INVESTMENT ADVISER ASSOCIATION

January 3, 2011

Issue Number 217

NEWSLETTER

SEC Proposes Substantial Amendments to Form ADV Part 1

On November 19, the SEC adopted proposed rules to implement provisions in Title IV of the Dodd-Frank Act that amend the Advisers Act. A significant part of the proposal includes substantial amendments to Part 1 of Form ADV. The amendments are intended to enable the SEC to enhance its oversight of investment advisers by improving the data collected from advisers.

The provisions in Title IV of the Dodd-Frank Act were designed to strengthen the SEC's oversight of investment advisers and fill key gaps in the scope of its regulation. Specifically, the proposed rules would introduce more narrow exemptions from registration with the SEC for advisers to private funds, increase the asset threshold for advisers required to register with the SEC, and transfer regulatory responsibility for smaller investment advisers to state securities authorities. The result of the proposed rules would shift about 4,100 advisers from SEC regulation to state regulation and would require an estimated 1,000 private fund advisers to register with the SEC.

> *"We are carefully reviewing the proposal in order to evaluate the feasibility and utility of providing the information requested and we urge all members to contact us with any questions or concerns."*
>
> *— Valerie Baruch, Associate General Counsel of the IAA*

The proposed amendments to Part 1 of Form ADV would affect all advisers and would impact an adviser's calculation of assets under management for purposes of SEC registration. In addition, the proposed rules would require advisers to provide the SEC with additional information about three areas of their operations: (1) the private funds they advise; (2) their advisory business and business practices that may present significant conflicts of interest; and (3) their non-advisory activities and financial industry affiliations. The proposal also includes several Form ADV amendments unrelated to the Dodd-Frank Act and other technical amendments to Form ADV.

"We support the SEC's efforts to enhance the investment adviser examination program by improving the data collected from investment advisers," said Valerie Baruch, Associate General Counsel of the IAA. "We are carefully reviewing the proposal in order to evaluate the feasibility and utility of providing the information requested and we urge all members to contact us with any questions or concerns."

Comments on the proposed rule are due January 24, 2011. Please contact Valerie Baruch or other members of the IAA legal staff if you have any comments on the proposal. Please see the related article for a more detailed overview of the proposed rules. ■

Overview of SEC's Proposed Amendments to Part 1 of Form ADV

The following is a detailed overview of the proposed amendments to Part 1 of Form ADV:

1. Regulatory Assets Under Management: Instruction to Item 5.F.

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 current instructions to Form ADV provide advisers with guidance with respect to the calculation of assets under management by including a list of certain types of assets that advisers may, but are not required to, include in their calculation, such as proprietary assets, assets an adviser manages without compensation, and assets of foreign clients. The SEC proposes to amend the instructions to Item 5.F. of Form ADV in order to create a new defined term "regulatory assets under management" (Regulatory AUM) and to implement a uniform method to calculate assets under management.

Specifically, advisers would be required to include in their Regulatory AUM securities portfolios for which they provide continuous and regular supervisory management services, regardless of whether those assets are proprietary assets, assets managed without receiving compensation, or assets of foreign clients. In addition, advisers would not be permitted to deduct from their Regulatory AUM accrued fees, expenses, or any borrowings that remain in a client's account.

The proposal also provides guidance to advisers with respect to how to count assets managed through private funds. An adviser to a private fund would be required to include as part of its Regulatory AUM: (1) the value of any private fund over which it exercises continuous and regular supervisory or management services, regardless of the nature of the assets held by the fund; and (2) the amount of any uncalled capital commitments made to the fund. In addition, advisers would be required to use the fair value of private fund assets, including illiquid securities. In the proposal, the SEC indicated that if a private fund's governing documents provide for a specific process for calculating fair value (*e.g.,* that the general partner rather than the board of directors, determines the fair value of the fund's assets), then the adviser would be able to rely on that process for calculating Regulatory AUM.

The new method of calculating Regulatory AUM would apply to the determination of eligibility for SEC registration, as well as for reporting assets under management on Part 1 of Form ADV, and for the new exemptions for private fund advisers and foreign private advisers set forth in the Dodd-Frank Act. Furthermore, proposed Rule 203A-5 of the Advisers Act would require each investment adviser registered with the SEC on July 21, 2011, to file an amendment to Form ADV by August 20, 2011, to report the market value of its Regulatory AUM, as determined within 30 days of the filing. The purpose of this one-time filing is to determine eligibility to remain registered with the SEC.

2. Private Fund Reporting: Item 7.B. and Schedule D

The SEC proposes to expand the information that it requires advisers to provide about the private funds they advise. According to the SEC, the additional information, which would be provided in response to Item 7.B. and Schedule D, would enable the SEC to have a more complete understanding of the private funds advised by advisers and would permit the SEC to enhance its assessment of private fund advisers for purposes of targeting examinations.

An adviser would be required to provide information about each of its private funds regardless of the fund's form of organization. Advisers, however, would not be required to provide information about funds that are advised by affiliates. Furthermore, to avoid multiple reporting, sub-advisers would be permitted to exclude private funds already reported by another adviser, and advisers sponsoring a master-feeder arrangement would be permitted to submit a single Schedule D for the master fund and all of the feeder funds that would be submitting substantially identical data. In addition, advisers with a principal office and place of business outside of the U.S. would not be required to submit a Schedule D for a private fund that is not organized in the U.S. and is not offered to, or owned by U.S. persons.

Information About Private Funds: Advisers would be required to provide expanded information in a new Section 7.B.1, which is intended to provide the SEC with basic organizational, operational, and investment characteristics of the private fund; the amount of assets held by the private fund; the nature of investors in the fund; and the fund's service providers. The information is expected to help the SEC identify potential compliance risks and help guide the SEC's regulatory activities. The following information would be required:

- Identifying information, including: the name of the private fund or its

Continued on page 4

continued from page 3

identification code (for advisers seeking to preserve the anonymity of a fund); where the fund is organized; the fund's general partner, manager, trustee or directors (or persons serving in a similar capacity); the applicable Investment Company Act exclusion; the name of each foreign financial regulatory authority with which the fund is registered; and whether the fund is part of a master-feeder fund arrangement;

- Whether the fund is a fund of funds (if the fund invests 10% or more of its total assets in other pooled investment vehicles, whether or not they are also private funds or registered investment companies);
- The fund's classification (*i.e.* whether the fund is a hedge fund, liquidity fund, private equity fund, real estate fund, securitized asset fund, venture capital fund, or other private fund);
- The fund's gross and net asset values, a summary of the current value of the fund's investments broken down by asset and liability class and categorized in the fair value hierarchy of GAAP;
- The fund's minimum investment commitment;
- Fund ownership information, including, the number of beneficial owners of the fund and the percentage of ownership of the fund by different groups of investors; and
- Whether clients are solicited to invest in the fund and the percentage of the adviser's clients that have invested in the fund.

Information About Service Providers to Private Funds. According to the SEC, the information sought regarding service providers is generally designed to improve the SEC's ability to assess conflicts and potential risks, identify funds with service provider arrangements that raise a "red flag," and identify firms for examination. Advisers would be required to report information concerning five types of service providers that the SEC identifies as generally performing a "gatekeeper" role for private funds: auditors, prime brokers, custodians, administrators, and marketers. In addition to identifying each of those service providers, the adviser would be required to identify their location, state whether they are related persons, and provide specific information intended to clarify the services provided, and other identifying information, such as registration status. Advisers also would be required to provide the following information:

- For an auditor, whether it is independent, registered with and subject to inspection by the PCAOB, and whether audited financial statements are distributed to investors;
- For a prime broker, whether it is SEC-registered and whether it acts as a custodian for the fund;
- For a custodian, whether it is a related person of the adviser;
- For an administrator, whether it prepares and sends account statements to investors, and what percentage of the fund's assets are valued by the administrator or another person that is not a related person of the adviser;
- For marketers, whether they are related persons of the adviser, their SEC file number, and the address of any website they use to market the fund.

3. Additional Disclosure About the Adviser and its Advisory Business: Item 5

Item 5 requires an adviser to provide basic information about its business in order to enable the SEC to identify the scope of the adviser's business, the types of services it provides, and the types of clients to whom it provides those services. It requires information about the adviser's employees, the amount of assets it manages, the number and types of clients, and its advisory services. According to the SEC, the proposed amendments primarily refine or expand information currently sought in Form ADV.

Employees. Item 5.A. currently asks for the total number of the adviser's non-clerical employees (in ranges) and 5.B. asks for the number of those employees (in ranges) that perform advisory functions or are registered representatives of a broker-dealer. As proposed, Item 5 would be expanded to also require the adviser to identify the number of its employees that are registered as investment adviser representatives or insurance agents. In addition, advisers would be required to provide the approximate number of such employees (instead of checking the box to reflect a range of the number of employees).

