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SEC Proposes Rules to Implement Dodd-Frank Provisions Relating To Registration and Reporting By Investment Advisers

The US Securities and Exchange Commission (SEC) recently proposed a series of rules and rule amendments designed to clarify the registration and reporting obligations for certain categories of investment advisers in the aftermath of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that amended the Investment Advisers Act of 1940 (Advisers Act). Among other things, the proposed rules provide guidance to certain “mid-sized” SEC-registered investment advisers concerning the process for transition to state regulation from SEC regulation; define the reporting obligations that certain advisers would need to undertake even if they are exempt from registration; and enhance public reporting by registered investment advisers and other reporting advisers, including significant new mandated disclosures concerning private funds advised by such investment advisers. The proposed rules, disseminated in a November 19, 2010 release (Proposing Release) are designed to implement provisions of Title IV of the Dodd-Frank Act. Among other things, Title IV of the Dodd-Frank Act: (a) reallocated responsibility for regulatory oversight of certain advisers with assets under management of between $25 million and $100 million (mid-sized advisers) to the states from the SEC; (b) repealed the Section 203(b)(3) exemption from Advisers Act registration historically relied upon by many advisers to private funds, including hedge funds, private equity funds, and venture capital funds (Private Fund Adviser Exemption); and (c) created several more narrowly tailored exemptions for certain categories of investment advisers, including, family offices, advisers solely to venture capital funds, advisers solely to private funds with assets under management of less than $150 million, foreign private advisers, and commodity trading advisers registered with the Commodity Futures Trading Commission. These exemptions are discussed in more detail in a separate advisory that can be found at http://www.arnoldporter.com/public_document.cfm?id=17125&key=3F1.

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I. Advisers Act Registration

A. Deregistration of Certain Investment Advisers

Historically, Section 203A of the Advisers Act has prohibited an investment adviser, that is regulated by a state in which it has its principal office and place of business, from registering with the SEC unless it has at least $25 million in assets under management. An adviser with $30 million or more in assets under management has been required to register as investment adviser with the SEC. The Dodd-Frank Act amended Section 203A of the Advisers Act to generally prohibit an investment adviser from registering with the SEC if it is registered as an investment adviser with the state in which it maintains its principal office and place of business and has less than $100 million in assets under management. Congress enacted this amendment in an effort to shift responsibility for regulating certain "mid-sized advisers" with between $25 million and $100 million in assets under management to the states. A mid-sized adviser, however, would not be subject to this prohibition if: (a) it is not required to register with the state in which it maintains its principal office and place of business, (b) if registered with that state, the adviser would not be subject to examination as an investment adviser by that state, or (c) the investment adviser would be required to register as an investment adviser with 15 or more states. These exceptions from the prohibition would not be available to advisers with less than $25 million in assets under management. In addition, mid-sized advisers that advise registered investment companies and business development companies (as defined in the Investment Company Act of 1940 (Company Act)) would be required to register with the SEC despite the prohibition.

The SEC estimates that approximately 4,100 advisers currently registered with the SEC would need to deregister with the SEC and register with the states in which they have their principal office and place of business. To facilitate this process, the SEC has proposed Rule 203A-5 under the Advisers Act which would require advisers currently registered with the SEC to amend Part I of their Form ADV by August 20, 2011, in order to report their assets under management to be determined within 30 days of the filing date. This filing would provide the SEC and state regulatory authorities with information necessary to determine whether an adviser would still be eligible for registration with the SEC. Advisers that would no longer be eligible for registration with the SEC would be required to deregister with the SEC by filing Form ADV-W by October 19, 2011. The SEC has proposed this transition period for deregistration to provide an adviser time to arrange for state registration and, if applicable, to ensure that its associated persons register as investment adviser representatives (which could include taking an examination). The SEC notes that the timing of these transition periods may be impacted by the need to reprogram the Investment Advisory Registration Depository (IARD) system through which investment advisers file Form ADV.

