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BROKER-DEALERS

How Developments With California's Pension Plan Disclosure Law, the SEC's Rules and FINRA's CAB License May Impact Hedge Fund Managers and Third-Party Marketers

By Kara Bingham

Hedge fund managers and many service providers have faced a wave of new regulatory requirements since the 2008 global financial crisis. This is particularly true for third-party marketers engaged by hedge fund managers to solicit clients and fund investors, which may be subject to a barrage of regulations at the federal, state and local level depending on the nature of their business.

To explore some of the latest regulatory challenges faced by funds and their marketers, The Hedge Fund Law Report recently interviewed Susan E. Bryant, counsel at Verrill Dana LLP, and Richard M. Morris, partner at Herrick, Feinstein LLP. This article sets forth the participants' thoughts on a host of issues, including new disclosure requirements for state pension plan investors; recent enforcement trends; and new rules adopted by the SEC, FINRA, Municipal Securities Rulemaking Board (MSRB) and state regulators.

Update on California Pension Plan Law

HFLR: The State of California recently enacted a law to require California public pension plans (CA Pension Plans) to disclose certain fee and expense information about their investments in any private fund that is an alternative investment vehicle (AIV). What is required to be disclosed?

Morris: The rule requires a CA Pension Plan to disclose on an annual basis, at a meeting open to the public, the following regarding its investments in AIVs:

1. the fees and expenses paid by the CA Pension Plan to the AIV, the fund manager or related parties;
2. to the extent not disclosed pursuant to number one above, the CA Pension Plan's pro rata share of fees and expenses paid from the AIV to the manager or related parties;
3. the CA Pension Plan's pro rata share of carried interest distributed to the fund manager or related parties; and
4. the CA Pension Plan's pro rata share of aggregate fees and expenses paid by all of the portfolio companies held within the AIV to the fund manager or related parties.

This legislation is one of those changing-tide type of events. Several states have proposed similar legislation. So far, California is the only one to have passed it, but I suspect that there will be greater demand for this fee transparency by other states and pension funds.

The new law requires a CA Pension Plan to require an AIV in which it invests to disclose the items identified above as well as the gross and net rate of return, since inception, of the AIV. Accordingly, I believe most plans will look to the adviser to calculate and certify the accuracy of this information.

HFLR: When is the new law effective, and what effect do you expect it to have on the industry?

Morris: From a practical perspective, I anticipate that a few things will occur as a result of this new legislation. First, CA Pension Plans may require fund sponsors to contractually agree (as part of a side letter) to provide and certify the accuracy of this information, and to indemnify the CA Pension Plan if it's wrong. Second, CA Pension Plans may require the manager to engage the fund's auditors to provide comfort around the calculations, either through a comfort letter or an attestation, such as agreed upon procedures. Third,

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as this information will be part of the public domain, managers should prepare for investor inquiries about the levels of fees paid by investors and support any differences that are charged to the institutional investors.

The new disclosure requirements apply to CA Pension Plans investing in an AIV on or after January 1, 2017, as well as to existing contracts for which a new capital contribution is made on or after January 1, 2017. The new rule also requires the CA Pension Plan to use reasonable efforts to obtain this information with respect to contracts in place prior to January 1, 2017.

Qualified Clients

HFLR: The Investment Advisers Act of 1940 (Advisers Act) restricts an adviser from receiving performance-based compensation from clients, unless certain conditions are met, the most common of which is that the client be a "qualified client." Effective August 15, 2016, the SEC increased the net worth requirement of the qualified client threshold from $2 million to $2.1 million. (An alternative test measuring the client's assets under management with the adviser remains at $1 million.) What steps should advisers receiving performance-based compensation take to ensure that they are complying with the new qualified client threshold?

Bryant: Ensuring that a client meets the qualified client threshold – whether it's $2 million or $2.1 million – is part of the manager's obligations under its customer identification program and is part of a solicitor's due diligence obligations in representing a manager. Managers that charge performance-based compensation, along with those marketers that solicit clients or investors on the manager's behalf, will need to verify that advisory and subscription agreements have been updated to incorporate the new threshold, so that the manager is obtaining the correct representation.

Morris: I agree with Susan. This is a part of a "know your customer" program.

The underpinning of the rule is that retail investors may not appreciate the full amount of fees that they are being charged under a performance-based compensation model. In my view, however, performance-based compensation aligns the interests of the adviser with those of the investor.

