owners may be eligible to report on short form Schedule 13G in lieu of filing on Schedule 13D, as discussed more fully below.

- **Schedule 13G** – Certain qualified investors may elect to report their holdings on Schedule 13G in lieu of filing on Schedule 13D. Investors eligible to file on 13G include: (i) non-institutional investors, holding in the ordinary course of business, and who acquire more than 5% but less than 20% of a

class of equity securities; and (ii) institutional investors, holding in the ordinary course of business, and who acquire beneficial ownership exceeding 5% (but less than 20%) of a class of equity securities.

→ 13G Filing Obligations for Passive Investors - A 13G filing with the SEC and the issuer is required within 10 days of the transaction resulting in beneficial ownership of an investment position of greater than 5% but less than 20% of the outstanding securities of a class of a publicly-traded "equity" security. Investors holding in the ordinary course of business whose beneficial ownership in a particular class of equity securities exceeds 20% who are not qualified institutional investors are not permitted to file on 13G, however, and are required to file on 13D.

→ 13G Filing Obligations for Qualified Institutional Investors – A 13G filing is required within 45 days after the end of the calendar year in which a qualified institutional investor acquired beneficial ownership of greater than 5% of the outstanding securities of a class of a publicly-traded "equity" security. However, if the investor's beneficial ownership exceeds 10% of such outstanding securities prior to the end of the calendar year, the institutional investor is required to make a 13G filing within 10 days after the end of the month in which the investor's beneficial ownership exceeded 10%.

→ Amendments to the 13G filings are also required at various other times to reflect certain changes in status. Additionally, any person who is a beneficial owner of more than 5% of a class of equity securities as of the end of any calendar year, but who is not required to file on Schedule 13D, must file on Schedule 13G.

- **Forms 3, 4 and 5/Section 16** – Persons deemed to be "insiders" of a particular issuer are required under Section 16 of the Exchange Act to report ownership and transactions in equity securities of such issuer. For purposes of Section 16, an "insider" is a director, officer or beneficial owner of more than 10% of a class of a particular issuer's equity securities. Section 16 "insiders" are subject to disgorgement of short-swing profits realized by any (i) purchase and sale or (ii) sale and purchase of equity securities of the issuer within a period of less than six months. Section 16 requires that Form 3 filings be made within 10 days of the initial trigger (i.e., within 10 days after the filer became a director, officer or beneficial owner of more than 10% of a class of securities). Form 4 filings are required within two business days following each transaction in the securities. Form 5 filings may be required annually to reflect certain other transactions. Each of Forms 3, 4, and 5 are filed with both the SEC and the exchange upon which the relevant issuer is listed. There are exemptions from the provisions of Section 16 available to certain institutional investors.

- **Form 13F** – Institutional investment managers that exercise investment discretion with respect to accounts that held, as of the last trading day of any month, in excess of $100 million[118] in certain publicly-traded U.S. equities, options, warrants and certain convertible securities are required by Section 13(f) of the Exchange Act to file a report with the SEC within 45 days after the last day of such calendar year, and within 45 days after the last day of each of the first three calendar quarters of the subsequent calendar year. Reports filed pursuant to 13(f) must provide, with respect to each 13F security, the name of the issuer, the title and the class of the securities held, the number of shares held, and the total fair market value of the securities. Short positions are not required to be reported on Form 13F.

- **Form 13H** – "Large Traders" are required by Rule 13h-1 to file Form 13H promptly after first effecting aggregate transactions equal to or greater than the "identifying activity level", and within 45 days of the end of each calendar year thereafter. A "Large Trader" is defined in the Rule as any

[118] On July 10, 2020, the SEC proposed to raise the reporting threshold from $100 million to $3.5 billion and to review and potentially adjust that threshold every five years. *See* Reporting Threshold for Institutional Investment Managers, Release No. 34-89290 (July 10, 2020), *available at* https://www.sec.gov/rules/proposed/2020/34-89290.pdf.

person that, directly or indirectly, including through other persons controlled by such person, exercises investment discretion over transactions in NMS securities, by or through one or more registered broker-dealers, in an aggregate amount equal to or greater than the "identifying activity level." The identifying activity level is equal to aggregate transactions in NMS securities equal to or greater than: (i) during a calendar day, either two million shares or shares with a fair market value of $20 million; or (ii) during a calendar month, either twenty million shares or shares with a fair market value of $200 million. "NMS securities" generally include U.S. exchange-listed securities, including equities and options.

