NATIONAL SOCIETY OF COMPLIANCE PROFESSIONALS
2013 SOUTHERN REGIONAL MEETING

INVESTMENT ADVISER, PRIVATE FUNDS AND HEDGE FUNDS - BOOKS AND RECORDS

Christine M. Slate — Sr. VP, Client Services and Chief Compliance Officer, Barrett Capital Management, LLC
Ph: (804) 419-1100 / E: cslate@barrettcap.com

Daniel E. LeGaye, Esq. — Partner, The LeGaye Law Firm, PC
Ph: (281) 367-2454 / E: dan.legaye@legayelaw.com

DISCLAIMER

This paper is not intended to be relied upon as a final analysis in resolving legal questions. The information presented herein is intended to provide an overview of recent law and or trends. There is no substitute for a thorough review of the relevant statutes and law to the facts of your particular situation by an experienced and competent attorney. Due to the summary nature of this paper, the level of detail necessary for a proper legal analysis of any particular situation cannot be reached.

A. OVERVIEW OF RECORDKEEPING OBLIGATIONS

The recordkeeping obligations of a registered investment adviser are defined by the actual advisory activities engaged in. To the extent investment advice is provided to individual accounts, the Investment Advisers Act of 1940 ("Advisers Act") may be the primary regulation that governs the day to day recordkeeping activities of the adviser. However, as the adviser expands its business mix and client base, the regulatory matrix becomes more complicated … and recordkeeping obligations likewise become more complicated. For example, the inclusion of a client account that is subject to the Employee Retirement Income Security Act of 1974 ("ERISA") requires more expansive disclosure, and the need to maintain those disclosures as evidence of compliance, protects an adviser against ERISA and or IRS sanctions. Likewise, a decision to overlay commodities over the investment advice, or investment products and services offered can result in subjecting the adviser to both the U.S. Commodities Future Trading Commission ("CFTC") rules and the compliance rules of the National Futures Association ("NFA"). The further expansion of the business mix, such as providing advice to a private equity fund, now results in being exposed to another level of recordkeeping requirements, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

B. REGULATORY FRAMEWORK

The following summarizes the regulatory framework and rules related to recordkeeping that is imposed by the Advisers Act, the Dodd-Frank Act, CFTC, NFA and ERISA. While these laws generally track a number of the recordkeeping rules imposed by the Advisers Act and SEC Rule 204-2; the NFA Rule 2-10 ("NFA Recordkeeping Rule") has specific requirements for NFA Members related to the location of certain records and the utilization of English and US Dollars for financial statements

1. Rule 204-2 of the Investment Advisers Act of 1940

Federally registered advisers are required to create and maintain true, accurate and current certain books and records relating to the investment advisory business engaged in pursuant SEC Rule 204-2 (the "Books and Records Rule"), which was promulgated pursuant to the Investment Advisers Act of 1940 ("Advisers Act").

a. Records Required to Be Maintained

The Books and Records Rule is very specific as to the records covered; however the following represents a brief summary by topic of the records required to be maintained:

i. Financial Records

Financial and accounting records, including: cash receipts and disbursements journals; income and expense account ledgers; checkbooks; bank account statements; advisory business bills; and financial statements.

ii. Records related to Investment Advice and Transactions

Records that pertain to providing investment advice and transactions in client accounts, including: orders to trade in client accounts (referred to as "order memoranda"); trade confirmation statements received from broker-dealers; documentation of proxy vote decisions; written requests for withdrawals or documentation of deposits received from clients; and written correspondence sent to or received from clients or potential clients discussing the specific recommendations or suggestions.

iii. Evidence of Authority

Records that document the advisers authority to conduct business in client accounts, including: a list of accounts in which it has discretionary authority; documentation granting that discretionary authority; and written agreements with clients, such as advisory contracts.

iv. Communications with the Public

Advertising and performance records, including: newsletters; articles; and computational worksheets demonstrating performance returns.

v. Code of Ethics and Personal Trading Records

Records related to the Code of Ethics Rule, including those addressing personal securities transaction reporting by access persons.

vi. Disclosure Documents

Records regarding the maintenance and delivery of written customer disclosure documents and disclosure documents provided by certain solicitors who seek clients on the advisers behalf.

vii. Policies and Procedures

Policies and procedures adopted and implemented under the Compliance Rule, including any documentation prepared in the course of the annual review.

viii. Business Specific Records

Advisers are also required to maintain additional records that are specific to their business. For example additional books and records must be maintained where the adviser (i) has custody and possession of clients' funds and/or securities; (ii) votes proxies on behalf of the advisory client; (iii) aggregates trades; (iv) markets investment products and services to municipal entities; (v) engages in principal transactions; (vi) recommends custodians and trading platforms; and or (vii) soft dollar relationships.

b. Record Retention Requirements

Advisers must maintain most books and records for five years from the last day of the fiscal year in which the last entry was made on the document or when the document was disseminated. However, some records are required to be maintained for longer time periods, such as records (i) that support performance calculations used in advertisements; and or (ii) employment and or client records. Finally, for the first two of these years, the adviser must maintain the records in its primary office, and thereafter the records should be maintained in a readily accessible location. If the adviser maintains some of the original books and records somewhere other than the principal office and place of business, that must be noted on the Form ADV and the alternative location identified.

