Davis Polk

CLIENT NEWSLETTER

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Breaking News on Dodd-Frank Private Fund Adviser Registration Deadline

SEC to Consider Delaying Dodd-Frank Private Adviser Registration Deadline Until First Quarter 2012

In a letter to David Massey, Deputy Securities Administrator of the North Carolina Securities Division, Robert Plaze, Associate Director of the SEC's Division of Investment Management, discussed the potential extension of compliance deadlines for certain amendments to the Investment Advisers Act of 1940 (the "**Advisers Act**") effected by Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). In particular, Plaze indicated that, given the time needed for advisers currently relying on the private adviser exemption to register and comply with the requirements for registered investment advisers, the SEC staff expects the SEC "will consider extending the date by which these advisers must register and come into compliance with the obligations of a registered adviser until the first quarter of 2012." The private adviser exemption currently exempts from SEC registration any adviser that, among other things, has fewer than 15 clients and does not hold itself out to the public as an investment adviser. It has been repealed by the Dodd-Frank Act, effective July 21, 2011.

In addition, Plaze explained that the Investment Adviser Registration Depository System (IARD) will need to be re-programmed in order to accept transition filings from advisers required to switch registration from the SEC to one or more states. Section 410 of the Dodd-Frank Act requires certain mid-sized advisers (advisers with between $25 and $100 million in assets under management) to withdraw their registration with the SEC and register with the states. This re-programming process, Plaze said, would not begin until the SEC adopts the relevant Dodd-Frank Act implementing rules and would not be complete until the end of the year. As such, Plaze stated that the SEC staff expects the SEC similarly to consider extending the deadline for SEC-registered mid-sized advisers to become registered with the states until the first quarter of 2012. Because under the SEC's proposed rules every adviser registered with the SEC would be required to file a one-time Form ADV amendment to report its eligibility for registration with the SEC, the letter indicated that the SEC staff expects the SEC would delay the deadline for such filing until the first quarter of 2012.

The SEC's proposed rules implementing the Dodd-Frank Act's amendments to the Investment Advisers Act of 1940 were previously reviewed in two Davis Polk client memoranda, ***SEC Proposes Rules Implementing New Exemptions from Advisers Act Registration Under the Dodd-Frank Act*** and ***SEC Issues Proposal Implementing Advisers Act Registration and Reporting Amendments Under the Dodd-Frank Act***. In the letter, Plaze also indicated that he expects the SEC will issue final rules in advance of July 21, 2011.

- See a copy of the letter

SEC Rules and Regulations

SEC Proposes Amendments to Remove Credit Rating References to Certain Investment Company Act Rules and Forms

On March 2, 2011, the SEC proposed rule and form amendments (the "**Proposal**") to remove references to credit ratings in certain rules and forms under the Investment Company Act of 1940 (the "**Investment Company Act**"), including rule 2a-7, which regulates the operations of money market funds.

Background

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") requires every federal agency, including the SEC, to review rules that use credit ratings to assess the creditworthiness of a security or money market instrument and replace such references with other appropriate standards. The SEC has previously proposed amendments to remove references to credit ratings issued by nationally recognized statistical rating organizations ("**NRSROs**") in certain Investment Company Act rules, as previously reported in the ***August 4, 2008*** and ***November 11, 2009 Investment Management Regulatory Updates***. In 2010, as detailed in the ***March 9, 2010 Investment Management Regulatory Update***, the SEC adopted certain amendments to rule 2a-7 under the Investment Company Act, but retained the use of credit ratings when determining whether a money market fund may invest in a security. Separately, as reported in the ***September 13, 2010 Investment Management Regulatory Update***, the SEC provided no-action relief to money market funds whose boards did not designate an NRSRO and make related disclosures before the SEC completed its review of rule 2a-7, as mandated by the Dodd-Frank Act.

Proposed Amendments to Rule 2a-7

In order to minimize the amount of risk a money market fund may assume, rule 2a-7 requires money market funds to invest only in "eligible securities," namely high-quality securities with short-term maturities. To achieve this stability, rule 2a-7 requires that money market funds may only invest in "first tier" or "second tier" securities, which means securities that have received the highest or second highest short-term securities rating, respectively, from an NRSRO that the board has designated. Under rule 2a-7, at least 97% of the portfolio of a money market fund must be invested in first tier securities. If a rating is not available for a particular security, the fund's board must evaluate the credit rating of the security and deem it to be of comparable quality to that of securities with the highest or second highest short-term rating. In addition, the board of directors of a money market fund, or its delegate, must determine that securities in its portfolio are of high credit quality and present minimal credit risks based on credit quality factors in addition to any ratings assigned to such securities by an NRSRO.

