European Securities and Markets Authority ("ESMA")

European Commission

Directorate-General for Financial Stability, Financial Services and Capital Markets Union: Sven Gentner

(together, the "Interested Parties")

16 December 2015

The Extension of the Passporting Regime to US Fund Managers – US Regulatory Regime and European Market Access Issues

Dear Sir / Madam:

The Private Equity Growth Capital Council (the "PEGCC") respectfully submits this letter to the Interested Parties to address certain matters identified in 'ESMA's advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs' of 30 July 2015 ("ESMA's Advice"). Given the focus in ESMA's Advice more generally on the importance of understanding and assessing the United States regulatory regime, this letter also provides information on the regulatory framework that applies to US alternative investment fund managers (whether those managers are managing US or non-US alternative investment funds) and the regulatory requirements applicable to European alternative investment fund managers seeking to market their alternative investment funds to US prospective investors.[1]

[1] For ease of review, this letter reiterates certain of the information the PEGCC previously has provided in respect of the AIFMD and US alternative investment fund managers. Please also see (*i*) our previous submission to ESMA dated 8 January 2015 in response to ESMA's 'Call for evidence – AIFMD passport and third country AIFMs,'; and (*ii*) our previous correspondence with the Interested Parties dated 3 July 2015 and titled 'The Extension of the Passporting Regime to U.S. Fund Managers – Response to a Further Information Request from the Interested Parties'.

799 9th Street NW, Suite 200 Washington, DC 20001 PH 202.465.7700 FX 202.783.0165 www.pegcc.org

As the trade association representing the US private equity and growth capital 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").

Given that ESMA declined to make a positive recommendation in respect of the extension of the Passporting Regime to US AIFMs, we appreciate the opportunity to provide information to the Interested Parties in respect thereof.

The purpose of this letter is to provide information on those aspects of the US regulatory regime either that were highlighted in ESMA's Advice or that the PEGCC considers relevant to ESMA's continuing assessment of whether the Passporting Regime should be extended to US AIFMs. In particular, this letter provides information in respect of the following:

(i) the importance of the national private placement regimes to US AIFMs in respect of both US alternative investment funds and non-US alternative investment funds (an alternative investment fund, an "AIF") and to European investors seeking to assess investment opportunities with US AIFMs;

(ii) a 'level playing field' – US securities laws do *not* place restrictions on EU alternative investment fund managers (each, an "EU AIFM") seeking to market their AIFs to prospective US professional investors[2] in a discriminatory manner as compared with equivalent US AIFMs seeking to market their AIFs to prospective US professional investors; and

(iii) the robust US regulatory approach to securities and investor protection laws, including in respect of custody matters.

(i) The Importance of Viable National Private Placement Regimes

In our previous correspondence with the Interested Parties dated 3 July 2015 and titled 'The Extension of the Passporting Regime to U.S. Fund Managers – Response to a Further Information Request from the Interested Parties', the PEGCC emphasised the importance of retaining strong national private placement regimes alongside any Passporting Regime. We continue to believe that this is a critical matter – for both

[2] We note that the concept of 'professional investor' is a European regulatory concept. For the purposes of this letter, however, we use 'professional investor' interchangeably with the US concepts of 'accredited investor' and 'qualified purchaser'. For more information on the concept of 'accredited investor', see Appendix 3. For more information on the concept of 'qualified purchaser', see Appendix 4.

European professional investors and US AIFMs – that should not be forgotten when undertaking the Passporting Regime analysis.

Increasing competition and European investor choice are important principles that will be well served by ensuring that workable national private placement regimes are in place throughout Europe, even in the event that the Passporting Regime is extended to US AIFMs. This will help to ensure that European institutional investors are able to access attractive investment opportunities that are made available by US AIFMs.

The PEGCC strongly supports the maintenance of national private placement regimes throughout Europe. Withdrawal of national private placement regimes will have a detrimental effect on:

(a) *European professional investors*, for the simple reason that those investors will have more limited access to US AIFMs (for the reasons set out in sub-paragraph (b) below); and

(b) *US AIFMs*, many of whom are unlikely to take up the AIFMD passporting route to the extent it is extended to US AIFMs – (A) certainly, at least until there is an established practice in respect of the operation of the AIFMD passport for non-EU AIFMs, and/or (B) perhaps only where the particular US AIFM expects to market widely throughout Europe and in circumstances where it expects to attract significant amounts of European capital, such that there is deemed to be sufficient benefit stemming from the assumption of the burden of AIFMD authorisation. For smaller US AIFMs, the cost/benefit analysis of AIFMD authorisation may never warrant the taking up of the AIFMD passport.

The PEGCC understands that it is a matter for each EU member state to determine the nature and scope of its own Article 42 private placement regime vis-à-vis non-EU AIFMs. However, the PEGCC supports the Interested Parties in taking action to encourage the member states to have private placement regimes in place that enable US AIFMs actively to market their AIFs to European professional investors – with the likely outcome being better access to investment opportunities for European professional investors.

A number of EU member states (including Austria, France, Greece, Italy and Spain) effectively have declined to make available a private placement regime. The concern is that if the Passporting Regime is extended to non-EU AIFMs (including where the Passporting Regime is extended only to non-EU AIFMs established in a subset of non-European jurisdictions), additional EU member states may withdraw their private placement regimes. We understand this is the position currently being taken by Germany.

The PEGCC supports the development and maintenance of an accessible national private placement regime in each European jurisdiction for US AIFMs that seek to market their AIFs in accordance with such regime and in compliance with the requirements set out in Article 42 of the AIFMD. This will ensure, so far as possible, that European institutional investors will have access to the AIFs managed and marketed by US AIFMs.