2. The Dodd-Frank Act

The Dodd-Frank Act was signed into law on July 21, 2010 by President Obama. The Dodd-Frank Act has had a significant impact on the investment management community, including investment advisers, hedge funds, private equity funds and their managers and advisers. The expansion of regulatory oversight over hedge fund and private funds resulting from the Dodd-Frank Act's registration requirements has resulted in a new level of recordkeeping for a market segment that historically operated "below the radar".

a. Registration Requirements of the Dodd-Frank Act

Title IV of the Dodd-Frank Act impacted the registration requirements for registered investment advisers in that if an adviser managed any separately managed accounts and had assets under management ("AUM") in excess of $100 million, the firm had to register with the SEC, even if the firm only had one account and or client. In the alternative, to the extent the adviser had separate accounts and AUM of $25 million to $100 million, the adviser had to register with its home state, unless it was exempt under state law, in which case, the adviser registered with the SEC.

Of more significance, the Dodd-Frank Act expanded the number of advisers by eliminating (1) the "private investment adviser" exemption contained in Section 203(b)(3) of the Investment Advisers Act; (2) the intrastate registration exemption for

investment advisers with any private fund client; and (3) required registration for certain foreign advisers. To this end, if the advisers only clients are investment funds and they have AUM of more than $150 million, they must also register with the SEC and if they have AUM of less than $25 million or are exempt from SEC registration, then they must be registered or find an exemption in any state where they have a place of business or more than 5 clients.

Non-U.S. advisers with any separate accounts, or with fund assets over $150 million, must also register with the SEC unless they have: (i) no place of business in the U.S.; (ii) less than $25 million in AUM from U.S. clients and U.S. fund investors; (iii) fewer than 15 U.S. clients and fund investors; and (iv) do not hold themselves out generally to the public in the U.S. as an adviser.

Finally, the Dodd-Frank Act provides a conditional SEC registration exemption for investment advisers registered with the CFTC as commodity trading advisers that advise private funds. Such advisers are exempt from SEC registration; however, if after the date of enactment the business of the adviser predominantly becomes the provision of securities related advice, the adviser must also register with the SEC.

b. Registration for Swaps

To the extent an adviser (i) buys commodities, and currently relies on an exemption based on margin and notional exposure percentage limitations, or (2) is defined as a "major swap participant" when new rules are adopted, registration may be required with the NFA as a Commodity Pool Operator.

c. Exemptions to the Dodd-Frank Act

The Dodd-Frank Act exempts from SEC registration for advisers (i) that act as an investment adviser solely to one or more venture capital funds or small business investment companies, (ii) that acts solely as an adviser to private funds and who has assets under management in the U.S. of less than $150 million (although they would be subject to the recordkeeping requirements). Additionally, the Dodd-Frank Act provides an exception for family offices from the definition of the term "investment adviser,"

d. Dodd-Frank Act Recordkeeping Obligations

The Dodd-Frank Act specifically requires that any private fund to which an investment adviser provides investment advice shall be deemed to be the records and reports of the investment adviser. Those records and reports required to be maintained by an investment adviser and subject to inspection by the Commission shall include, for each private fund advised by the investment adviser, a description of:

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

- such other information as the Commission, in consultation with the Council, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk, which may include the establishment of different reporting requirements for different classes of fund advisers, based on the type or size of private fund being advised.

Notwithstanding the above, should the adviser be required to register with the NFA, it will be subject to NFA recordkeeping requirements as set forth below.

3. NFA / Commodities Futures Trading Commission

The NFA is responsible for enforcing the recordkeeping rules of the U.S. Commodities Future Trading Commission ("CFTC"). While those rules generally track a number of the recordkeeping rules imposed by the Advisers Act and SEC Rule 204-2; the NFA Rule 2-10 ("NFA Recordkeeping Rule") has specific requirements for NFA Members related to location of certain records and the utilization of English and US Dollars for financial statements

a. NFA Recordkeeping Rule

In addition to the records required to be kept under CFTC Regulations 1.18 and 1.32 through 1.37 for the period required under CFTC Regulation 1.31 which are discussed below, NFA member firms must also comply with the other requirements set forth in NFA Rule 2-10. Those requirements include:

i. Location of Books and Records

Generally, all FCM Members and Forex Dealer Members must maintain an office in the continental United States, Alaska, Hawaii, or Puerto Rico responsible for preparing and maintaining financial and other records and reports required by CFTC and/or NFA rules under the supervision of a listed principal and registered associated person of the FCM or Forex Dealer Member who is resident in that office (unless the FCM, maintains an office in a jurisdiction that the CFTC has found to have a comparable regulatory scheme).

ii. Net Capital

Each NFA member subject to minimum capital requirements must prepare financial reports required to be filed with the CFTC and/or NFA in English, using U.S. dollars, U.S. accounting standards; and maintain a general ledger in English using U.S. dollars.

iii. English Required

Each NFA Member must (1) file reports, requests for extensions, and other documents required to be filed with the CFTC and/or NFA in English; (2) maintain English translations of all foreign-language promotional material, including disclosure documents and Web sites, distributed to or intended for viewing by customers located in the U.S., its territories, or possessions; (3) maintain written procedures required by CFTC or NFA rules in English (as well as in any other language if necessary for them to be understood by the NFA member's employees and agents); (4) provide English translations of other foreign-language documents and records and file financial information in U.S. dollars when requested by NFA; and (5) make available to NFA (during an examination or to respond to other inquiries) an individual who is authorized to

act on the member's behalf, is fluent in English, and is knowledgeable about the member's business and about financial matters.

b. CFTC Record Keeping Regulations

In addition to the other requirements of the NFA Compliance Rule 2-10, the NFA Recordkeeping Rule also requires that each NFA member shall maintain adequate books and records necessary and appropriate to conduct its business including, without limitation, the records required to be kept under CFTC Regulations 1.18 and 1.32 through 1.37 for the period required under CFTC Regulation 1.31, which are set forth below:

i. CFTC Regulation 1.31 - Books and records

CFTC Regulation 1.31 requires that all books and records required to be kept by the Commodities Act shall be kept in their original form (for paper records) or native file format (for electronic records) for a period of five years from the date thereof and shall be readily accessible during the first two years of the five year period; provided, however, that records of any swap or related cash or forward transaction shall be kept until the termination, maturity, expiration, transfer, assignment, or novation date of the transaction and then for a period of five years after such date. Records of oral communications kept pursuant to CFTC Regulation 1.35 shall be kept for a period of one year.

