PRIVATE EQUITY GROWTH CAPITAL COUNCIL

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Response submitted online at: www.esma.europa.eu

8 January 2015

Response to Call for Evidence - AIFMD Passport and Third Country AIFMs Doc. 7 November 2014 | ESMA/2014/1340

Dear Sir / Madam:

The Private Equity Growth Capital Council (the "PEGCC") respectfully submits this letter in response to the "*Call for evidence - AIFMD passport and third country AIFMs*" (the "Call for Evidence") of the European Securities and Markets Authority ("ESMA").

As the trade association representing the US private equity and growth capital ("private equity") industry, the PEGCC is well placed to comment on the extension of the Alternative Investment Fund Managers Directive (2011/61/EU) (the "AIFMD") management and/or marketing passporting regime (the "Passporting Regime") to alternative investment fund managers established in the United States (each, a "US AIFM"), and we appreciate the opportunity to do so. We have not attempted to answer all of the questions posed in the Call for Evidence, however, because the PEGCC is not itself an alternative investment fund manager and believes that others are better placed to answer the questions that we do not address below.

As a consequence of the robust and comprehensive US regulatory regime and as further discussed below, the PEGCC is of the view that there are "no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk" that would impede the application of the Passporting Regime to US AIFMs and the alternative investment funds (both US and non-US) they manage.[1] Accordingly, the PEGCC respectfully submits that if ESMA issues positive advice to extend the Passporting Regime to non-European AIFMs, US AIFMs should benefit from the extension of the Passporting Regime.

The PEGCC has had the benefit of reviewing the response to the Call for Evidence to be submitted by the European Private Equity and Venture Capital Association ("EVCA") and broadly supports that response (the "EVCA Response"). The PEGCC specifically endorses the EVCA's recommendations with respect to: extending the Passporting Regime to non-European AIFMs in a proportionate way; greater certainty regarding selection of the Member State of Reference; adoption of

[1] *See* Article 67(4) of the AIFMD.

clear grandfathering rules; the benefits of ensuring a harmonised approach throughout Europe to the application of the Passporting Regime[2]; and, the requirement for OECD model tax convention-compliant agreements.

I. Who We Are

The PEGCC, based in Washington, DC, is an advocacy, communications and research organization established to develop, analyze and distribute information about the private equity industry and its contributions to the US and global economy. Our members represent a broad cross-section of the private equity industry in the United States, and include many of the world's largest and best known private equity firms, as well as leading small and medium-sized private equity firms.[3]

Our members are united by their commitment to growing and strengthening the businesses in which they invest. Many of our members invest in the European Union and market their alternative investment funds to professional investors in the European Union.[4] For further information about the PEGCC, please see www.pegcc.org.

II. Background Information

As a preliminary matter, it is worth noting that:

(a) appropriate cooperation agreements are in place between the US Securities and Exchange Commission (the "SEC"), the relevant regulatory authority with respect to US AIFMs, and the national competent authorities of the European Union, other than the national competent authorities of Croatia and Slovenia, in order to ensure at least an efficient exchange of information that allows the EU national competent authorities to carry out their duties in accordance with the AIFMD;[5]

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2 Including consistency with respect to proportionate fees to be charged by the Member States to an AIFM wishing to utilise the marketing passport.

3 For a list of our members, please see www.pegcc.org/about/members.

4 9.3% of investment in US-based private equity funds closed from 2009 to 2014 comes from European investors. European investors currently have invested approximately $140 billion in US-based private equity funds. (Preqin data, accessed on 5 January 2015).

5 *See* Article 37(7)(d) of the AIFMD. European Securities and Markets Authority, "MoU concerning consultation, cooperation and the exchange of information related to the supervision of the relevant entities in the asset management industry," 18 July 2013 (ESMA/2013/998-Annex 38) (*available at:* http://www.esma.europa.eu/system/files/mou_with_us_sec.pdf). This assumes that the cooperation agreements entered into in connection with Article 42 of the AIFMD will be applicable to the satisfaction of the Article 37(7) condition.