Clients. Items 5.C. and D. currently require an adviser to report how many clients it has (in ranges) and to identify the types of clients (*e.g.* high net worth individuals, investment companies). The proposal expands the list of types of clients provided in Item 5.D. to include business development companies, insurance companies, and other investment advisers, as well as to distinguish pension and profit sharing plans subject to ERISA from those that are not subject to ERISA. The proposal also requires an adviser to indicate the approximate amount of its Regulatory AUM attributable to each type of client. In addition, advisers would be required to report in Item 5.C. the percentage of their clients that are non-U.S. persons.

Advisory Activities. Item 5.G. currently requires an adviser to identify (from a list) the types of advisory services that it provides. The list would be expanded to include portfolio management for pooled investment vehicles, other than registered investment companies, and educational seminars or workshops. An adviser also would be required to provide the SEC with the file number for a registered investment company if it checks the box for portfolio management for an investment company. In addition, new Item 5.J. would require an adviser to identify (from a list)

Continued on page 5

the types of investments that it provided advice about during the reporting period.

4. Additional Disclosure About the Adviser's Non-Advisory Activities and Financial Industry Affiliations: Items 6 and 7

Items 6 and 7 require an adviser to report (from a list) the financial services the adviser or a related person provides. Under the proposal, the lists in Items 6 and 7 would be expanded to so that an adviser also would be required to report if the adviser or a related person provides services as a trust company, registered municipal advisor, registered security-based swap dealer, major security-based swap participant, or as an accountant or lawyer.

Other Business Names. An adviser that indicates that it is engaged in other financial services business under a different name would be required to list that other business name and identify the other lines of business that it engages in using that name.

Adviser's Related Persons. Section 7.A. of Schedule D currently requires advisers to provide identifying information for related persons that are investment advisers or broker-dealers. Under the proposal, advisers would be required to provide this same identifying information for all related persons listed in Section 7.A. In addition, the information requested would be expanded to include more details about the relationship between the adviser and the related person, whether the related person is registered with a foreign financial regulatory authority, and whether the adviser and the related person share any related person that is an access person. This section also would include a question currently under Section 9 that requires reporting of whether a related person bank or futures commission merchant is a qualified custodian for client assets under the custody rule, and to ask, if the adviser is reporting a related person investment adviser, whether the related person is exempt from registration.

5. Participation in Client Transactions: Item 8

Item 8 requires an adviser to report information about its transactions with clients, including whether the adviser or a related person engages in transactions with clients as a principal, sells securities to clients, or has discretionary authority over client assets. An adviser is also required to indicate if it has discretionary authority to determine the brokers for client transactions and if it recommends brokers or dealers to clients.

Under the proposal, an adviser also would be required to indicate whether those brokers or dealers are related persons of the adviser. An adviser that indicates that it receives "soft dollar benefits" also would report whether all of those benefits qualify for the safe harbor as eligible research or brokerage services. In addition, an adviser would be required to indicate whether it or its related person receives direct or indirect compensation for client referrals.

6. Other Form ADV Amendments

Advisers With $1 Billion in Assets. Under the proposal, an adviser would be required to indicate in Item 1 whether it had total assets (as opposed to assets under management) of $1 billion or more as of the last day of its most recent fiscal year. The SEC indicated that it intends to use this information to identify advisers that would be subject to Section 956 of the Dodd-Frank Act, which requires the SEC to adopt rules or guidelines addressing certain excessive incentive-based compensation arrangements, including those of investment advisers with $1 billion or more in assets.

Amendments Unrelated to Dodd-Frank. The proposal includes several amendments to Form ADV that are unrelated to the Dodd-Frank Act and that are intended to improve the SEC's ability to assess compliance risk. These amendments include requirements for an adviser to: (1) provide contact information for its chief compliance officer (advisers would also have the option of providing an additional regulatory contact for Form ADV, and the contact information provided would not be listed publicly on the SEC's website); (2) indicate whether it or any of its control persons is a public company under the Exchange Act; and (3) indicate in Item 9 the total number of persons that act as qualified custodians for the adviser's clients in connection with advisory services provided by the adviser. The proposal also includes technical amendments to Form ADV pertaining to the reporting of disciplinary events.

The release is available at http://www.sec.gov/rules/proposed/2010/ia-3110.pdf. The text of the amendments to Part 1 of Form ADV can be found at http://www.sec.gov/rules/proposed.shtml. Comments on the proposal are due on January 24, 2011. If you have any comments on the proposal, please contact Valerie Baruch, valerie.baruch@investmentadviser.org, or any member of the IAA legal staff at (202) 293-4222. ■

SEC Proposes New Exemptions from Registration

On November 19, the SEC proposed rules that would implement the Dodd-Frank Act's new exemptions from the registration requirements of the Advisers Act for advisers to certain private funds and foreign advisers. The full text of the rule proposal is available at: http://www.sec.gov/rules/proposed/2010/ia-3111.pdf. Comments on the proposed rules are due to the SEC on January 24, 2011.

The Dodd-Frank Act's amendments to the Advisers Act repeal the current exemptions from registration in section 203(b)(3) for advisers to private funds, and introduce three more limited exemptions. These exemptions apply to: (1) advisers solely to private funds with less than $150 million in assets under management in the United States; (2) foreign private advisers with less than $25 million in aggregate assets under management from U.S. clients and private fund investors and who have fewer than 15 such clients and investors; and (3) advisers solely to venture capital funds. The SEC proposed rules to implement these new exemptions.

Section 203(m) of the Advisers Act directs the SEC to provide an exemption from registration for any investment adviser that advises solely private funds if the adviser has assets under management in the United States of less than $150 million. Under corresponding proposed rule 203(m)-1, a U.S. adviser would be exempt from registration if the adviser acts solely as an investment adviser to private funds and all of the private fund assets the adviser manages amount to less than $150 million. A non-U.S. adviser would be exempt only if all of the adviser's clients that are United States persons are qualifying private funds, and all assets managed by the adviser from a place of business in the United States are solely attributable to private fund assets, the total value of which is less than $150 million. The exemption would, in effect, be broader for non-U.S. advisers than for U.S. advisers.

The SEC proposes to define a "United States person" generally by incorporating the definition of a "U.S. person" in Regulation S. Proposed rule 203(m)-1 contains a special rule for discretionary accounts maintained outside of the United States for the benefit of United States persons, requiring that an adviser must treat such an account as a United States person if the account is held for the benefit of a United States person by a non-U.S. fiduciary who is a related person of the adviser.

The proposed rule also provides that the value of private fund assets for all advisers should be calculated by reference to "regulatory assets under management" in Form ADV, a new method of calculation proposed in a corresponding release issued on the same date regarding other Advisers Act amendments. Each adviser would need to determine the amount of its private fund assets quarterly, based on fair value, but would need only to report on Form ADV its regulatory assets under management annually.

The second exemption would amend section 203(b)(3) to provide a limited exemption for certain foreign private advisers. Section 202(a)(30) of the Advisers Act defines "foreign private adviser" as an investment adviser with less than $25 million in aggregate assets under management from clients and private fund investors in the United States and fewer than 15 such clients and investors.

Corresponding proposed rule 202(a)(30)-1 defines "in the United States" by incorporating the definition of a "U.S. person" and "United States" under Regulation S as incorporated into proposed rule 203(m)-1, with similar treatment of certain discretionary accounts. The proposed rule also specifies that a person "in the United States" may be excluded from the calculation of clients and investors if such person was not "in the United States" at the time of becoming a client or at the time the person as an investor acquired the fund's securities.

For the purpose of counting clients and investors, proposed rule 202(a)(30)-1 includes many of the safe harbor rules that are in effect currently under rule 203(b)(3)-1, but requires advisers to count clients from which they receive no compensation. It also includes a provision that would eliminate double-counting private funds and their investors. The proposed rule defines "investor" as any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Investment Company Act, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of that Act. Additionally, the definition of investors also includes beneficial owners who are "knowledgeable employees" and beneficial owners of short-term paper issued by the private fund. Finally, the SEC proposes to require that advisers "look through" nominee or similar arrangements to the underlying holders of private fund-issued securities.