(ii) A 'Level Playing Field' for EU AIFMs Marketing AIFs in the United States

As previously noted by the PEGCC and Invest Europe (formerly, EVCA), a 'level playing field' assessment is not expressly provided for in Article 67 of the AIFMD (cf, Article 67(2)(b)(iii)-(v) and 67(2)(c)).

Without prejudice to the concerns the PEGCC has in respect of the 'equivalence' or 'level playing field' assessment that ESMA has applied in ESMA's Advice, the PEGCC can assure the Interested Parties that US securities laws do not place restrictions on non-US AIFMs (specifically EU AIFMs) seeking to market their AIFs (or, in US-speak, private funds) to prospective US professional investors in a discriminatory manner as compared with equivalent US AIFMs seeking to market their AIFs (or, in US-speak, private funds) to US professional investors. In fact, non-US AIFMs have certain US securities law advantages over US AIFMs in respect of private funds.

(a) Distinction between Mutual Funds and Private Funds

ESMA's refusal to provide a positive recommendation regarding the extension of the Passporting Regime to US AIFMs appears to be based, in large part, on questions arising from the 'level playing field' assessment. To the extent that ESMA continues to believe this assessment is an important factor in the Passporting Regime analysis as it applies to US AIFMs, the PEGCC respectfully submits that the distinction between 'mutual funds' and 'private funds' must be recognised.

ESMA's Advice in respect of the United States appeared heavily to focus on the US regulatory regime as it applies to mutual funds and other public funds registered under the U.S. Investment Company Act of 1940 ("Investment Company Act") (see paragraphs 54-57 and 61-63 of ESMA's Advice) rather than on private funds. Broadly, an 'investment company' is not permitted to be marketed in the United States to the general public unless it is registered under the Investment Company Act (e.g., a 'mutual fund'). As with the marketing, establishment and operation of UCITSs, the marketing, establishment and operation of mutual funds are governed by a complex and detailed regulatory regime.

It is unclear why ESMA's Advice focused on mutual funds, particularly as to the difficulties that may arise for a European AIFM seeking to market a mutual fund in the United States. The AIFMD does not apply to UCITSs (the European equivalent of a mutual fund) so applying a 'level playing field' assessment comparing the marketing (and management) of AIFs to European professional investors to the marketing (and management) of mutual funds to US retail investors seems inappropriate. To the extent a 'level playing field' assessment is to be made, the PEGCC respectfully submits that the assessment should look at the capacity to market (and manage) private funds to US professional investors[3].

(b) Registration Requirements[4] for US and non-US AIFMs

Both a US AIFM and non-US AIFM that markets its AIFs to US investors or has a place of business in the United States must register as an 'investment adviser' under the Investment Advisers Act of 1940, as amended (the "Advisers Act") with the Securities and Exchange Commission ("SEC"), unless it can rely on an exemption. As discussed further below, *most non-US AIFMs with no US place of business would not be required to register with the SEC as such AIFMs may rely on the 'private fund adviser' exemption.*

In general, if a US AIFM or non-US AIFM is not able to rely on an exemption from registration under the Advisers Act, then the AIFM must register with the SEC (with each such registered investment adviser, an "SEC-registered AIFM"). Among other compliance requirements, an SEC-registered AIFM is subject to periodic examinations by SEC staff and to various SEC rules related to disclosure, record-keeping, custody of AIF assets (see paragraph (iii)(c) below) and compliance programmes.[5] All SEC-registered AIFMs must go through the same process of registration with the SEC.[6] The SEC takes the view, however, that certain of the substantive provisions of the Advisers Act do not apply to a non-US SEC-registered AIFM's dealings with non-US AIFs.[7] On the other hand, all of the substantive provisions of the Advisers Act apply to a US SEC-registered AIFM's dealings with US and non-US AIFs.

---

3 As noted above, the concept of 'professional investor' is a European regulatory concept. For the purposes of this letter, however, we use 'professional investor' interchangeably with the US concepts of 'accredited investor' and 'qualified purchaser'. For more information on the concept of 'accredited investor', see Appendix 3. For more information on the concept of 'qualified purchaser', see Appendix 4.

4 We note that this paragraph (b) focuses on private funds, as opposed to mutual funds (compare with paragraph 56 of ESMA's Advice).

5 Appendix 5 sets out a brief summary of the key substantive provisions of the Advisers Act and demonstrates the extensive regulatory framework within which US AIFMs operate.

6 One of the registration requirements that need to be satisfied is the filing of a Form ADV with the SEC. For further information on the Form ADV filing requirements, please see Appendix 2.

7 ABA Subcommittee on Private Investment Companies, SEC No-Action Letter (Aug. 10, 2006) and Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Release No. IA-2333 (Dec. 2, 2004) at notes 210 to 222 and the accompanying text. For example, certain parts of the recordkeeping rule (Rule 206(4)-2), the requirements of the advisory contracts (Section 205), the restrictions on principal and agency transactions (Section 206(3)), the brochure delivery requirement

Generally, a US AIFM will be required to register as an 'investment adviser' with the SEC and, therefore, be an SEC-registered AIFM if it has US$150 million or more in assets under management[8]; however, a non-US AIFM has significantly more flexibility in qualifying for exemptions and, in particular, qualifying for the private fund adviser exemption (described below).