- Hart Scott Rodino Act – Unless an exemption is available, a filing is required to be made with the Federal Trade Commission and Department of Justice for positions in the assets or voting securities of an issuer in an amount greater than the specified HSR thresholds, as adjusted from time to time, which are posted at the following website: http://www.ftc.gov/enforcement/premerger-notification-program/current-thresholds. The penalty for failure to make an HSR filing is up to $40,654 per day of noncompliance.

- Issuer-Specific Limitations/Industry-Specific Limitations and Application of Other State and Federal Laws – Various other requirements and limitations may apply to an adviser's beneficial ownership of an issuer's securities on behalf of its clients. An issuer may have limitations in its organizational documents (e.g., charter and bylaws) restricting or limiting the ability of a shareholder to acquire large blocks (e.g., 5%, 10%, 15%) of the issuer's equity securities. An issuer may be subject to various state or federal industry-related (e.g., insurance, real estate, gaming, banking) laws restricting or limiting the ability of a shareholder to acquire large blocks of the issuer's equity securities. In many instances, the applicable restrictions or limitations may require periodic reporting by the adviser to the issuer or regulatory authority responsible for the regulated activity. In addition, state corporate law may restrict or limit large positions in an issuer organized pursuant to that law.

V. ADVERTISING

The term "advertisement" is broadly defined to include any communication that offers an advisory service to more than one person. This definition may encompass statements made on websites or in connection with social media providers such as "Facebook" or "LinkedIn". The SEC has stated, for example, that the use of "social plug-ins" such as the "like" feature on an investment adviser's social media site could be deemed a testimonial if it is an explicit or implicit statement of a client's experience with an investment adviser.[119] Under the antifraud provisions of the Advisers Act, the SEC regulates the content of marketing materials and disclosure of performance results of both registered and unregistered investment advisers.

A. Prohibited Advertisements

Under Rule 206(4)-1,[120] a registered investment adviser may not publish, circulate or distribute any advertisement which:

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[119] *See* Office of Compliance Inspections and Examinations, Securities and Exchange Commission, National Examination Risk Alert Vol. 2-1, Investment Adviser Use of Social Media (Jan. 4, 2012), *available at* https://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf.

[120] *See* Investment Adviser Advertisements; Compensation for Solicitations, SEC Release Nos. IA-5407 (Nov 2019) *available at* https://www.sec.gov/rules/proposed/2019/ia-5407.pdf. On November 4, 2019, the SEC published proposed amendments to Rule 206(4)-1 which would (i) replace the per se prohibitions of Rule 206(4)-1 with a principles-based approach under which an advertisement may not, among other things, (a) include any untrue statements or omissions; (b) include any unsubstantiated material claim or statement; (c) include any untrue or misleading implications or inferences to be drawn about a material fact relating to the adviser; (d) discuss or imply any potential benefits of the adviser's services or methods of operation without discussing any associated material risks or limitations; or (e) be materially misleading; (ii) expand and modernize the definition of "advertisement" to mean "any communication disseminated by any means, by or on behalf of an investment adviser, that offers or

- refers to testimonials of any kind concerning the investment adviser or any advice or other services rendered by the adviser;

- refers to specific past recommendations which were or would have been profitable, unless a list is provided of all recommendations made by that adviser within the immediate preceding period of at least one year and such list includes certain relevant information and cautionary language;[121]

- represents that any graph, chart, formula, or other device being offered can, in and of itself, be used to determine which securities to buy or sell, or when to buy or sell them; or represents that any graph, chart, formula, or other device being offered will assist any person in making his own decisions as to which securities to buy or sell, or when to buy or sell them, without prominently disclosing in such advertisement the limitations thereof and the difficulties with respect to its use;

- contains any untrue statement to the effect that any report, analysis, or other service will be furnished free or without charge, unless such report, analysis or other service actually is or will be furnished entirely free and without any condition or obligation, directly or indirectly; or

- contains any untrue statement of a material fact, or which is otherwise false or misleading.