ii. CFTC Regulation 1.18

Any person registered as a futures commission merchant or as an introducing broker under the Commodities Act shall prepare and keep current financials, including formal computations of its adjusted net capital and of its minimum financial requirements.

iii. CFTC Regulation 1.32 - Segregated accounts

Each futures commission merchant must compute as of the close of each business day, on a currency-by-currency basis the total amount of futures customer funds on deposit in segregated accounts on behalf of futures customers; including the amount of such futures customer funds required by the Commodities Act to be on deposit in segregated accounts on behalf of such futures customers; and the amount of the futures commission merchants residual interest in such futures customer funds. These daily computations must be must be maintained in accordance with the requirements of § 1.31.

iv. CFTC Regulation 1.33 - Monthly and confirmation statements

Monthly customer statements and confirmations reflecting any commodity interest or commodity option transaction, including any foreign futures or foreign options transactions, which are furnished to each customer or foreign futures or foreign options customer, must be maintained by the firm.

v. CFTC Regulation 1.34 - Monthly record, "point balance"

Each futures commission merchant must prepare, and retain a statement commonly known as a "point balance," which accrues or brings to the official closing price, or settlement price fixed by the clearing organization, all open contracts of customers as of the last business day of each month or of any regular monthly date selected.

vi. CFTC Regulation 1.35 - Records of commodity interest and related cash or forward transactions

Each futures commission merchant, retail foreign exchange dealer, introducing broker, and member of a designated contract market or swap execution facility shall keep full, complete, and systematic records, which include all pertinent data and memoranda, of all transactions relating to its business of dealing in commodity interests and related cash or forward transactions. Included among such records shall be all orders (filled, unfilled, or canceled), trading cards, signature cards, street books, journals, ledgers, canceled checks, copies of confirmations, copies of statements of purchase and sale, and all other records, which have been prepared in the course of its business of dealing in commodity interests and related cash or forward transactions. Among such records each member of a designated contract market or swap execution facility must retain and produce for inspection all documents on which trade information is originally recorded, whether or not such documents must be prepared pursuant to the rules or regulations of either the Commission, the designated contract market or the swap execution facility.

vii. CFTC Regulation 1.36 - Record of customer securities and property

Each futures commission merchant and each retail foreign exchange dealer shall maintain a record of all securities and property received from customers or retail forex customers in lieu of money to margin, purchase, guarantee, or secure the commodity interests of such customers or retail forex customers.

viii. CFTC Regulation 1.37 – Customer Information

Each futures commission merchant, retail foreign exchange dealer, introducing broker, and member of a contract market shall keep a record in permanent form which shall show for each commodity interest account carried or introduced by it the true name and address of the person for whom such account is carried or introduced and the principal occupation or business of such person as well as the name of any other person guaranteeing such account or exercising any trading control with respect to such account. For each such commodity option account, the records kept by such futures commission merchant, introducing broker, and member of a contract market must also show the name of the person who has solicited and is responsible for each customer's account or assign account numbers in such a manner to identify that person.

4. ERISA

Section 408(b)(2) ("Section 408(b)(2) Disclosures") of ERISA has imposed an obligation on investment advisers and certain service providers to pension plans, to disclose information about the service providers' compensation and potential conflicts of interest. These disclosure requirements are established as part of a statutory exemption from ERISA's prohibited transaction provisions. To be in compliance with the obligation to provide the Section 408(b)(2) Disclosures, service providers to ERISA plans were required to provide the Section 408(2)(b) Disclosure to all plans by July 1, 2012. Subsequently, service providers to ERISA plans must disclose changes to the initial information as soon as practicable, but no later than 60 days from when the service provider is informed of such change and disclosures of changes to investment-

related information are to be made at least annually. The costs of non-compliance are significant, to wit, includes both subjecting the service providers to the prohibited transaction rules of ERISA section 406 and Internal Revenue Code section 4975 penalties.

As a result, covered service providers, which include investment advisers giving portfolio advice to an ERISA plan, should maintain all 408(b)(2) Disclosure documentation for a minimum of 5 years from the time that the ERISA plan terminated its relationship with the firm.

C. RECONCILIATION OF THE PRIVATE FUND AVISER AND MONEY MANAGER BUSINESS MODELS

The Advisers Act, as amended by the Dodd-Frank Act has, and will continue to have a significant impact on the books and records obligations of advisers to private equity and hedge funds. In addition to the historical impact regulation has had on registered investment advisers with respect to their recordkeeping, it is clear that the list of required books, records, and reports, was not drafted with private equity advisers in mind, nor do the recordkeeping obligations of related regulatory requirements "neatly fit" the historical model. As a result, advisers to private advisers will need to assess a full range of regulatory issues that impact the respective firm, prior to grasping the full impact of recordkeeping on the respective firm. With that being said, the following is a brief summary of a number of regulatory issues that create hybrid solutions and additional recordkeeping obligations, if for no other purpose than to evidence compliance with the respective rules and regulations.