Private fund adviser exemption

As is the case for most EU AIFMs, if the EU AIFM has no place of business in the United States, then that EU AIFM could raise an unlimited amount of capital from US investors for its AIFs without being required to comply with the SEC registration regime applicable to US AIFMs (these EU AIFMs rely on the private fund adviser exemption[9]). In addition, the EU AIFM would not be required to register to the extent the EU AIFM does not 'manage' (i.e., does not provide 'continuous and regular supervisory or management services'[10] with respect to) any of the AIFs' assets at a United States place of business (or manages less than US$150 million from a United States place of business). The private fund adviser exemption is relied upon by many large EU AIFMs and those EU AIFMs are still then able to take advantage of the US private placement regime in order to market AIFs in the United States or to US persons.[11]

(Rule 204-3), the advertising rule (Rule 206(4)-1), the custody rule (Rule 206(4)-2) and the cash solicitation rule (Rule 206(4)-3) generally do not apply to a non-US SEC-registered AIFM with respect to its interactions with non-US clients. In addition, a non-US SEC-registered AIFM with no US clients would not be required to comply with the requirement for policies on the protection of material non-public information (Section 204), the code of ethics rule (Rule 204A-1), the proxy voting rule (Rule 206(4)-6), or the compliance rule (Rule 206(4)-7).

8 A US AIFM that provides advice only or manages only private funds and has less than US$150 in assets under management would be permitted to rely on the private fund adviser exemption (described below) and would not be required to register with the SEC. A US AIFM that has less than US$100 million in assets under management (or in the case of an AIFM whose principal place of business is in New York, US$25 million) is generally prohibited from registering with the SEC. In either case, a US AIFM would still be required to determine if it is required to register as an investment adviser under any applicable US state law.

9 § 203(m) of the Advisers Act and Rule 203(m)-1 under the Advisers Act.

10 This language appears in the instructions for completing Part 1A of the Form ADV.

11 EU AIFMs also are able to rely on an additional exemption from registration that is available to 'foreign private advisers' (§§ 202(a)(30), 203(b)(3) of the Advisers Act). Note that, unlike AIFMs relying on the private fund adviser exemption, AIFMs relying on the foreign private adviser exemption are not required to file information with the SEC. For these purposes, a foreign private adviser is an AIFM that has: (*1*) no place of business in the United States; (*2*) in total, fewer than 15 clients in the United States and investors in the United States in private funds managed/advised by the AIFM; (*3*) aggregate assets under management attributable to those clients and investors of less than US$25 million; and (*4*) not held itself out generally to the public in the United States as an investment adviser. Consequently, smaller EU AIFMs benefit from an exemption from registration as an investment adviser with the SEC that is not available to a similarly situated US AIFM.

More specifically, a non-US AIFM will be able to rely on the private fund adviser exemption from registration as an investment adviser with the SEC if: (*1*) the AIFM has no client[12] that is a "US person"[13] (see Appendix 1), except for one or more 'private funds'[14]; and (*2*) all assets managed by the AIFM from a place of business in the United States are solely attributable to the assets of private funds, the total value of which is less than US$150 million.[15] A non-US AIFM that relies on the private fund adviser exemption is considered an 'exempt reporting adviser' and is required to file certain parts of Part 1A of Form ADV that requires only minimal information to be prepared and reported.[16] As such, a non-US AIFM that is an 'exempt reporting adviser' largely is exempt from complying with the Advisers Act requirements.

The ability for large non-US AIFMs to rely on an exemption from the requirement to be registered as an investment adviser with the SEC demonstrates the proportionate approach taken by the SEC in respect of non-US AIFMs. In fact, we note that an EU AIFM is at an advantage to a similarly situated US AIFM, since a US AIFM is required to include the assets under management at any place of business (both United States and non-United States), while an EU AIFM is only required to include assets under management at a United States place of business. The SEC acknowledged that non-US AIFMs were being advantaged in adopting these exemptions and considered whether the exemption would create an incentive for a US AIFM to move outside the United States.[17]

---

12 A US investor in an AIF managed by a non-US AIFM is not a 'client' of the non-US AIFM for these purposes (the client is the AIF that the non-US AIFM is managing and providing investment services in respect of).

13 For the purposes of determining whether an entity (including a manager, general partner or private fund) is treated as being a 'US person' the definition set forth in Rule 902(k)(1) of Regulation S promulgated under the Securities Act needs to be considered (please refer to Appendix 1) for the full definition. In broad terms, the following constitute US persons: (*i*) any natural person resident in the United States; (*ii*) a partnership or corporation that is organised or incorporated under the laws of the United States; (*iii*) any branch of a foreign entity located in the United States; and (*iv*) any partnership or corporation if (*1*) organised or incorporated under the laws of any non-US jurisdiction and (*2*) formed by a US person principally for the purpose of investing in securities, unless it is organised or incorporated, and owned, by 'accredited investors' who are not natural persons, estates or trusts. Category (iv) means that a private fund which is owned by accredited investors will not be deemed to be a US person for the purposes of the Custody Rule or US securities law more generally, meaning that US securities laws are intended to be proportionate and not impose a global obligation upon AIFMs.

14 Rule 203(m)-1(d)(5) promulgated under the Advisers Act.

15 Rule 203(m)-1(b) promulgated under the Advisers Act.

16 This information includes: basic information about the AIFM, including contact details; details of private funds managed by the AIFM; information on group entities and affiliates; details of the executive officers of the AIFM; and details of the disciplinary history of the AIFM and its employees.

17 Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, SEC Release No. IA-3222 (Jun.