In a no-action letter to the Investment Counsel Association of America (pub. avail. March 1, 2004), the SEC staff stated that an adviser may provide prospective clients and consultants with written information regarding past specific recommendations and client testimonials that would otherwise be considered an advertisement when responding to direct, unsolicited requests for such information. The adviser may also provide information about past specific recommendations to existing clients, but only to the extent the recommendations concern securities that are or were recently held by each of those clients.

The staff of the Division of Examinations issued a Risk Alert in September 2017 on the most frequently identified compliance issues relating to Rule 206(4)-1. Those compliance issues included misleading

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promotes the investment adviser's investment advisory services or that seeks to obtain or retain one or more investment advisory clients or investors in any pooled investment vehicle advised by the investment adviser;" (iii) permit the use of (a) past specific recommendations, or specific investment advice, provided they are presented in a fair and balanced manner; (b) testimonials and endorsements, and third-party ratings, subject to certain conditions; and (c) hypothetical performance, related performance and extracted performance, subject to certain conditions; (iv) establish additional requirements for advertisements based on whether an advertisement is directed to "Retail Persons" or "Non-Retail Persons;" (v) require, prior to dissemination, a designated employee of the adviser to review and approve an advertisement as consistent with the requirements of Rule 206(4)-1; and (vi) amend Form ADV to provide additional information regarding an adviser's advertising practices.

[121] The SEC staff has indicated that it would not recommend enforcement action if an adviser included in its marketing materials past specific recommendations, provided that (i) the adviser uses objective, non-performance based criteria to select the specific securities that it will list and discuss; (ii) the adviser uses the same selection criteria for each quarter for each particular investment category; (iii) the materials do not discuss, directly or indirectly, the amount of the profits or losses, realized or unrealized, of any of the specific securities; and (iv) the adviser maintains records of all of its recommendations for each performance period for inspection by the SEC upon request. *See* Franklin Management, Inc. (pub. avail. Dec. 10, 1998). Such recommendations may be chosen with performance-based criteria so long as the adviser does not "cherry-pick" the most profitable recommendations. Specifically, the SEC staff has indicated that it would not recommend enforcement action against an investment adviser who has selected recommendations with performance based criteria provided that, among other things, (i) the adviser shows no fewer than ten holdings, including an equal number of positive and negative holdings; (ii) the marketing materials disclose how to obtain the calculation methodology that was employed as well as a list showing each holding's contribution to the overall account performance during the relevant period; and (iii) the adviser maintains records of all of its recommendations for each performance period for inspection by the SEC upon request. *See* TCW Group, Inc. (pub. avail. Nov. 7, 2008).

performance results, misleading one-on-one presentations, misleading claims of compliance with voluntary performance standards, cherry-picked profitable stock selections, misleading selection of investment recommendations, inadequate policies and procedures, misleading use of third party rankings or awards, misleading use of professional designations and prohibited testimonials.[122]

B. Advertisements Containing Performance Results

An investment adviser presenting performance results in an advertisement must meet certain conditions set forth in a series of no-action letters.

(i) Clover Capital Disclosures

In 1986, the SEC staff addressed the issue of advertising practices in the Clover Capital Management, Inc. no-action letter (pub. avail. Oct. 28, 1986). In the Clover letter, the SEC staff stated that it would be "inappropriate" under Rule 206(4)-1 for an investment adviser to portray performance results without engaging in the following practices:

- disclose the effect of material market or economic conditions on the results portrayed;
- reflect the deduction of advisory fees, brokerage commissions, and other client expenses;
- disclose whether the results portrayed include reinvestment of dividends and other earnings;
- suggest the possibility of loss in connection with claims for potential profits;
- disclose material factors relevant to a comparison of the results to any index used;
- disclose any material conditions, objectives, or investment strategies used to obtain the performance advertised;
- disclose the effect of material changes in the market conditions on investment strategies during the time portrayed in the advertisement; and
- if applicable, disclose that the results portrayed reflect only a certain portion of the adviser's clients.