Section 203(l) of the Advisers Act provides that an investment adviser that advises solely venture capital funds is exempt from registration under the Advisers Act. Proposed rule 203(l)-1 defines a "venture capital fund" as a private fund that owns solely equity securities of qualifying portfolio companies; directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company; does not borrow or otherwise incur leverage; does not offer its investors redemption or other liquidity rights except in extraordinary circumstances; represents itself as a venture capital fund to investors; and is not registered under the Investment Company Act and has not elected to be treated as a business development company. The proposed rule also includes a grandfather provision for certain private funds that sell securities prior to December 31, 2010, and do not sell securities after July 21, 2011. ■

President Obama Signs Act Narrowing the Scope of the Red Flags Rule

On December 18, President Obama signed into law the Red Flag Program Clarification Act of 2010. Congress passed on December 7 a bill amending the Fair Credit Reporting Act to clarify the definition of "creditor" under the Red Flags Rule. The Federal Trade Commission (FTC) has adopted rules that can affect investment advisers in that the SEC has no rulemaking authority for Red Flags Rules. The rule applies to creditors and certain financial institutions. The FTC's prior interpretation of "creditor" was very broad, covering various types of payment plans, potentially including billing in arrears. Thus, the rule would have required many doctors, lawyers, accountants, and other small businesses to implement Red Flags identity theft prevention programs by December 31, 2010.

The new definition limits the Red Flags Rule only to "creditors" who (1) use consumer reports in connection with credit transactions, (2) furnish information to consumer reporting agencies in connection with a transaction, or (3) advance funds to or on behalf of a person. The definition expressly excludes creditors who advance funds on behalf of a person for expenses incidental to a service provided by the creditor to that person. However, the bill provides that if the FTC determines that a particular industry presents a reasonably foreseeable risk of identity theft, it has the authority to expand the definition through rulemaking. The IAA will monitor any developments in this area.

Although the Act clarified that investment advisers are not subject to the rule simply by virtue of billing in arrears, investment advisers still need to analyze the rule to determine whether they are covered under other provisions. ■

Custody Rule Developments: SEC Issues New FAQs

On December 2, the staff of the Division of Investment Management updated its responses to questions about the amended custody rule (FAQs). The responses were last updated in September. The updated responses are available at http://www.sec.gov/divisions/investment/custody_faq_030510.htm.

The three new FAQs provide additional information about Form ADV-E and accountant oversight of adviser recordkeeping under the rule for advisers that are subject to the surprise exam. FAQ IV.5 clarifies the accounting guidance, which states that the accountant's surprise exam report must include an opinion as to whether the adviser had been complying with Rule 204-2(b) (the recordkeeping requirements pertaining to the custody rule) since the prior examination date. Specifically, the FAQ indicates that when an adviser becomes subject to the surprise exam requirement for the first time, the accountant's report should address the adviser's compliance with Rule 204-2(b) for the time period "beginning no later than the date the adviser became subject to the [exam] requirement" through the date of the surprise exam.

FAQ IV.6.A clarifies that Form ADV-E and the accountant's surprise exam report must be filed electronically through the IARD by the independent public accountant performing the surprise exam. FAQ IV.6.B addresses the process for filing ADV-E and the surprise exam report. First, the adviser must submit to the IARD a Form ADV-E that identifies the accountant who will be performing the surprise exam. Then, after receiving an e-mail from the IARD providing a unique secure link, the accountant will be able to upload the surprise exam report to the IARD.

FAQ XI.1 was updated to reflect the amended requirements set forth in Part 2 of Form ADV regarding balance sheets. Specifically, it indicates that Item 18 of Form ADV Part 2 requires an SEC-registered investment adviser that receives prepayment of fees exceeding $1,200 per client and six or more months in advance to include an audited balance sheet in its brochure to clients from whom the adviser has received such prepayments.

If you have any questions about the SEC's or the IAA's FAQs, or the amended rule, please contact Valerie Baruch or any member of the IAA legal team at (202) 293-4222. ■

SEC Proposes Amendments to Pay to Play Rule

Limits Third-Party Solicitors to Registered Municipal Advisors Instead of Broker-Dealers or Advisers

On November 19, 2010, the SEC proposed to amend Investment Advisers Act Rule 206(4)-5, Political Contributions for Certain Investment Advisers, in light of a new category of SEC registrants called "municipal advisors" created under Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The proposed pay to play rule amendment will prohibit advisers from paying an affiliated broker-dealer or other affiliated or unaffiliated entity for soliciting government entities for the adviser if the solicitor is not registered with the SEC and Municipal Securities Rulemaking Board (MSRB) as a "municipal advisor." The three proposed amendments are as follows:

(1) Permissible Third-Party Solicitors: Municipal Advisors Instead of Broker-Dealers and Advisers. The SEC proposed to amend the provision in Rule 206(4)-5(a)(2)(i) that currently would permit advisers to pay third-party persons (*e.g.,* affiliated or unaffiliated broker-dealers, solicitors, placement agents, *etc.*) to solicit government entities only if such persons are "regulated persons." "Regulated persons" is currently defined in the pay to play rule to include SEC-registered investment advisers, or broker-dealers subject to what had been an expected FINRA rule that would have restricted its broker-dealer members from engaging in pay to play activities. Under the proposed amendments, however, the SEC would not permit advisers to pay any third-party to solicit government entities unless the person is a "regulated municipal advisor" registered under Section 15B of the Securities Exchange Act of 1934 and subject to pay to play rules of the MSRB that are equally or more stringent than the Advisers Act pay to play rule.

In the proposal, the SEC states that it expects broker-dealer solicitors to be subject to the MSRB's pay to play rules and therefore it is unnecessary for FINRA to adopt pay to play rules. The MSRB has announced that it intends to have in place pay to play rules for municipal advisors similar to Rule G-37 for municipal securities dealers before the current September 11, 2011 compliance deadline for the Advisers Act pay to play rule.

Municipal Advisor Definition and Exclusion for Affiliated Solicitors. A "municipal advisor" is defined in Section 975(e) of the Dodd-Frank Act as "a person (who is not a municipal entity or an employee of a municipal entity) that – (i) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues; or (ii) undertakes a solicitation of a municipal entity."

An adviser's affiliated solicitor or placement agent (affiliated broker-dealer, affiliated investment adviser, or affiliated bank) may be exempt from the municipal advisor definition under the definition of "solicitation of a municipal entity." The term "solicitation of a municipal entity or obligated person" under Section 975(e)(9) of the Dodd-Frank Act means a "direct or indirect communication" with a municipal entity by a person for direct or indirect compensation on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser that *does not control, is not controlled by,* or is not under common control with the person undertaking such solicitation for the purpose of retaining or engaging an engagement by a municipal entity for or in connection with municipal financial products, the issuance of municipal securities, or of an investment adviser to provide advisory services to or on behalf of a municipal entity. Therefore, a solicitation by a broker-dealer on behalf of an affiliated investment adviser appears to be excluded from the definition of "solicitation of a municipal entity," and therefore, the affiliated broker-dealer would be excluded from the definition of "municipal advisor" under the second prong of the definition. As a result, if an adviser's affiliate only solicits for the adviser, it will not be a "municipal advisor" and the adviser will not be able to pay the affiliate to solicit government entity clients on its behalf.

The SEC acknowledges that the proposed amendment results in prohibiting advisers from paying affiliated solicitors that are not registered as municipal advisors. The SEC requests comment on: (i) whether its proposal results in Rule 206(4)-5's solicitation limitations applying to certain solicitors affiliated with an investment adviser; (ii) whether the SEC should amend Rule 206(4)-5 expressly to allow advisers to pay these investment adviser-affiliated solicitors; (iii) whether the SEC should amend Rule 206(4)-5 to provide that any person that controls, is controlled by, or is under common control with an investment adviser (and, if that person is an entity, its personnel) would be deemed to be a *"covered associate"* of the investment adviser if the adviser pays or agrees to pay such person (or such personnel) to solicit a government entity on its behalf; and (iv) its cost-benefit analysis that changing from regulated persons (broker-dealers and investment advisers) to regulated municipal advisors as permissible third-party solicitors "may

Continued on page 9

continued from page 8

result in limited additional costs to comply" with the rule and that the change "would allow [advisers] greater latitude in hiring placement agents."

The SEC retained the exception in Rule 206(4)-5(a)(2) that permits advisers to pay an "executive officer, general partner, managing member (or, in each case, a person with similar status or function), or employee of the investment adviser" to solicit government entities.

(2) Covered Associate Definition. The SEC also proposed to amend the definition of "covered associate" to clarify that a legal entity, in addition to a natural person, that is a general partner or managing member of an adviser is a covered associate. Specifically, the definition of covered associate in Rule 206(4)-5(f)(2) is amended from "any general partner, managing member or executive officer, or other individual with a similar status or function" to a "any general partner, managing member or executive officer, or other person with a similar status or function." As a result of this "clarification" by the SEC, any PAC controlled by an adviser's general partner or managing member that is a legal entity (as well as controlled by the adviser or any other covered associate) is also a covered associate under the rule.