(c) US Private Placement Rules

Unless an exemption is available, all offers and sales of securities (including interests in AIFs) in the United States or to US persons must be registered with the SEC under the Securities Act of 1933, as amended (the "Securities Act"). *The US private placement regime does not discriminate between US AIFMs and non-US AIFMs, meaning that an EU AIFM that wishes to market under the private placement regime in the United States would not be at a competitive disadvantage from a regulatory perspective when compared with an equivalent US AIFM.*

The exemption most frequently relied upon by both US AIFMs and non-US AIFMs in respect of the marketing of their AIFs is the 'private placement exemption' in section 4(a)(2) of the Securities Act. When marketing to investors within the territory of the United States, the most prominently utilised 'safe harbour' for the private placement exemption is Rule 506 of Regulation D promulgated under the Securities Act ("Regulation D") which provides that an AIF can be marketed to an unlimited number of "accredited investors"[18] (see Appendix 3).

In addition to relying on an exemption from the Securities Act in respect of the marketing of interests in an AIF, an AIFM must also ensure that the AIF is not required to register as an 'investment company' under the Investment Company Act.

The registration requirements for US and non-US AIFs are different under the Investment Company Act. Broadly:

(A) a US AIF is prohibited from, among other things, engaging in any business in United States interstate commerce unless it can rely on an exemption from the definition of 'investment company'.[19] Substantially all US AIFs rely on either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Section 3(c)(1) of the Investment Company Act provides an exemption to an AIF with fewer than 100 beneficial owners and that has not made a public offering.[20] Section 3(c)(7) of the Investment Company Act provides an exemption to an AIF whose beneficial owners are all "qualified purchasers" (see Appendix 4)[21] and that has not made a public offering.

22, 2011) at 174 – 175 (discussing potential impact of U.S. investment advisers moving offshore to take advantage of the private fund adviser exemption).

18 As defined in Rule 501(a) of Regulation D. For the full definition, please see Appendix 3.

19 § 7(a) of the Investment Company Act.

20 These 100 beneficial owners are still required to be accredited investors in order to meet the requirements of Regulation D.

21 As defined in section 2(a)(51) of the Investment Company Act. For the full definition, please see Appendix 4.

(B) a non-US AIF is prohibited from making a 'public offering' of securities in the United States.[22] The SEC staff has interpreted the definition of 'public offering' to require that a non-US AIF comply with the requirements of either Section 3(c)(1) or 3(c)(7) of the Investment Company Act with respect to the interests offered to US persons.[23] Unlike a US AIF, however, a non-US AIF may either (*1*) if relying on Section 3(c)(1) of the Investment Company Act (i.e., the less than 100 beneficial owners exemption), offer to an unlimited number of non-US persons, (*2*) if relying on Section 3(c)(7) of the Investment Company Act (i.e., the qualified purchasers exemption), offer to non-US persons who are not qualified purchasers, or (*3*) engage in a public offering of its securities to non-US persons in compliance with Regulation S under the Securities Act.

The PEGCC respectfully submits that an EU AIFM seeking to market its AIF to US professional investors does not register such AIF pursuant to the Investment Company Act (compare with paragraph 61 of ESMA's Advice). Instead, it ensures that it does not make a 'public offering' of interests in such AIF and therefore is not required to register the AIF pursuant to the Investment Company Act. Again, it is unclear why ESMA's Advice focuses on how an EU AIFM may market its AIF to retail investors when the AIFMD deals only with professional investors.

In the ordinary course and as a general rule, an EU AIFM will market its AIFs in the United States to prospective US investors that constitute both accredited investors and, in most cases, qualified purchasers. The private placement regime of the United States is clearly defined and sets out an unambiguous set of rules that an EU AIFM is capable of complying with if it wishes to market its AIFs to US professional investors. This is evident from the fact that (*i*) in 2014, US investors accounted for 24.4% of the capital raised by European AIFMs (around EUR10 billion); and (*ii*) 9.3% of investment in US-based private equity funds closed from 2009 to 2014 came from European investors.[24] European investors currently have invested approximately $140 billion in US-based private equity funds.[25]

---

22 § 7(d) of the Investment Company Act.

23 *See* Touche Remnant & Co., SEC No-Action Letter (Aug. 27, 1984) (providing no-action relief for the offer and sale of shares of a non-US AIF in the United States if the non-US AIF complies with the Investment Company Act by, for example, offering to fewer than 100 beneficial owners resident in the United States); Goodwin, Proctor & Hoar LLP, SEC No-Action Letter (Feb. 28, 1997) (providing no-action relief for non-US AIFs to offer and sell shares to US residents that are 'qualified purchasers' in accordance with Section 3(c)(7) of the Investment Company Act).

24 *See* EVCA 2014 European Private Equity Activity: Statistics on Fundraising, Investments & Divestments, p. 20, http://www.investeurope.eu/media/385581/2014-european-private-equity-activity-final-v2.pdf. In 2013, 35.7% of funds raised by European private equity firms came from North America.

25 Preqin data, accessed on 5 January 2015

(d) Volcker Rule

In paragraph 64 of ESMA's Advice, ESMA expressed a concern the Volcker Rule "might have implications for European actors in the asset management industry notably in relation to the scope of the entities that might qualify as 'banking entities' or 'covered funds'." *The PEGCC is of the view that the Volcker Rule (and the implementing rules*[26] *adopted thereunder) creates at least a level playing field between US and non-US AIFMs and, in certain circumstances, a more favourable playing field for non-US AIFMs.*

For AIFMs that are not affiliated with either a US bank or a non-US bank with a US banking presence, such US and non-US AIFMs generally may solicit the investment of non-US banks in either US or non-US vehicles.[27] An AIFM affiliated with a non-US bank has greater flexibility with respect to sponsorship of private funds than an AIFM affiliated with a US bank.[28]

(iii) US Approach to Securities and Investor Protection Laws

As a consequence of the robust and comprehensive US regulatory regime, 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 AIFs (both US and non-US) they manage.[29] Much of the information set out in this paragraph (iii) replicates information that previously has been provided by the PEGCC. As a consequence of the importance of this information to the overall assessment of the US regulatory environment for the purposes of the extension of the Passporting Regime to US AIFMs and for ease of reference, we have repeated this information here.