(b) the United States is not on the list of Non-Cooperative Countries and Territories maintained by the Financial Action Task Force;[6] and

(c) the PEGCC supports the establishment and maintenance of an accessible national private placement regime in each European jurisdiction for US AIFMs that desire to market their AIFs in accordance with such regime and in compliance with the requirements set out in Article 42 of the AIFMD.[7]

III. The Passporting Regime Should be Extended to US AIFMs

US AIFMs are already subject to an extensive US regulatory regime that has objectives equivalent to those of the AIFMD regime (including, without limitation, the objectives of investor protection and monitoring of systemic risk). As such, the PEGCC is of the view that the application to US AIFMs of an additional European regulatory overlay is not necessary. The PEGCC understands though that the AIFMD prescribes a European regulatory framework that will apply where the Passporting Regime is extended to non-European AIFMs. The PEGCC respectfully submits that, when determining the specifics of implementation of a Passporting Regime for US AIFMs, due consideration and recognition should be given to the US regulatory regime that already applies to US AIFMs and the extensive oversight and scrutiny to which they are already subject.

As noted in the Call for Evidence, the criteria for ESMA to issue positive advice is that there should be no significant obstacles regarding (*a*) investor protection, (*b*) market disruption, (*c*) competition and (*d*) the monitoring of systemic risk that would impede the application of the Passporting Regime to non-European AIFMs. No such obstacles exist with respect to US AIFMs. Each of these criteria is considered in turn below with respect to US AIFMs.

(a) Investor Protection

Investor protection is a hallmark of the US regulation of alternative investment fund managers and other investment advisory firms. The management of AIFMs and the marketing of interests in alternative investment funds (an "AIF") are subject to a comprehensive, substantive regulatory regime in the United States.

First, the marketing of interests in AIFs is subject to the provisions of the US Securities Act of 1933, as amended (the "Securities Act").[8]

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6 *See* Article 37(7)(e) of the AIFMD. Financial Action Task Force, "High-risk and non-cooperative jurisdictions", 24 October 2014 (*available at:* http://www.fatf-gafi.org/topics/high-riskandnon-cooperativejurisdictions/documents/public-statement-oct2014.html).

7 The PEGCC notes that the EVCA Response highlights a number of fundamental issues with the operation of the current national private placement regimes. The PEGCC supports the call for a more streamlined and practical approach to the national private placement regimes.

8 The Securities Act contains anti-fraud provisions (and associated penalties for violation of those provisions) applicable to both public and private offers and sales of interests in AIFs. Private

Second, for sales of interests in most US AIFs, the US Investment Company Act of 1940, as amended (the "Investment Company Act"), requires that the investors be limited in number (to no more than 100 beneficial owners) or that an investor has investment assets of at least $5 million (in the case of an individual and a family company) or of at least $25 million (in all other cases).

Third, additional US federal and/or state statutes and rules regulate (1) the management and activities of placement agents and certain other persons who are in the business, for compensation, of marketing securities, including interests in AIFs, to investors (*e.g.,* the US Securities Exchange Act of 1934, as amended), (2) anti-corruption and bribery concerns with respect to the activities of US persons, including US AIFMs and their affiliates (*e.g.,* the US Foreign Corrupt Practices Act), and (3) a variety of other matters.

Fourth, US AIFMs are regulated under the US Investment Advisers Act of 1940, as expanded and amended by the US Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Advisers Act").[9] Even before the Dodd-Frank Act, the marketing activities and ongoing dealings with clients of all US AIFMs were subject to the anti-fraud requirements and certain other provisions of the Advisers Act. The Dodd-Frank Act, by expanding the scope of the Advisers Act's registration requirement, layered additional requirements on top of the already extensive and longstanding regulatory regime described above. As a result, every sizeable US AIFM is subject to additional substantive regulation by, is required to register with, and is subject to examination (to ensure compliance with the foregoing) by the SEC under the Advisers Act. Appendix A sets out a brief summary of the key substantive provisions of the Advisers Act and demonstrates the extensive regulatory framework within which US AIFMs currently operate.