The SEC has also proposed to grant relief from registration for certain state-registered advisers that would otherwise have to register with the SEC before July 21, 2011 because they would have between $30 million and $100 million in assets under management before implementation of the new higher SEC-registration threshold. This will allow such advisers to avoid the regulatory burdens of having to register with the SEC (as they cross the $30 million assets threshold) only to deregister once the new $100 million registration threshold becomes effective. Advisers would be permitted to take advantage of this relief if: (a) they are able to report on Form ADV that they have between $30 million and $100 million in assets under management between January 1, 2011 and October 19, 2011 and (b) the adviser is registered with the state where it has its principal office and place of business, and it reasonably believes it is required to be registered with and is subject to examination as an investment adviser by that state.

B. Assets Under Management

The SEC has also modified the method for calculating an adviser's assets under management to determine an adviser's eligibility to register with the SEC. This new measure, which would be known as an adviser's "regulatory assets under management" would also be used to determine an adviser's eligibility for various exemptions from Advisers Act registration including: (a) the exemption for advisers that advise only private funds and have less than $150 million in assets under management and (b) certain "foreign private advisers" with fewer than 15 US clients and investors in private funds and less than $25 million in assets under management from US clients and investors in private funds.

Section 203A(a)(2) of the Advisers Act defines "assets under management" as the "securities portfolios" with respect to which an adviser provides "continuous and regular supervisory or management services." The instructions to Form ADV provide further clarification on the calculation of assets under management and include a list of certain types of assets that advisers are permitted but not required to include in such a calculation. These include proprietary assets, assets managed without compensation, and assets of foreign clients. The SEC has proposed amending the instructions to Form ADV to require all advisers to include such assets in their calculations of regulatory assets under management. In addition, an adviser would neither be permitted to subtract outstanding indebtedness nor accrued but unpaid liabilities that are in a client's account managed by the adviser.

In addition, the SEC is also amending the instructions to Form ADV to provide guidance on how to calculate the regulatory assets under management of "private funds" managed by the adviser. Advisers would be required to include the value of any private fund over which the adviser exercises continuous and regular supervisory or management services. Sub-advisers, however, would only be required to count those assets of a private fund for which they actually provide sub-advisory services, as opposed to the total assets of the private fund. In addition, an adviser would be required to include capital that has been committed by investors to a private fund but has not yet been called for contribution by the adviser. An adviser would also be required to value private fund assets at fair value instead of being permitted to value such assets at cost. The SEC noted that it has proposed this method of calculation to ensure more consistent calculation of assets among investment advisers and to deter advisers from understating their assets to avoid registration.

For the purpose of determining eligibility to register with the SEC based on its assets under management, an adviser would only be required to make such a determination once a year based on its assets under management disclosed on its annual updating amendment to Form ADV. However, for the purpose of determining whether an adviser is eligible for the exemption from Advisers Act registration for advisers to private funds with less than $150 million in assets, an adviser would be required to value its private fund assets at fair value on a quarterly basis as opposed to an annual basis.

The SEC recognized that an adviser's regulatory assets under management, as disclosed in Part I of its Form ADV, would likely differ from the assets under management reported by an adviser in Part II of Form ADV.

III. Exempt reporting Advisers

As noted above, the Dodd-Frank Act repealed the Private Fund Adviser Exemption which was relied on by many advisers to private funds, including hedge funds, private equity funds, and venture capital funds. While advisers solely to venture capital funds and advisers to private funds with less than $150 million in assets under management would be eligible for exemption from Advisers Act registration, they would nonetheless be subject to reporting requirements proposed by the SEC in the Proposing Release. Such advisers would be known as "exempt reporting advisers."