The $2.1 million threshold is arbitrary, and I could just as easily argue that the threshold should be decreasing, not increasing. The increase in the threshold is not significant, but I remember a time when it was quite a bit lower.

Municipal Advisors

HFLR: With the approval of the SEC, the MSRB adopted new rules establishing professional qualification requirements for "municipal advisor representatives" and "municipal advisor principals," including that they pass a qualification exam (Series 50). Who falls within these new registration classifications, and when are they required to have passed Series 50?

Bryant: The new rules governing "municipal advisors" stem largely from the pay to play scandals that came to light in 2009. [See "*What Do the Regulatory and Industry Responses to the New York Pension Fund 'Pay to Play' Scandal Mean for the Future of Hedge Fund Marketing*?" (Jul. 29, 2009).]

In response, the Dodd-Frank Act expanded the jurisdiction of the MSRB to require registration of municipal advisors with the SEC and MSRB (a self-regulatory organization). Notably, the definition of municipal advisors captures entities that, among other things, solicit business from state or local pension plans. [See "*Third-Party Marketers That Solicit Public Pension Fund Investments on Behalf of Hedge Funds May Have to Register With the SEC Within Three Weeks*" (Sep. 10, 2010).]

Series 50 was developed because the MSRB took its obligations under the Dodd-Frank Act very seriously. The deadline to take and pass Series 50 is September 12, 2017. A municipal advisor representative includes

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any individual associated with a municipal advisor who engages in municipal advisory activities on the advisor's behalf, other than a person performing only clerical, administrative, support or similar functions.

Municipal advisory activities include, among others, the solicitation of a municipal entity. A municipal advisor principal is also required to pass Series 50 and possess sufficient knowledge, experience and training to understand and discharge the principal's responsibilities. Additionally, the MSRB may adopt a principal-level examination in the future.

Notably, when developing the rules governing Series 50, the MSRB elected not to grandfather in individuals who have passed MSRB or MSRB-recognized exams (e.g., Series 52 or Series 7) or hold the chartered financial analyst or other designations.

Due Diligence

HFLR: In August of this year, the SEC announced that it had settled charges against thirteen investment advisory firms, assessing penalties ranging from $100,000 to $500,000, for spreading false performance claims originally made by F-Squared. [See "SEC Settlements Highlight Need for Managers to Verify Performance Claims of Others Prior to Use" (Sep. 22, 2016).] The SEC previously found that F-Squared presented backtested performance as actual performance results and, due to a calculation error, materially overstated the extent to which the strategy outperformed the S&P index. [See "SEC Settles Enforcement Action and Pursues Company Founder Over Use of Backtested Performance Data" (Jan. 8, 2015).] Why were the advisory firms found culpable by the SEC when it was F-Squared who originally made the false performance claims?

Bryant: In the SEC's view, these advisers took the information from F-Squared and passed it on to their clients. According to the order, it does not appear that they conducted any sort of verification of the information; the SEC said this was unacceptable.

Morris: Investment advisers owe a fiduciary obligation to their clients; it's clear from the actions by the SEC that in merely passing over the performance materials, they breached this duty.

That being said, this line of cases may lead to the opening of Pandora's Box. In the next case, the SEC may claim that while the adviser conducted some due diligence to verify the information, it didn't do enough, or that the adviser didn't adequately document the review process.

HFLR: In retrospect, what steps could those advisory firms have taken to prevent this sort of liability?

Bryant: It's critical to have a process in place and to document the steps taken. I don't think that advisers or third-party marketers have to go as far as independently calculating the performance figures, but they need to ask enough questions to be comfortable that the information is valid.

Sample questions may include:

- Who at the firm is responsible for preparing the performance figures?
- What is that person's experience and role at the firm?
- Does the fund's administrator independently calculate the fund's performance, and do you reconcile against those figures?
- Was the track record audited, and if so, by whom? If not, why not?
- If the fund is a registered fund, was the performance calculated in compliance with the Investment Company Act of 1940?

Business Continuity Plans

HFLR: The SEC and state regulators are taking a greater interest in ensuring that their registrants have adequate business continuity plans in place. Where do these proposals stand, and what steps should firms be taking now to ensure that they are in compliance?