Under the Clover letter, actual results would be misleading if they describe the results of only a select group of clients and fail to disclose the basis for the selection and, if material, its effect on portrayed results.

In the Clover letter, the SEC staff stated that the use of "model" portfolios - i.e., portfolios containing hypothetical results as opposed to the performance results of actual accounts - would be misleading if, in addition to the above requirements, they failed to disclose:

- limitations inherent in model results;

[122] *See* Office of Compliance Inspections and Examinations, Securities and Exchange Commission, National Examination Risk Alert Vol. 6-6, The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers (Sept. 14, 2017), *available at* https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf.

- any material changes in conditions, objectives, or investment strategies portrayed in the model and their effects;
- that, where applicable, some of the securities or strategies reflected in the model portfolio do not relate wholly or partially to services currently offered by the adviser; or
- that, where applicable, actual investment results of the adviser's clients were materially different from results portrayed in the model.

The SEC staff also stated that the list of practices set forth in the letter does not create a "safe harbor" that may be relied upon by an adviser as an exhaustive list of the factors that must be considered in determining the type of disclosure necessary when advertising model or actual results.

(ii) Limited Use of Gross Performance

The SEC staff has acknowledged an exception to the adviser's affirmative duty to disclose performance results net of adviser's fees in the situation involving "one-on-one" presentations in a 1988 no-action letter to the Investment Company Institute (pub. avail. Sept. 23, 1988). "One-on-one" presentations would generally involve meetings with wealthy individuals and other sophisticated clients (e.g., pension funds, universities, and other institutions) whose sizable assets justify the cost of such presentation. These presentations may be made to more than one person, provided that they are private and confidential and the individuals are provided with opportunities to discuss fees with the adviser.[123] However, in presenting "gross" performance results, the adviser must disclose to the client:

- that performance results do not reflect deduction of the adviser's fees;
- that a client's return will be reduced by those fees and other expenses;
- that the adviser's fee schedule is disclosed in Part 2 of its Form ADV; and
- a table, chart, graph, narrative, etc. showing the compounded effect of an advisory fee over a period of years.

In a no-action letter issued to the Association for Investment Management and Research ("AIMR") (pub. avail. Dec. 18, 1996), the SEC staff granted relief from the duty to disclose performance results net of adviser's fees in circumstances where the adviser distributes advertisements presenting both gross and net-of-fee performance information with equal prominence and in a format designed to facilitate ease of comparison, provided that the advertisement contains sufficient disclosure to ensure that the material presented is not misleading.

C. Performance Results Recordkeeping

For recordkeeping purposes, advisers must retain all performance reports and supporting documents for the entire measuring period portrayed for at least five years from when the reports were last used.[124] For

[123] Consultants to clients may also make one-on-one presentations using gross investment performance figures that are supplied by the investment adviser to the consultants.

[124] An adviser that was, prior to March 31, 2012, exempt from registration in reliance on Section 203(b)(3) of the Advisers Act is not required to maintain supporting documentation with respect to performance results related to the period prior to its registration to the extent that the adviser did not produce or retain such documentation; provided, however, that the adviser should continue to preserve any books and records in its possession that pertain to the performance or rate of return of private funds or other accounts under its management for such period. Rule 204-2(e)(3)(ii).

more information regarding specific recordkeeping requirements *see* Section XX. – "Recordkeeping Requirements" below.

D. Portability of Performance Results

In order for an adviser to advertise performance results achieved by a portfolio manager while working for another adviser, the adviser must meet all of the relevant requirements related to using prior performance, and must ensure the following[125]:

- no other individual played a significant role in the performance results;
- the performance results advertised do not differ materially from the performance results of accounts not brought to the new adviser;
- the current and previously managed accounts have substantially similar investment objectives, policies and strategies; and
- that it retains Performance Records (as defined in Section XX below).