Under the Proposal, the amendments to rule 2a-7 would eliminate the credit rating requirements of the rule. Instead, the amended rule would require the following:

- Money market fund boards of directors would be required to determine whether the portfolio securities are "first tier" or "second tier" securities; and
- Money market fund boards would continue to be required to assess the credit quality of portfolio securities and determine that each security presents minimal credit risks.

First Tier Securities. A security would be first tier only if the board of directors of the fund, or its delegate (such as the adviser), determines that the issuer of the security has the "highest capacity to meet its short-term financial obligations," regardless of its credit rating. Such standard, the SEC indicated, would be similar to the credit quality standards articulated by certain credit rating agencies, such as Standard & Poor's, Moodys and Fitch. An issuer that would satisfy the proposed standard, according to the SEC, should have an "exceptionally strong ability to repay its short-term debt obligations and the lowest expectation of default."

Second Tier Securities. A security would be second tier only if, though not a first tier security, the board of directors of the fund, or its delegate, determines that the security presents minimal credit risk, based on factors relating to credit quality and the issuer's ability to meet its short-term financial obligations. According to the Proposal, the credit risk of a second tier security would differ only slightly from that of a first tier security and an issuer of a second tier security should have a "very strong ability to repay its short-term debt obligations, and a very low vulnerability to default."

In determining whether a security is a first tier or second tier security, a money market fund's board (or its adviser) would still be able to consider, among other factors relating to credit quality, NRSRO ratings that it concludes are "credible and reliable." The SEC notes that, in making this determination, it would expect "fund advisers to understand the method for determining the rating and make an independent judgment of credit risks, and to consider an outside source's record with respect to evaluating the types of securities in which the fund invests."

As with the current rule, a money market fund would continue to be required generally to invest at least 97% of its assets in first tier securities. A money market fund would also continue to be prohibited from (i) acquiring second tier securities with remaining maturities greater than 45 days and (ii) having more than one half of one percent of fund assets in second tier securities of any one issuer. The Proposal would eliminate the requirement that guarantors of securities held by money markets funds be rated by an NRSRO.

Conditional Demand Feature. Under current rule 2a-7, a security with a conditional demand feature may be an eligible security or a first tier security if, among other things, (i) the conditional demand feature is an eligible security or a first tier security, as the case may be, and (ii) the underlying security has received either a short-term or long-term rating within the two highest categories from the fund's requisite NRSROs (or is an unrated security with comparable credit quality). Under the Proposal, the credit rating requirement would be removed and replaced with the board's (or its delegate's) determination that the underlying security is of high quality and subject to minimal credit risk. The SEC indicates in the Proposal that an issuer satisfying the proposed definition would be one "determined to have a very strong capacity to meet its financial commitments, a very low risk of default, and a capacity for payment of its financial commitments that is not significantly vulnerable to reasonably foreseeable events." In making such determinations, a fund's board could use credit ratings from NRSROs it concludes are credible and reliable.

Monitoring Minimal Credit Risks. Under rule 2a-7, if a portfolio security has been downgraded by an NRSRO, a money market fund board must promptly reassess whether the security continues to present minimal credit risks and, if not, take appropriate action in the best interests of the fund. The Proposal would remove the reference to credit ratings in this provision. Instead, if a fund's board (or its delegate, such as its adviser) becomes aware of credible information that a portfolio security is no longer a first tier security or, if applicable, a second tier security, the board must promptly reassess whether the security would continue to present minimal credit risks. According to the Proposal, to meet this standard, the fund's investment adviser, as the board's delegate, would have to "exercise reasonable diligence in keeping abreast of new information about a portfolio security that the adviser believes to be credible."