1. Books and Records

As previously discussed, the Books and Records Rule of the Advisers Act require registered investment advisers to maintain extensive books and records for compliance. However, in addition to the Books and Records Rule, the Dodd-Frank Act authorizes the SEC to require any registered adviser to maintain such records of, and file with the SEC such reports regarding, the private funds advised by the adviser "…as are necessary or appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the Council, and to provide such records and reports to the Council." While the Dodd-Frank Act does not discuss the meaning of systemic risk, it does require that the private fund records and reports include information for each private fund advised by the adviser regarding assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposure, trading and investment positions, valuation policies and practices of the fund, types of assets held, side arrangements or side letters (affording certain investors more favorable rights or entitlements than other investors), and trading practices. It is clear that the records required to support the assessment of "systemic risk" by a private fund adviser will be assessed in hindsight by the SEC, and will in all likelihood be expansive rather than a limited reading.

a. Records related to Investment Advice and Transactions

The Books and Records Rule was not drafted with private fund advisers in mind, and thus many requirements need interpretation to fit into the context of private equity advisers. For example, the recordkeeping rules require a memorandum for each purchase or sale of a security that "shall show the terms and conditions of the order, instruction, modification, or cancellation; and shall identify the person connected with the investment adviser who recommended the transaction to the client and the person who placed such order; and shall show the account for which entered, the date of entry, and the bank, broker or dealer by or through whom executed ....". As this information may not exist for

the typical private equity transaction; a private fund adviser may have difficulty identifying the information that needs to be maintained in its place.

b. Communications with the Public

A registered investment adviser must ensure that any advertising complies with the Advisers Act and the SEC's interpretative guidance. "Advertising" is broadly defined for purposes of the Advisers Act and would include, for example, any offering or private placement memorandum for a fund, pitchbooks related to the offering, and adviser websites. If a communication is deemed to be "advertising," the use of testimonials, past recommendations, charts, graphs, models, and similar tools and historical performance results (particularly, gross performance) are prohibited or heavily restricted. This is significant in that the SEC's enforcement program is quite vigorous with respect to adviser advertising, and advisers may be subject to significant sanctions for misleading or inappropriate advertising.

To address this regulatory exposure, advisers to funds will need to examine its external communications to determine whether they may constitute advertising, including communications that may not traditionally be considered to be advertising, such as communications to current investors of the funds, responses to due diligence requests from investors, press releases regarding completed portfolio company transactions, and communications with potential portfolio companies. Additionally the advisers will need to pay particular attention to documenting the review and analysis of any (i) discussions of past performance in any fund documentation (including representations set forth in offering documents, pitchbooks, etc.); (ii) representations regarding the prior performance of managers of the private fund while with other funds; (iii) past profitable recommendations; (iv) presentations of recommendations, without presenting all recommendations over a fixed time period that includes at least the prior year; and (iv) performance reporting to confirm that it has been presented net of all advisory fees (including any carried interest) and other expenses (other than custodian fees, which are viewed as expenses the client would have otherwise have had to bear). For private equity funds, showing net performance of individual portfolio companies is not always possible due to the manner in which fees and carry are allocated at a fund level. Accordingly, when disclosing performance of portfolio companies, it may be necessary to consider whether the "net of fees" requirement would be satisfied by including the net performance for the funds in which particular investments were made.

Finally, the Books and Records Rule requires registered investment advisers to retain copies of all advertisements and all documentation necessary to support the accuracy of performance or rate of return information shown in advertisements. Consequently, a private equity adviser will need to determine the information received from portfolio companies and other information regarding portfolio company transactions that need to be maintained to support the performance disclosure.

c. Code of Ethics and Personal Trading Records

Records related to the Code of Ethics Rule, including those addressing the reporting of personal securities transactions by access persons include the documentation to evidence the review of the personal securities transactions and securities holdings, and the preclearance access persons' investments in initial public offerings and private placements (including investments by advisory personnel in private equity funds managed by the adviser). Special issues face private fund advisers with respect to the code of ethics include whether certain paid consultants with access to the adviser's

recommendations must comply with the code of ethics, and whether the pre-clearance of personal securities transactions, which is considered a "best practice," should be adopted in light of the nature of a private fund's investments.

Additionally, an adviser must establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the adviser's business, to prevent the misuse of material non-public information by the adviser or by any person associated with the adviser. As private equity firms do not generally engage in transactions in publicly traded securities, the issues associated with insider trading may be less prominent. However, these requirements take on heightened significance for private equity advisers to the extent they may receive such information in connection with a potential “going-private” transaction or may exchange information with an affiliate that does buy or sell publicly traded securities or otherwise owes a duty to an issuer, and as such, there should be a focus on the utilization of restricted lists and the documentation related to same.

d. Disclosure Documents

Arrangements involving compensation paid by a registered investment adviser to persons for client solicitation or referral are subject to certain restrictions under the Advisers Act. At this time, such restrictions do not generally apply to the solicitation of investors for a fund managed by a private equity adviser as the relationships are generally regarded as placement agent arrangements in which such persons are generally regarded as being solicited to become investors in the fund rather than advisory clients of the adviser. However, the SEC has the ability to define "client" for such purposes in a manner that would make such restrictions applicable; and in the interim, it is clear that subscription agreements and offering documentation would be required to be maintained by the adviser to the private equity fund.

e. Policies and Procedures

All registered investment advisers must adopt written compliance policies and procedures that are reasonably designed to prevent violation of the Advisers Act, and they must review the adequacy and effectiveness of such policies and procedures at least annually. The procedures, at a minimum, should include (i) the portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions; (ii) trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients; (iii) proprietary trading of the adviser and personal trading activities of supervised persons; (iv) the accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements; (v) safeguarding of client assets from conversion or inappropriate use by advisory personnel; (vi) the 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; (vii) marketing advisory services, including the use of solicitors; (viii) processes to value client holdings and assess fees based on those valuations; (ix) safeguards for the privacy protection of client records and information; and (x) business continuity plans.