(b) Market Disruption

The PEGCC submits that no risk of market disruption is posed by permitting the extension of the Passporting Regime to US AIFMs. US AIFMs have long been marketing in the European Union and the nature of the US regulatory regime is rigorous (including, in particular, but not limited to, the SEC's ability to monitor

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offers and sales of securities, including of interests in AIFs (which are typically sold in private offerings) are also typically subject to restrictions on the manner and nature of the offering and the number and sophistication of offerees.

[9] A US AIFM of private funds generally is required to register with the SEC if it has more than $150 million in assets under management. Certain venture capital fund advisers (narrowly defined) are exempt from registration, but these venture capital fund advisers are still required to make filings with the SEC, are subject to the anti-fraud provisions of the Advisers Act and are subject to examination by the SEC. We further note that, in addition to fund managers/investment advisers, the general partners of AIFs organized as limited partnerships are also typically subject to registration with the SEC as investment advisers.

systemic risk[10] discussed below). In fact, limiting or prohibiting European professional investors' access to US AIFMs may lead to market disruption.

(c) Competition

From a practical perspective, extending the Passporting Regime to US AIFMs will mean that professional investors in the European Union will continue to have access to AIFs managed by US AIFMs.[11] European investors should be permitted, within an appropriate regulatory framework, full flexibility in choosing between investing with European AIFMs and US AIFMs. Investment with US AIFMs serves a number of important functions for many European investors, including diversification of investment opportunities and access to attractive returns[12].

The PEGCC believes that not extending the Passporting Regime to US AIFMs would raise significant and important market access issues for US AIFMs and could seriously harm the interests of European institutional investors. Extension of the Passporting Regime to US AIFMs is important for ensuring that European AIFMs and US AIFMs have a "level playing field" in connection with the marketing of AIFs to European professional investors.

A European AIFM may market its AIFs organized outside the US to a prospective investor in the United States, *provided* that (*a*) the interests in the non-US AIFs are not offered in a public offering in the United States and (*b*) the interests in the relevant non-US AIF will be beneficially owned by either (*i*) not more than 100 US persons or (*ii*) with respect to investors that are US persons only, exclusively by "qualified purchasers" (as defined in Section 2(a)(51) of the Investment Company

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10 *See* paragraph III (d) of this letter.

11 We understand that, on and from the date on which the Passporting Regime is extended to non-European AIFMs, Germany will no longer allow a non-European AIFM actively to market its AIF to German professional investors unless such non-European AIFM holds an AIFMD marketing passport with respect to such AIF (even where such non-European AIFM is established in a jurisdiction that does not qualify for the Passporting Regime).

12 Annualized returns generated by US private equity funds equalled 14.3% over the last ten years, according to the Q2 2014 US Private Equity Fund Index (Cambridge Associates). These annualized returns far exceed annualized returns that investors could have obtained by investing in various public market indexes: MSCI Europe Index (US$), 7.54% annualized returns over the past 10 years (as of 30 June 2014) (reported by Cambridge Associates); Russell 2000 Index, 8.70% annualized returns over the past 10 years (as of 30 June 2014 (reported by Cambridge Associates); S&P 500 Index, 7.78% annualized returns over the past 10 years (as of 30 June 2014) (reported by Cambridge Associates).

The PEGCC notes that the response to the Call for Evidence to be submitted by the Emerging Markets Private Equity Association also highlights the need to consider how the application of the AIFMD and the possibility of extending the Passporting Regime will impact on European investor choice and associated diversification issues. The PEGCC also notes that the EVCA Response also makes similar macro observations that may materialise if an effective Passporting Regime is not implemented for non-European AIFMs.

Act).[13] Access to the US investor base is important for European AIFMs, just as access to the European investor base is important for US AIFMs.[14]

The European Commission and the US Government have signed multiple cooperation agreements with respect to competition matters to enable effective collaboration and comity between the European Union and the United States.[15] Extending the Passporting Regime so that they apply to US AIFMs will not distort or undermine competition within the European Union.