Stress Testing. Rule 2a-7 requires money market funds to stress test the fund's ability to maintain a stable net asset value per share upon the occurrence of certain events, including a downgrade in the credit rating of a portfolio security. Under the Proposal, the amendments would replace this reference to credit rating downgrades with a "hypothetical event that is designed to have a similar impact on a money market fund's portfolio." Money market funds would continue to be required to stress test for adverse changes in the ability of an issuer of a portfolio security to meet its short-term financial obligations, and the Proposal indicates that funds could continue to stress test their portfolios by treating a downgrade as an adverse credit event that could impact the fund.

Repurchase Agreements

Rule 5b-3 under the Investment Company Act permits a fund to treat a repurchase agreement ("**repo**") as an acquisition of securities collateralizing the repo, for the purposes of determining compliance with certain provisions of the Investment Company Act, if the obligation of the seller to repurchase the securities from the fund is "collateralized fully." A repo is collateralized fully under rule 5b-3 if, among other things, the collateral for the repo consists of (i) cash, (ii) government securities, (iii) securities rated in the highest rating category by the fund's requisite NRSROs or (iv) unrated securities that are of comparable quality to those rated in the highest category by such NRSROs, as determined by the fund's board or its delegate.

The Proposal would eliminate the reference to NRSROs in rule 5b-3. In its place, the Proposal would require that, for collateral other than cash or government securities, the fund's board of directors (or delegate) determine, at the time the repo is entered into, that the collateral securities are "(i) issued by an issuer that has the highest capacity to meet its financial obligations; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days." The Proposal notes that the new standard would be satisfied if an issuer of collateral securities has "an exceptionally strong capacity to repay its short or long-term debt obligations . . . the lowest expectation of default, and a capacity for repayment of its financial commitments that is the least susceptible to adverse effects of changes in circumstances." In addition, the liquidity prong of the new standard would be satisfied, according to the Proposal, if the collateral securities trade in a secondary market at the time of entering into the repo.

According to the proposal, the board of directors of a money market fund could delegate the day-to-day determinations of quality and liquidity of repo collateral securities, but must retain sufficient oversight. Similar to the proposed amendments to rule 2a-7, the amendments to rule 5b-3 would allow fund boards to consider NRSRO ratings and other outside analyses in their determinations, provided the board concludes such ratings and outside sources are credible and reliable.

Amendments to Forms

The Proposal would make corresponding amendments to Forms N-1A, N-2 and N-3 to remove references to the use of credit ratings of an NRSRO. These forms require shareholder reports to include certain information regarding the portfolio securities of the relevant fund. Currently, if credit quality information is used in the presentation of portfolio securities in such reports, these forms require that credit ratings from a single NRSRO be included. As amended, these forms would eliminate the required use of NRSRO credit ratings, though funds could choose to continue to use credit ratings from a single NRSRO in the presentation of the credit quality of portfolio securities.

The SEC is seeking comments on the Proposal, which are due by April 25, 2011.

- See a copy of the Proposal
- See a copy of the SEC's press release and fact sheet

Industry Update

New Form SLT Reporting Requirements Applicable to Funds and Investment Managers Proposed by U.S. Department of Treasury

In connection with its Treasury International Capital reporting system, which tracks international capital movements, the U.S. Department of Treasury ("**Treasury**") has released its revised proposed new Form SLT, which is to be completed by certain U.S. issuers and U.S. end-investors, including applicable funds and investment managers, on a monthly basis to provide Treasury and related government agencies with timely information on holdings of certain long-term U.S. and foreign securities. According to the proposal, Form SLT would require the monthly reporting by applicable "U.S. resident reporters" of the fair values of long-term U.S. securities owned by foreign residents and long-term foreign securities owned by U.S. residents.

Covered U.S. Entities; $1 Billion Threshold

Under the proposal, Form SLT must be completed by all U.S. persons who are either (i) U.S.-resident custodians, (ii) U.S.-resident issuers of U.S. securities or (iii) U.S.-resident end-investors in foreign securities, whose consolidated total of all reportable securities exceeds the reporting threshold of $1 billion. The $1 billion threshold, for purposes of the form, is calculated based on the total fair value of the applicable long-term U.S. and foreign securities as of the last business day of the reporting month.

U.S. funds and U.S. investment advisers, in their capacity as U.S. resident issuers of U.S. securities or U.S.-resident end-investors in foreign securities (which include U.S. feeder funds that own shares of a non-U.S. master fund), respectively, would be required to file and report on Form SLT if the aggregate fair market value, as of the last business day of the reporting month, of the following equals or exceeds $1 billion:

- all securities issued directly to or placed with foreign residents (including interests issued by a U.S. master fund to a non-U.S. feeder fund); and
- all investments in foreign securities held directly for their own portfolio or for the portfolios of their clients that, in each case, *are not held by U.S. custodians*.