---

26 "Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds," 79 Fed. Reg. 5536 (Jan. 31, 2014) ("Final Volcker Implementing Rules").

27 Pursuant to Section _.10(b)(1)(iii) of the Final Volcker Implementing Rules, a non-US banking entity is permitted to acquire and retain ownership interests in certain foreign funds that are not included in the definition of 'covered fund' with respect to non-US banking entities (but that are included in the definition of 'covered fund' with respect to US banking entities) (sometimes referred to a foreign non-covered funds or foreign excluded funds). Section _.13(b) also permits certain non-US banking entities to acquire or retain an ownership interest in certain covered funds that, among other things, have not sold any ownership interests pursuant to an offering that targets US persons and, thus, are offered 'solely outside the United States' ("SOTUS funds"). The regulatory agencies responsible for implementing the Volcker Rule clarified that the prohibition on the sale of ownership interests to US persons does not apply to an unaffiliated (or third-party) private fund sponsor. Federal Reserve Board, Volcker Rule: Frequently Asked Questions at Question 13, available at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#13.

28 *See* id. (an AIFM affiliated with a non-US banking entity may sponsor a foreign non-covered fund or SOTUS fund, but an AIFM affiliated with a US banking entity may not).

29 *See* Article 67(4) of the AIFMD.

(a) General Overview

Investor protection is a hallmark of the US regulation of AIFMs and other investment advisory firms. Fund management and the marketing of interests in AIFs are subject to a comprehensive and substantive regulatory regime in the United States.

In addition to the private placement regime described in paragraph (ii)(c) above, which prevents an AIF from being marketed to retail investors in the United States, additional US federal and/or state statutes and rules regulate a variety of matters, including (*A*) 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 (the "Exchange Act")), and (*B*) anti-corruption and bribery concerns with respect to the activities of US persons, including US AIFMs and their affiliates (*e.g.*, the Foreign Corrupt Practices Act of 1977).

In addition to the Securities Act, the Advisers Act and the Investment Company Act, generally applicable anti-fraud provisions need to be considered in the context of AIFMs and the marketing of their AIFs.[30] The most important anti-fraud provision is Rule 10b-5 promulgated under the Exchange Act.[31] Prevention of fraud on investors is arguably the primary reason for US securities laws. For this reason, most of the anti-fraud provisions of US securities laws apply to a non-US AIFM that markets interests in its AIF in the United States or to US persons, irrespective of whether or not the AIF or the AIFM is required to register, or is otherwise regulated, under any of the above-referenced legislation.

(b) Role of the SEC

The SEC is the primary regulator in respect of private funds. Given the expansion of the SEC registration requirements as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), every sizeable US AIFM is

[30] EU AIFMs marketing their AIFs in the United States or to US persons that are exempt from SEC registration (see paragraph (ii)(b) above) must comply with anti-fraud provisions.

[31] Rule 10b-5: "It shall be unlawful for any person… (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice or course of business which operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security". *See also* Rule 206(4)-8 under the Advisers Act (prohibiting an AIFM of a pooled investment vehicle from (*i*) making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (*ii*) otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle).

subject to the requirements of the Advisers Act and those requirements do not distinguish between US investors and non-US investors invested in AIFs managed by such US AIFM (see paragraph (ii) above). Appendix 5 sets out a brief summary of the key substantive provisions of the Advisers Act (including a description of the risk management systems and the policies that must be put in place and the disclosure obligations) and demonstrates the extensive regulatory framework within which US AIFMs operate.

Broadly, there are three pillars to the SEC's approach to investor protection – (*A*) SEC examination; (*B*) SEC enforcement; and (*C*) whistle-blower rules.

SEC examination

The SEC's Office of Compliance Inspections and Examinations ("OCIE") selects an SEC-registered AIFM for examination based on, among other things, its risk profile, a tip, complaint or referral, or the SEC's desire to review a particular compliance area.[32] Examinations may be conducted on an announced or unannounced basis and often include a visit to an SEC-registered AIFM's physical premises.[33] As a result of the large number of new SEC-registered AIFMs following the Dodd-Frank Act enacted in 2010, OCIE commenced a 'presence exam' initiative in 2012 with the purpose of conducting "focused, risk-based examinations of investment advisers to private funds that recently registered" with the SEC.[34] During this exam program, OCIE conducted examinations of approximately 25% of new SEC-registered AIFMs.[35] OCIE has also established a Private Funds Unit, dedicated to examining SEC-registered AIFMs and composed of experienced, specialised examiners.[36] As discussed further below, these examinations have led to a number of enforcement actions.[37]

SEC enforcement

The SEC's Division of Enforcement also may investigate violations of the US federal securities laws. These investigations may, among other things, arise out of a referral from (or in coordination with) an OCIE examination or a tip or complaint. The

32 OCIE, Examination Information for Entities Subject to Examination or Inspection by the Commission, available at https://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf.

33 Id.

34 OCIE, Presence Exam Letter (Oct. 9, 2012), *available at* https://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf.

