November 24, 2010

SEC Issues Proposal Implementing Advisers Act Registration and Reporting Amendments Under the Dodd-Frank Act

On November 19, 2010, the SEC issued a release (the "**Implementing Release**") in which it proposed rules and rule amendments, including various amendments to Form ADV, to implement certain provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") that amend the Investment Advisers Act of 1940 (the "**Advisers Act**"). The SEC's proposal implements:

- the increased statutory threshold for adviser registration with the SEC, which will generally be $100 million for most U.S. advisers;
- the reporting requirements of certain advisers exempt from registration;
- conforming and other changes to Form ADV; and
- certain rule amendments, including amendments to the SEC's "pay-to-play" rule in light of changes made by the Dodd-Frank Act.

On the same day, the SEC also issued a companion release proposing rules to implement new exemptions from the registration requirements of the Advisers Act created by the Dodd-Frank Act, a summary of which is available in the Davis Polk Client Memorandum ***SEC Proposes Rules Implementing New Exemptions from Advisers Act Registration Under the Dodd-Frank Act.***

Increased Threshold for Adviser Registration with the SEC

Under the Dodd-Frank Act, Congress transferred most of the regulatory burden of monitoring many smaller advisers to the states by increasing the threshold for SEC registration to $100 million in assets under management for most U.S. investment advisers. The apparent purpose of this reallocation was to allow the SEC to focus its examination resources on larger investment advisers.

Effective July 21, 2011, the minimum assets under management threshold for SEC registration for most U.S. investment advisers (that do not manage registered investment companies or business development companies) will be:

- $100 million in general, but
- $25 million for advisers that would either (i) not be subject to registration and examination in the state in which they maintain their respective principal offices and places of business or (ii) otherwise be required to register with 15 or more states.

Advisers with more than $100 million in assets will generally not be affected by this reallocation of federal and state authority. However, this new standard will require a significant number (approximately 4,100, according to the SEC) of so-called "mid-sized advisers" (those that have between $25 and $100 million of assets under management) to withdraw their SEC registrations and instead register with the state securities authorities of their homes states (and potentially other states in which they have clients).

The proposed rules provide the SEC with the means to implement this new regulatory shift. Under proposed new rule 203A-5, *every* adviser that is registered with the SEC will be required to file an amendment to its Form ADV by August 20, 2011 (30 days after the July 21 effective date of Title IV of the Dodd-Frank Act) and to report the market value of its assets under management to determine whether the adviser meets the revised eligibility rules for registration with the SEC. An adviser that does not meet the revised criteria would be required to withdraw its SEC registration by filing Form ADV-W no later than

October 19, 2011 (60 days after the required refiling of all advisers' Forms ADV). An adviser who no longer qualifies for SEC registration would thus in total have a 90-day "grace period" from July 21, 2011 (the effective date of most of Title IV of the Dodd-Frank Act) to register in the states, acquire any relevant licenses and require personnel to take any relevant examinations pursuant to applicable state law before withdrawing its SEC registration.

For the subset of advisers that would have to register with the SEC before the $100 million threshold becomes effective (because their assets under management crossed the current minimum mandatory threshold of $30 million), but then would be forced to withdraw their SEC registration once the new threshold goes into effect, the proposed rule would allow such advisers not to register with the SEC if, on or after January 1, 2011 until the end of the registration transition period (October 19, 2011), the adviser has between $30 and $100 million in assets under management, provided that the adviser is, and has a reasonable basis to believe that it is required to be, registered in the state in which it maintains its principal office and is subject to examination in that state.

Removal of the $5 million buffer. The proposal would amend rule 203A-1, which provides most advisers with $25 to $30 million in assets under management the option to register either with the states or with the SEC. The proposal eliminates this buffer in light of (i) the new $100 million threshold, (ii) the fact that advisers need only assess their registration eligibility on Form ADV on an annual basis and (iii) the existing 180-day grace period applicable to advisers that in the normal course must switch from SEC to state registration (or vice versa).