E. Social Media

Social media is a term that encompasses various activities that integrate technology, social interaction and content creation. Social media may use many technologies, including, but not limited to, blogs, microblogs, wikis, photo and video sharing, podcasts, social networking and virtual worlds. The SEC staff has stated that advisers using social media should adopt as part of their compliance program mandated by Rule 206(4)-7 under the Advisers Act, policies and procedures regarding the use of social media and periodically review the effectiveness of such policies.[126] In adopting such policies, advisers should be aware of applicable employee protection laws to ensure that its policies do not violate or otherwise conflict with such laws (for example, by restricting employees from engaging in conduct that is protected under such laws).[127]

Item 1.I of the Form ADV asks whether the adviser has one or more accounts on social media platforms, such as Twitter, Facebook or LinkedIn, and requests the address of each of the adviser's social media pages in addition to the address of each of the adviser's websites. An adviser needs to disclose only the addresses of websites or accounts on publicly available social media platforms where the adviser controls the content.

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[125] *See* Bramwell Growth Fund, SEC No-Action Letter (pub. avail. Aug. 7, 1996) (finding that a mutual fund's prospectus may include performance of another registered investment company previously managed by the fund's portfolio manager provided that (1) no other individuals played a significant part in achieving the prior performance, and (2) the performance is not presented in a misleading manner and does not obscure or impede understanding of information required to be in the prospectus); Conway Asset Management Incorporated, SEC No-Action Letter (pub. avail. Jan. 27, 1989) (allowing a solely-owned and newly-registered investment adviser to use performance data of several accounts managed by the individual prior to registration).

[126] *See* Office of Compliance Inspections and Examinations, Securities and Exchange Commission, National Examination Risk Alert Vol. 2-1, Investment Adviser Use of Social Media (Jan. 4, 2012), *available at* https://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf.

[127] The National Labor Relations Board ("NLRB") has released various memoranda regarding the lawfulness of employers' social media policies. Among other things, the NLRB has provided that an employer may require its employees who identify themselves as the employer's employees on social media to state that the views expressed are their own, but that an employer may not prohibit employees from posting material that is embarrassing to another person, the employer or customers because employees would reasonably construe such a prohibition as barring them from discussing work-related complaints. *See* The NLRB and Social Media, National Labor Relations Board, *available at* https://www.nlrb.gov/about-nlrb/rights-we-protect/your-rights/the-nlrb-and-social-media.

An adviser's use of social media potentially can violate the prohibitions of Rule 206(4)-1 under the Advisers Act regarding fraudulent, deceptive, or manipulative acts or practices in advertisements. A social media communication, to be compliant with Rule 206(4)-1, must disclose all material facts relevant to the client or potential client, must avoid misleading statements and must not imply that past positive performance will be repeated in the future.

The SEC staff has issued guidance concerning the application of Rule 206(4)-1(a) (the "testimonial rule") to the use of public commentaries from social media on an investment adviser's website. The guidance states that advisers may use public commentary from third party social media without violating the testimonial rule, so long as the content is independent of the adviser and its representatives, there is no material connection between the social media site and the adviser or its representatives that would call into question the independence of the social media or commentary, and the adviser or its representative publishes all of the unedited comments appearing on the social media site regarding the adviser.[128]

Advisers that communicate through social media must retain records of those communications if they contain information that falls within an investment adviser's recordkeeping obligations under the Advisers Act. The SEC staff has stated that the content of a communication is determinative. The recordkeeping obligation does not differentiate between various media, including paper and electronic communications, such as e-mails, instant messages and other Internet communications that relate to the adviser's recommendations or advice.

[128] *See* Investment Management Guidance Update, Guidance on the Testimonial Rule and Social Media, No. 2014-4 (March 2014), *available at* https://www.sec.gov/investment/im-guidance-2014-04.pdf.