35 Marc Wyatt, Acting Director, OCIE, Private Equity: A Look Back and a Glimpse Ahead (May 13, 2015), available at http://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html. *See also* Andrew J. Bowden, Director, OCIE, Spreading Sunshine in Private Equity (May 6, 2014), available at http://www.sec.gov/news/speech/2014--spch05062014ab.html.

36 Id.

37 Id.

SEC's Division of Enforcement has a wide range of enforcement options, including instituting an administrative proceeding, commencing an action in civil court, or referring the matter to the US Department of Justice for criminal proceedings. In 2010, the Division of Enforcement created a special Asset Management Unit for the purpose of investigating potential misconduct by, among others, SEC-registered AIFMs.[38] Over the past several years, the SEC's Division of Enforcement has brought a number of enforcement actions against SEC-registered AIFMs.[39]

We note that the description, at paragraph 53 of ESMA's Advice, of the Office of Investor Education and Advocacy broadly is accurate but the PEGCC is unclear as to why this aspect of the SEC's approach to investor protection was highlighted and analysed. As noted on the complaint website, that Office handles "certain general questions about the securities laws and complaints relating to financial professionals or a complainant's personal financial matters".

Whistle-blower rules

The SEC accepts complaints and enforcement tips through its website.[40] Attorneys in the SEC Division of Enforcement "evaluate information and tips concerning violations of the federal securities laws".[41] Pursuant to the Dodd-Frank Act, there is also a whistleblower program that enables the SEC to pay an award, subject to certain limitations, to eligible whistleblowers who voluntarily provide the SEC with original information about a violation of the federal securities laws that leads to a successful enforcement action. Employers are also expressly prohibited from retaliating against

---

38 Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, Conflicts, Conflicts Everywhere (Feb. 26, 2015), available at http://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html.

39 See, e.g., Blackstone Management Partners L.L.C., et al., SEC Release Nos. IA-4219 (Oct. 7, 2015); SEC v. Summit Asset Strategies Investment Management, LLC, Complaint, Case 2:15-cv-01429 (Sep. 4, 2015); AlphaBridge Capital Management, LLC, SEC Release No. IA- 4135 (Jul. 1, 2015); Kohlberg Kravis Roberts & Co. L.P., SEC Release No. IA-4131 (Jun. 29, 2015); Alpha Titans, LLC et al, SEC Release No. IA-4073 (Apr. 29, 2015); In re Clean Energy Capital, LLC et al. , SEC Release No. IA- 3955 (Oct. 17, 2014); In re Lincolnshire Management, Inc., SEC Release No. IA- 3927 (Sept. 22, 2014).

40 http://www.sec.gov/complaint.shtml.

41 *Id.*

individuals who become whistleblowers.[42] The SEC has established the Office of the Whistleblower to administer the SEC's whistleblower program.[43]

(c) Focus on US Custody Issues[44]

ESMA's Advice

ESMA's Advice (see paragraph 54) describes the US custody requirements in respect of mutual funds. As discussed in paragraph (ii)(a) above, it is not clear why ESMA's Advice focused on mutual funds.

ESMA's Advice notes that the US self-custody system would not be accepted for AIFMs and AIFs that intend to utilise the Passporting Regime (see paragraph 54). Given that a US AIFM utilising the Passporting Regime (assuming that the Passporting Regime is extended to US AIFMs) would be required to satisfy the AIFMD depositary requirements, it is unclear as to why the compatibility or otherwise of the US self-custody system is relevant.

US custody requirements in respect of private funds

Rule 206(4)-2 promulgated under the Advisers Act (the "Custody Rule") complements the investor protection and the anti-fraud provisions described above. Safeguarding of AIF assets is a key concern of the SEC. The Custody Rule relates to the custody of AIF assets by SEC-registered AIFMs and was amended significantly in 2009 by the SEC following the exposure of a number of Ponzi schemes.

All cash and securities of AIFs (including non-US AIFs)[45] managed by an SEC-registered AIFM must be maintained with a Qualified Custodian (as defined below), except for (*1*) privately-offered, uncertificated securities and (*2*) certain restricted, privately-offered securities that are transferable only with the prior consent of the issuer

---

42 *See* In re Paradigm Capital Management, Inc. et al., SEC Release No. IA-3857 (June 16, 2014)(settling an administrative proceeding with respect to retaliatory actions taken against a whistleblower).

43 *See* https://www.sec.gov/whistleblower. Since its inception in 2011, the SEC's whistleblower program has paid more than $54 million to 22 whistleblowers who provided the SEC with unique and useful information that contributed to a successful enforcement action.

44 Note that the description of the Custody Rule, and the approach that an SEC-registered AIFM takes to compliance with the Custody Rule, assumes that the 'standard' annual audit approach is followed by the relevant SEC-registered AIFM.

45 As noted supra note 21, a non-US SEC-registered AIFM is not required to comply with certain provisions of the Advisers Act, including the Custody Rule, with respect to non-US AIFs. However, a US SEC-registered AIFM is required to comply with the Custody Rule (and all other aspects of the Advisers Act) with respect to both US and non-US AIFs.

or holders of the outstanding securities of the issuer. Broadly, an SEC-registered AIFM has custody of assets if "it holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them"[46]. A private fund AIFM is presumed to have 'custody' for purposes of the Custody Rule if it or a related person serves as general partner, managing member or a comparable position for the AIF.

