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SEC Issues Proposals To Implement Dodd-Frank and Require Private Fund Advisers To Register

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On November 19, 2010 the Securities and Exchange Commission ("SEC") issued a release proposing new rules and rule amendments under the Investment Advisers Act of 1940 ("Advisers Act") to give effect to the provisions of Title IV of the Dodd-Frank Act (a/k/a, the "Private Fund Investment Adviser Registration Act of 2010") (See Release No. IA-3110). Among other changes, these amendments include reallocating oversight of certain mid-sized investment advisers to the states, repealing the "private adviser exemption" currently included in the Advisers Act, and amending the SEC's "pay-to-play" rules.

Eligibility of Advisers for SEC Registration

The Advisers Act currently prohibits an adviser from registering with the SEC if such adviser is regulated by the state in which it has its principal office and place of business, unless it has assets under management of at least $25 million. Dodd-Frank provides for a new group of "mid-sized advisers," and prohibits an adviser that is registered in the state in which it has its principal office and place of business, and has between $25 million and $100 million in assets under management, from registering with the SEC. The Dodd-Frank provision effectively raises the threshold for SEC registration from $25 million to $100 million.

Dodd-Frank provides for three exemptions to the prohibition on SEC registration: (1) if the adviser is not required to register as an adviser in the state in which it maintains its principal office and place of business; (2) if the adviser was registered, it would not be subject to an examination by the state regulator; and (3) if the adviser is required to register in 15 states or more. The SEC previously adopted six exemptions from the prohibition, and is proposing amendments to three of those exemptions as discussed in more detail below.

The Transition to State Registration

New Rule 203A-5 will require each adviser registered with the SEC on July 21, 2011 (effective date of Title IV of Dodd-Frank) to file an amendment to its Form ADV no later than August 20, 2011, and then to report the market value of its assets under management within 30 days of the filing. The filing will require an adviser to re-evaluate whether or not it is eligible for SEC registration. The filing will also aid the SEC and state regulators in assessing which advisers will transition to state registration, and the basis for either the transition or continued SEC registration. If an adviser is no longer eligible for SEC registration, it must file a Form ADV-W to withdraw its SEC registration by October 19, 2011. The transitional process proposed by the SEC includes two grace periods: (1) the 30-day period from the July 21, 2011 effectiveness of Dodd-Frank for advisers to determine whether they are eligible for SEC registration and to file an amended Form ADV; and (2) an additional 60 days from the end of that first 30-day grace period to register with the states and arrange for its associated persons to qualify for investment adviser representative registration, before withdrawing registration with the SEC.

Related Amendments to Form ADV

In light of the new $100 million threshold for SEC registration, the SEC is proposing to amend Item 2 of Part 1A to reflect the new threshold. Item 2 will require SEC registered advisers (and each applicant for registration) to state the basis for SEC-registration eligibility as: (1) it's a large adviser (at least $100 million assets under management); (2) it's a mid-sized adviser that doesn't meet the criteria for state registration and examination; (3) it has its principal office and place of business in Wyoming (Wyoming does not regulate advisers) or outside the United States; (4) it meets the requirements for an exemption under the Advisers Act (detailed below); (5) it's an adviser or sub-adviser to a registered investment company; (6) it's an adviser to a business development company (and each applicant for registration) and has $25 million or more of regulatory assets under management; or (7) some other basis for SEC registration.

Determining Assets Under Management for Purposes of SEC Registration

The Advisers Act defines "assets under management" as the "securities portfolios" to which an adviser provides "continuous and regular supervisory or management services." The instructions to Form ADV currently list certain types of assets that advisers may include, but are not required to include, in the calculation, which in effect gives the adviser the opportunity to opt between state or SEC registration by either including or excluding a class of assets. The SEC is now proposing to apply a uniform method for the calculation of assets under management.

In addition, the SEC proposes to use the term "regulatory assets under management" in Part 1A of Form ADV in order to recognize the distinction from the amount of assets disclosed in Part 2 of Form ADV. The SEC proposes that "regulatory assets under management" include portfolios for which they provide continuous and regular supervisory or management services, regardless of whether the assets are proprietary assets, assets managed without compensation, or assets of foreign clients (all of which an adviser may currently include). In addition, advisers would no longer be permitted to subtract outstanding indebtedness, and other accrued but unpaid liabilities remaining in a client's account and managed by the adviser.