The United States has one of the world's most advanced competition regimes, referred to as "antitrust" law, which is primarily enforced by the US Department of Justice's Antitrust Division and the US Federal Trade Commission. The US Sherman Act of 1890[16] and the Clayton Antitrust Act of 1914[17] prohibit cartels and monopolists that impose unreasonable restraints of trade which are harmful to consumers. Accordingly, the aims, objectives and structure of the US antitrust regime are broadly similar to articles 101 and 102 of the Treaty on the Functioning of the European Union.

(d) The Monitoring of Systemic Risk

The regulatory regime for a US AIFM ensures the SEC has comprehensive, detailed and vigorous oversight of that US AIFM, as discussed above. This oversight extends to potential systemic risk concerns.[18] While recognising that the AIFMD

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13 The SEC staff no-action letters that set forth these restrictions are premised on the policy that non-US AIFs should be on equal footing with US AIFs. *See* Touche Remnant & Co., SEC Staff No-Action Letter (Aug. 27, 1984) (providing no-action relief for the offer and sale of shares of a non-US fund in the US if the non-US fund complies with the Investment Company Act by, for example, offering to fewer than 100 beneficial owners resident in the U.S.); Goodwin, Proctor & Hoar LLP, SEC Staff No-Action Letter (Feb. 28, 1997) (providing no-action relief for non-US funds to offer and sell shares to US residents that are "qualified purchasers" in accordance with Section 3(c)(7) of the Investment Company Act). Furthermore, we note that a non-US AIF has an advantage over a US AIF, since a US AIF must include both US and non-US persons for purposes of determining its compliance with either Section 3(c)(1) or 3(c)(7) of the Investment Company Act, while a non-US AIF must only include US persons.

14 For example, in 2013, 36.2% of funds raised by European private equity firms came from North America. *See* EVCA, 2013 European Private Equity Activity: Statistics on Fundraising, Investments & Divestments, p. 20, http://www.evca.eu/media/142790/2013-European-Private-Equity-Activity.pdf.

15 For example: The Agreement between the Government of the United States of America and the Commission of the European Communities regarding the application of their competition laws, 27 April 1995; The Agreement between the European Communities and the Government of the United States of America on the application of positive comity principles in the enforcement of their competition laws, 18 June 1998; and, US-EU Merger Working Group – Best Practices on Cooperation in Merger Investigations, 14 October 2011.

16 15 U.S.C. §§ 1–7.

17 15 U.S.C. §§ 12-27

18 Although not the subject of this letter, the PEGCC notes that the private equity business model does not present systemic risk concerns, as explained in detail in comment letters submitted by the

prescribes a regulatory framework that will apply in the event that the Passporting Regime is extended to US AIFMs, the PEGCC is of the view that the regulatory regime already applicable to US AIFMs is robust.

The SEC requires that a US AIFM that is registered with the SEC and has greater than USD 150 million in assets under management attributable to AIFs file a Form PF in addition to a Form ADV. Form PF is a report that is designed to allow the SEC, the US Financial Stability Oversight Council (the "FSOC") and other financial regulators to assess any potential for systemic risks related to AIFs. The frequency and level of detail required by a Form PF depends on the US AIFM's assets under management and the types of AIFs the US AIFM manages, but a Form PF must be updated and filed at least annually.

In its Form PF a US AIFM must file information about each AIF it manages (this includes both US AIFs and *non-US AIFs*). Further and for the purposes of assessing the effectiveness of the cooperation agreements in place between the SEC and the various European national competent authorities, the records and reports of each such AIF (US and *non-US*) are deemed to be the records and reports of the US AIFM and are subject to examination by the SEC. The SEC requires US AIFMs to maintain certain books and records relating to its AIFs and it has the authority to examine all the books and records of those AIFs.

The information contained in the Form PF submitted by a US AIFM is primarily intended to provide empirical data to the FSOC based on which the FSOC may make determinations about the extent to which the activities of AIFs or US AIFMs pose systemic risks.[19] In addition, Form PF was drafted with the intention of advancing "international efforts relating to the collection of systemic risk information."[20] To this end, the SEC staff consulted with ESMA, the United Kingdom's Financial Services Authority, the International Organization of Securities Commissions and Hong Kong's Securities and Futures Commission during the

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PEGCC, including the comment letters that can be found at www.pegcc.org/issues/the-dodd-frank-act-summary/systemic-risk.

