January 18, 2011

Comments Due January 24 on SEC's Proposals to Implement $100 Million Asset Threshold, Other Dodd-Frank Changes for Investment Advisers

The Securities and Exchange Commission has proposed a number of new rules and rule amendments (the Proposed Implementing Rules) to implement provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act), which made significant changes to the Investment Advisers Act of 1940, as amended.

Title IV of Dodd-Frank, the Private Fund Investment Advisers Registration Act, was intended to require many managers of hedge funds and private equity funds to register with the SEC. Effective July 21, 2011, Dodd-Frank repeals the exemption from registration in Section 203(b)(3) of the Advisers Act for investment advisers who (i) have had fewer than 15 clients in the preceding 12 months; (ii) do not generally hold themselves out to the public as investment advisers; and (iii) do not act as advisers to registered investment companies or business development companies. Although it repealed Section 203(b)(3), Congress expressly directed the SEC to promulgate rules exempting, among others, advisers managing only private funds with less than $150 million in assets under management (AUM) in the United States, foreign private advisers and venture capital fund advisers. These exemptions (the Proposed Exemptive Rules) were proposed in a companion release and are addressed in a separate advisory.[1]

While the focus of Title IV of Dodd-Frank was on the registration of advisers to private funds, the Proposed Implementing Rules may also have significant consequences for other money managers. The Proposed Implementing Rules address several issues, including:

- the increased threshold of $100 million in AUM for investment adviser registration with the SEC;
- reporting requirements for exempt reporting advisers;
- amendments to Form ADV that affect all advisers, and not only private fund managers; and
- amendments to the Advisers Act "pay to play" rule.

The SEC has asked for comments on the approaches taken in its proposals, and on alternate approaches. The comment period closes on January 24, 2011.

[1] The Proposed Implementing Rules were published in Release No. IA-3110 (Nov. 19, 2010). On the same day, the SEC also issued the Proposed Exemptive Rules in Release No. IA-3111.

If you would like assistance in commenting on the Proposed Implementing Rules or more information about the matters discussed in this Client Advisory, please contact your Katten Muchin Rosenman LLP attorney or any of the following members of Katten's **Financial Services Practice**.

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$100 Million Threshold for SEC Registration

Section 410 of Dodd-Frank increases the AUM threshold for eligibility to register (or remain registered) as an investment adviser with the SEC. Section 203A of the Advisers Act currently provides that an investment adviser that would otherwise be regulated by the state in which it maintains its principal office and place of business is ineligible to register with the SEC unless it has at least $25 million of AUM. SEC registration currently is optional for advisers with between $25 million and $30 million of AUM and mandatory for advisers with $30 million or more of AUM. Effective July 21, 2011, Dodd-Frank raises the level of AUM required for SEC registration generally to $100 million. The SEC estimates that the new threshold will require approximately 4,100 advisers with AUM of between $25 million and $100 million (Mid-Sized Advisers) that are currently registered with the SEC to withdraw their SEC registrations and re-register in the relevant states, provided the adviser would be subject to state registration and examination.

Mid-Sized Adviser Requirements. Section 203A(a)(2) of the Advisers Act, as amended by Dodd-Frank, prohibits a Mid-Sized Adviser from registering with the SEC if:

- it is required to be registered as an investment adviser with the state in which it maintains its principal office and place of business; and
- upon registering in the state, would be subject to examination as an investment adviser by that state.

Under the Proposed Implementing Rules, a Mid-Sized Adviser would not be deemed to be "required" to register in the state where it maintains its principal office and place of business if an exemption from state registration is available. In that case, the adviser would be required to register with the SEC (absent an exemption from SEC registration), and could not avoid SEC registration by voluntarily registering at the state level. A Mid-Sized Adviser that registers with the SEC on this basis will be required to affirm in its initial Form ADV and annual updates thereafter that it is not required to be registered as an adviser with the state where it maintains its principal office and place of business.

The SEC proposes to confirm with each state securities authority whether an adviser registered in that state would be subject to examination by that authority. The SEC will update the Investment Adviser Registration Depository system to identify those states in which the state securities authority did not certify that advisers are subject to examination, and would require Mid-Sized Advisers maintaining their principal offices and places of business in those states to register with the SEC.