The SEC has proposed a new rule, Rule 204-4 under the Advisers Act, which would require an exempt reporting adviser to file reports with the SEC by completing a subset of information required by Form ADV, which would be filed through the IARD and become available to the public. Specifically, the SEC is proposing that exempt reporting advisers complete the following items in Form ADV along with corresponding information required by Schedules A, B, C, and D: (a) Item 1, which requires basic identifying information about an adviser, including its contact information; (b) Item

2.C., which requires an exempt reporting adviser to indicate the exemption from Advisers Act registration on which it is relying as an exempt reporting adviser; (c) Item 3, which requires an adviser to indicate its form of organization; (d) Item 6, which requires an adviser to delineate its other business activities; (e) Item 7, which requires an adviser to provide information about its related persons as well as detailed information about private funds it advises; (f) Item 10, which requires an adviser to provide information about its direct and indirect owners; and (g) Item 11, which requires an adviser to disclose certain disciplinary information about itself and its employees. An exempt reporting adviser would not be required to provide other information required by other items in Part I or to complete and file Part II of Form ADV. Rule 204-1 under the Advisers Act would also be amended to require an exempt reporting adviser to file annual updating amendments to Form ADV within 90 days of the end of its fiscal year or other amendments "promptly" if certain material information becomes inaccurate. Also, as proposed, Rule 204-4 under the Advisers Act would require an exempt reporting adviser to amend its Form ADV to indicate that is no longer an exempt reporting adviser when it ceases to be an exempt reporting adviser. Proposed amendments to the instructions to Form ADV would also make it clear that those exempt reporting advisers that no longer qualify as exempt reporting advisers, because they must register with the SEC, must simultaneously file their last report on Form ADV as an exempt reporting adviser and their first Form ADV as a registrant. Exempt reporting advisers would be required to file their first reports on Form ADV by August 20, 2011.

IV. Amendments to Form ADV

The SEC has also proposed general amendments to Form ADV designed to enhance disclosures about the private funds advised by an investment adviser as well as additional information about an adviser's employees, clients, advisory activities, non-advisory business activities, financial industry affiliations, business practices, and related persons.

A. Information about Private Fund Clients

To begin with, registered advisers and exempt reporting advisers would be required to provide more detailed information about private funds that they advise in Item 7.B. and Schedule D of Form ADV. However, such advisers would not be required to include information about private funds advised by their related persons, which would likely be reported in a separate Form ADV by the related persons. Sub-advisers would not be required to provide information about a private fund if such information is already being provided by another adviser. Also, advisers to funds established as a master-feeder structure could complete a single Schedule D for the master fund and all of the feeder funds. Also, advisers with a principal office and place of business outside of the United States would not be required to provide information about a private fund organized outside of the United States that is not offered to or owned by "United States persons."

The SEC is proposing to require advisers to report information about a private fund, including information concerning the fund's organizational and investment characteristics, assets, investors, and service providers.

An adviser would generally be required to provide identifying information about a private fund client, including the name of the private fund, provided that an adviser could withhold the name of the client if it maintained the identity of the private fund client in code in its records to identify the private fund listed in Schedule D using the same code. With respect to a private fund's organizational characteristics, the SEC has proposed that an adviser provide information about: (a) the state or country where the private fund is organized; (b) the name of its general partner, directors, trustees, or persons occupying similar positions; (c) whether the fund is established as a master-feeder structure; and (d) the regulatory exclusions and exemptions relied on by the fund. Thus, an adviser to a fund that relies on any of the exclusions found in Section 3(c)(1) or Section 3(c)(7) from Company Act registration and a fund that relies on the exemption found in Regulation D under the Securities Act of 1933 (Securities Act) , with respect to its offerings of securities, would be required to indicate that the fund relies on any such exclusions or exemptions. With respect to a fund's investment characteristics, an adviser would be required to indicate the type of investment strategy employed by the fund by choosing among seven broad categories of strategies. With respect to the fund's assets, an adviser would be required to provide: (a) the gross and net assets of the fund (to facilitate the SEC's evaluation of any leverage utilized by the fund) and (b) a breakdown of the fund's assets and liabilities by class and categorization in the fair value hierarchy established under US generally accepted accounting principles (GAAP). This could prove to be burdensome where a fund does not prepare its financial statements in accordance with GAAP. With respect to the fund's investors, the adviser would be required to indicate the number and type of investors in the fund and the minimum investment required. To identify conflicts of interest, an adviser would be required to indicate whether its clients are solicited to invest in the fund and what percentage of the adviser's other clients have invested in the fund.