In these circumstances, the assets must be held with a bank, registered broker-dealer, registered futures commission merchant or foreign financial institution that customarily holds financial assets for its customers (a "Qualified Custodian"[47]). When client assets are held by a Qualified Custodian, such Qualified Custodian must hold the client assets in a segregated account that is either in the name of the client (*i.e.*, the AIF) or in the name of the AIFM acting as agent or trustee for the AIF.[48] By taking this approach to the protection and segregation of client assets, the Custody Rule takes the same approach to asset segregation as is taken under the AIFMD in respect of the depositary requirements to ensure segregation of financial instruments that can be held in custody.[49]

Each AIF (including each non-US AIF)[50] that is managed by an SEC-registered AIFM must be subject to an annual audit and an audit upon liquidation. The audit must be conducted by an accounting firm registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB"). The accounting firm does not need to be established in the United States. Audited financial statements must be prepared in accordance with US Generally Accepted Accounting Principles ("GAAP") or, if the AIF is managed by a non-US AIFM or has a non-US general partner,[51] then the AIF's financial statements can be prepared in accordance with accounting standards other than GAAP as long as the information contained in the financial statements is equivalent to the information included in the statements prepared in accordance with GAAP.

---

46 Rule 206(4)-2(b)(6)(i).

47 Rule 206(4)-2(d)(6). If an AIFM (or an affiliate) is qualified as a Qualified Custodian (i.e., it is a broker-dealer or bank), then that AIFM (or the affiliate) may act as custodian for the AIF. However, under these circumstances, the Custody Rule has certain enhanced procedures, including that the AIFM must receive an annual internal control report by an independent public accountant covering, among other things, an opinion of the accountant that the controls are "suitably designed and are operating effective to meet control objectives relating to custodial services, including the safeguarding of funds and securities". Rule 206(4)-2(a)(6).

48 Rule 206(4)-2(a)(1).

49 Article 21(8)(a)(ii) of the AIFMD: "…the depositary shall ensure that all those financial instruments that can be registered in a financial instruments account… [are] opened in the name of the AIF or the AIFM acting on behalf of the AIF, so that they can be clearly identified as belonging to the AIF".

50 As noted supra note 21, a non-US SEC-registered AIFM is not required to comply with certain provisions of the Advisers Act, including the Custody Rule, with respect to non-US AIFs.

51 Question VI.5, 'Staff Responses to Questions About the Custody Rule,' dated 1 September 2013.

*   *   *

ESMA's Advice indicated that ESMA could have benefitted from having more time to assess the detailed information it received on the US regulatory framework before giving its views on whether to offer positive advice on the extension of the Passporting Regime to US AIFMs. The PEGCC hopes that the information included herein is helpful. The PEGCC would be happy to provide any further information on the US regulatory regime that an Interested Party would like to receive.

Respectfully submitted,

Jason Mulvihill
General Counsel
Private Equity Growth Capital Council

Appendix 1

Definition of "US person"

Pursuant to Regulation S of the Securities Act, a "US person" is any person that comes within any of the following categories:

(1) (i) any natural person resident in the United States;

(ii) any partnership or corporation organised or incorporated under the laws of the United States;

(iii) any estate of which any executor or administrator is a US person;

(iv) any trust of which any trustee is a US person;

(v) any agency or branch of a foreign entity located in the United States;

(vi) any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a US person;

(vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organised, incorporated, or (if an individual) resident in the United States; or

(viii) any partnership or corporation if:

(A) organised or incorporated under the laws of any non-US jurisdiction; and

(B) formed by a US person principally for the purpose of investing in securities not registered under the Securities Act, unless it is organised or incorporated, and owned, by accredited investors (as defined in Rule 501(a) under the Securities Act) who are not natural persons, estates or trusts.

(2) Notwithstanding 1 above, any discretionary account or similar account (other than an estate or trust) held for the benefit or account of a non-US person by a dealer or other professional fiduciary organised, incorporated, or (if an individual) resident in the United States shall not be deemed a US person.

(3) Notwithstanding 1 above, any estate of which any professional fiduciary acting as executor or administrator is a US person shall not be deemed a US person if:

(i) an executor or administrator of the estate who is not a US person has sole or shared investment discretion with respect to the assets of the estate; and

(ii) the estate is governed by non-US law.

(4) Notwithstanding 1 above, any trust of which any professional fiduciary acting as trustee is a US person shall not be deemed a US person if a trustee who is not a US person has sole or shared investment discretion with respect to the trust assets, and no beneficiary of the trust (and no settlor if the trust is recoverable) is a US person.

(5) Notwithstanding 1 above, an employee benefit plan established and administered in accordance with the law of a country other than the United States and customary practices and documentation of such country shall not be deemed a US person.

(6) Notwithstanding 1 above, any agency or branch of a US person located outside the United States shall not be deemed a US person if:

(i) the agency or branch operates for valid business reasons; and

(ii) the agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located.

The International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies, affiliates and pension plans, and any other similar international organisations, their agencies, affiliates and pension plans shall not be deemed US persons.

For the purposes of this definition, "United States" means the United States of America, its territories and possessions, any State of the United States and the District of Columbia.

Appendix 2

Form ADV Filing Requirements

Set out below is a summary of the Form ADV filing requirements applicable to an SEC-registered AIFM.

(1) Registration and Other Regulatory Reporting

An 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 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 AIF. Parts 1A and 2A of Form ADV include substantial information about the AIFs managed or advised by the AIFM and are publicly available on the SEC website. The Brochure Supplement is not filed with the SEC, but must be maintained by the SEC-registered AIFM. An SEC-registered 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 the Brochure. The SEC may bar an AIFM from registering with the SEC if the AIFM or certain persons associated with the AIFM have committed certain disciplinary infractions.