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Morris: In the alternative space, the market has already addressed this issue in part as many advisers already have a "key man" clause, which typically requires the adviser to either return investor capital or wind-down the fund upon the departure, incapacity or death of individuals identified as key persons.

In June 2016, the SEC proposed a new rule that would require all SEC-registered investment advisers to adopt a written business continuity and transition plan. Most registrants already have some sort of business continuity plan in place, as investors want to know how the firm will continue to operate after the occurrence of a disaster or event.

In terms of succession planning, a lot of firms refer to the procedures designated in the investment manager's constituent documents. For example, if a firm has three partners and makes decisions through a majority vote, even if one partner is no longer at the firm, there is still a mechanism in place pursuant to which the other two partners can make decisions and take action. Assuming that the proposed rule is adopted, advisers may be required to put in place more formal transition or succession plans.

Bryant: Investment advisers registered with the states tend to be smaller in scale, some with one or two persons. For these firms, regulators are concerned that if a person dies or becomes incapacitated, the lack of continuity will result in harm to the adviser's clients. Therefore, many states require their registrants to adopt succession plans.

For my clients, these issues often surface during the examination process. Even if a state does not have a formal rule in place requiring advisers to have a written business continuity plans, they expect advisers to adopt them as part of their fiduciary duty to their clients.

FINRA Membership and Rules

HFLR: In August 2016, the SEC approved FINRA's proposal to adopt a new rulebook for Capital Acquisition Brokers (CABs) to operate under a more limited FINRA rule set. What types of activities is a CAB permitted to engage in under the rule?

Bryant: CABs are limited to advising companies on mergers and acquisitions, raising capital through private placement and certain financial advisory services. In my view, these rules were drafted to attempt to tackle the private equity business and the broker-dealer registration issues that have been the subject of enforcement actions.

[See "*SEC Settlement Order Reignites Concerns Over Whether Private Fund Managers Must Register As Brokers" (Jun. 16, 2016); and "Do In-House Marketing Activities and Investment Banking Services Performed by Private Fund Managers Require Broker Registration?*" (Apr. 18, 2013).]

HFLR: As a follow-up, what are the pros and cons of having a CAB registration? What types of entities is the CAB regime appropriate for?

Morris: I have presented this option to clients, and many are wary of becoming subject to a new set of rules. After years of complying with the existing FINRA regime and being examined by FINRA, many broker-dealers feel comfortable with the existing rules. Transitioning to a CAB could be an expensive and operationally intensive process; thus, the significance of the relief may not outweigh the cost of learning a new regime.

Bryant: I expect the CAB regime to be an option for private fund managers that maintain affiliated broker-dealers to raise capital for the funds. One concern my third-party marketer clients have with the CAB regime is that it is too narrow. For example, while it permits placement agent activity on behalf of an issuer in connection with the sale of newly issued unregistered

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securities, it would not permit them to participate in a secondary market transaction or in the resale of unregistered securities.

HFLR: FINRA recently proposed to amend the rules governing gifts, gratuities and non-cash compensation, including most notably: increasing the limit from $100 to $175 per year; adding a de minimis threshold below which firms would not have to maintain records of gifts given or received; amending the non-cash compensation rules to apply to all securities products; and requiring firms to adopt written policies and supervisory procedures on business entertainment. If adopted, what steps do FINRA members need to take to comply with the new rule?

Morris: I view the existing rules on gifts, along with this proposal, as an extension of the pay to play type provisions that have been in place for mutual funds and variable annuity products for many years. This is a new requirement for other broker-dealers. FINRA is taking a more proactive approach as to what a member's gift and entertainment policy should be. The primary impact will be for compliance to upgrade their existing policies to incorporate the new requirements.

Bryant: Some of the background on the non-cash compensation aspect of the proposal is that the existing rules only apply to arrangements for the sale and distribution of variable insurance contracts, direct participation programs, investment company securities and public offerings of debt and equity securities. FINRA is proposing to adopt these rules for all securities-related products.

For some FINRA members, this will be a significant change. For others, they've already been dealing with a lot of this; the increase of the limit from $100 to $175 isn't that significant of a change.

[For discussion of the FSA's views on gifts and entertainment, see "*FSA Report Warns Investment Managers to Revise Their Compliance Policies and Procedures to Address Key Conflicts of Interest*" (Nov. 29, 2012).]

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