[19] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, SEC Release No. IA-3308 (Oct. 31, 2011) at p. 8. The FSOC has stated that it will consider the data provided on Form PF when considering whether to designate either US AIFMs or the AIFs as nonbank systemically important financial institutions. Thus far, no US AIFMs have been designated as nonbank systemically important financial institutions. Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637 (Apr. 11, 2012).

[20] SEC Release No. IA-3308 at 11.

development of Form PF[21] and the SEC expects that it may share information reported on Form PF with various foreign financial regulators.[22]

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Given the nature and scope of the US regulatory regime applicable to US AIFMs, the PEGCC respectfully submits that there are "no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk" that would impede the application of the Passporting Regime to US AIFMs and the alternative investment funds (both US and non-US) they manage. If ESMA issues positive advice to extend the Passporting Regime to non-European AIFMs, US AIFMs should benefit from the extension of the Passporting Regime. The PEGCC also supports the establishment and maintenance of an accessible national private placement regime in each European jurisdiction for US AIFMs that desire to market their AIFs in accordance with such regime and in compliance with the requirements set out in Article 42 of the AIFMD.

The PEGCC appreciates the opportunity to submit this letter. We hope you find it helpful, and we would be pleased to answer any questions that you might have.

Respectfully submitted,

Steve Judge
President and CEO
Private Equity Growth Capital Council

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[21] Id. at 12. In adopting Form PF, the SEC explicitly noted that it had made changes to the originally proposed Form PF to further align the Form PF with the survey efforts of ESMA and the UK Financial Services Authority (now the Financial Conduct Authority).

[22] Id. at fn. 29. The Financial Stability Board and the International Organization of Securities Commissions noted Form PF as one of the data sources for consideration in the identification of non-bank non-insurer global systemically important financial institutions. Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies (8 January 2014), available at http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf.

See, also PEGCC and EVCA Comment Letter on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions at http://www.pegcc.org/issues/comment-letters/pegcc-and-evca-comment-letter-on-assessment-methodologies-for-identifying-non-bank-non-insurer-global-systemically-important-financial-institutions.

Appendix A:
Summary of the Substantive Requirements applicable to an SEC Registered US AIFM[23]

(1) Registration and Other Regulatory Reporting

A US AIFM registers with the SEC by filing a Form ADV. Form ADV is divided into three parts: (*i*) Part 1A requires general identification and financial information about the US AIFM and its business; (*ii*) Part 2A of Form ADV (the "Brochure") is designed to be a client disclosure document, including descriptions, in narrative form, of among other things, its advisory services, fees and compensation, methods of analysis and investment strategies (and related risks), disciplinary information, material relationships with other financial industry participants, material financial conditions and potential conflicts of interest with clients; and (*iii*) Part 2B of Form ADV (the "Brochure Supplement") provides information about the educational background, business experience and disciplinary history (if any) of the supervised persons who provide management/advisory services to the client. Parts 1A and 2A of Form ADV include substantial information about the AIFs managed or advised by the US AIFM and are publicly available on the SEC website. Part 2B of Form ADV is not filed with the SEC, but must be maintained by the US AIFM. A US AIFM is required to update its Form ADV at least annually and promptly under certain other circumstances, such as a material change to the information in Part 2A of Form ADV. The SEC may bar a firm from registering if the firm or certain persons associated with the firm have committed certain disciplinary infractions.

(2) SEC Review of Registration Statements; Basis for Denying Registration

The major focus of the SEC's review of a US AIFM's Form ADV is on the disciplinary history of the firm and its personnel. The US AIFM must provide information with respect to its disciplinary history as well as the disciplinary history of its "advisory affiliates" -- that is, the firm's employees (other than those performing purely clerical or ministerial functions), officers, partners or directors and all persons directly or indirectly controlling or controlled by the US AIFM.

A US AIFM must disclose its disciplinary history with respect to a variety of matters, including felony convictions, certain misdemeanor convictions and proceedings related to violations of investment-related laws and regulations (whether US or non-US) as well as suspensions of the authorization to practice and proceedings brought by self-regulatory agencies. Generally, disciplinary events that occurred within the prior 10 years must be disclosed.