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

The major focus of the SEC's review of an SEC-registered AIFM's Form ADV is on the disciplinary history of the AIFM and its personnel. The SEC-registered AIFM must provide information with respect to its disciplinary history as well as the disciplinary history of its 'advisory affiliates' – that is, the AIFM'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 AIFM.

An 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 authorisation 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 an SEC-registered AIFM. In addition, subsequent to registration, the SEC may, in its discretion, censure, place limitations on the activities of, suspend or revoke the registration of, any SEC-registered AIFM if it finds that such AIFM or any person associated with such 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 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 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 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.

Appendix 3

Definition of "Accredited Investor"

"Accredited investor" means any person that comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities or interests to that person:

(1) Any bank as defined in section 3(a)(2) of the Securities Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Securities Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the U.S. Securities Exchange Act of 1934; any insurance company as defined in section 2(a)(13) of the Securities Act; any investment company registered under the Investment Company Act or a business development company as defined in section 2(a)(48) of the Investment Company Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the U.S. Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of ERISA if the investment decision is made by a plan fiduciary, as defined in section 3(21) of ERISA, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

(2) Any private business development company as defined in section 202(a)(22) of the U.S. Investment Advisers Act of 1940;

(3) Any organisation described in section 501(c)(3) of the Code, a corporation, a Massachusetts or similar business trust, a partnership or a limited liability company, in each case not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;

(4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

(5) Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000, excluding the value of the primary residence of such natural person and any indebtedness that is secured by that person's primary residence, except for the amount of indebtedness that is secured by that person's primary residence that exceeds, at the time of the sale of the securities, (*i*) the estimated fair market value of the primary residence or (*ii*) the amount of indebtedness outstanding 60

days before the sale of securities, other than as a result of the acquisition of the primary residence;

(6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

(7) Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii) of the Securities Act; and

(8) Any entity in which all of the equity owners are accredited investors.

Appendix 4

Definition of "Qualified Purchaser"

"Qualified purchaser" means any person that comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities or interests to that person:

(1) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 80a–3 (c)(7) of this title with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission;

(2) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organisations, or trusts established by or for the benefit of such persons;

(3) any trust that is not covered by paragraph (2) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorised to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in paragraph (1), (2) or (4); or

(4) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.

Appendix 5

Key Substantive Provisions of the Advisers Act

Set out below is a summary of the key substantive provisions of the Advisers Act applicable to an SEC-registered AIFM.

(1) Disclosure and Delivery Requirements

An SEC-registered AIFM must provide clients with a copy of its Brochure and Brochure Supplement before or at the time such AIFM enters into a management/advisory contract with the client. Thereafter, an SEC-registered 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, an SEC-registered 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.

(2) Books and Records

The Advisers Act imposes extensive books and records requirements. An SEC-registered AIFM must keep true, accurate and current books and records reflecting its financial affairs and describing transactions for and communications with its clients. An 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. An AIFM's books and records include the books and records of its AIFs (including non-US AIFs).

(3) Coordinated Compliance Program and Risk Management

An SEC-registered AIFM is required to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by such 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 AIFMs must include in their policies and procedures. However, as discussed below in other contexts, the SEC has identified certain minimum requirements with respect to the policies and procedures.

Rule 206(4)-7 also requires an SEC-registered 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 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 AIFM.

An important component of an AIFM's compliance program is risk management. In adopting Rule 206(4)-7, the SEC stated that an 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 emphasised 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 AIFMs focusing principally on enterprise risk management.[52]

The SEC expects that an 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 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 AIFM, and applicable regulatory restrictions;

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

- Proprietary trading of the 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 unauthorised alteration or use and protects them from untimely destruction;

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

[52] 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.

- 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 an SEC-registered AIFM, the SEC staff will request information about the compliance risks that such AIFM has identified and the written policies and procedures such AIFM has established and implemented to address each of those risks to provide an understanding of compliance risks and corresponding controls.[53] 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 emphasised the need for liquidity issues to be considered. For example, in the public fund context, the SEC staff has urged 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 AIFMs to consider assessing the impact (beyond just liquidity) of various stress-tests and/or other scenarios on AIFs.[54]

(4) Code of Ethics; Personal Securities Trading

An SEC-registered 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 AIFM's 'access persons' (employees with access to certain types of information) to periodically report their personal securities transactions and holdings to the AIFM's chief compliance officer or other designated persons. Certain types of personal securities transactions are subject to an enhanced review and approval process. The code of ethics must also require the AIFM to review these reports. The transaction reports must be retained in the AIFM's books and records for SEC review.

[53] *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).

[54] 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).

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

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

(6) 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 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 an 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 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 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 AIFs managed by the AIFM.

(A) <u>Advertising Restrictions</u>

Generally, the Advisers Act prohibits 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 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) <u>Use of Solicitors</u>

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

(C) 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 characterised as ‘pay to play’ practices). The rule, in effect, imposes significant restrictions on the political contributions and certain other fundraising activities by an AIFM and its affiliates, officers and employees when the AIFM provides (or is seeking to provide) advice to local or state government entities, whether directly or through an AIF.

(D) Proxy Voting

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

(7) Performance-Based Fees; Management Agreements

An SEC-registered AIFM may not enter into an investment management/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 AIFM is organised as a partnership, a provision requiring notification to the client of any change in the partners.

(8) Business Continuity Plans

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

(9) Client Privacy

The SEC’s Regulation S-P requires an SEC-registered 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 flag rules require certain AIFMs to adopt a written identity theft program.