With respect to a fund's primary service providers, (including its auditors, prime brokers, custodians, administrators, and marketers) an adviser to a fund would be required to disclose: the service provider's name and location; whether it is a related person of the adviser; information about the services it provides to the fund; and certain identifying information (such as its registration status). With respect to a fund's auditors, an adviser would be required to disclose whether the auditor is an independent auditor; whether the auditor is registered with and subject to supervision by the Public Company Accounting Oversight Board; and whether audited statements are delivered to fund investors. With respect to a prime broker, an adviser would be required to disclose whether the prime broker is an SEC-registered broker-dealer and whether it acts as custodian for the private fund. With respect to the custodians of a private fund, the adviser would be required to disclose whether the custodian is a related person of the private fund. With respect to the fund's administrators, the adviser would be required to disclose whether the administrator prepares and sends account statements to fund investors and what percentage of the private fund's assets are valued by the administrator or another person that is not a related person of the adviser. With respect to marketers, an adviser would be required to disclose whether the marketer is a related person of the adviser, its SEC file number, and the address of any website the marketer uses to market the private fund. The SEC noted that the proposed new disclosures are designed to improve the SEC's ability to assess conflicts and potential risks, identify private funds with service provider arrangements that raise a red flag, and identify firms for examination.

As proposed, an adviser to a private fund would also be required to indicate whether it is subject to foreign regulatory authorities and whether it is a primary adviser or sub-adviser to the fund. In addition, an adviser to a private fund would be required to list all of the advisers to the private fund as well as their SEC file numbers.

Because this information about private funds would be filed on an adviser's Form ADV, such public disclosures raise the question of whether private funds can continue to rely on the exemption from registration of their securities found in Regulation D under the Securities Act, which prohibits a private fund from engaging in "general solicitation and advertising" in offering its securities. The SEC did not address this issue in the Proposing Release.

B. Information about an Adviser's Employees, Clients, and Advisory Activities

The SEC has proposed expanding existing questions in Item 5 of Form ADV which ask about an adviser's employees, clients, and advisory activities. First, the SEC would require an adviser to disclose the number of its employees that are registered investment adviser representatives or insurance agents in addition to the current mandated disclosure related to the number of employees that are registered representatives of a broker-dealer. In addition, the SEC has proposed requiring an adviser to provide a numerical approximation of the number of its employees instead of checking a box corresponding to a range of numbers of employees.

With respect to client and advisory activity disclosures, an adviser is currently required to "check the box" if it advises certain categories of clients or engages in certain types of advisory activities. The SEC has proposed expanding these categories of clients and advisory activities to gain more insight into an adviser's client base and advisory activities. With respect to clients, the SEC has proposed adding business development companies, insurance companies, and other investment advisers as new categories of clients and to distinguish pensions and profit-sharing plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) from those that are not subject to ERISA. The SEC has also proposed requiring that an adviser estimate the percentage of its total regulatory assets under management that are represented by each client type. Also, the SEC has proposed requiring advisers to indicate the approximate percentage of its clients that are not United States persons

With respect to advisory activities, the SEC has proposed expanding the list of advisory activities to include portfolio management for pooled investment vehicles, other than registered investment companies, and educational seminars or workshops. In addition, the SEC would mandate a new disclosure that would require an adviser to indicate the types of investments for which the adviser provided investment advice during a fiscal year.

C. Other Amendments to Form ADV

The SEC also proposed amendments to Items 6 and 7 of Form ADV which require an adviser to indicate whether it or one of its related persons provides certain types of financial services to the adviser's clients. The SEC noted that these amendments are designed to identify any conflicts of interests or risks that could be created by the provision of these services to an adviser's clients. The SEC has also proposed requiring advisers to disclose the name under which they engage in other business activities. In addition, the SEC has also proposed expanding the information an adviser would be required to disclose with respect to its related persons, including identifying information; how the adviser and the related person are related; whether the related person is registered with a foreign financial regulatory authority; and how the adviser and related person share personnel and confidential information.