Certain Amendments to Item 2 of Form ADV. The proposed rules would modify Item 2 of Part 1A of Form ADV, which requires an adviser to indicate its basis for SEC registration, to account for the new statutory thresholds and proposed implementing rules. Under the proposed amended Item 2, an adviser would be required to indicate its eligibility to register with the SEC as one of the following seven types of SEC-eligible advisers:

- large advisers (more than $100 million in regulatory assets under management, as further explained below);
- mid-sized advisers that do not meet the criteria for state registration or examination;
- foreign advisers or advisers with their principal place of business in the State of Wyoming;
- advisers that meet certain exemptive requirements under rule 203A-2 (*e.g.*, pension consultants, multi-state advisers);
- advisers to registered investment companies;
- advisers to business development companies with at least $25 million in regulatory assets under management; and
- advisers with some other basis of registering with the SEC.

Advisers Exempted from the Prohibition on SEC Registration. The proposal would eliminate and amend certain exemptions from the prohibition on SEC registration for advisers that do not meet the assets under management threshold, such as those contained in rule 203A-2. The proposal also clarifies certain terms used in the Dodd-Frank Act regarding the registration requirements of mid-sized advisers.

- ***NRSROs.*** The proposal would eliminate the exemption from the prohibition on SEC registration for nationally recognized statistical rating organizations with less than $100 million in assets under management.
- ***Pension consultants.*** Pension consultants, which typically do not have "assets under management," are nonetheless currently eligible to register as investment advisers with the SEC, if they advise plans with at least $50 million in assets. The proposed rule would increase this

plan asset eligibility requirement to $200 million in order to maintain the same two-to-one proportion between required plan assets and the assets under management threshold.

- ***Multi-state advisers.*** To conform with changes created by the Dodd-Frank Act, the proposed rule would also modify the current exemption from the prohibition of registering with the SEC for advisers that are required to register in 30 or more states in rule 203A-2(e) to permit investment advisers required to be registered with 15 or more states to register with the SEC.
- ***Rule 203A-4 Safe Harbor.*** The proposal would also eliminate the rule 203A-4 safe harbor from SEC registration for an investment adviser registered with the state in which it has its principal office based on a reasonable belief that it lacks sufficient assets under management to register with the SEC.
- ***Mid-Sized Advisers.*** As described above, an adviser with $25 million to $100 million in assets under management would be prohibited from registering with the SEC *if* such adviser is "required to be registered" as an investment adviser, and is "subject to examination" in its home state. Under the proposed rule, a mid-sized adviser that relies on an exemption from registration with its home state would not be considered to be "required to be registered" with its home state and thus would be required to register with the SEC. With regard to whether an adviser in a given state is "subject to examination," the SEC proposes to correspond with each state's investment adviser regulator and request that it advise the SEC on whether advisers would be subject to examination in that state.

New Calculation of Assets Under Management. Under Section 203 of the Advisers Act, "assets under management" is defined as the "securities portfolios" with respect to which an investment adviser provides "continuous and regular supervisory or management services." The Instructions to Form ADV provide guidance on the calculation of assets under management by allowing (but not requiring) advisers to include certain types of assets in the calculation, namely proprietary assets, assets an adviser manages without receiving compensation, and assets of foreign clients. The proposed rule creates a new defined term "regulatory assets under management" and requires advisers to include the foregoing categories in their calculation of regulatory assets under management. Moreover, under the proposed rule an adviser would not be allowed to subtract from the calculation outstanding indebtedness and other accrued but unpaid liabilities that are in client accounts.

The proposed rule also provides guidance on how private fund advisers must calculate the value of their regulatory assets under management. Currently, Form ADV does not provide specific instructions applicable to calculating the assets under management for private funds. Under the proposed rules, in calculating its regulatory assets under management with respect to its private funds, an adviser would be required to:

- include the value of any private fund over which it exercises "continuous and regular supervisory or management services," regardless of the nature of the assets of the fund;
- include any uncalled capital commitments made to the fund; and
- value the private funds using a fair value methodology (even for illiquid or other securities that are not readily marketable). If the governing documents of a fund provide for a specific process for calculating fair value (e.g., providing the General Partner discretion over the determination of fair value), then the adviser could rely on such process for calculating its regulatory assets under management.

Subadvisors to private funds would only include the value of the portion of the portfolio for which they provide sub-advisory services.

This new method of calculating assets under management would apply uniformly for purposes of determining eligibility of SEC registration, reporting regulatory assets under management on Form ADV, and the new exemptions from registration under the Advisers Act created by the Dodd-Frank Act.