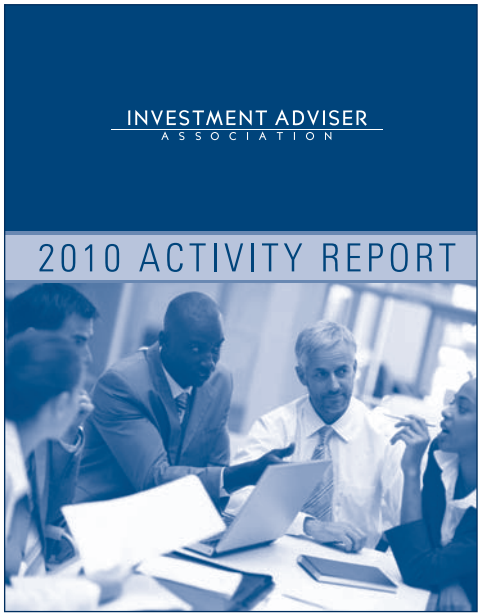
(3) Application to Federally Exempt Advisers. The SEC also proposed to amend the scope of the rule to apply all "exempt reporting advisers" defined in proposed Rule 204-4(a), including venture capital fund advisers under Advisers Act Section 203(l) and exempt private fund advisers under Advisers Act Section 203(m). The rule currently applies to SEC-registered advisers and advisers relying on the current private adviser exemption contained in Section 203(b)(3). The SEC clarified that the rule continues to apply to the same advisers it intended when the rule was adopted (including also new foreign private advisers relying on amended Section 203(b)(3)).

The SEC's release proposing the pay to play rule amendments, *Rules Implementing Amendments to the Investment Advisers Act of 1940,* SEC Rel. IA-3110 (Nov. 19, 2010), is available at: http://www.sec.gov/rules/proposed/2010/ia-3110.pdf. Comments on the proposed amendments are due to the SEC by January 24, 2011. Please contact Monique Botkin, IAA Assistant General Counsel, at (202) 293-4222 or monique.botkin@investmentadviser.org with any questions or comments about the proposed amendments. ■

IAA 2010 Activity Report

Included with this month's *IAA Newsletter* is the *2010 IAA Activity Report.* The report can also be accessed on the IAA web site under "Publications/News" and "Reports & Brochures." The report describes the many accomplishments and activities of the Investment Adviser Association during 2010.

The Board of Governors notes in the report that 2010 was a productive and challenging year for the IAA. The Association continued its active involvement in representing the interests of the investment advisory profession during the enactment of the Dodd-Frank Act. The hours of hard work of many IAA volunteers and dedicated IAA staff provided valuable and quality services in the three primary categories addressed in the annual report: advocacy, compliance, and education.



In 2011 and beyond, the IAA's role in representing investment advisers' interests will be critical. Many important issues will arise in the implementation of the Dodd-Frank Act. Further legislative and regulatory actions may have profound consequences for the investment advisory community that underscores the need to support the work of the IAA to ensure that advisers' views on relevant issues are heard and understood.

The IAA truly appreciates all members continued support of the IAA and looks forward to working with all members as together we strive to build on the IAA's proud record of serving its membership.

You are encouraged to read the *2010 IAA Activity Report* and to provide any comments, suggestions, or feedback to the IAA at (202) 293-4222 or iaaservices@investmentadviser.org. ■

INTERNATIONAL DEVELOPMENTS

FSA Issues Final Revisions to Remuneration Code

On December 17, the UK's Financial Services Authority (FSA) revised its Remuneration Code as mandated by the EU's Capital Requirements Directive (CRD3). The updated Code significantly expands application of the FSA's remuneration policies and, for the first time, covers investment firms subject to the Capital Adequacy Directive, which in the UK includes all UCITS investment firms, most hedge fund managers, firms engaged in venture capital, and firms providing financial advice. The FSA's final rules provide more guidance on the proportionality approach and for a transitional implementation period, which will soften the impact of these new rules and procedures for "lower risk" firms.

Through its proportionality approach, the FSA gave some comfort to entities whose activities generally have a lesser impact on systemic risk. This approach entails application of the remuneration principles to firms in a manner that is in line with firm size, organization, and activities. In the final rules, the FSA created a four-tiered hierarchy of firms with credit institutions and broker dealers engaging in significant proprietary trading or investment banking activities at one end (in Tiers 1 and 2) and firms generating income from agency business without putting their own balance sheets at risk at the other (in Tier 4). The firms in the lower tiers (Tiers 3 and 4), which include many investment advisers, were given relief from the new guidelines in several key areas. Specifically, these firms will not be expected to apply rules requiring a UK-based remuneration committee, deferral (the delayed payment of variable remuneration), or paying a certain proportion of variable remuneration in shares. Other rules may be relaxed to varying degrees in specific instances at the FSA's discretion. Moreover, for firms brought under the Remuneration Code's purview for the first time by the new rules, transitional guidance provided by the FSA allows these firms until July 1, 2011, to become fully compliant with the new provisions of the Code rather than January 1, 2011 (the date on which the revised Code becomes effective). Rules requiring disclosure of remuneration policies and pay-outs were published concurrently with the Code revisions. These rules will require annual disclosure of remuneration policies, with the first such disclosures required by December 31, 2011. These requirements will also be applied proportionally according to the four-tier system described above.

Lastly, in the final rules, the FSA clarified several additional issues with respect to the Remuneration Code. Following the guidance published by the Committee of European Banking Supervisors, the FSA stated that at least 50% of variable pay and benefits should consist of shares and that this requirement would be applied equally to both the deferred and undeferred portions. In addition, the FSA noted that variable remuneration paid in shares should be subject to an appropriate retention period and that

Continued on page 11

continued from page 10

guaranteed bonus provisions should be applied firm-wide and not just to staff who have a material impact on the firm's risk profile (so-called "Code Staff").

If you have any questions regarding these developments, please contact the IAA Legal Staff. For more information, *see Financial Services Authority, Revising the Rumuneration Code, PS10/20* (Dec. 2010), *available at* http://www.fsa.gov.uk/pubs/policy/ps10_20.pdf; *Financial Services Authority, Implementing CRD3 Requirements on the Disclosure of Remuneration, PS10/21* (Dec. 2010), *available at* http://www.fsa.gov.uk/pubs/policy/ps10_21.pdf; Press Release, Financial Services Authority, *FSA Publishes Revised Remuneration Code* (Dec. 17, 2010), *available at* http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/180.shtml. ■

DID YOU KNOW?

Organization Information Page is Available on Your "My Profile" Page

The "Organization Information" page is now available to all employees listed in each firm's record. Employees may find this information by logging into the "My Profile" section located in the Members Only area of the Investment Adviser Association web site (www.investmentadviser.org).

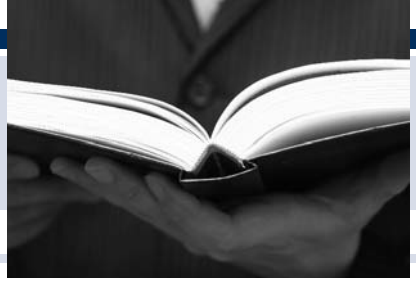
The data listed on the "Organization Information" page includes your firm's public listing information, your firm's primary contacts, your firm's assets under management, and a listing of your firm's employees currently receiving member benefits. Please note that you may add or remove individuals from your firm's record at any time and there is no limit to how many employees may receive member benefits.

If you have questions about updating your organization's information or other member services related items, please contact Garrett Honea at garrett.honea@investmentadviser.org or Megan Olson at megan.olson@investmentadviser.org. We look forward to working with each of you in 2011! ■

Kathy Ireland Joins IAA Legal Team

The IAA is pleased to announce that Kathy Ireland has joined the IAA legal team as Associate General Counsel. Kathy joins the IAA with substantial experience providing counsel regarding pension and securities issues relevant to the investment management industry. She spent seven years in private practice at Gibson, Dunn & Crutcher as associate and of counsel advising clients on labor and pension matters under ERISA and other laws. Kathy served as Associate Counsel and then Senior Associate Counsel at the Investment Company Institute for 12 years representing the mutual fund industry in regulatory matters before the Department of Labor, the IRS, and the SEC. She also worked as an attorney in the Division of Investment Management at the SEC. More recently, Kathy has acted as an independent consultant focusing on pension and securities issues for clients, including the IAA. Ms. Ireland is a graduate of the Marshall-Wythe School of Law, College of William & Mary and received her LL.M from the George Washington University National Law Center.

"Kathy's expertise will significantly enhance the IAA's advocacy and compliance capabilities with respect to ERISA and pension matters on behalf of our members," said IAA Executive Director David Tittsworth. "We are extremely pleased that she has agreed to join our excellent legal team." ■



Compliance Corner

*— By: Robert L.D. Colby and David L. Portilla**

An Overview of Clearance and Settlement of Securities Transactions

Introduction

Clearance and settlement are essential to the successful execution of a securities transaction, and are critical to the safe and efficient operation of the securities markets. This article explains the basic legal framework for securities clearance and settlement, highlights select regulatory issues that impact investors and broker-dealers, and looks forward to potential future developments.