According to the instructions to proposed Form SLT, direct investments in a fund by the fund's adviser would not be included when calculating the $1 billion threshold.

For purposes of calculating reportable assets for Form SLT, the proposal indicates that a reporting adviser should consolidate the holdings and issuances of all U.S.-resident entities in its organization and all U.S.-resident entities that the adviser manages. Under the proposal, the reporting investment adviser would file one consolidated report for all such entities.

Scope of Reporting

Reportable securities are classified on proposed Form SLT as U.S. securities owned by foreign residents and foreign securities owned by U.S. residents. Reportable securities must be "long-term" securities, which means those having an original maturity of at least 1 year or no contractual maturity.

For U.S. securities owned by foreign residents, Form SLT would require disclosure of (i) the residence of the foreign holder, (ii) the fair market value and type of U.S. securities and (iii) whether the foreign holder is a "foreign official institution," which includes national governments, international and regional organizations and sovereign wealth funds.

For foreign securities owned by U.S. residents, Form SLT would require the disclosure of the (i) residence of the foreign issuer, (ii) fair market value and (iii) type of foreign security.

Implementation Timing

Under the proposal, reporting would be phased in during 2011, with quarterly reporting required for eligible reporters as of June 30, September 30 and December 30. Monthly reporting for eligible entities would commence in 2012. According to the proposal, Form SLT would be required to be submitted no later than the 23rd calendar day of the month following the applicable reporting as-of date. Once one report is filed in a calendar year, a report for each remaining month in the calendar year would be required to be submitted, regardless of whether the consolidated total of reportable securities held in each subsequent month meets or exceeds the $1 billion threshold.

Confidentiality

According to the proposal, individual data reported on Form SLT will generally be kept confidential by Treasury, though information may be given to the Board of Governors of the Federal Reserve or other federal agencies. In addition, the proposal indicates that aggregate data derived from reports may be publicly disclosed.

Treasury is soliciting comments on its revised Form SLT and instructions, which are due by May 5, 2011.

- See a copy of the proposed Form SLT
- See a copy of the proposed instructions to Form SLT

SEC's Division of Investment Management Issues Responses to Questions Concerning Part 2 of Form ADV

On March 18, 2011, the staff of the SEC's Division of Investment Management issued responses to a number of questions concerning Part 2 of Form ADV, including Part 2A (the "**Firm Brochure**") and Part 2B (the "**Brochure Supplement**"), which was recently amended pursuant to final rules adopted by the SEC on July 20, 2010. For a summary of the SEC's amendments to Part 2 of Form ADV, please see the ***August 16, 2010 Investment Management Regulatory Update***.

The staff's responses addressed a variety of topics relating to the new Form ADV Part 2, including (i) the content of Part 2, (ii) the preparation and delivery of Firm Brochures, (iii) the delivery obligations to private fund investors and (iv) the transitional compliance dates for delivery to clients of the Firm Brochure and Brochure Supplements.

Content of Part 2

The staff made some clarifications regarding the content required to be included in the Firm Brochure and the Brochure Supplement, including as follows:

- Instruction 1 of the General Instructions for Part 2, which requires that an adviser respond to each item in Part 2 in the same order with the same heading as they appear in Part 2, does not require an adviser to include headings of sub-parts or follow the order of sub-parts within each item in Part 2. In addition, the cover page need not be identified as Item 1, Cover Page.
- Item 2 of the Firm Brochure, Material Changes, which requires a Firm Brochure to identify material changes from the previous filing, does not require an adviser to discuss material changes in its new Firm Brochure that is transitioning from the prior version of Part II of Form ADV. However, the staff advised that if the new version of the Firm Brochure contains material information, such as a new conflict of interest or new disciplinary information, that is being

provided to clients for the first time, an adviser may want to highlight the new information to clients.