Because the matters recommended were not necessarily prepared with private fund advisers in mind, a private fund adviser will need to consider carefully how to tailor its compliance manual to its business, operations and recordkeeping obligations. To this

end, a typical private equity adviser is unlikely to need substantial policies relating to directed brokerage, brokerage allocation, soft dollars, liquidity, or cash payments for client solicitations, as the adviser will not be placing ordinary course securities transactions with brokers, its investments are generally illiquid, and the adviser will not use solicitors to find "clients". Additionally, (i) valuation procedures would address valuations utilized for marketing and other reports, but not necessarily for compensation purposes and (ii) depending on the nature of a private fund adviser's business and operations, policies and related recordkeeping could be advisable in other areas, including procedures to address gifts and entertainment matters.

Finally, to the extent the fund and adviser are affiliated, policies will need address the contractual requirements set forth in the limited partnership agreements for its funds or other applicable agreements; as such documents typically address the allocation of investment opportunities among funds.

f. Business Specific Records

Advisers are also required to maintain additional records that are specific to their business. For example additional books and records must be maintained where the adviser (i) has custody and possession of clients' funds and/or securities; (ii) votes proxies on behalf of the advisory client; (iii) aggregates trades; (iv) markets investment products and services to municipal entities; (v) engages in principal transactions; and (vi) recommends custodians and trading platforms.

i. Trading Practices

A private fund adviser must comply with requirements relating to principal transactions and cross trades. These requirements may be applicable to a private fund adviser when the adviser has held an investment prior to the initial closing of a fund, or parallel funds rebalance their portfolios at their final. Issues specific to private equity advisers include (i) whether certain funds should be considered a principal transaction for purposes of these requirements. For example, if a fund is deemed to be a proprietary vehicle for the investment adviser by virtue of the size of the interest of the adviser and its affiliates in that fund; (ii) whether consent of an affiliated general partner to a principal transaction is sufficient or whether advisory board or investor consent should be obtained); and (iii) whether the mechanics for principal and cross transactions that are set forth in limited partnership agreements and agreed to by all investors so as to satisfy any consent and valuation requirements.

ii. "Pay-to-Play" Restrictions

The "pay-to-play" rule prohibits an investment adviser: (i) from receiving compensation for providing advice to a government entity within two years after the adviser or any of its covered associates makes a contribution to an official of the government entity; (ii) or its covered associates from providing, directly or indirectly, payment to any third party (such as a solicitor or placement agent) to solicit a government entity for investment advisory services on behalf of the adviser, unless the third party is a registered investment adviser or a registered broker-dealer subject to similar "pay-to-play" restrictions; and (iii) and certain of its executives and employees from coordinating or soliciting any person or political action committee to make any contribution to an official of a government entity to which the adviser is providing or seeking to provide investment advisory

services or payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.

The rule includes a provision that applies each of the foregoing prohibitions to an investment adviser that manages the assets of a government entity through certain pooled investment vehicles, including private equity funds, and, therefore, private equity advisers will need to comply with the rule with respect to investors who are government entities.

iii. Custody

Because either the private equity adviser or its affiliate is typically the general partner of a fund, most private equity advisers are deemed to have "custody" of the fund's assets. Except for certain privately offered securities, a registered investment adviser is prohibited from having custody of a client's funds or securities unless a "qualified custodian" maintains such funds and securities as follows: (i) in a separate account for each client under such client's name or (ii) in accounts that contain only the funds and securities of the adviser's clients, under the adviser's name as agent or trustee for the clients. If the fund is not audited at least annually by an independent public accounting firm registered with the PCOAB, and its financials are distributed to investors within 120 days after the fund's fiscal year end (the "audit exemption"), then, in addition to the "qualified custodian" requirement above the private fund and or adviser must (i) have a qualified custodian hold the privately offered securities, (ii) have a reasonable basis for believing that the qualified custodian provides account statements, at least quarterly, to fund investors; and (iii) the fund's assets must be verified by a surprise examination, generally at least once each calendar year, performed by an independent public accountant.

It is common for private equity funds to have complex structures, with multiple investment and acquisition vehicles serving various tax, liability and marketing related functions that are positioned between or alongside the fund and the ultimate portfolio company. In this context, it may be challenging to determine the vehicles the holdings of which may be subject to the Advisers Act's requirements. For example, whether the securities held by a special purpose vehicle owned or co-owned by the fund are subject to custody requirements. Additionally, if a private equity fund does not meet the requirements of the audit exemption, the private equity adviser faces issues determining what evidence of private investments must be held by a qualified custodian (e.g., investments made in a partnership for which there was no subscription agreement), how to custody investments that cannot be held by a qualified custodian (e.g., certain foreign investments or pledged securities), and how to explain to investors receiving statements directly from custodians the various investment and acquisition vehicles that do not otherwise appear on the fund's financial statements. Due to the complexity of the custody issues, care should be taken such that custody and recordkeeping procedures adequately address the core issues so as to minimize the exposure of the adviser to a deficiency related to compliance with the custody rule.

iv. Proxy Voting

Procedures should address the obligation for the adviser to ensure that the adviser votes proxies on behalf of its clients in the best interest of the client, and address the resolution of material conflicts between the interests of the adviser and the interests of its clients. Additionally, the procedures and supporting recordkeeping should address the obligations of the adviser to (i) disclose to clients how they can obtain information about how the adviser voted their securities; and (ii) describe the advisers proxy voting procedures to its clients and offer to furnish a copy to them upon request. Although private equity advisers are unlikely to vote proxies or be sent proxy statements regularly, due to the fact that private equity funds do not generally hold many publicly traded securities, the terms of the Proxy voting rule refer to exercising "voting authority with respect to client securities." Consequently, a private equity firm should consider whether it needs to adopt procedures to address the voting of portfolio company securities (e.g., a shareholder consent required to approve a portfolio company transaction).