The SEC also proposes guidance (via instructions to Form ADV) as to how an adviser to private funds should determine the amount of assets it has under management. The SEC proposes that regulatory assets under management include the value of any private funds over which the adviser exercises continuous and regular supervisory or management services, regardless of the nature of the assets held by the fund. Advisers would also be required to include any uncalled capital commitments made to the fund. In addition, all advisers would be required to use the fair valuation method to value their private fund assets under management that the SEC believes would result in more consistent calculations across the industry. Advisers would apply the revised method to calculate assets under management to determine eligibility for SEC registration, as well as for purposes of the new exemptions from registration under the Advisers Act for private advisers and certain private fund advisers (see Release No. IA-3111, November 19, 2010).

Moving Between State and SEC Registration

The Advisers Act currently includes two mechanisms that allow advisers to avoid having to switch between state and SEC registration because of fluctuations in their assets under management: The first, a $5 million buffer for advisers with assets under management between $25 million and $30 million, such that they can remain state-registered, and not be subject to cancellation of SEC registration until its assets under management drop below $25 million; and second, the rule permits an adviser to rely on the firm's assets under management reported annually in the annual updating amendments for purposes of determining eligibility to register with the SEC, so that the adviser would not need to change registration status based on fluctuations that occur during the course of the year. Since Dodd-Frank requires most advisers with between $30 million and $100 million in assets under management to register with the states, the SEC believes that the $5 million buffer is no longer necessary. Instead, the SEC proposes retaining the current requirement that allows advisers to rely on the amount of assets under management as reported once a year in the adviser's annual update to its Form ADV. The Advisers Act also provides for a grace period of 180 days from the adviser's fiscal year to switch to state registration, should an adviser no longer be eligible for SEC registration. The SEC believes that the annual assessment of assets under management and the grace period to switch registration are sufficient to prevent advisers from having to move between state and SEC registration on a frequent basis.

Exemptions from the Prohibition on SEC Registration

As previously mentioned, the SEC has adopted six exemptions from the prohibition on SEC registration in Rule 203A-2 of the Advisers Act. The SEC proposes amendments to three of those exemptions to reflect recent regulatory developments.

NRSROs

The SEC has proposed eliminating the exemption for NRSROs as Congress has since excluded NRSROs from the Advisers Act, instead regulating such entities via the Securities Exchange Act of 1934 ("Exchange Act"). The SEC also noted that only one NRSRO is currently registered as an adviser with the SEC, noting that that NRSRO has assets of more than $100 million and therefore would not need to avail itself of the exemption.

Pension Consultants

Rule 203A-2(b) currently provides an exemption for advisers that are pension consultants, with respect to benefit plans having an aggregate value of more than $50 million in assets. The SEC is proposing that the $50 million threshold be increased to $200 million, consistent with the increased threshold for assets under management requiring advisers to register with the SEC.

Multi-State Advisers

Rule 203A-2(e) currently provides an exemption from the prohibition on SEC registration for advisers that are required to register in 30 states or more, and once registered with the SEC, that adviser remains eligible for SEC registration so long as it would be required to register in at least 25 states. The SEC is proposing to lower that threshold to 15 states or more, and eliminate the cushion for continued eligibility.

The SEC has also requested comment as to whether some or all of the exemptions should not be made available to the new class of "mid-sized advisers."

Elimination of Rule 203A-4 Safe Harbor

The SEC proposes to eliminate the current safe harbor for an adviser registered in the same state in which it has its principal office and place of business, based on a reasonable belief that it is prohibited from SEC registration because of insufficient assets under management. The SEC notes that it is unlikely an adviser would be reasonably unaware that its assets under management exceed $100 million, given that advisers are required to report their regulatory assets under management on Form ADV.

Mid-Sized Advisers

Mid-sized advisors will be prohibited from SEC registration if the adviser is required to register with the state in which it maintains its principal office and place of business, and if so registered, would be subject to examination by the state regulator. The SEC has proposed to amend Form ADV to include an explanation of both "required to be regulated" and "subject to examination." The SEC has interpreted "regulated or required to be regulated" to mean that the state has enacted an investment adviser statute, regardless of whether the adviser has actually registered in the state. The SEC is proposing to amend Form ADV to require mid-sized advisers registered with the SEC to affirm at initial application, and then on an annual basis, that it is not required to be registered at the state level. The SEC intends to confirm with the various state securities authorities whether an adviser registered in that state would be subject to an examination by that state's securities regulator.

Exempt Reporting Advisers

As noted earlier, Dodd-Frank repealed the "private adviser exemption" of the Advisers Act that many hedge fund advisers and advisers to other pooled investment vehicles relied upon to avoid SEC registration. Dodd-Frank amends the Advisers Act to include more narrow exemptions for: (1) advisers that advise only venture capital funds, and (2) advisers that only advise private funds and have less than $150 million in assets under management, provided that these advisers are subject to reporting requirements as determined by the SEC. Accordingly, the SEC proposes to require such "exempt reporting advisers" to file and update certain items of Form ADV. Form ADV would then serve as both a reporting and registration form.