- Item 8.B of the Firm Brochure, which requires an explanation of the material risks of investment strategies or methods of analysis used by the adviser, (i) requires advisers who use multiple significant investment strategies or methods of analysis to explain the risks of each such strategy or method and (ii) may be satisfied by briefly explaining the material risks of each strategy or method and referring clients to the prospectus, offering memorandum or other documentation that clients have received for more detailed information.
- Instruction 6 of the Brochure Supplement requires that each supervised person have a separate and distinct Brochure Supplement containing separate responses to each of the six items required by the Brochure Supplement, and does not permit a group brochure supplement that makes general responses for each member of the group.
- Item 2 of the Brochure Supplement, which requires advisers to state in the brochure the minimum qualifications required for each professional designation listed for the applicable supervised person of the adviser, may include a reference to the professional organization or its website for additional information on the requirements for such professional designations as long as the adviser has a reasonable basis for believing that the information provided by such professional organization is accurate and not misleading at the time the adviser delivers the Brochure Supplement.
- Item 6 of the Brochure Supplement, which requires an adviser to explain how it supervises the applicable supervised person and to provide contact information for the person supervising the supervised person's advisory activities, does not apply to services other than investment advice that the supervised person may provide to clients.

General Guidance Regarding Preparation and Delivery of Brochure Supplements

Definition of "Formulating Investment Advice"

The staff provided guidance about the general rule that an SEC-registered investment adviser must prepare a Brochure Supplement with respect to each supervised person of the investment adviser who: (i) formulates investment advice for a client and has direct client contact or (ii) has discretionary authority over a client's assets, even if the supervised person has no direct client contact.

With respect to whether a supervised person is "formulating" investment advice for purposes of the Brochure Supplement delivery requirement, the staff provided two hypothetical examples:

- If a supervised person's role is limited to entering client information into a computer program that produces an asset allocation or list of recommended securities for the client, which the supervised person cannot alter, the staff has stated that it would not view engaging in such limited activities as formulating investment advice. Under these circumstances, the investment adviser would have an obligation to disclose to its clients the respective roles of the computer program and the supervised person.
- On the other hand, if a supervised person assists a client in choosing among several investment advisers or mutual funds that are identified by a computer program or are produced as a result of the completion of an investment questionnaire, the staff *would* view this as formulating investment advice, even if the supervised person could not suggest advisers or funds not included in the list.

Team Exception

Under the general rule, if a team of more than five individuals renders the investment advice or manages client assets, the investment adviser is only required to provide Brochure Supplements for the five supervised persons with the most significant responsibility for the day-to-day advice provided to the client.

The staff stated that an adviser is not required to deliver a supplement for a supervised person who has no direct client contact and has discretionary authority over a client's assets only as part of a team. However, the staff also stated that if a client routinely interacts with a supervised person or group of supervised persons for which a Brochure Supplement is not required to be delivered, the adviser should consider disclosing to clients that these supervised person(s) are not permitted by the investment adviser to formulate any advice for the client.

The staff also confirmed that an investment adviser does not need to have discretionary authority over client assets to rely on this team delivery exception. In addition, the staff stated that it would view the supervised person who has primary client contact and who selects or recommends advisory programs for a client as one of the five supervised persons with the most significant responsibility for the day-to-day advice provided to a client.

Certain Exceptional Situations

The staff also provided guidance on the general rule that an SEC-registered investment adviser must prepare and deliver a Brochure Supplement regarding a supervised person to a client before or at such time that the supervised person begins to provide advisory services to such client. The staff stated that it would not recommend enforcement action:

- if an adviser did not prepare or deliver a Brochure Supplement for a supervised person who is providing advisory services to clients on a temporary basis (such as while the primary supervised person is on medical leave or vacation), which it defined as 30 days or less; or
- if a supervised person has taken over after the termination or resignation of another supervised person prior to the delivery of a Brochure Supplement, so long as the adviser (i) delivers a Brochure Supplement regarding the replacement supervised person within 30 days after such supervised person provides advisory services to the client and (ii) notifies clients that the supervised person previously providing advisory services to the client will no longer do so.

Delivery of Brochure Supplements

- The staff confirmed that an adviser is not required to deliver more than one Brochure Supplement to a client who participates in multiple advisory programs or who has more than one account serviced by the same supervised person.
- The staff also reiterated that, other than with respect to clients who have agreed to electronic delivery, an adviser may not satisfy the delivery requirements relating to disciplinary events under Item 3 of the Brochure Supplement through the delivery of the BrokerCheck or IPAD report.