Based on this disciplinary disclosure, the SEC may deny registration or impose limits on the activities of a US AIFM. In addition, subsequent to registration, the SEC may, in its discretion, censure, place limitations on the activities or suspend

[23] A US alternative investment fund manager that is registered with the SEC under the Advisers Act typically is referred to as a 'registered investment adviser', although for the purposes of this Appendix A is referred to as a 'US AIFM'.

for a period not exceeding 12 months or revoke the registration of any US AIFM if it finds that the US AIFM or any person associated with the US AIFM has been subject to these types of disciplinary action. The disciplinary events that the SEC may use as a basis to deny registration or take these other actions include, among other things:

- making a false or misleading statement in any material required to be filed with the SEC;

- conviction of a felony or misdemeanor or of a substantially equivalent crime by a foreign court within the prior 10 years (*i*) involving the purchase or sale of any security or involving fraud, (*ii*) arising out of the conduct of the US AIFM, broker, dealer, bank or similar financial service businesses or (*iii*) involving larceny, theft or misappropriation of funds or securities;

- conviction, within the prior 10 years, of any crime that is punishable by imprisonment for one or more years;

- being permanently or temporarily enjoined from acting as an investment manager/adviser, broker, dealer or in similar capacities;

- a willful violation of the US securities laws, causing another person to have willfully violated those laws or failing to supervise a person who commits such a violation;

- becoming subject to an order of the SEC barring or suspending the right of the person to be associated with the US AIFM;

- a finding by a foreign financial regulatory authority of having (*i*) made a false statement in any materials required to be filed with a foreign securities authority, (*ii*) violated any foreign statute or regulation regarding transactions in securities or (*iii*) aided or abetted the violation by any other person of a foreign statute or regulation involving transactions in securities; and

- becoming subject to a bar by a state regulatory agency that regulates certain financial service companies.

(3) Disclosure and Delivery Requirements

A US AIFM must provide advisory clients with a copy of its Brochure and Brochure Supplement before or at the time the US AIFM enters into an advisory contract with the client. Thereafter, a US AIFM must deliver its Brochure and Brochure Supplement to its clients on an annual basis or deliver a summary of material changes to the Brochure since it was last delivered, accompanied by an offer to provide the Brochure. Also, as discussed below, a US AIFM is a fiduciary and must make full disclosure to clients of all material facts relating to the management/advisory relationship, including full disclosure of all material conflicts

of interest that could affect the relationship, even if not specifically required by Part 2 of Form ADV.

(4) Books and Records

The Advisers Act imposes extensive books and records requirements. A US AIFM must keep true, accurate and current books and records reflecting its financial affairs and describing transactions for and communications with its clients. A US AIFM must also maintain all accounts, books, internal working papers and any other documents necessary to form the basis for, or demonstrate the calculation of, the performance information used in advertising. A US AIFM's books and records include the books and records of its AIFs (including non-US AIFs).

(5) SEC Examination

The SEC actively monitors compliance with the Advisers Act through its examination program. An examination typically involves an SEC visit to a US AIFM's offices. During an SEC inspection, the US AIFM's books and records are usually the subject of careful review. An SEC inspection often occurs within a year after initial registration; the frequency of examinations thereafter depends upon the SEC's assessment of the firm's risk profile. SEC examinations can last anywhere from a week or more to many months, depending on the focus of the exam and the size and complexity of the US AIFM. Violations of the Advisers Act may result in the imposition of civil or administrative sanctions by the SEC, as well as substantial monetary penalties.

In 2012, the SEC launched an initiative to conduct focused, risk-based examination of US AIFMs that recently registered with the SEC.[24] The SEC staff recently announced that it has completed its goal of examining 25% of the new private fund registrants by the end of 2014. As discussed below, risk management is a major focus of the SEC's examination program.

(6) Coordinated Compliance Program and Risk Management

A US AIFM is required to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the US AIFM or any of its supervised persons. In adopting Rule 206(4)-7, the rule that requires such policies, the SEC did not impose a set of specific elements that US AIFMs must include in their policies and procedures. As discussed below, however, in other contexts the SEC has identified certain minimum requirements with respect to the policies and procedures.