Permissive Registration Categories. The SEC has proposed to continue permissive registration for five categories of advisers who do not meet the $100 million AUM threshold:

- pension consultants who provide investment advice with respect to at least $200 million (increased from $50 million currently);
- advisers in the same controlled group with a registered adviser;
- advisers expecting to be eligible for SEC registration within 120 days;
- advisers who would be required to register with 15 or more states (reduced from 30 states currently); and
- internet investment advisers.

Initial Transition to State Regulation. The SEC has proposed Rule 203A-5, which would provide for two "grace periods" to facilitate the transition for advisers who will be required to deregister with the SEC and re-register with the states. First, each investment adviser registered with the SEC on July 21, 2011, will be required to file an amendment to its Form ADV no later than August 20, 2011, to report its AUM. Second, an adviser that is no longer eligible for SEC registration based on the AUM on the August 20 report would be required to file a Form ADV-W to withdraw its SEC registration no later than October 19, 2011, and would be subject to both the Advisers Act and relevant state law during the interim period. In light of the forthcoming changes to the AUM threshold for SEC registration, the Proposed Implementing Rules also provide that from January 1, 2011, until the end of the transition process (October 19, 2011), a state-registered or newly registering Mid-sized Adviser having

AUM of between $30 million and $100 million (which, under current regulations, would subject such adviser to mandatory SEC registration) need not register with the SEC if such adviser: (i) reports on its Form ADV that it has between $30 million and $100 million of AUM; (ii) is registered as an investment adviser in the state in which it maintains its principal office and place of business; and (iii) has a reasonable belief that it is required to be registered with, *and* is subject to examination as an investment adviser by, that state. Such an adviser should remain registered with, or, in the case of a newly registering adviser, apply for registration with the state securities authority.

Ongoing Transition Rules Between State and Federal Registration. The SEC proposal would amend Rule 203A-1 to eliminate provisions making SEC registration optional for advisers having AUM between $25 million and $30 million, which were designed to permit advisers to avoid frequent changes between state and SEC registration due to periodic AUM fluctuations. The SEC has not proposed a similar permissive registration "buffer" for Mid-sized Advisers. However, it noted that advisers will be required to assess their eligibility for registration only on an annual basis, and therefore will not be required to change their registration status as a result of intra-year AUM fluctuations (except for advisers who register with the expectation that they will have the requisite AUM within 120 days). Under the proposed revised rule, state-registered advisers that become eligible for SEC registration and are not relying on the proposed exemptions for venture capital fund advisers or private fund advisers must apply for SEC registration within 90 days of filing an annual updating amendment to Form ADV reporting eligibility. The annual updating amendment must be filed within 90 days of the adviser's fiscal year end, and thus the grace period is effectively 180 days.

Advisers moving from SEC to state registration have 180 days from their fiscal year end to withdraw from registration unless they are again eligible for SEC registration on the date of required withdrawal. These proposed grace periods have not changed from current requirements. Similarly, an SEC registered adviser who takes advantage of the 180-day grace period to deregister with the SEC will be deemed registered with both the SEC and the state of its principal office and place of business and both the Advisers Act and state law will apply to its advisory activities, as is the case under current rules.

Calculation of AUM. The SEC has proposed revisions to the instructions for Form ADV to implement a uniform method for calculating AUM to determine whether an adviser will be eligible to register or remain registered with the SEC or to rely upon various exemptions. The proposed rules refer to the result reached using this method as "regulatory assets under management" (RAUM), a term used in numerous contexts in both the Proposed Implementing Rules and the Proposed Exemptive Rules.

For purposes of calculating RAUM, advisers would be *required* to include the following categories of assets, the inclusion of which is optional under the current instructions for Form ADV:

- proprietary assets;
- assets managed without receiving compensation; and
- assets of foreign clients.

Also, for purposes of RAUM calculation, advisers would not be permitted to subtract any outstanding indebtedness or other accrued but unpaid liabilities (including accrued fees or expenses) that remain in a client's account. Thus, it appears that borrowings to provide trading leverage would not be deducted from assets under management.