Exempt Reporting Advisers

The Dodd-Frank Act created two new exemptions from Advisers Act registration for advisers that solely advise (i) venture capital funds or (ii) private funds and have assets under management in the United States of less than $150 million. For each of these exemptions, the Dodd-Frank Act directs the SEC to require these advisers to maintain such records and submit such reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors. To implement this reporting requirement, the SEC proposed new rule 204-4 requiring such advisers ("**exempt reporting advisers**") to file certain reports with the SEC using Form ADV.

Scope of Reporting. Exempt reporting advisers would not be subject to the full panoply of reporting required for registered investment advisers, but would need only to report a narrower subset of such information. Under the proposed rule, exempt reporting advisers would be required to complete the following items in Part 1A of Form ADV and corresponding sections of Schedules A, B, C and D:

- Item 1 – Identifying information;
- Item 2.C. – SEC Reporting by Exempt Reporting Advisers;
- Item 3 – Form of Organization;
- Item 6 – Other Business Activities;
- Item 7 – Financial Industry Affiliations and Private Fund Reporting (revisions to Item 7 are discussed below);
- Item 10 – Control Persons (including disclosure of the owners of the adviser); and
- Item 11 – Disclosure Information (including the disciplinary history for the adviser and its employees).

Such advisers would not be required to complete the remaining items of Part 1A or prepare a client brochure on Form ADV Part 2.

Updating Requirements. The proposal would require an exempt reporting adviser to file updates to its Form ADV filing, as is currently the case for registered advisers, on an annual basis within 90 days of the end of the adviser's fiscal year (or more frequently if specifically required by the instructions to Form ADV).

Transition Period. Each exempt reporting adviser would be required to file its initial report on Form ADV by August 20, 2011.

Changes to Form ADV Disclosure

The SEC has also proposed changes to Form ADV that are designed to enhance its oversight of investment advisers. The proposed rules require advisers to provide the SEC with additional information primarily about three areas of their business: (i) information regarding the private funds they advise; (ii) more information in general about their advisory business, including the types of clients they advise, their employees and advisory activities and business practices that may present conflicts of interest, such as the use of affiliated brokers, soft dollar arrangements and payments for client referrals and (iii) additional information about certain non-advisory activities and their financial industry affiliations. The SEC anticipates that the increased knowledge it will glean from the revised Form ADVs will enable it to better understand advisers' operations and business focus, and would thereby facilitate its assessment of risks and conflicts and aid in its identification of firms for examination.

Private Fund Reporting

Scope of Private Fund Reporting. The proposal would modify Form ADV to require an adviser, in response to Item 7.B and Schedule D, to provide information about all of the adviser's private funds regardless of their forms of organization. Form ADV would no longer require reporting of funds advised by the adviser's affiliates, and sub-advisers would be permitted to exclude private funds that are included on another adviser's Schedule D. In addition, an adviser that sponsors funds in a master-feeder structure would generally be permitted to submit one Schedule D for all funds in such structure. Non-U.S. advisers would be permitted to forego reporting on private funds they advise that are both organized outside the U.S. and not offered to or owned by U.S. persons.

Information Required To Be Disclosed About Private Funds. The Proposal would create a new Section 7.B.1 of Schedule D that would expand the data advisers are required to disclose about their private funds. Among other items, the Schedule D submitted for each fund would need to disclose certain information about the fund, including:

- (i) the name of the private fund; (ii) its jurisdiction of organization; (iii) its general partner, directors, trustees or persons occupying similar positions; (iv) the Investment Company Act of 1940 exclusion on which the fund relies; (v) the names and jurisdictions of each foreign financial regulatory authority with which the fund is registered; and (vi) whether the fund is in a master-feeder arrangement;
- whether the fund is a fund of funds (for these purposes, the Form ADV instructions specify that the fund should be considered a "fund of funds" if it invests 10% or more of its total assets in other pooled investment vehicles, whether or not they are also private funds);
- the fund's investment strategy (by checking the box corresponding to one of seven categories – 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; the value of the fund's investments by asset and liability class and categorized in the U.S. GAAP fair value hierarchy; the fund's minimum investment amount and the number of beneficial owners of the fund;
- whether clients of the adviser are solicited to invest in the fund, and the percentage of the adviser's clients that has invested in the fund; and
- the number and types of investors in the fund.

In lieu of reporting a fund's name on its Schedule D, advisers would be allowed to use a code, thereby preserving the anonymity of the name of the fund.