Defining Comparison, Clearance and Settlement

The terms comparison, clearance and settlement are often used together, and sometimes used interchangeably. Yet these terms refer to distinct legal concepts and operational activities.

The term comparison generally refers to the process of confirming between broker-dealers that each in fact agrees that they effected the same transaction. Where trading is manual or in person, comparison is a process that follows execution of a trade. For electronic executions, comparison is largely inherent in the execution.

The term clearance, or clearing, generally refers to the process of updating the accounts of trading parties, after a transaction has been executed and compared, including recording that a transaction has been agreed upon and the details of the transaction. Clearing also includes the role of a clearing agency, such as the National Securities Clearing Corporation ("NSCC"), in netting and novating transactions.

The ability of a clearing agency to net transactions is one of the significant efficiencies provided by central clearing. Netting by the clearing agency enables a member of a clearing agency to deliver only cash or securities representing the member's net long or net short position for a particular day, even though the member agreed to numerous buy and sell transactions.

Netting is supported by novation, by which the clearing agency becomes the buyer to all sellers and the seller to all buyers. Novation by the clearing agency reduces counterparty risk because after novation, clearing agency members have the clearing agency as their counterparty rather than the counterparty with which they traded, and so are not subject to the risk of default by their trading counterparty. Without novation, a market participant likely would be reluctant to enter into a transaction without first assessing the risk profile of its trading counterparty. On the other hand, novation increases concentration risk, as all clearing agency participants are at risk of the default of the clearing agency.

The term settlement generally refers to the exchange of money and securities between parties to a trade. Thus, settlement is the process by which a transaction is completed. A seller receives money in exchange for delivering securities to a buyer. In the U.S., securities have largely been immobilized, meaning that physical certificates are normally not exchanged to settle a trade. Without immobilization, settling a securities transaction would require physical delivery of a securities certificate to the buyer. There is, of course, inherent time delay and operational risk involved in physical delivery.

The inefficiencies and risks of physical delivery of securities certificates were highlighted by the so-called "paperwork" or "back office" crisis of the late 1960s. During that time, a bull market resulted in a significant and rapid increase in the volume of securities transactions. Many broker-dealers were overwhelmed by the increased volume of transactions, and were not able to deliver securities certificates to properly settle transactions, thus resulting in a number of firms becoming insolvent. The paperwork crisis was, in part, an impetus for Congress to mandate the national system for clearance and settlement that exists today.

Robert L.D. Colby

David L. Portilla

Today, most exchange-traded equity securities are largely immobilized, with most share certificates kept in a central securities depository, the Depository Trust Company ("DTC"). Securities held with the depository are held in book entry form in the "street name" of a securities intermediary, such as a broker-dealer or bank, for the ultimate beneficial owner. Transfers of ownership are recorded through book-entry movements between the depository's participants' accounts. For most stocks, certificates are still available to investors directly registered with the issuer's transfer agent. For a growing number of stocks, investors can hold their shares directly in book entry form with the issuers' transfer agent, rather than holding a certificate.

Thus, in the U.S., exchange-traded equity securities are most often held in

Continued on page 13

street name, transactions are cleared and settled through NSCC, and transfers are recorded in book entry form at DTC. NSCC and DTC are each wholly-owned by the Depository Trust and Clearing Corporation, or DTCC, which is owned by its participants.

The Parties Involved

As mentioned above, NSCC is the clearing agency for equity securities, and DTC is the depository where immobilized stock certificates are held. However, few investors deal directly with NSCC and DTC. Instead, an investor deals with a broker-dealer or custodian bank, which in turn interacts with NSCC and DTC. Various arrangements may be used.

For example, an investor may have a prime brokerage relationship with a broker-dealer. The prime broker is not necessarily the broker-dealer that is responsible for executing transactions or clearing and settling transactions with NSCC. If other broker-dealers are involved in execution and clearance and settlement, the prime broker facilitates the movement of funds and record keeping for the investor.

Alternatively, an investor may deal individually with various broker-dealers in executing transactions. The executing broker-dealer may clear and settle transactions itself, or may have a relationship with another "clearing broker," who would be responsible for clearing and settling transactions with NSCC.

In addition, an investor may have a relationship with an "introducing" broker-dealer that, in turn, uses an executing broker-dealer to execute transactions. As above, the executing broker may use a separate broker-dealer to clear and settle transactions.

Select Regulatory Issues

Clearance and settlement of investor trades is governed both by the rules of NSCC and DTC, and by specific rules designed to address issues involving broker-dealers.

For example, recently adopted Rule 204 under Regulation SHO generally requires a broker-dealer that fails to deliver to a clearing agency sufficient securities to cover its short sales within three days of the sale, to borrow or purchase the shares before the beginning of trading hours on the first settlement day after the settlement date or suffer penalties. This rule is intended to reduce naked short selling, which often involves fails to deliver on time. As noted above, fails were a large part of the back office crisis that spurred the creation of today's clearance and settlement framework. Thus, the failure to properly complete a securities transaction has long been a focus of policy makers.

The Federal Reserve's margin regulations also impact clearance and settlement of investor trades. Specifically, under these rules, a broker-dealer generally must obtain full cash payment from a customer for an equity security within five business days or comply with strict margin requirements. Although, as a policy matter, the margin regulations are designed to protect the customer from over-borrowing and the broker-dealer from over-lending using securities as collateral, the five business day settlement requirement also helps avoid fails to deliver. In other words, the margin requirement encourages broker-dealers to receive full cash payment promptly when not extending margin, which, in turn, ensures that broker-dealers are able to meet their settlement obligations with NSCC.

Looking Forward

Recognizing that central clearing and settlement activities have the potential to concentrate risks to the financial system, the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act subjects financial market utilities, such as NSCC and DTC, to the prospect of being designated as systemically important. Systemically important financial market utilities will be subject to prudential regulation, including risk management standards and examinations by regulators. In addition, financial institutions could be subject to prudential regulation with respect to specific payment, clearing and settlement activities.

Another potential area for future regulatory action is the settlement cycle. Today, clearance and settlement for exchange-traded equity securities occurs on a T+3 settlement cycle, with payment of money and delivery of securities on the third day after the trade date. From time to time, the idea of accelerating the settlement cycle to a one day settlement cycle --T+1 -- has arisen. The main impetus to move to T+1 is to reduce the risk inherent in settlement delay. Proponents of moving to a T+1 settlement cycle state that "time equals risk." However, introducing a new settlement cycle would require significant investment by industry participants. Given the work load imposed on the SEC and the industry by Dodd-Frank, it is unlikely that the SEC will reinvigorate a T+1 settlement initiative any time soon. But at some point, the SEC could propose a T+1 rule as a part of its mandate under Section 17A of the Securities Exchange Act to promote prompt and accurate settlement of trades.

Conclusion

Even a brief acquaintance with the system for clearance and settlement of securities transactions quickly reveals the importance of this system for investors and the securities markets generally. Investors will want to pay attention to ongoing developments regarding clearance and settlement for securities.

**Robert L.D. Colby is a partner at Davis Polk & Wardwell LLP in Washington, DC and New York City, and David L. Portilla is an associate at Davis Polk & Wardwell LLP in Washington, DC. Mr. Colby may be reached at (202) 962-7121 or (212) 450-6564 or at robert.colby@davispolk.com. Mr. Portilla may be reached at (202) 962-7124 or david.portilla@davispolk.com.* *This article is for general informational purposes only and should not be relied upon for legal advice on any specific matter.* ■

IAA INVESTMENT ADVISER compliance CONFERENCE/2011

INVESTMENT ADVISER ASSOCIATION

Navigating The New Regulatory Environment

March 10-11, 2011 / Crystal Gateway Marriott, Arlington, VA

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The Investment Adviser Association (IAA) is pleased to announce the 2011 *IAA Investment Adviser Compliance Conference* to be held on **March 10-11, 2011**, at the Crystal Gateway Marriott in Arlington, VA.

Uniquely focused on need-to-know issues that specifically affect investment advisers, this event is designed to address the specific topics, best practices, and challenges facing compliance professionals. Our distinguished roster of speakers will include SEC staff, investment adviser industry professionals, and legal experts.

Our comprehensive two-day program will provide the most current information available on the changing regulatory landscape and assist you in gaining a clear understanding of what is necessary to maintain a successful compliance program.

Topics will include:

- New Part 2 of Form ADV
- Implications for Investment Advisers of the Dodd-Frank Act
- SEC Examinations
- Hot Topics on the SEC's Priority Agenda
- Political Contributions and Pay to Play
- Data Security
- And much more...