With respect to "private funds," an adviser would be required to (i) 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 held by the fund (although a sub-adviser to a private fund would include in its AUM only that portion of the fund's portfolio for which it provides sub-advisory services); (ii) include the value of any uncalled capital commitments made to the fund; and (iii) use a fair value methodology to value private fund assets, but would not be required to determine fair value in accordance with U.S. generally accepted accounting principles (GAAP). A private fund would be defined as an issuer that would be an "investment company" but for the exclusions provided in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (Investment Company Act).

Accordingly, the SEC's proposal would appear to require advisers to funds that meet the requirements of these exclusions to include the entire value of each such fund's investment portfolio in AUM calculations, even if such portfolio would not otherwise constitute a "securities portfolio" as described in the instructions to Part 1A of the Form ADV (for example, because less than 50% of the portfolio's value consists of securities).

The requirement to include proprietary assets, assets managed without compensation and assets of foreign clients has led to uncertainty for some firms previously of the view that they did not have assets under management for purposes of investment adviser registration. For example, controlled subsidiaries that manage only proprietary assets and assets of their corporate affiliates previously might not have registered as investment advisers on several possible bases, including that they only managed proprietary assets or they were not compensated for such management. The proposed calculation of regulatory AUM raises the possibility that advisers with only assets in such category could be subject to regulation under the Advisers Act.

Reporting by Exempt Reporting Advisers

Dodd-Frank includes new provisions authorizing the SEC to require advisers relying on the newly created "private fund adviser" and "venture capital fund adviser" registration exemptions (referred to, collectively, as "exempt reporting advisers") to maintain certain records and to submit such reports as the SEC determines "necessary or appropriate in the public interest," notwithstanding their unregistered status.

Limited Reporting. The SEC proposes to use Form ADV as the primary means for collecting required information from exempt reporting advisers. Accordingly, such advisers would be required to complete a limited subset of items from Part 1A of Form ADV and file this through the Investment Adviser Public Disclosure system. This would include identifying organizational and ownership information of the adviser; details regarding other business activities, including acting as a commodity pool operator, commodity trading advisor, security-based swap dealer or major security-based swap participant; disciplinary histories of the adviser and its affiliates; and information regarding the private funds advised by such adviser. Such reports would be publicly available, although this was not specifically mandated by Dodd-Frank. Exempt reporting advisers would not be required to complete the remaining items in Part 1A or to prepare a client brochure (Form ADV Part 2). The SEC has solicited comments on the requirement that disclosures be public and on the scope of reporting requirements for exempt reporting advisers.

Updating Requirements. An exempt reporting adviser would be required to amend its Form ADV at least annually, within 90 days of the end of the adviser's fiscal year, and promptly if its responses to certain items become inaccurate. Under the SEC's proposal, exempt reporting advisers would be required to file their initial report on Form ADV no later than August 20, 2011.

Proposed Blue Sky Exemption for Advisers to Section 3(c)(7) Private Funds. As noted by the SEC staff, the North American Securities Administrators Association, Inc. (NASAA) has proposed a model rule for state securities administrators that would exempt from state registration an exempt reporting adviser that:

- has not been disqualified under the "bad boy" provisions of 17 CFR Section 230.262;
- acts as an adviser solely to private funds meeting the exclusion from the definition of "investment company" under Section 3(c)(7) of the Investment Company Act;
- files a copy of each report and amendment required of exempt reporting advisers with the state along with a consent to service of process; and
- pays the state's required fee.

The rule would also exempt any investment adviser representatives of advisers exempt from state registration under the proposed rule. The rule proposal does not extend to Section 3(c)(1) funds or their investment adviser representatives. NASAA has requested that comments on this proposal be submitted to advcomments@nasaa.org no later than January 24, 2011. As with any model rule, after adoption by NASAA this rule would have to be adopted by each state separately.

Enhanced Reporting for Registered Advisers and Exempt Reporting Advisers

The SEC also has proposed substantive changes to the Form ADV that would require advisers to provide additional information about three specified areas of their business for risk monitoring purposes:

- information regarding private funds they advise;
- expanded information about their advisory business and their business practices that may present significant conflicts of interest; and
- additional information about their non-advisory activities and their financial industry affiliations.