Delivery of Form ADV Part 2 to Private Fund Investors

The staff, citing the decision in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), stated that an investment adviser could meet its Firm Brochure delivery obligations to a "hedge fund client" by delivering its Firm Brochure to a legal representative of the fund, such as the fund's general partner, manager or person serving in a similar capacity. The SEC had made a similar statement in a footnote in the July 2010 adopting release of the amendments to Form ADV Part 2. Although the staff's response only refers to "hedge fund clients" and does not make specific reference to Brochure Supplement delivery obligations, the reasoning underlying the SEC staff's answer would appear to apply to all private funds, such that a private fund could satisfy its Firm Brochure delivery obligations in the same manner. Such reasoning would also seem to apply to delivery obligations of the Brochure Supplement.

Following the SEC's recent guidance, some advisers to private funds may decide to dispense with the traditional practice of delivering Form ADV Part 2 to underlying investors in a private fund, and instead rely on the disclosure in the offering materials for such private fund to satisfy the investment adviser's disclosure requirements under Rule 206(4)-8 under the Advisers Act, which concerns disclosures made to underlying investors in pooled investment vehicles. As the staff reiterated in these responses, the Firm

Brochure of an SEC-registered investment adviser must still be filed with the SEC and made publicly available.

The staff further provided that an offshore adviser whose only clients are offshore funds is not required to file a Firm Brochure with the SEC or to deliver such Firm Brochure to any of its offshore funds or any investors in such offshore funds.

No Filing Requirement After Optional Delivery of Firm Brochure

As described in more detail in the ***August 16, 2010 Investment Management Regulatory Update*** discussing the amendments to Form ADV Part 2, an SEC-registered investment adviser is not required to deliver a Firm Brochure or a Brochure Supplement to certain clients, such as registered investment companies and business development companies. If an adviser is not required to deliver a Firm Brochure to any client, an adviser's choice to prepare and deliver a Firm Brochure to such clients would not trigger an obligation to file the Firm Brochure with the SEC.

Compliance Dates for Delivery of the Firm Brochure and Brochure Supplements

The staff discussed the compliance dates for delivery of the Firm Brochure and a Brochure Supplement to an adviser's clients.

An SEC-registered adviser must amend its Form ADV within 90 days of the end of its fiscal year to update its responses to all questions and, for its annual updating amendment for 2011, use the new Form ADV Part 2. Subject to certain exceptions, an adviser is also generally required to deliver to each of its existing clients (other than those who are exempt from the initial delivery requirement), within 120 days of the end of its fiscal year, either (i) a copy of the investment adviser's current Firm Brochure that includes a summary of material updates to the prior version or (ii) a summary of material updates made to the prior version of the Firm Brochure together with an offer to provide a copy of the current Firm Brochure.

The SEC promulgated a transitional rule on December 28, 2010 extending the compliance dates for 2011 such that an adviser is required to deliver to existing clients a Firm Brochure that meets the requirements of amended Form ADV within 60 days of when the adviser is required to file such annual updating amendment with the SEC. For example, an SEC-registered adviser with a fiscal year end of December 31, 2010 must file with the SEC an annual updating amendment to its Firm Brochure on amended Form ADV no later than March 31, 2011 and deliver such amended Firm Brochure to its clients prior to May 30, 2011 (regardless of when the annual updating amendment was actually filed with the SEC). An adviser which has registered with the SEC after January 1, 2011 must file a Firm Brochure that meets the requirements of the amended Part 2 and begin delivering its Firm Brochure to its clients and prospective clients immediately upon registering.

In general, a Brochure Supplement covering a supervised person must be delivered to a client at or before the time such supervised person begins to provide advisory services to that client. The SEC's transitional rule states that advisers that were registered with the SEC prior to January 1, 2011 and have a fiscal year ending on December 31, 2010 through April 30, 2011 will have until (i) July 31, 2011 to begin delivering Brochure Supplements to new and prospective clients and (ii) September 30, 2011 to deliver Brochure Supplements to existing clients. For an investment adviser that was registered with the SEC prior to January 1, 2011 and has a fiscal year ending after April 30, 2011, such investment adviser will need to begin providing Brochure Supplements to new and prospective clients upon filing its annual updating amendment for such fiscal year ending in 2011 (which, as discussed above, is required to be filed within 120 days after the end of such investment adviser's fiscal year), and to existing clients within 60 days of filing such annual updating amendment. Under the transitional rule, advisers registering with the SEC from January 1, 2011 through April 30, 2011 will have until (i) May 1, 2011 to begin delivering Brochure Supplements to new and prospective clients and (ii) July 1, 2011 to deliver Brochure Supplements to existing clients. Investment advisers registering after April 30, 2011 will need to deliver (with respect to existing clients) and begin delivering (with respect to new and prospective clients) Brochure Supplements immediately upon registering.