Rule 206(4)-7 also requires a US AIFM (*i*) to review its policies and procedures annually to determine their adequacy and the effectiveness of their implementation and (*ii*) to designate a chief compliance officer to administer its

[24] *See* http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf.

compliance policies and procedures. The SEC's guidelines indicate that the chief compliance officer should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the US AIFM.

An important component of a US AIFM's compliance program is risk management. In adopting Rule 206(4)-7, the SEC stated that a US AIFM, in designing its policies and procedures, "should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks." Risk management has continued to be emphasized by the SEC. Enterprise risk management is one of the examination priorities for the SEC and the SEC staff has conducted a series of examinations on a wide sample of US AIFMs focusing principally on enterprise risk management.[25]

The SEC expects that a US AIFM's compliance program will cover the following risk areas (certain of which are addressed in more detail below):

- Identification and, to the extent necessary, the mitigation and disclosure of conflicts of interest between the US AIFM and its clients;

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the US AIFM, and applicable regulatory restrictions;

- Trading practices, including procedures by which the US AIFM satisfies its best execution obligation;

- Proprietary trading of the US AIFM and personal trading activities of its employees and the protection of material non-public information;

- Accuracy of disclosures made to investors, clients, and regulators, including account statements, regulatory filings, advertisements and other marketing materials;

- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;

- Accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;

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[25] Examination Priorities for 2014, National Exam Program (Jan. 9, 2014), available at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.

- Marketing advisory services or interests in an AIF, including the use of solicitors and placement agents;

- Processes to value client holdings and assess fees based on those valuations;

- Allocation of fees and expenses; and

- Safeguards for the privacy protection of client records and information.

In examining a US AIFM, the SEC staff will request information about the compliance risks that the firm has identified and the written policies and procedures the firm has established and implemented to address each of those risks to provide an understanding of the firm's compliance risks and corresponding controls.[26] Among other things, the SEC staff requests (*i*) an inventory of compliance risks that forms the basis for policies and procedures and notations regarding changes made to the inventory; (*ii*) documents mapping the inventory of risks to written policies and procedures; and (*iii*) written guidance provided to employees regarding compliance risk assessment process and procedures to mitigate and manage compliance risks.

As relevant, the SEC staff has also emphasized the need for liquidity issues to be considered. For example, in the public fund context, the SEC staff has urged US AIFMs generally to assess overall fund liquidity and funds' ability to meet potential redemptions in light of potential market volatility, including assessing their sources of liquidity (such as cash holdings and other assets that would not require selling into declining or dislocated markets if volatility or market stress increases). In this connection, the staff has urged US AIFMs to consider assessing the impact (beyond just liquidity) of various stress-tests and/or other scenarios on funds.[27]

(7) Code of Ethics; Personal Securities Trading

A US AIFM must adopt a code of ethics that sets forth, among other things, a standard of conduct for its employees and requires compliance with federal securities laws. The code of ethics also must require the US AIFM's "access persons" (employees with access to certain types of information) to periodically report their personal securities transactions and holdings to the US AIFM's chief compliance officer or other designated persons. Certain types of personal securities transactions (such as purchases of IPOs and private placements) are subject to an enhanced review and approval process. The code of ethics must also require the US AIFM to review these reports. The transaction reports must be retained in the US AIFM's books and records for SEC review.

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[26] *See* Office of Compliance Inspections and Examination, "Investment Adviser Examinations: Core Initial Request for Information" (*available at*: http://www.sec.gov/info/cco/requestlistcore1108.htm).

[27] SEC Division of Investment Management Guidance Update No. 2014-1, "Risk Management in Changing Fixed Income Market Conditions," (*available at:* http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf).

(8) Policies to Prevent the Misuse of Non-Public Information

A US AIFM must establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information by the US AIFM or any person associated with the US AIFM.