Reporting by Exempt Reporting Advisers

Exempt reporting advisers would file their reports electronically on Form ADV through the IARD process. The SEC would make these reports publicly available via its website. Exempt reporting advisers may request a temporary hardship exemption from electronic filing by filling out Form ADV-H.

Form ADV would be re-titled "Uniform Application for Investment Adviser Registration" and "Report by Exempt Reporting Advisers," and advisers would indicate which type of report they are filing. In addition, an exempt reporting adviser would identify the exemption on which it relies to report, but not register. Form ADV would include an instruction for exempt reporting advisers to complete only certain items of the Form. The SEC proposes that exempt reporting advisers address the following items, which are contained in Part 1A:

- 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
- Item 10 - Control Persons
- Item 11 - Disclosure Information

In addition, exempt reporting advisers would complete corresponding sections of Schedules A, B, C and D. The SEC noted that it is seeking information it believes would help to identify advisers, their owners, and their business models, and that is also sufficient to indicate whether advisers or their activities may warrant additional attention to protect investors.

Updating Form ADV Reports

Exempt reporting advisers would be required to amend their Form ADV reports at least annually (within 90 days of the adviser's fiscal year end) or more frequently, if required under the Instructions to Form ADV. Accordingly, the Instructions would be amended to require that Items 1 (Identifying Information), 3 (Form of Organization) or 11 (Disclosure Information) be updated promptly should this information become inaccurate in any way, and Item 10 (Control Persons) be updated if it becomes materially inaccurate. An exempt reporting adviser would also be required to amend its Form ADV in the event that it ceases to be an exempt reporting adviser. It is proposed that the Instructions also be amended to provide guidance for exempt reporting advisers filing final reports because they are required to register with the SEC.

Transition for Exempt Reporting Advisers

The SEC proposes to require that exempt reporting advisers file their initial reports by August 20, 2011.

Form ADV

The SEC is proposing that advisers provide additional information regarding: (1) private funds advised by the adviser; (2) their advisory business, including information about the types of clients the adviser has, its employees, and the activities of the employees; and (3) the adviser's non-advisory activities and its affiliations within the financial industry.

Private Fund Reporting

The SEC proposes that the information required by Item 7.B and Schedule D concerning private funds be expanded. Private fund reporting would be required by both registered and exempt reporting advisers. Item 7 currently requires advisers to complete Section 7.B of Schedule D for any "investment-related limited partnership" that it, or a related person, advises. The SEC proposes to modify Item 7 to apply to "private funds" advised by the adviser (and not related persons of the adviser). The Advisers Act is amended to define "private fund" such that advisers would report on pooled investment vehicles whether or not they are organized as limited partnerships. Sub-advisers would be allowed to exclude private funds for which an adviser is already reporting on a Schedule D. Advisers sponsoring a master-feeder structure would submit a single Schedule D for the master and all feeder funds that would otherwise submit the same data. In addition, advisers with a principal office and place of business outside the United States could omit a Schedule D for a private fund not organized in the United States, and not offered to or owned by a U.S. person (proposed to be defined by tracking the same definition under Regulation S, except for a special rule related to discretionary accounts for the benefit of a U.S. person).

Item 7.B would also be amended to expand identifying information required to provide organizational, operational and investment characteristics of the fund, the amount of the fund's assets, the nature of the fund's investors, and the fund's service providers.

Advisory Business Information

Item 5 requires each advisor to report the number of its employees that are registered representatives of a broker-dealer. This Item would be expended to also include the number of employees registered as investment adviser representatives or insurance agents. Each advisor is required by Items 5.C and 5.D to report how many clients it has and to describe the types of clients it has. The SEC proposes to expand the list of types of clients to be included in Item 5.D, and distinguish between pension and profit-sharing plans subject to ERISA. In addition, advisers would disclose the amount of assets under management for each client type, as well as what percentage of the adviser's clients are not U.S. persons.

Item 5.G requires each adviser to select, from a list, the types of advisory services that it provides. The SEC proposes to expand that list to include portfolio management for pooled investment vehicles other than registered investment companies, and educational seminars or workshops. Proposed new Item 5.J would require each adviser to select from a list the types of investments about which they provided advice during that fiscal year.