D. CURRENT ENFORCEMENT ISSUES

1. SEC Issues 2013 Examination Priorities

The National Examination Program ("NEP") released its examination priorities on February 21, 2013 to communicate with investors and registrants about areas that are perceived by the staff to have heightened risk, and to support the SEC's mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. These priorities, while set by the staff rather than by the Commission, are aligned with the SEC's mission by seeking to improve compliance, prevent fraud, inform policy, and monitor firm-wide and systemic risk. While the NEP's examination priorities address issues that span the entire market, they set forth issues related specifically to particular business models and organizations, including specifically advisers to hedge funds and private equity funds.

a. Investment Adviser Program Examination Focus Areas

The scope of an IA-IC examination is generally limited to the issues and business practices of the registrant that are perceived by the staff to present the highest risks to investors and the integrity of the market. Thus, the scope of exams will vary from registrant to registrant. Nevertheless, across the program, there are certain issues that predominate. In addition to the specific risk areas unique to each registrant, the staff will consider the following focus areas when scoping and conducting examinations in 2013.

i. Ongoing Risks

Safety of assets continues to be a primary focus of the SEC. That focus will include a will review of the measures taken by advisers to protect client assets from loss or theft, *the adequacy of audits of private funds*, and the effectiveness of policies and procedures in this area. Other ongoing risks targeted include (i) conflicts of interest related to compensation arrangements, including undisclosed fee or solicitation arrangements, referral arrangements (particularly to affiliated entities), (ii) marketing and performance advertising, with a focus on the accuracy of advertised performance, including hypothetical and back tested performance, the assumptions or methodology utilized, and related disclosures and *compliance with record keeping requirement*; (iii) conflicts of interest related

to allocation of investment opportunities, including side-by-side with accounts that pay performance-based fees (e.g., most hedge funds) who face unique conflicts of interest and the staff will confirm that the adviser has controls in place to monitor the side-by-side management of its performance-based fee accounts, such as certain private investment vehicles, and registered investment companies, or other non-incentive fee-based accounts, with similar investment objectives, especially if the same portfolio manager is responsible for making investment decisions for both kinds of client accounts or funds.

ii. New and Emerging Issues

The staff anticipates that the new and emerging risks for IA-ICs in 2013 will includes hedge fund and private equity fund advisers who were required to register as a result of the Dodd-Frank Act. Since the effective date in early 2012 of Section 402 of the Dodd-Frank Act, approximately 2,000 investment advisers have registered with the SEC for the first time. The vast majority of these new registrants are advisers to hedge funds and private equity funds that have never been registered, regulated, or examined by the SEC. As a result the IA-IC Program intends to launch a coordinated national examination initiative designed to establish a meaningful presence with these newly registered advisers. The initiative is expected to run for approximately two years and consists of four phases: (i) engage with the new registrants; (ii) examine a substantial percentage of the new registrants; (iii) analyze our examination findings; and (iv) report to the industry on our observations. In addition to the new registrant initiative, the IA-IC Program will also prioritize examinations of private fund advisers where the staff's analytics indicate higher risks to investors relative to the rest of the registrant population, or there are indicia of fraud or other serious wrongdoing. The impact of this examination initiative is that it appears that the SEC will be reviewing the books and records of advisers to private equity and hedge funds sooner, rather than later.

2. Private Equity Enforcement Concerns

Bruce Karpati, Chief, SEC Enforcement Division's Asset Management Unit, U.S. Securities and Exchange Commission spoke to the Private Equity International Conference, in New York, N.Y. on January 23, 2013. The Asset Management Unit ("AUM") of the SEC focuses on investment advisers, investment companies, and managers of private equity funds. He stated that AUM has hired industry specialists that have deep asset management industry experience that allows AUM to enhance the Enforcement Division's investigative capabilities, and since many private equity managers have only recently become registered investment advisers, it's not unreasonable to think that the number of enforcement cases involving private equity will increase. In his speech regarding the SEC's concerns related to private equity funds, he also discussed some common conflicts, which can result in enforcement actions and he stated that all investment advisers need to be alert and prepared for exam inquiries as its important to be cooperative with exam staff while an examination takes place. It is clear that for an adviser to be prepared to defend itself against greater regulation and the perceived conflicts of interest, that greater focus needs to be placed on recordkeeping, as without adequate support documentation, the presumption will be that the adviser is not in compliance.

3. E-Mail and Social Media

On January 4, 2012, the SEC Issued Social Media Alert and brought an enforcement action against an Illinois adviser. In the enforcement action, the SEC charged Anthony Fields with making fraudulent offers through two sole proprietorships, Anthony Fields & Associates (AFA) and Platinum Securities Brokers. The SEC alleged that "Fields provided false and misleading information concerning AFA's assets under management, clients and operational history to the public through its website and in SEC filings". While the alert issued at the same time is merely a list of staff observations and not binding on the SEC, it does reflect current concerns. Such a statement of good and bad practices is often a means of the SEC to commence building a body of law in a new and developing area.

While the enforcement act was based on fraud, the alert is much more expansive. In writing the document, SEC staff noted that the operative rules are those under the Advisers Act which set out the basic requirement for writing and maintaining effective compliance programs. But the alert notes that other securities laws apply, including antifraud laws under the Securities Act of 1933 (”33 Act”) and the Securities Exchange Act of 1934 (“Exchange Act”).

The alert addresses some issues that advisers may want to consider closely, including:

- prohibiting specific content or imposing other content restrictions for investment adviser representatives to follow;
- training employees, including investment adviser representatives on the issues;
- reviewing the adviser's fiduciary duties in setting social website content standards, particularly for content that contains investment recommendations or information on specific investment services or investment performance; and
- monitoring of the firms' social media sites. Firms should consider the limitations, the alert suggests. Remember that many third-party sites may not provide the level of access needed by supervisors or compliance personnel. Decide how frequently to monitor.