Information Required To Be Disclosed About Private Funds' Service Providers. A reporting adviser would also be required to identify its funds' auditors, prime brokers, custodians, administrators and marketers, and disclose their locations and whether such service providers are related persons of the adviser. For each service provider, the SEC would also require that an adviser clarify the nature of the services it provides and disclose certain other information, such as:

- with respect to an auditor, whether it is independent, registered with and subject to inspection by the PCAOB, and whether audited financial statements are distributed to investors;
- with respect to a prime broker, whether it is SEC-registered and acts as a fund's custodian;
- with respect to a custodian, whether it is a related person of the adviser;
- with respect to an administrator, whether it prepares and sends account statements to investors and the percentage of the fund's assets for which it provides valuation services; and

- with respect to each marketer, whether it is a related person of the adviser, its SEC file number and the URL for any website used to market the fund.

Because the above information would be public, the SEC expects that it would supplement investors' due diligence efforts and allow service providers to identify the funds claiming to rely on their services.

Additional Disclosure About the Adviser and its Advisory Business

Information About the Adviser's Employees. Item 5.B of Part 1A of Form ADV requires advisers to report the number of employees who are registered representatives of a broker-dealer. This Item would be expanded to also require the reporting of the number of the adviser's employees who are registered as investment adviser representatives or insurance agents. In addition, the revised Form ADV would require advisers to report the specific number of such employees rather than checking a box that corresponds to a range of the number of employees.

Information About the Adviser's Clients. The check-the-box responses in Item 5.D of Part 1A of Form ADV would be expanded to (i) report whether any of an adviser's clients are business development companies, insurance companies or other investment advisers and (ii) distinguish between clients that are pension and profit-sharing plans subject to ERISA and those that are not. Additionally, advisers would be required to report the percentage of their clients that are non-U.S. persons.

Information About Assets Under Management. Advisers would be required to report assets under management by client type.

Information About the Adviser's Advisory Services. The proposal would expand the list of advisory activities reportable by an adviser. Such list would now include: (i) portfolio management for pooled investment vehicles other than registered investment companies and (ii) educational seminars/workshops. Additionally, an adviser would now be required to report, by selecting from a list, the types of investments about which it provided advice during the reporting period.

Additional Disclosure About Participation in Client Transactions. Under the Proposal, advisers that have discretionary authority to determine the brokers or dealers used for client transactions, or that recommend brokers or dealers to clients, would be required to report whether any such brokers or dealers are related persons. An adviser would also need to disclose whether any soft dollar benefits received qualify for the safe harbor under Section 28(e) of the Securities Exchange Act of 1934 (the "**Exchange Act**"), and whether it or any related person receives compensation, directly or indirectly, for client referrals.

Advisers With $1 Billion in Assets. The revised Form ADV would also require an adviser to indicate whether or not the adviser itself had total assets (rather than assets under management) of $1 billion or more as of its most recent fiscal year. According to the SEC's release, it intends to use this information to identify firms that would be subject to future rules or guidelines called for by Section 956 of the Dodd-Frank Act that will address certain incentive-based compensation arrangements.

Additional Disclosure About the Adviser's Non-Advisory Activities and Affiliations

Information About the Adviser's Non-Advisory Activities. The Proposal augments the check-the-box categories of financial services activities on the Form ADV and, in addition to the existing categories, would now require registered advisers and exempt reporting advisers to report if they or any related person are engaged in business as a registered municipal advisor, registered security-based swap dealer, major security-based swap participant (all of which are new SEC-registrants under the Dodd-Frank Act), or as a trust company. In addition, the new Form ADV would require advisers to disclose if they are engaged in the business of providing professional accounting or legal services.

Information About the Adviser's Related Persons. For each related person included in the financial services categories above, an adviser would be required to disclose: (i) its legal and business names

(which requirement currently only applies with respect to related persons that are investment advisers or broker-dealers); (ii) the relationship between the adviser and the related person; (iii) the name and jurisdiction of any foreign financial regulatory authority with which the related person is registered and (iv) whether the adviser and the related person share any personnel who would be considered an "access person" (as defined in Rule 204A-1(e)(1) of the Advisers Act) or share confidential information.

Information About Other Business Names. The new Form ADV would require an adviser engaged in business under a different name to list such other name(s) and identify the line(s) of business in which the adviser is engaged using such name(s).