The staff plans to update its responses and to address additional questions from time to time.

- See the full staff Q&A

SEC's Division of Investment Management Answers Questions Concerning Pay-to-Play Rule

On March 22, 2011, the staff of the SEC's Division of Investment Management (the "**Staff**") issued responses to a number of frequently asked questions ("**FAQs**") regarding rule 206(4)-5 under the Investment Advisers Act of 1940 (the "**Advisers Act**"), which restricts "pay-to-play" practices by investment advisers seeking to provide investment advisory services to public pension funds and other state and local government clients (the "**Rule**").

The Rule generally (i) imposes a two-year "time out" on the receipt of compensation for the provision of investment advisory services to a government client after an adviser or its covered associates makes a political contribution to certain government entity officials; (ii) limits the use of placement agents to regulated persons (*i.e.*, registered advisers or registered broker-dealers) and (iii) bans an adviser and its covered associates from soliciting political contributions from any person to, or coordinating political action committees for, certain government entity officials. For more information on the Rule, please see the ***July 14, 2010 Investment Management Regulatory Update***.

The FAQs answer a number of common questions regarding the Rule, including the following of particular note:

- *Affiliates*. The FAQs indicate that an adviser's affiliated company and that affiliated company's personnel are not "covered associates" under the Rule (*i.e.*, they generally are not persons prohibited from making political contributions). However, an affiliated company that is paid to solicit government entities on the adviser's behalf must be a "regulated person" under the Rule (*i.e.*, a registered investment adviser or registered broker dealer).

- *Participant-Elected Members of a Board*. The FAQs note that participant-elected members of public pensions boards are considered "officials" of a government entity. Thus, if a board member of a public pension fund is "elected" by its consitutents, a political contribution made to that board member would trigger a two-year time out in the same manner as a contribution made to a publicly elected official who is able to appoint members to such a board.

- *Independent Contractors*. The FAQs indicate that independent contractors would be considered "employees" of the investment adviser. Therefore, independent contractors (*e.g.*, certain hired consultants of an adviser) will be regarded as "covered associates" subject to the limitations on political contributions under the Rule if they solicit, or supervise those who solicit, government entities on behalf of the adviser.

- *Covered Associates' Family Members*. The FAQs state that family members of advisory employees generally are not "covered associates" under the Rule. However, the FAQs note that both the Rule and Section 208(d) of the Advisers Act prohibit doing indirectly what would be prohibited if done directly.

- *Trailing Compensation for Solicitation*. The FAQs note that placement agent compensation arrangements in place for solicitation activities conducted before September 13, 2011, which is the date by which a placement agent must be a "regulated person" under the Rule in order to accept compensation from investment advisers for solicitation activities relating to such government entity clients, are permitted to have trailing payments that continue after the compliance date, even if such placement agent is not a "regulated person," so long as the placement agent does not solicit the government entity client after the compliance date. The FAQs warn, however, that "solicitation" is broadly defined and would include communications to retain a client for the adviser.

- *Reliance on MSRB Interpretations*. The FAQs note that interpretations under MSRB Rule G-37 (which governs pay-to-play practices in connection with municipal securities) are not authoritative, but may be "useful to consider" if the interpretations directly address an issue that the SEC has not addressed.

  - See a copy of the FAQs

SEC to Bring Cases Against Mutual Funds for Inappropriate Fees

Plans are underway at the SEC's Division of Enforcement to bring cases against mutual funds that pay inappropriate advisory and service fees, says Robert Kaplan, co-chair of the SEC's Division of Asset Management. According to remarks made by Kaplan at a recent Practicing Law Institute event, cases against mutual funds with inappropriate fees could be expected sometime this year. According to Kaplan, the cases would likely be brought under Section 15(c) of the Investment Company Act, which governs the process by which mutual funds approve advisory contracts and fees.