E. TEN BEST PRACTICES

In addition to the matters set forth in the prior sections that an adviser to a private equity and or hedge fund has to address to obtain compliance with the recordkeeping obligations of the various regulators, the following lists a number of the best practices for advisers to consider with respect to their recordkeeping obligations:

1. E-Mail & Social Media

Utilize third party e-mail retention system. Costs are significantly less as the industry has matured, and it increases the ability of the adviser to monitor, maintain and retrieve e-mail communications. Review the key word search word annually and remove words that create large exception reports. Implement social media procedures that include acceptable and unacceptable actions, monitoring and recordkeeping to evidence review.

2. Code of Ethics and Personal Trading Records

To assure compliance with the Code of Ethics and personal trading regulations, Advisers should (i) maintain the annual attestations that are executed annually by the access persons attesting to their to knowledge of the Code of Ethics and agreement to be bound by them; (ii)

statements issued by the respective custodians for each security account held by an access person; (iii) a spread sheet reflecting all of the securities accounts, that can be used to evidence the receipt of all statements; and (iv) a consolidated file reflecting pre-clearance of securities purchases, relevant (e.g. purchases of initial offerings and private funds need pre-approval regardless of other requirements).

3. Performance-Based Communications

As discussed herein, this is one of the most difficult areas of compliance, both for money manager and potentially for the adviser to private equity and hedge funds as there are many specialized and complicated rules and numerous no action letters that govern any given fact situation. Thus all work papers, memoranda and other records that the adviser used in order to compute performance must be retained and available for inspection during the audit. Depending on whether the performance is net of fees or gross of fees, differing disclosures must be included in the performance reports. Although the reports need not be compliant with the Global Investment Performance *Standards* (GIPS *Standards*), if the reports claim to be compliant with the GIP *Standards*, and they aren't, the adviser is subjected to the anti-fraud provisions of the Advisers Act.

4. Disclosure Documentation

Records regarding the Advisers Form ADV Part 1, Part 2A and Part 2B should be maintained in a central file, and the file should include all prior versions, including a red-line of the changes to the respective documents, along with any worksheets documenting assets under management, the number and type of clients the annual maintenance and documentation evidencing the delivery of your written brochure to prospective and current clients, and or subsequently delivery of material changes to the brochure. Additionally, advisers to private equity and hedge funds should maintain all offering documentation related to marketing and sale of interests in the respective funds.

5. Policies and Procedures

Policies and procedures adopted and implemented under the Compliance Rule, including any documentation prepared in the course of your annual review. The record should be maintained on a consolidated basis, and should include all prior versions, including a red-line of the changes to the respective documents. It is recommended that a list or log of all material changes also be maintained to evidence the evolving nature of the procedures for regulators.

6. Advisers Who Have Custody

Advisers who have custody of client accounts should maintain records reflecting all client activity with respect to the assets custodied. Those records should include:

- Journals showing securities transactions.
- Separate client ledger.
- Copies of trade confirmations.
- Record for each security held by client showing amount and location.
- Audits, if necessary, and proof of delivery if appropriate.

7. Proxy Voting Records

Advisers who vote proxies are required to prove that they follow their procedures so as to minimize any conflicts. To the extent the adviser does not utilize a third party service provider, the records required of investment advisers who vote proxies on behalf of their clients include:

- Copies of proxy voting policies.
- Copies of proxy statements received regarding client securities.
- Records of votes cast by the adviser on behalf of client.
- Copies of documents used in making a decision as to how to vote proxies.
- Copies of client correspondence requesting how the adviser voted proxies.

8. ERISA Clients

Advisers who have ERISA clients should maintain evidence that the Section 408(b)(2) Disclosures were made to all Qualified ERISA plan by July 1, 2012, upon the engagement of the adviser by a Qualified ERISA plan and or disclosures of changes to investment-related information are to be made at least annually. Additionally, a copy of all disclosures should be maintained in a central ERISA disclosure file.

9. Principal Trading

Records related to all principal trading needs to be maintained, including evidence of client approval, which needs to be executed prior to settlement. The advisers' staff needs to be educated on (i) the ramification of riskless principal trading in debt instruments, and (ii) the issues related to being an adviser to a private equity fund or hedge fund and importance of the recordkeeping obligations related thereto.

10. "Pay-to-Play"

To the extent that an adviser manages the assets of a government entity, either directly or through certain pooled investment vehicles, including private equity funds, that adviser is subject to the "pay-to-play" rule and as such need to evidence it's compliance with the rule. Which could include attestations related to their political contributions of persons seeking employment with the adviser, and annual attestations of persons covered associates related to their political contributions, and or pre-approval forms for political contributions.

F. TECHNICAL SOLUTIONS

1. Third Party Service Providers

There are clearly a number of third party service providers who can support the recordkeeping obligations of an adviser, including e-mail retention and monitoring systems, document retention and electronic filing systems and data destruction services and while advisers have no specific rule or regulation related to third party outsourcing of services, members of the Financial Industry Regulatory Authority must comply with FINRA Rule 3190(a)(2), which requires each member firm, pursuant to its obligations under FINRA rules, to establish and maintain a supervisory system and written procedures for any functions or activities performed by a third-party service provider that are reasonably designed to achieve compliance with applicable securities laws and regulations and applicable FINRA and MSRB rules. While there are a number of notifications and rules specific to clearing firms, the extrapolation of the

fiduciary standard over the underlying purpose of the FINRA rule (to wit, protection of privacy and customer information) results in the assessment that advisers should take certain limited steps with respect to their hiring and retention of third party service providers to support their record keeping activities.