Who Should Attend?

- Chief Compliance Officers
- General Counsel
- Senior Staff and Executives
- Outside Counsel
- Compliance Staff

Location

Washington, DC Metro Area
Crystal Gateway Marriott
1700 Jefferson Davis Highway, Arlington, VA 22202
Phone (703) 920-3230 • Fax (703) 271-5212

- Hotel location is less than a mile from Ronald Reagan Washington National Airport and 0.1 miles from the Crystal City Metro station.
- For reservations, call (800) 228-9290 or (703) 920-3230. A special room rate of $209 has been negotiated for the group. Book early as space is limited.
- You are responsible for making your own hotel arrangements. *Please mention that you will be attending the IAA Compliance Conference.*
- All hotel reservations must be made no later than **Friday, February 11, 2011.**

Event Registration:

Visit the IAA website at www.investmentadviser.org or contact IAA Director of Meetings & Events Lisa Gillette with questions at lisa.gillette@investmentadviser.org.

Deadline Dates	Regular Price	IAA Member Fee
Regular Rate *Register after Jan. 1, 2011*	$1,450	$1,250

Cancellation/Refund Policy:
There will be a $200 cancellation fee assessed if cancellation is received prior to January 31, 2011. No refunds for cancellations received after January 31, 2011. Notice of cancellation must be received by the IAA in writing at iaaevents@investmentadviser.org. Substitutions can be made at any time prior to the event at no charge.

Exhibitors:
If you are interested in exhibiting at the 2011 IAA Investment Adviser Compliance Conference, please contact IAA Director of Meetings and Events, Lisa Gillette.

SEC Names Jennifer B. McHugh Acting Director of Division of Investment Management

On November 19, Chairman Schapiro named Jennifer B. McHugh as Acting Director of the SEC's Division of Investment Management. Ms. McHugh, who currently serves as a senior advisor in the Office of the Chairman, replaces Andrew J. "Buddy" Donohue. Ms. McHugh has been with the SEC for 11 years. She has served in several capacities within the Division of Investment Management, including Special Counsel in the Office of Investment Adviser Regulation and Senior Advisor to the Director. According to the release, Ms. McHugh will return to the Chairman's office when a new director is appointed. For more information, *see Jennifer B. McHugh Named Acting Director of SEC Division of Investment Management* SEC Rel. No. 2010-227 (Nov. 19, 2010), *available at* http://www.sec.gov/news/press/2010/2010-227.htm.

SEC Proposes Guidance Regarding Shift to State Oversight for Certain Advisers

In its November 19 release proposing rules to implement amendments to the Advisers Act, the SEC proposes guidance on the transition from SEC registration to state registration for certain advisers. The Dodd-Frank Act created a new group of "mid-sized advisers"—those advisers with assets under management between $25 million and $100 million and that are registered in the state in which they maintain their principal offices and places of business—and prohibited them from registering with the SEC, subject to certain exemptions. As a result, the SEC estimates that approximately 4,100 SEC-registered advisers will be required to withdraw their registrations and register with one or more state securities authorities. To assist in the transition, the SEC has proposed rule 203A-5, which provides a procedure to identify which advisers must change their registrations and a grace period for the transition. A multi-state advisory firm without $100 million AUM may still register with the SEC if that firm will be required to register in 15 or more states (compared to 30 states before the Dodd-Frank Act). The SEC will request each state to declare whether an advisory firm in that state would be subject to examination and reflect the answers in the IARD system as to which states would be eligible for registration of mid-sized advisers.

Proposed rule 203A-5 would require each investment adviser registered with the SEC as of July 21, 2011, to file an amendment to its Form ADV no later than August 20, 2011, and report the market value of its assets under management determined within 30 days of the filing. This filing would determine which advisers are no longer eligible for SEC registration and which should transition to state registration. An adviser no longer eligible for SEC registration would have to withdraw its registration by filing Form ADV-W no later than October 19, 2011. Because the Dodd-Frank Act prohibition on registration will be effective in July 2011, the proposed rule would in effect implement a 90-day grace period for advisers to transition from SEC registration to state registration. This grace period would be shorter than the 180-day transition period currently permitted for advisers switching to state registration. However, the proposed rule would permit the SEC to postpone the effectiveness of, and impose additional terms and conditions on, an adviser's withdrawal from SEC registration if the SEC institutes certain proceedings before the adviser files Form ADV-W.

The SEC seeks comment on proposed rule 203A-5, as well as the other proposed rules to implement amendments to the Advisers Act, until January 24, 2011. For more information, *see Rules Implementing Amendments to the Investment Advisers Act of 1940,* Advisers Act Rel. No. IA-3110 (proposed Nov. 19, 2010), *available at* http://www.sec.gov/rules/proposed/2010/ia-3110.pdf. See also *IAA Newsletter* article "SEC Proposes New Exemptions from Registration," page 6.

States Consider New Model Rule on Private Fund Adviser Registration and Exemption

The North American Securities Administrators Association (NASAA), an organization of state securities agencies, is considering adopting a model rule that would, in many respects, complement at the state level the treatment of private fund advisers at the federal level. The model state rule would require state registration of venture capital funds and private fund advisers to 3(c)(1) funds with less than $150 million in assets. The model rule would provide the basis for an exemption from state registration for advisers only to 3(c)(7) funds, including venture capital funds formed under 3(c)(7). Section 3(c)(7) requires all investors to qualify as "qualified purchasers" under the Investment Company Act; whereas under 3(c)(1) funds have fewer than 100 investors and lower wealth thresholds. Exempt 3(c)(7) advisers would need to file with the state a copy of reports they would file with the SEC for exempt

Continued on page 16

continued from page 15

reporting advisers. Additionally, the model rule confirms that private fund advisers subject to SEC registration are subject to the notice filing references applicable to SEC-registered investment advisers. More information is available on the NASAA web site including text of the proposed rule. *See* http://www.nasaa.org/content/Files/Exempt_Report_Adviser_Model%20Rule.pdf. Comments are requested by January 24, 2011.

FinCEN Issues Guidance on Sharing Suspicious Activity Reports with Affiliates

The Financial Crimes Enforcement Network (FinCEN) has issued guidance to confirm that under the Bank Secrecy Act and its implementing regulations, securities broker-dealers, mutual funds, futures commission merchants, and introducing brokers in commodities ("authorized institutions") may share suspicious activity reports (SAR), or information that would reveal the existence of a SAR, with certain affiliates. The Bank Secrecy Act prohibits the filer of a SAR from notifying any person involved in a suspicious transaction that the activity has been reported. Bank Secrecy Act regulations permit disclosures to FinCEN, any law enforcement agency, or any examining federal regulatory authority or SRO. The regulations allow sharing of a SAR, or any information as to the existence of the SAR as needed within the authorized institution.

While the recently-issued guidance clarifies the scope of these regulations for some entities, investment advisers are neither subject to requirements to have an anti-money laundering program nor required to file SARs with FinCEN. Advisers do not generally enjoy related immunities and protections for filing and handling SARs but mutual funds may share SARs with investment advisers that control the fund. Thus, while certain affiliates may share information about the SAR with an affiliate if that affiliate is subject to SAR regulations—sharing with registered investment advisers is not authorized generally. Further, an authorized institution must not share a SAR with an affiliate if there is reason to believe that the information may be disclosed to any person involved in the suspicious activity that is the subject of the SAR. Finally, the guidance advises that the authorized institution, its affiliate, or both entities may be liable for any disclosure by the affiliate of a SAR or information revealing the existence of a SAR.

For more information, contact the IAA legal staff or *see FinCEN Rule Strengthens SAR Confidentiality; Provides Guidance to Permit Sharing with Affiliates,* FinCEN Rel. (Nov. 23, 2010), *available at* http://www.fincen.gov/news_room/nr/html/20101122.html. The text of the final rule is *available at* http://edocket.access.gpo.gov/2010/pdf/2010-29869.pdf.

SEC Proposes to Extend Availability of Temporary Rule Regarding Principal Trades with Certain Advisory Clients

On December 1, the SEC proposed amending temporary rule 206(3)-3T by extending the expiration date two years from December 31, 2010 to December 31, 2012. The Advisers Act Rule establishes an alternative means for dual registrants to comply with section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients. The SEC is proposing to extend the applicability of this rule to consider issues raised by principal trading, and other regulatory requirements applicable to broker-dealers and advisers as part of the study mandated by Dodd-Frank Act section 913. If the rule were to expire on December 31, dual registrants who currently rely on the rule would be required to comply with section 206(3)'s transaction-by-transaction written disclosure and consent requirements without the benefit of the alternative means provided by the rule. Some of those entities argued that their non-discretionary advisory clients would have their access limited and dual registrants would need to make substantial changes to their disclosure documents, client agreements, procedures, and systems. Additionally, the SEC noted that its staff has observed several compliance issues with the rule, including failure to comply with the rule, inadequate policies and procedures concerning the rule, failure to provide required disclosures, and failure to obtain transaction-by-transaction consent. The SEC staff stated it will pursue those matters where appropriate, including referrals to the Division of Enforcement, and will continue to do so if the rule is extended. For more information, *see Temporary Rule Regarding Principal Trades with Certain Advisory Clients,* SEC IA Rel. No. 3118 (proposed Dec. 1, 2010) *available at* http://www.sec.gov/rules/proposed/2010/ia-3118.pdf. Comments were requested by Dec. 20.