The SEC also proposed amending Item 8 which discusses the adviser's participation in client transactions. Notably, the SEC has proposed requiring an adviser to indicate whether broker-dealers used by the adviser are related persons of the adviser. Also, an adviser that indicates that it receives soft-dollar benefits would be required to report whether those soft-dollar benefits qualify for the safe harbor provided in Section 28(e) of the Securities Exchange Act of 1934 (Exchange Act) as "eligible research or brokerage services." Also, an adviser would be required to disclose whether it or a related person receives compensation for client referrals.

Also, the SEC would require an adviser to indicate on Form ADV whether it had $1 billion or more in assets under management (as measured by the total assets on the adviser's balance sheet) as of the last day of the adviser's most recent fiscal year. The SEC is interested in identifying such advisers because Section 956 of the Dodd-Frank Act tasks the SEC to work with certain other federal regulators to adopt rules or guidelines addressing excessive incentive-based compensation arrangements, including those for advisers with $1 billion or more in assets under management.

Because of the amendments to the Dodd-Frank Advisers Act registration requirements, the SEC has also proposed conforming changes to Item 2, which requires an adviser to indicate the basis for its SEC registration.

The SEC has also proposed additional amendments to Form ADV, including requiring an adviser to indicate: (a) contact information for its chief compliance officer in Item 1; (b) whether the adviser or any of its control persons is a public-reporting company under the Exchange Act in Item 1; and (c) the number of persons that act as qualified custodians for the adviser's clients.

V. Amendments to the Pay to Play Rule and Other Amendments to the Advisers Act

In the Proposing Release, the SEC also proposed other amendments to the Advisers Act, including amendments to the recently adopted pay-to-play rule found in Rule 206(4)-5 under the Advisers Act, which prohibits an adviser from engaging in certain pay-to-play practices, including paying third party marketers that are not "regulated persons" (i.e. registered investment advisers or broker-dealers subject to rules of a registered national securities association, that restricts its members from engaging in pay to play activities) to solicit government entities on the adviser's behalf.

The rule, as adopted, was designed to cover those investment advisers that were registered with the SEC as well as those investment advisers that relied on the Private Fund Adviser Exemption. Because the Dodd-Frank Act repealed the Private Fund Adviser Exemption, the SEC proposes to amend Rule 206(4)-5 to cover not only registered advisers, but also exempt reporting advisers and foreign private advisers.

In addition, the SEC has proposed amendments to Rule 206(4)-5 to prohibit advisers from paying third party marketers unless they are "regulated municipal advisors", (as opposed to "regulated persons"). "Regulated municipal advisors" would be defined under the Advisers Act as persons that are registered pursuant to Section 15B of the Exchange Act and subject to pay-to-play rules adopted by the Municipal Securities Rulemaking Board (MSRB). The Dodd-Frank Act created a new category of persons called "municipal advisors" that are defined as persons that undertake a solicitation of a municipal entity. These persons include third party solicitors, including registered investment advisers and broker-dealers, that seek business on behalf of an investment adviser from a municipal entity, including a pension fund. These municipal advisors are subject to MSRB rules. The SEC believes that the MSRB will adopt pay-to-play rules that will apply to these municipal advisors.

In addition to amendments to the Advisers Act pay-to-play rule, the SEC is also proposing to amend Rule 204-2 under the Advisers Act, which requires registered advisers to keep certain delineated books and records, including performance-related records. The SEC is proposing to exempt certain advisers that would be required to register with the SEC because of the repeal of the Private Fund Adviser Exemption by the Dodd-Frank Act from having to maintain certain performance-related records as long as the adviser did not voluntarily register with the SEC while it was still eligible for the Private Fund Adviser Exemption. The SEC has also adopted other technical and conforming amendments to the Advisers Act relating to client-counting, the keeping of books and records, and various definitions under the Advisers Act.

VI. Conclusion

The SEC will accept comments on the rule proposals throughJanuary 24, 2011. Comments may be sent via the SEC's internet comment form, which can be found at http://www.sec.gov/rules/proposed.shtml or by sending an email to rule-comments@sec.gov with a subject line of "File Number S7-36-10".

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys.

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