VI. PAYMENTS TO SOLICITORS

Rule 206(4)-3 under the Advisers Act permits advisers to make cash payments to solicitors (i.e., finders) for client referrals provided certain conditions are met.[129] A registered investment adviser may pay cash fees to solicitors if:

- the solicitor has not been subject to sanctions by the SEC under provisions of the Advisers Act; and
- there is a written agreement between the adviser and solicitor containing certain enumerated terms.

Generally, the written agreement is required to describe the solicitation activity as well as the compensation to be received. It must also include an undertaking by the solicitor to perform its duties in accordance with the adviser's instructions and the provisions of the Advisers Act. Finally, the solicitor must provide the client with (i) a current copy of the adviser's Part 2 of Form ADV, and (ii) a separate written solicitor's disclosure document including, among other things:

- the names of the solicitor and adviser;
- the nature of their relationship;
- a statement that the solicitor will be compensated by the adviser;
- the terms of compensation;
- the amount, if any, the client will be charged above the advisory fee; and

[129] *See* Investment Adviser Advertisements; Compensation for Solicitations, SEC Release Nos. IA-5407 (Nov 2019), *available at* https://www.sec.gov/rules/proposed/2019/ia-5407.pdf. In July 2008, the SEC staff issued an Interpretive Letter indicating that Rule 206(4)-3 "generally does not apply" to cash payments an adviser makes to a person solely to compensate that person for soliciting investors to an "investment pool" managed by the adviser. For purposes of this Rule, investors in an investment pool are not "clients" of the adviser. *See* Mayer Brown LLP (pub. avail. July 28, 2008). However, on November 4, 2019, the SEC published proposed amendments to Rule 206(4)-3 which, among other things, would expand the scope of the rule to apply to the solicitation of current and prospective investors in any private fund. The proposed amendments would also (i) expand the scope of the rule to cover solicitation arrangements involving all forms of compensation, rather than only cash compensation, (ii) no longer require that the solicitor provide the investor with a copy of the adviser's brochure or that the adviser obtain and retain a signed and dated acknowledgement from the investor that the investor has received the disclosure documents, (iii) add new exceptions for *de minimis* compensation and certain nonprofit programs, and (iv) expand the types of disciplinary events that would trigger the rule's disqualification provision as well as provide for certain conditional carve-outs for enumerated events in the current rule.

Additionally, Rule 206(4)-5 bans an investment adviser from making payments to third parties for the solicitation of advisory business from any government entity, unless the third party is a regulated person. A regulated person is defined as an SEC registered investment adviser, a registered broker or dealer subject to the pay-to-play restrictions adopted by a registered national securities association, or a registered municipal advisor subject to pay-to-play restrictions adopted by the Municipal Securities Rulemaking Board. *See* Rule 206(4)-5. However, the SEC has stated that it would not recommend enforcement action against an investment adviser or its covered associates under the Pay-to-Play Rule for payments to third-party solicitors until the Financial Industry Regulatory Authority (FINRA) and the MSRB have adopted equivalent pay-to-play rules for broker-dealers and municipal advisers, respectively. *See* Staff Responses to Questions About the Pay to Play Rule, *available at* https:/www.sec.gov/divisions/investment/pay-to-play-faq.htm#1.4 (Updated June 25, 2015).

- the difference, if any, among clients with respect to the amount of advisory fee charged, if that difference is attributable to the solicitation compensation agreement.

When the adviser enters into an agreement with the client, the adviser must receive and maintain for its records a copy of a signed and dated acknowledgment of receipt by the client of the adviser's Firm Brochure and the solicitor's disclosure document.

The staff of the SEC's Division of Examinations issued a Risk Alert in October 2018 on the most frequently identified compliance issues relating to Rule 206(4)-3. Those compliance issues included missing or deficient solicitor disclosure documents, client acknowledgements and solicitation agreements.[130]

For a discussion of limitations on payments to solicitors in connection with their activities in relation to government entities, *see* Section XII.C. above.

[130] *See* Office of Compliance Inspections and Examinations, Securities and Exchange Commission, National Exam Program Risk Alert, Investment Adviser Compliance Issues Related to the Cash Solicitation Rule (Oct. 31, 2018), *available at* https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Cash%20Solicitation.pdf.

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