Other Form ADV Amendments

Form ADV Amendments Unrelated to Dodd-Frank. The Proposal also includes amendments to Form ADV that are unrelated to Dodd-Frank, including new requirements to report (i) contact information for an adviser's chief compliance officer, rather than the person designated to handle Form ADV inquiries; (ii) whether the adviser or any of its control persons is a public reporting company under the Exchange Act and (iii) the total number of persons that act as qualified custodians for the adviser's clients in connection with advisory services the adviser provides.

Technical Amendments to Form ADV. The Proposal would make the following technical amendments to Form ADV relating to the reporting of disciplinary events: (i) there would now be a checkbox for the adviser to indicate whether the disciplinary information reported relates to the adviser or any of its supervised persons, (ii) advisers would be permitted to remove disclosure reporting pages that were filed in error, and (iii) the new form clarifies that disclosure would be required in the brochure supplement of any hearing or formal adjudication in which a professional attainment, designation or license of a supervised person was revoked or suspended because of a violation of rules relating to professional conduct.

Amendments to the "Pay-to-Play" Rule

The SEC's recently adopted "pay-to-play" rule, Rule 206(4)-5 (the "**Pay-to-Play Rule**"), generally prohibits registered and certain unregistered advisers from engaging in certain "pay-to-play" practices. The SEC's proposal would amend the Pay-to-Play Rule in response to certain changes made to the Advisers Act by the Dodd-Frank Act.

Application to Newly Created Exemptions. Rule 206(4)-5 currently applies to advisers that are either registered with the SEC or unregistered in reliance on the exemption under Section 203(b)(3) of the Advisers Act. The SEC's proposal would extend the Pay-to-Play Rule to apply to exempt reporting advisers. In addition, the Implementing Release confirms that the Pay-to-Play Rule applies to advisers relying on the foreign private adviser exemption from registration that was added to Section 203(b)(3) of the Advisers Act by the Dodd-Frank Act. Due to the repeal of the private adviser exemption in Section 203(b)(3), many unregistered advisers will register under the Advisers Act and will continue to be subject to the Pay-to-Play Rule.

Registered Municipal Advisors. The SEC's proposal would amend the provision of the Pay-to-Play Rule that prohibits advisers from paying third-party solicitors and placement agents to solicit governmental entities unless such persons are "regulated persons" (*i.e.,* registered investment advisers or broker-dealers that are members of the Financial Industry Regulatory Authority ("**FINRA**")) subject to similar pay-to-play restrictions. Instead, the SEC would permit an adviser to pay any "regulated municipal advisor" to solicit governmental entities on its behalf. A "regulated municipal advisor" is defined as a municipal advisor that:

- is registered under section 15B of the Exchange Act; and

- is subject to pay-to-play rules adopted by the Municipal Securities Rulemaking Board ("**MSRB**") and determined by the SEC to be substantially equivalent to or more stringent than the Pay-to-Play Rule imposed on investment advisers.

Municipal advisors, which are a new category of persons created by the Dodd-Frank Act, are subject to MSRB rules and include any third-party solicitors, *including* registered investment advisers and broker-dealers, that solicit a municipal entity (such as a state or local pension fund). The MSRB intends to promulgate rules that would subject municipal advisors to pay-to-play rules similar to those currently governing municipal securities dealers under the MSRB rules. Since third-party solicitors that are broker-dealers are expected to be subject to any such pay-to-play rules adopted by the MSRB, FINRA has deemed it unnecessary to adopt its own pay-to-play rules that would satisfy the requirements of the Pay-to-Play Rule with respect to broker-dealer solicitors. The SEC therefore proposes to replace references to FINRA's pay-to-play rules in Rule 206(4)-5 with references to any MSRB pay-to-play rules adopted with respect to municipal advisors that the SEC finds are at least as stringent as those imposed by the SEC on investment advisers.

Compliance Date Not Amended. The proposed amendments to the Pay-to-Play Rule retain the September 13, 2011 compliance date with respect to the Pay-to-Play Rule's limitations on payments to third-party solicitors.

Technical Amendments. The SEC's proposal would include several minor technical amendments, including an amendment to the definition of "covered associate" in the Pay-to-Play Rule to clarify that a legal entity, not just a natural person, that is a general partner or managing member of an investment adviser would satisfy the definition.

- See the Implementing Release containing the full text of the proposed rules
- See the press release and fact sheet issued by the SEC

The SEC has requested public comment on the proposed rules. Comments are due to the SEC within 45 days after publication in the Federal Register. Assuming Federal Register publication by November 29, the Monday after Thanksgiving, comments would be due the first week of January.

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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