Previously, on September 22, 2010, the head of the SEC's Enforcement Division, Robert Khuzami, announced that the Asset Management Unit had established a Mutual Fund Fee Initiative (the "**Initiative**") designed to examine whether mutual fund advisers charge excessive fees. When announcing the establishment of the Initiative, Khuzami stated that examination of adviser fees would be executed through the development of analytics to identify fees considered excessive by the Commission. Khuzami noted that these analytics would likely lead to examinations and investigations of mutual fund advisers and their boards of directors regarding their duties under the Investment Company Act of 1940. According to Kaplan, the SEC's asset management unit began a review of investment firms' advisory and service fees last year. Additionally, Kaplan stated, members of the SEC's enforcement staff met with industry representatives last November and the Division of Asset Management has been working to develop mechanisms to identify inappropriate fees in fund contracts. For more information on the Initiative, please see the ***October 12, 2010 Investment Management Regulatory Update***.

Litigation

SEC Charges Hedge Fund Manager with Securities Fraud for Misappropriating "Side Pocketed" Assets

On March 1, 2011, the SEC charged Lawrence R. Goldfarb, a hedge fund manager, and his company, Baystar Capital Management, LLC ("**BCM**"), with misappropriating the proceeds from one of their fund's "side pocket" investments. Side pocket investments are those which are considered illiquid compared to the other investments of a fund and are often accounted for separately from the rest of a fund's portfolio. According to the SEC, Goldfarb and BCM clandestinely diverted approximately $12 million in cash that should have been returned to investors of the fund to other entities Goldfarb owned and controlled and used the cash for other business ventures and personal expenses. Moreover, Goldfarb and BCM, the SEC alleged, concealed their fraud by intentionally distributing false and misleading account statements and written updates to investors, which allegedly misinformed investors about the profitability of their investment and failed to disclose the misuse of proceeds.

In approximately 2003, according to the SEC, Goldfarb formed Baystar Capital II, L.P. ("**Baystar II**"), a hedge fund that invested in a variety of public and private companies. BCM served as Baystar II's general partner and investment adviser with Goldfarb as the sole managing member of BCM, the SEC alleged. Baystar II's partnership agreement contained provisions relating to side-pocket investments, according to the SEC, which required the fund to allocate any gains or losses pertaining to side-pocket investments to investors' capital accounts. Furthermore, the SEC indicated that Baystar II's partnership agreement and offering memorandum did not contain any disclosures about the fund's ability to enter into related party transactions.

That same year, Baystar II allegedly made an investment in a real estate fund called Island Fund and placed the Island Fund investment in a side pocket. According to the SEC's allegations, Island Fund began making cash distributions to Baystar II in 2004, but in early 2007 Goldfarb directed Island Fund to make such distributions to IFI Capital, LLC ("**IFI**"), a Delaware entity of which Goldfarb was the sole member (and whose registration Goldfarb had cancelled with the State of Delaware a few months prior). The SEC alleged that Goldfarb did not disclose to Baystar II's investors that he had transferred the Island Fund distributions from Baystar II to IFI until August 2010, nor did he disclose that the distributions were transferred to an entity he solely owned and controlled and that no longer validly existed. According to the SEC, Goldfarb used at least a portion of the diverted proceeds for personal purposes, such as funding for a record company, rather than paying the fund's investors.

In addition to failing to disclose this misappropriation of a side-pocket investment, Goldfarb actively instructed Baystar II's third-party administrator to remove references to Island Fund distributions in statements sent to Baystar II's investors and also directed the administrator not to increase the value of the Island Fund side pocket to reflect distributions in such investor statements, the SEC alleged. Furthermore, Goldfarb allegedly directed his employees to provide investors with false and misleading communications and financial statements.

The SEC charged Goldfarb and BCM with violating anti-fraud provisions of Sections 206(1), (2) and (4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder. Goldfarb agreed to pay disgorgement of $12,112,416 and prejudgment interest of $1,967,371, which, according to the settlement, will be distributed to Baystar II's investors. Goldfarb also agreed to pay a $130,000 penalty and to a bar from association with an investment adviser or broker-dealer for five years.

- See a copy of the SEC Complaint
- See a copy of the SEC's Press Release
- See a copy of the SEC's Litigation Release

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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