Private Fund Reporting. The SEC proposal would expand the information that registered advisers must provide regarding the private funds they advise and would also apply these requirements to exempt reporting advisers. Item 7.B of Form ADV would be revised to require information regarding all private funds (irrespective of their form of organization) advised by the adviser, but no longer would require the adviser to provide information regarding funds advised by their affiliates (on the assumption that the affiliates will be subject to registration and reporting requirements directly). A separate Schedule D to Form ADV would be required for each such private fund. Advisers would be permitted to submit a single Schedule D for all funds within the same "master-feeder" structure for which the information is substantially identical. Sub-advisers would be permitted to exclude certain reporting information with respect to those private funds for which another adviser is already reporting on Schedule D. Advisers having their principal office and place of business outside the United States would not be required to submit a Schedule D for a private fund that is neither organized in the United States nor offered to or owned by "United States persons" (defined in substantially the same manner as "U.S. Person" under Regulation S under the Securities Act of 1933, with an exception for discretionary accounts managed by non-U.S. persons for the account of U.S. Persons if the account manager is affiliated with the adviser).

Some of the newly required information about funds would include:

- the identities of all sub-advisers;
- the general category of investment strategy employed by the fund (i.e., (i) hedge fund, (ii) liquidity fund, (iii) private equity fund, (iv) real estate fund, (v) securitized asset fund, (vi) venture capital fund or (vii) other private fund);
- the amount of such fund's gross and net assets;
- an indication of whether the fund invests in securities of U.S. registered mutual funds;
- a breakdown of assets and liabilities of the fund into Levels I, II and III, as established by U.S. GAAP;
- the number and type (e.g., individuals, government entities, broker-dealers, pension plans, banking entities, other private funds) of investors in the private fund and the percentage owned by U.S. persons and non-U.S. persons;
- the percentage owned by the adviser and its related persons;
- the minimum amount required to be invested; and
- an indication of whether the fund relies on a private placement exemption in the United States and if so, the file number of any Form D on file.

An adviser that seeks to preserve the anonymity of a private fund client may identify the client using a code name.

Advisers also would be required to provide basic identifying information regarding the fund's auditors, prime brokers, custodians, administrators and marketers, the status of such service providers as related persons of the adviser, and other specified information.

A technical question left open by the proposals is whether foreign funds not offered to U.S. persons must be reported in response to item 7.B. Because a "private fund" is defined in the Act as a fund that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act, foreign funds not offered to U.S. persons are not relying on these exceptions and technically are not private funds. Absent further clarification in the final rule upon adoption, disclosure of such funds would not appear to be required.

Other Business Information. The Proposed Implementing Rules would require additional disclosures in Items 6 and 7 that would (i) expand the list of financial services for which disclosure would be required if the adviser or a related person is actively engaged in such services; (ii) require an adviser to indicate if it is engaged in another business and to provide the name of the business; and (iii) require an adviser to provide identifying and more detailed information with respect to related persons, disclose whether a related person is registered with a foreign financial regulatory authority and explain how they share personnel and confidential information.

Participation in Client Transactions. The Proposed Implementing Rules would add additional questions to Item 8 to confirm (i) whether the adviser uses or recommends affiliated brokers or dealers for client transactions; (ii) for those advisers that indicate they receive "soft dollar" benefits, whether such benefits qualify for the "safe harbor" under Section 28(e) of the Securities Exchange Act of 1934; and (iii) whether the adviser or a related person receives direct or indirect compensation for client referrals.

"Pay to Play" Amendments

The Proposed Implementing Rules would make three amendments to Advisers Act Rule 206(4)-5 (the "Pay to Play" Rule), which generally prohibits registered and certain unregistered advisers from engaging in providing advisory services to a government entity within two years after making a contribution to an official of such entity. The proposal would amend the Pay to Play Rule to (i) make it applicable to exempt reporting advisers and foreign private advisers (new exemption categories created by Dodd-Frank and proposed to be defined in the Proposed Exemptive Rules), in addition to registered advisers; (ii) permit an adviser to pay any "regulated municipal advisor" (a newly created registration category under Dodd-Frank, defined to include persons that undertake a "solicitation of a municipal entity"); and (iii) clarify that a legal entity (not just a natural person) that is the general partner or managing member of an investment adviser would also be included within the definition of "covered associate" of an investment adviser.

The compliance date for the Pay to Play Rule remains September 13, 2011.