Chairman Schapiro Testifies on U.S. Equity Market Structure

On December 8, Chairman Schapiro testified before the Subcommittee on Securities, Insurance, and Investment of the Senate Committee on Banking, Housing, and Urban Affairs and the Senate Subcommittee on Investigations regarding the SEC's review of U.S. equity market structure. The SEC is initiating improvements to address the quality and effectiveness of market structure. The SEC will be mindful of the principles of capital formation, investor protection, competition, price discovery, surveillance, inspection, and enforcement. She noted several recent developments in market structure including enhanced speed, greater capacity, and sophistication of trading in its relation to the significant securities market price decline on May 6 and related investors' concerns. Additionally, OCIE and the Division of Enforcement are developing a risk-focused strategic examination program and a new unit in the Division of Enforcement focused on market abuse. The SEC has also implemented a circuit breaker

Continued on page 18

INSIDE *the Beltway*

Congress Adopts Tax Package

Congress has adopted the $858 Billion tax cut and unemployment insurance proposal negotiated by President Obama and congressional Republicans that would extend the 2001 and 2003 Bush tax cuts for all taxpayers for two years; extend the current capital gains and dividend rates at 15 percent for all taxpayers for an additional two years; provide for a 2 percent cut in federal payroll taxes for one year; and extend for 13 months federal unemployment insurance benefits.

The "Reid-McConnell Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010" was adopted by the Senate on December 14 by a 81 to 19 vote and approved by the House two days later 277 to 148.

Democrats had earlier hoped to allow tax rates to rise for the wealthiest households and many were upset that the President Obama agreed to Republican demands that the estate tax be lowered from 45 percent to 35 percent and boost the exemption to estates of $5 million or less, from $3.5 million. House passage of the Senate proposal followed a failed attempt of liberal Democrats in the House to make these estate tax provisions less generous. President Obama signed the measure into law on December 17.

Congressman Spencer Bachus Named Chairman of House Financial Services Committee

Rep. Spencer Bachus (R-AL) has been selected to serve as the Chairman of the House Financial Services Committee for the 112th Congress. The House Republican Conference confirmed the Steering Committee's choice of Bachus to chair the panel on December 8. Bachus has served as Ranking Member of the Committee since 2007 and has been on the panel since 1993. He will succeed Rep. Barney Frank (D-MA) as chairman at the start of the new Congress in January.

Following his appointment, Bachus stated his first priority will be "to end the taxpayer funded bailout" of Fannie Mae and Freddie Mac. He stated further that he is committed "to going title by title through the 2,300 page Dodd Frank Act to correct, replace, or repeal the job killing provisions." Bachus also announced that Rep. Scott Garrett (R-NJ) will become chairman of the Capital Markets and Government-Sponsored Enterprises Subcommittee, the panel previously chaired by Rep. Paul Kanjorski (D-PA) that has primary jurisdiction over the SEC and the Investment Advisers Act.

112th Congress—By the Numbers

With final resolution of a half-dozen contested races, the final results are in for the 112th Congress. In the House of Representatives, Republicans will have a 242 to 193 majority, having picked up 63 seats—the largest Republican gain since 1938. In the Senate, the Democratic majority shrank by 6 seats, from 59 - 41 to 53 - 47. The Senate majority includes two independents (Connecticut Senator Joe Lieberman and Vermont Senator Bernie Sanders) who caucus with the Democrats.

SEC Delays Creating New Offices Mandated by Dodd-Frank Act Due to Funding Concerns

The Securities and Exchange Commission has deferred creating several departments required under the Dodd-Frank Act due to funding concerns. In a notice posted to the agency's website on December 2, the SEC disclosed that "budget uncertainty" had caused it to defer creating an Office of Women & Minority Inclusion, an Investor Advisory Committee, the Office of Investor Advocate, the Whistleblower Office, the Office of Credit Ratings, and the Office of Municipal Securities. The SEC said that the functions of the whistleblower office will be carried out by existing enforcement staff. The SEC has also backed out of a lease for almost 1 million square feet of new office space and cancelled a request for proposals issued in October for a new data center. Further, the SEC has reportedly slowed the pace of some investigations and routine inspections due to its budget concerns.

Congress has not approved a federal budget for the 2011 fiscal year that began on October 1, so the SEC is operating under a "continuing resolution" that temporarily extended last year's $1.12 billion budget at the agency. The House passed a $1.09 trillion budget bill on December 8 by a 212-206 vote that would boost the SEC budget more than 10 percent to $1.25 billion, but the Senate has not yet acted on its federal spending bill. Under the Senate Appropriations Committee proposed $1.1 trillion "omnibus" appropriations measure, the SEC's budget would increase to $1.3 billion.

However, as of this writing, Senate Democratic leadership has abandoned its effort to gain passage of the legislation in the face of a threat by Senate conservatives to block a vote on the measure by forcing Senate clerks to read aloud the entire 1,923-page bill. Although uncertainty remains, the Senate is now expected to extend the current stop gap funding resolution—that has kept the

Continued on page 20

2010 Compliance Workshops a Great Success — Thank You!

Over 350 people attended the IAA's 14th Annual Compliance Workshops, which took place in eight cities this fall. As in past years, the workshops addressed a range of current important regulatory and compliance issues facing investment advisory firms, including the Dodd-Frank Act and the amendments to Part 2 of Form ADV. The seminars featured expert investment management attorneys and IAA legal staff, as well as regional SEC staff from the Office of Compliance Inspections and Examinations (OCIE) who addressed significant changes underway in the examination and inspection program and the SEC generally. In addition, national law firms prepared extensive written materials for our members.

The IAA would like to express its appreciation to the following individuals for their contributions toward making the workshops a success:

Law Firm Attorneys

- Jim Anderson, *WilmerHale LLP*
- Jason Brown and Elizabeth Reza, *Ropes & Gray LLP*
- Sara Emley, *BuckleySandler LLP*
- Stuart Fross, *K&L Gates LLP*
- Michele "Mitch" Gibbons, *Mayer Brown*
- Christopher Harvey, Jane Kanter, and Michael Sherman, *Dechert LLP*
- Jennifer Klass, *Morgan Lewis & Bockius LLP*
- Mari-Anne Pisarri, *Pickard & Djinis LLP*
- Lorna Schnase, *Attorney at Law*
- Michael Wolensky, *Schiff Hardin LLP*

SEC Speakers

- David Bergers, Regional Director, Boston Regional Office
- James Capezzuto, Associate Regional Director, New York Regional Office
- Peter Driscoll, Assistant Regional Director, Chicago Regional Office
- Gene Gohlke, Associate Director, OCIE
- Edward Haddad, Assistant Regional Director, San Francisco Regional Office
- Aaron Kohler, Staff Accountant, Atlanta Regional Office
- Martin J. Murphy, Associate Regional Director, Los Angeles Regional Office
- Linda Yoder, Staff Accountant, Fort Worth Regional Office

If you were not able to attend one of the workshops and would like to purchase the written materials for $75 plus shipping, please contact the IAA office. ■

Legal and Regulatory Corner—continued from page 16

program to halt trading for individual stocks if their price moves 10 percent in a five minute period. The SEC approved exchange rules to eliminate market maker "stub quotes," and a new market access rule which requires broker-dealers that offer market access to customers to have appropriate pre-trade risk management controls and supervisory procedures. Finally, the SEC has proposed large trader reporting requirements and a consolidated audit trail system to enhance ability to collect and monitor data on significant market participants. The full text of Chairman Schapiro's testimony is available at http://sec.gov/news/testimony/2010/ts120810mls.htm.