a. Due Diligence

Based upon the underlying goals of the FINRA rules, it would appear that the best practice for an adviser would be to provide for a due diligence analysis of each current or prospective third-party service provider to determine, at a minimum, whether: (1) the third-party service provider is capable of performing the activities being outsourced; and (2) with respect to any activities being outsourced, the member firm can achieve compliance with applicable securities laws and regulations, including the protection of confidential information and the ultimate destruction of data. The review should be done upon the initial hiring of the third party service provider, and annually thereafter. In the interim, the services need to be monitored to confirm they are complying with relevant expectations (e.g. do they shred documents on-site or remove them for handling off-site, are requests for archived e-mails performed timely).

b. Procedures

Procedures should be developed for and advisers outsourcing practices to ensure such compliance and that those procedures could include, without limitation, conducting a due diligence analysis of all of its current or prospective third-party service providers to determine whether they are capable of performing the outsourced activities, record retention guidelines, the monitoring of such relationships and an annual review of such activities.

2. Electronic versus paper

a. SEC Adviser

You may store your original books and records in paper format or by using either micrographic media or electronic media. These media generally include microfilm or digital formats (e.g., electronic text, digital images, proprietary and off-the-shelf software, and email). If you use email or instant messaging to make and keep the records that are required under the Advisers Act, you should keep the email, including all attachments that are required records, as examiners may request a copy of the complete record. In dealing with electronic records, you must also take precautions to ensure that they are secure from unauthorized access and theft or unintended destruction (similar safeguarding provisions regarding client information obtained by you is required by Regulation S-P under the Gramm-Leach-Bliley Act). In general, you should be able to promptly (generally within 24 hours) produce required electronic records that may be requested by the SEC staff, including email. In order to do so, the Advisers Act requires that you arrange and index required electronic records in a way that permits easy location, access, and retrieval of any particular electronic record. To the extent an adviser utilizes electronic media; the adviser is not required to notify the SEC.

b. NFA Member

As with the SEC, an NFA member may maintain its original books and records in either paper format or by using either micrographic media or electronic media. To the extent it utilizes micrographic media or electronic media, CFTC Regulation 1.31 requires such storage media must (i) preserve the native file format of the electronic records (ii)

preserve the records exclusively in a non-rewritable, non-erasable format; (iii) serializes the original and, if applicable, duplicate units of storage media and creates a time-date record for the required period of retention for the information placed on such electronic storage media; and (iv) permits the immediate downloading of indexes and records preserved on the electronic storage media onto paper, microfilm, microfiche or other medium acceptable under this paragraph upon the request of representatives of the Commission or the Department of Justice.

Additionally, persons who use either micrographic media or electronic storage media to maintain records in accordance with this section must: (i) Have available at all times, for examination by representatives of the Commission or the Department of Justice, facilities for immediate, easily readable projection or production of micrographic media or electronic storage media images; (ii) Be ready at all times to provide, and immediately provide at the expense of the person required to keep such records, any easily readable hard-copy image that representatives of the Commission or Department of Justice may request; (iii) Keep only Commission-required records on the individual medium employed (e.g., a disk or sheets of microfiche); (iv) Store a duplicate of the record, in any medium acceptable under this regulation, at a location separate from the original for the period of time required for maintenance of the original; and (v) organize and maintain an accurate index of all information maintained on both the original and duplicate storage media. Additionally, it is necessary for the NFA member to develop and maintain written operational procedures and controls (an “audit system”) designed to provide accountability over both the initial entry of required records to the electronic storage media and the entry of each change made to any original or duplicate record maintained on the electronic storage media.

Finally, in addition to the foregoing conditions, any person who uses only electronic storage media to preserve some or all of its required records (“Electronic Recordkeeper”) shall, prior to the media's use, enter into an arrangement with at least one third party technical consultant (“Technical Consultant”) who has the technical and financial capability to perform the undertakings described in the rule. The arrangement shall provide that the Technical Consultant will have access to, and the ability to download, information from the Electronic Recordkeeper's electronic storage media to any medium acceptable under this regulation. Additionally, the Technical Consultant must file with the Commission an undertaking in a form acceptable to the Commission, signed by the Technical Consultant or a person duly authorized by the Technical Consultant.

c. Data destruction

A recent amendment to the FACT Act, a consumer protection/creditor's rights statute, imposed a responsibility upon investment advisers concerning the destruction of confidential client information. This measure was precipitated by the alarming increase in identity theft. In any event, all investment advisory firms must not only have an express plan with regard to the confidentiality and destruction of client data, they must also identify the steps they will take to dispose of it in a prudent manner.

G. CONCLUSION

While the core recordkeeping requirements set forth in the Advisers Act have not changed substantially in the last 70 years, the spectrum of investment advisory services now provided by advisers, the expansion of business activities which are now subject to the Advisers Act and new

technology have had a major impact on the recordkeeping requirements. When viewed in conjunction with the SEC's enforcement goals it is critical for investment advisers to fully understand their recordkeeping obligations. Ultimately, good recordkeeping by advisers is the foundation for a compliance program that allows a firm to evidence its compliance with the myriad of laws, rules and regulations that impact the day to day operations of a registered investment adviser.

H. HANDOUTS / RESOURCES

Please refer to your NSCP CD for:

- Example Social Media Procedures (provided courtesy of IA Watch)
- Sample Key Words for e-mail review (provided courtesy of IA Watch);
- 3rd Party Vendor Due Diligence Worksheet
- Social Media Review Worksheet
- Sample Annual IAR Attestation package

For a copy of the respective document in word and or excel format, please contact Daniel LeGaye, at dan.legaye@legayelaw.com.