(9) Anti-fraud Provisions

The anti-fraud provisions are at the heart of the Advisers Act and are the basis for many SEC enforcement proceedings. The statutory anti-fraud provision makes it unlawful for any US AIFM (*i*) to employ any device, scheme, or artifice to defraud any client or prospective client or (*ii*) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. This provision also prohibits a US AIFM from engaging in certain principal and agency transactions with its clients without client consent. The anti-fraud provisions of the Advisers Act have been interpreted to impose on the US AIFM an affirmative duty of utmost good faith to act solely in the best interests of its clients and to make full and fair disclosure of all material facts, particularly where the US AIFM's interests conflict with those of its clients.

The SEC also has adopted a number of specific anti-fraud rules governing, among other things, advertisements, the custody of client assets, the use of client solicitors, political contributions and proxy voting. These rules are described below. In addition, as described above, the SEC has adopted Rule 206(4)-7, which requires, among other things, the adoption of compliance policies and procedures and the appointment of a chief compliance officer. The SEC has also adopted a general anti-fraud rule (Rule 206(4)-8) that prohibits conduct that defrauds investors or prospective investors in pooled investment vehicles managed by the US AIFM.

(A) Advertising Restrictions

Generally, the Advisers Act prohibits US AIFMs from distributing any advertisement that, among other things, contains untrue statements of material fact or that is otherwise false or misleading. Rule 206(4)-1 prohibits, among other things, the use of testimonials in advertisements and sets forth conditions for disclosing prior recommendations of the US AIFM. In addition, the SEC has issued a number of "no-action" letters setting forth its views on the manner in which prior performance may be presented.

(B) Custody of Client Assets

The safeguarding of client assets is a key concern of the SEC. Rule 206(4)-2 (the "Custody Rule") requires that a US AIFM having "custody" of client funds or securities maintain them with a "Qualified Custodian" such as a bank, registered broker-dealer, registered futures commission merchant or foreign financial institution that customarily holds financial assets for its customers. The Custody Rule also requires, among other things, that an independent accountant verify the existence of

the client funds and securities either through a "surprise" examination or, if the client is a pooled investment vehicle, an annual audit.

The term "custody" is broadly defined under the Custody Rule. A US AIFM has custody if "it holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them" either directly or through a related person. For example, the general partner of an AIF (and any manager that is a related person of the general partner) is deemed to have custody of the fund's assets.

(C) Use of Solicitors

Some US AIFMs retain solicitors to assist them in establishing client relationships. Rule 206(4)-3 under the Advisers Act requires that the US AIFM enter into a written agreement with any such solicitor addressing certain matters, oversee the activities of the solicitor and arrange for the solicitor to provide certain disclosures to clients.

(D) Pay-to-Play Prohibitions

Rule 206(4)-5 under the Advisers Act is designed to prohibit certain practices relating to the solicitation of business from US state and local governments (generally characterized as "pay to play" practices). The rule, in effect, imposes significant restrictions on the political contributions and certain other fundraising activities by a US AIFM and its affiliates, officers and employees when the US AIFM provides (or is seeking to provide) advice to local or state government entities, whether directly or through an AIF.

(E) Proxy Voting

A US AIFM must have written proxy voting policies and procedures that are reasonably designed to ensure that the US AIFM votes proxies in the best interest of clients. In addition, the US AIFM must disclose to clients information about its proxy voting policies and procedures and about how clients may obtain information on how the US AIFM has voted their proxies.

(10) Performance-Based Fees; Management Agreements

A US AIFM may not enter into an investment advisory contract that provides for compensation based on a share of capital appreciation, unless the client is a qualified sophisticated investor or a non-US person. In addition, any investment management/advisory agreements with clients must contain (*i*) a provision requiring the client's consent to an "assignment" of the agreement (including transfers of a controlling interest in the firm) and (*ii*) if the investment advisory firm is organized as a partnership, a provision requiring notification to the client of any change in the partners.

(11) Business Continuity Plans

While not required by any rule, the SEC expects a US AIFM to develop a business continuity plan identifying procedures relating to an emergency or significant business disruption.

(12) Client Privacy

The SEC's Regulation S-P requires a US AIFM to "adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information." The SEC's identity theft red flags rules require certain US AIFMs to adopt a written identity theft program.