Investment Adviser Subsidiary and BD Charged for Inadequate Procedures to Protect Nonpublic Information

On November 17, the SEC announced a settlement of its case against a registered broker-dealer, its investment adviser subsidiary, and the chief compliance officer for both entities. The related firms shared office space, facilities, a chief executive officer, and a chief compliance officer. The two firms failed to follow written procedures designed to detect and prevent misuse by the adviser of the broker-dealer's material research information. The adviser subsidiary traded stock in the same direction as the broker-dealer's research suggested but failed to provide required internal certifications and documentation. Restrictions on use of material, non-public information were particularly salient since two of the adviser's senior portfolio managers were former executives with long standing relationships with industry insiders in the sector in which adviser's clients' funds were invested. The SEC had earlier identified firm failures to conduct an annual compliance review in 2005, and the firm failed to fully implement remedial measures to monitor employees' personal trading. During a 2006 SEC examination, the adviser allegedly created and produced to SEC staff artificial documents to hide missing forms and logs. For more information, *see In the Matter of The Buckingham Research Group, Inc., Buckingham Capital Management, Inc., and Lloyd R. Karp,* IA Rel. No. 3109 (Nov. 17, 2010), *available at* http://www.sec.gov/litigation/admin/2010/34-63323.pdf; *see also SEC Charges New York Firms and Chief Compliance Officer for Inadequate Procedures to Protect Nonpublic Information,* SEC Rel. No. 2010-223 (Nov. 17, 2010), *available at* http://www.sec.gov/news/press/2010/2010-223.htm.

A complete copy of each month's Legal and Regulatory Update column is available on the Members Only section of the IAA web site. ■

INVESTMENT ADVISER ASSOCIATION

COMPLIANCE TRAINING

NRS

Co-sponsored by the IAA, the Investment Adviser Compliance Certificate Program (IACCP) was established by National Regulatory Services in 2004 and is designed to advance investment adviser compliance as a profession. The program involves education, work experience, examination, ethics, and continuing education requirements.

To learn more about the program or view the complete 2010 schedule, go to: http://www.nrs-education.com/professional-development.html. For more information please contact IAA Special Counsel Paul Glenn, (202) 293-4222, with any questions.

UPCOMING EVENTS:

January 11	SEC Examinations for Investment Advisers Elective *Online 1:00 pm –-3:00 pm (ET)*
January 20	Form ADV Part 1: Annual Updating Amendment and More Disclosure 1 *Online 1:00 pm - 3:00 pm (ET)*
January 25	Enterprise Risk Management for Investment Advisers and Broker-Dealers Elective/Risk Management 1 Concentration *Online 1:00 pm - 3:00 pm (ET)*
January 27	New Form ADV Part 2—Identifying and Disclosing Conflicts Disclosure 2 *Online 1:00 pm - 3:00 pm (ET)*
February 3	Investment Adviser Performance and Advertising—Spotting Red Flags Disclosure 3 *Online 1:00 pm - 3:00 pm (ET)*
February 8	Investment Adviser Codes of Ethics—The Basics Plus Pay to Play; Gifts and Whistleblowers Ethics 1 *Online 1:00 pm - 3:00 pm (ET)*
February 15	How to Create a Plain English Form ADV Part 2 Elective *Online 1:00 pm - 3:00 pm (ET)*
February 24	Advisers Act Primer—Focus on the New State/Federal Regulatory Divide; New Private Adviser Exemption; Supervision Requirement and More Advisers Act 1 *Online 1:00 pm - 3:00 pm (ET)*
March 3	Hedge Funds in Transition: SEC Examination Priorities and Strategies for Building an Advisers Act Compliance Program Elective HF 1 Concentration *Online 1:00 pm - 3:00 pm (ET)*
March 8	Books and Records Management for Investment Advisers Advisers Act 2 *Online 1:00 pm - 3:00 pm (ET)*
March 15	Advisers Act Primer: Focus on the New ADV Delivery Requirements, Contracts and Insider Trading Advisers Act 3 *Online 1:00 pm - 3:00 pm (ET)*
March 22	Understanding Fiduciary Duties under the Advisers Act Advisers Act 4 *Online 1:00 pm - 3:00 pm (ET)*

2011 Annual Conference—Register Today!

IAA's 2011 Annual Conference will be held in Boston at the Boston Harbor Hotel, April 27-29, 2011. Featured speakers include:

- Richard Chilton, founder, Chairman, CEO and CIO of Chilton Investment Company
- Benjamin Friedman, Ph.D., Harvard Professor of Political Economy
- Michael Murphy, one of the Republican party's most successful media consultants
- Ron O'Hanley, President of Asset Management and Corporate Services at Fidelity
- Robert Pozen, Chairman of MFS Investment Management
- Robert Reynolds, President and CEO of Putnam
- William Truscott, CEO, U.S. Asset Management & President, Annuities for Ameriprise Financial

The conference opens on Wednesday with workshops on *Connecting with Decision Makers* and *Litigation and Enforcement: Today's Risks,* conducted by representatives from Communicate to Connect and Ropes & Gray, respectively. Sessions will be conducted concurrently and consecutively so that attendees will be able to participate in both workshops.

Breakout sessions will be held on Thursday afternoon and provide an excellent networking opportunity to discuss practice management issues. Social activities include a welcome reception sponsored by U.S. Bancorp, a private dinner at the Museum of Fine Arts, and a final New England Clam Bake (*sans* sand).

On-line registration opens in early January. In the meantime, please email any questions to Lisa Gillette at lisa.gillette @investmentadviser.org. ■

MAILING ADDRESS:
1050 17th Street, N.W., Suite 725
Washington, D.C. 20036

TELEPHONE:
(202) 293–4222

FAX:
(202) 293–4223

INTERNET:
www.investmentadviser.org

E–MAIL ADDRESSES:

David G. Tittsworth
Executive Director
david.tittsworth@investmentadviser.org

Karen L. Barr
General Counsel
karen.barr@investmentadviser.org

Neil A. Simon
Vice President for Government Relations
neil.simon@investmentadviser.org

Valerie M. Baruch
Associate General Counsel
valerie.baruch@investmentadviser.org

Jennifer S. Choi
Associate General Counsel
jennifer.choi@investmentadviser.org

Kathy Ireland
Associate General Counsel
kathy.ireland@investmentadviser.org

Monique S. Botkin
Assistant General Counsel
monique.botkin@investmentadviser.org

Paul D. Glenn
Special Counsel
paul.glenn@investmentadviser.org

Linda Hollands
Director of Finance and Operations
linda.hollands@investmentadviser.org

Lisa Gillette
Director of Meetings and Events
lisa.gillette@investmentadviser.org

Nicole Hadfield
Director of Member Services
nicole.hadfield@investmentadviser.org

Andrea T. Owens
Operations Coordinator
andrea.owens@investmentadviser.org

Garrett Honea
Member Services Coordinator
garrett.honea@investmentadviser.org

Megan Olson
Jr. Member Services Coordinator
megan.olson@investmentadviser.org

Suzanne M. Snyder
Office Administrator
suzanne.snyder@investmentadviser.org

Compliance Training: Investment Adviser Compliance Certification Program

The IAA cosponsors two focused education programs developed by National Regulatory Services (NRS). The programs are designed to help compliance professionals achieve a solid understanding of the Investment Advisers Act of 1940 and to advance compliance as a profession through the opportunity to earn an industry designation.

- NRS started the Investment Adviser Certified Compliance Professional (IACCP℠) Program in 2004. Program requirements include 40 hours of education, two-years of work experience, examination, and ethics attestation to earn the IACCP℠ designation and an annual continuing education requirement to maintain the designation.
- The Investment Adviser Core Compliance Program, introduced in 2010, enables compliance professionals to begin their education with a foundation level of Advisers Act knowledge and earn a Certificate of Achievement. The Core Program can also be used as a stepping stone to the IACCP Program and includes 20 hours of education, a written assessment, and ethics attestation.

IAA and NRS are committed to providing quality compliance education to help support firms' compliance programs and professionals. IAA and NRS update the IACCP and Core Programs in real time to keep you compliance-ready.

Program Enhancements for 2011

The IACCP team 2011 Program enhancements include:

- A 2011 calendar with over 60 online and onsite education events to tailor curriculum to the firm's needs while earning credentials to support personal career goals
- The opportunity to earn the IACCP designation *and* additional recognition as a specialist in one or two concentrated fields of study within the IACCP Program: (1) Risk Management and (2) Hedge Fund Compliance and Operations
- Onsite training locations in Miami, Chicago, Boston, and Las Vegas

With a focused program of study, earning the IACCP designation or receiving the Core Compliance Certificate of Achievement can help identify you as an investment adviser compliance professional committed to competency.

For more information see the IAA web site under "Events" and "IACCP." ■

Inside the Beltway—continued from page 17

SEC and other government agencies funded since October 1—for ten weeks through March 4, 2011. Once passed by the Senate, the spending measure is likely to be quickly adopted in the House. This will set the stage for a political tug-of-war—and a potential "shut down the government" veto fight—between the Administration and House Republicans in February, just as the President readies his budget proposal for 2012.

Contact Neil Simon, IAA Vice President for Government Relations, to share your views—or for more information—about these and other government relations matters. ■