Other Business Activities and Financial Industry Affiliations

In Items 6 and 7, an adviser selects from a list the types of financial services it provides. The SEC is proposing that the lists for Items 6 and 7 be expanded to include business as a trust company, registered municipal adviser, registered security-based swap dealer, and major security-based swap participant. In addition, similar to the list in Item 7, accountants and lawyers would be added to the list in Item 6. The disclosure required by Item 7.B regarding whether a related person is a sponsor, general partner, or managing member of a pooled investment vehicle, would move to Item 7.A. The instruction to Item 7 would be amended to clarify that advisers should include related persons that are foreign affiliates. Additional reporting is proposed in relation to the corresponding sections Schedule D for Items 6 and 7.

Participation in Client Transactions

Item 8 currently requires an adviser to disclose, among other things, whether it has discretionary authority to determine the brokers or dealers for client transactions, and whether it recommends brokers or dealers to clients. The SEC proposes that advisers also disclose whether any of the brokers or dealers are related persons of the adviser. In addition, an adviser that received soft dollar benefits would indicate whether those benefits qualify for the safe harbor for eligible research or brokerage services under section 28(e) of the Exchange Act. Lastly, the SEC also proposes requiring an adviser to disclose whether it or a related person receives direct or indirect compensation for client referrals.

Advisers Reporting $1 Billion in Assets

Dodd-Frank requires the SEC and other regulators to adopt rules relating to certain excessive incentive-based compensation arrangements, including those arrangements used by advisers with assets of $1 billion or more. In order to identify such advisers, the SEC proposes to amend Item 1 of Form ADV for advisers to indicate whether or not they have $1 billion or more in assets. The SEC also proposes that to satisfy the Item 1 requirement, the adviser's total assets would be determined in the same manner as its total assets are determined for the adviser's balance sheet for its most recent fiscal year end.

Other Amendments to Form ADV

The SEC has also proposed additional changes unrelated to Dodd-Frank, relating to assessment of compliance risks. Item 1 would be amended to require advisers to provide contact information for their chief compliance officer (instead of an employee designated to handle ADV-related questions) so that the SEC would have direct access to the person in charge of the adviser's compliance program. Advisers would also be permitted (but not required) to include an additional contact for Form ADV. Item 1 would also be amended to require an adviser to disclose whether it or any of its control persons is a public reporting company under the Exchange Act.

Item 9 would be amended to require an adviser to disclose the total number of persons that act as qualified custodians for its clients in connection with the advisory services provided by the adviser. Current Item 9 asks for this information only in respect to the adviser or its related persons acting as custodian (and not other qualified custodians).

Three technical changes related to disclosure of disciplinary events are also proposed. Item 11 would be amended so that advisers would indicate whether any of the disciplinary information included in Item 11 and the corresponding disclosure pages concerns the adviser or the adviser's supervised persons, allowing the SEC to quickly determine whether such information reported only relates to affiliates. The disclosure reporting pages would also be changed to permit an adviser to remove a page filed in error by checking a box. Item 3.D of the brochure supplement currently requires disclosure relating to administrative "proceedings" before the SEC or other regulatory authority. The SEC has proposed amending that item to require disclosure relating to a "hearing or formal adjudication" rather than "proceeding," as this Item was intended to disclose actions taken by the designating authority to revoke or suspend the license it administers, rather than actions taken by regulators who are not likely to pursue the revocation or suspension of a professional license.

Other Amendments - 'Pay to Play' Rule

In addition to other technical and conforming amendments, the SEC has proposed changes to the "Pay to Play" rule, which generally prohibits registered and certain unregistered advisers from engaging directly or indirectly in pay-to-play practices identified in Rule 206(4)-5. The SEC proposes to extend the scope of the rule to apply to exempt reporting advisers and foreign private advisers. In addition, advisers are currently prohibited from paying persons to solicit government entities unless they are "regulated persons" subject to the rules of a registered national securities association that restricts engaging in pay-to-play activities. The SEC proposes to instead permit advisers to pay a "regulated municipal adviser" for such solicitations. A "regulated municipal adviser" would be a person registered under section 15B of the Exchange Act, and subject to the Municipal Securities Rulemaking Board's ("MSRB") pay-to-play rules.

Under Dodd-Frank, a "municipal adviser" is a new category of person that includes persons who undertake "a solicitation of a municipal entity." This category includes third-party solicitors, such as advisers and broker-dealers, that seek business on behalf of an adviser from a municipal entity, including a pension fund. These municipal advisers are subject to the rules of the MSRB, which intends to consider subjecting municipal advisers to pay-to-play rules.

Lastly, it is proposed that the definition of "covered associate" of an adviser be amended to clarify that a legal entity, not just a natural person, which is a general partner or managing member of an adviser, fall under this definition.