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DODD-FRANK NEWSLETTER MARCH 2011

Herrick, Feinstein is proud to launch our "Dodd-Frank Newsletter," which we will issue regularly to keep you informed on different aspects of Dodd-Frank implementation. In proposed exemptions from registration for certain investment advisers, (ii) the SEC's proposed rules implementing the Dodd-Frank Act's amendments to the Advisers Act, and (iii) the private fund systemic risk reporting rule jointly proposed by the SEC and CFTC. In forthcoming issues, we will select topics of interest to private fund advisers and to the financial services industry, including the Financial Stability Oversight Council, derivatives, and changes to various securities laws.

SEC Proposes Numerous Investment Adviser Rules under Dodd-Frank Act

Parts of the sweeping reforms contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act [1](the "Dodd-Frank Act") promise to have a significant impact on the investment adviser industry. These reforms include: (i) the repeal of the private adviser exemption; (ii) the creation of several new exemptions from registration; (iii) new reporting requirements for advisers to private funds; and (iv) the reallocation of jurisdictional responsibility between the SEC and state regulators.

Recently the SEC has proposed a number of new and amended rules to implement these reforms. In Part I of this Dodd-Frank Newsletter, we will address the SEC's proposed rules related to the newly created exemptions from investment adviser registration, including the exemptions for (i) advisers to venture capital funds; (ii) advisers to private funds with less than $150 million in assets under management and (iii) foreign private advisers. Then, in Part II, we will discuss the SEC's proposed rules implementing the amendments to the Advisers Act, which are related to: (i) the new eligibility requirements for registering with the SEC, (ii) the new reporting obligations of certain advisers that are exempt from registration, and (iii) changes to the disclosure obligations of registered investment advisers set out in Form ADV. Finally in Part III, we will provide a preview of the SEC's proposed rules on private fund systemic risk reporting, which will be covered more fully in a forthcoming Dodd-Frank Newsletter.

Part I: New Exemptions from Registration for Certain Advisers

A. Exemption for Advisers to Venture Capital Funds

The SEC recently proposed a rule defining the term "venture capital fund" for purposes of the new venture capital fund exemption from registration. Though advisers that qualify for this exemption would not be required to register with the SEC, they would nonetheless be subject to certain limited reporting requirements, as discussed more fully in Part II below. In its proposed rules, the SEC describes venture capital funds as long-term investors in early-stage or small companies that are privately held. In light of this description, the SEC proposes to require a venture capital fund to meet all of the following requirements:

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

Private Fund

The SEC would require a venture capital fund to be a private fund as defined under the Advisers Act. As amended by the Dodd-Frank Act, the Advisers Act defines a private fund as a fund that would otherwise be required to register as an investment company under the Investment Company Act, but for the exceptions provided by sections 3(c)(1) or 3(c)(7) thereunder.

Qualifying Portfolio Companies

A venture capital fund must invest only in equity securities issued by "qualifying portfolio companies." The SEC would define a qualifying portfolio company for purposes of the exemption as a company that: (i) does not have publicly traded equity securities; (ii) does not borrow or issue debt obligations in connection with the venture capital fund's investments; (iii) uses the capital provided by the venture capital fund for working capital or business expansion purposes; and (iv) is not itself a fund. In turn, the SEC would require a venture capital fund to acquire at least 80% of each qualifying portfolio company's securities directly from such company (as opposed to acquiring securities from other security holders as part of a recapitalization plan).

Management Involvement

The SEC would also require a venture capital fund to offer or provide significant managerial assistance to, or control, the qualifying portfolio company in connection with the fund's investment.

Limit on Fund Leverage and Guarantees

For purposes of the exemption, a venture capital fund must not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the fund's aggregate capital contributions and uncalled committed capital. Any such borrowing, indebtedness, guarantee or leverage within the 15% threshold must be for a non-renewable term of no longer than 120 calendar days. As such, leveraged buyout funds and other types of funds that use leverage or finance their investments in portfolio companies would not normally qualify for this exemption from registration.

No Redemption Rights

A venture capital fund relying on this exemption would also not be permitted to provide investors with redemption rights except in certain extraordinary circumstances. It would, however, be permitted to make pro rata distributions to investors.

Holds Itself Out as a Venture Capital Fund

The proposed definition would be limited to a private fund that represents itself as being a venture capital fund to its investors and potential investors. A fund could satisfy this requirement by describing its investment strategy as venture capital investing or as a fund that is managed in compliance with the elements of the SEC's proposed rule.

Not a Registered Investment Company or Business Development Company

The venture capital fund cannot be registered under the Investment Company Act or have elected to be treated as a business development company to qualify for this exemption from registration.

Application of Venture Capital Exemption to Non-U.S. Advisers

Neither the Dodd-Frank Act nor its legislative history indicate whether Congress intended to make the venture capital fund exemption available to an adviser with its principal office and place of the business outside of the United States (a “Non-U.S. Adviser”), but that invests in U.S. companies or solicits U.S. investors. Under the SEC’s proposal, a Non-U.S. Advisor may rely on the venture capital exemption if all of its clients, whether U.S. or non-U.S. persons, are venture capital funds. The SEC requested comment on whether the proposed rules should specify that a Non-U.S. Adviser is eligible to rely on the venture capital fund exemption even if it advises non-U.S. clients, which are not venture capital funds. As proposed, this approach appears inconsistent with the treatment of Non-U.S. Advisers under the private fund exemption discussed below, which focuses only on the private funds managed from a U.S. office of the Non-U.S. Adviser.

Grandfathering Provision Extending the Venture Capital Exemption

The SEC would include within the definition of venture capital fund any private fund that (i) represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund; (ii) has sold securities to one or more investors prior to December 31, 2010; and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011. Moreover, this rather broad grandfathering provision would include any fund that has accepted capital commitments by the specified dates even if none of the commitments has been called. The SEC believes that funds previously marketed and sold as venture capital funds would likely satisfy most, if not all, of the requirements of the proposed exemption and as such, may be treated as venture capital funds for the purposes of the exemption as long as they meet the requirements of the grandfathering provision.

B. Exemption for Advisers to Private Funds with Less than $150 Million in Assets Under Management

The Dodd-Frank Act creates a new exemption from registration for private fund advisers with less than $150 million in assets under management in the United States (the “private fund exemption”). Like venture capital advisers, advisers that qualify for this exemption would not be required to register with the SEC, but would nonetheless be subject to certain reporting requirements, as discussed more fully in Part II below. Under the private fund exemption, a U.S. adviser with its principal office and place of business in the U.S. must act solely as an investment adviser to private funds and manage private fund assets of less than $150 million, which amount includes assets managed from a place of business located outside of the United States. The SEC’s proposed rules would clarify this exemption and require such advisers to meet the requirements set forth below.

<u>Advises Solely Private Funds</u>

The proposal would limit an adviser relying on the private fund exemption to advising only “private funds” as defined under the Advisers Act (i.e., no managed accounts or other types of clients). Under the private fund exemption, an adviser would be able to advise an unlimited number of private funds, provided the adviser’s aggregate assets under management is less than $150 million. Conversely, if an adviser acquires even one non-private fund client, it would be required to register unless another exemption is available. The SEC would permit Non-U.S. Advisers with various types of clients to rely on the private fund exemption as long as all of the adviser's clients that are U.S. persons are private funds and it satisfies the assets managed in the United States requirement noted below.[2]

Private Fund Assets

The SEC would require advisers to calculate the value of private fund assets by reference to Form ADV, under which the SEC proposed a uniform method of calculating "regulatory assets under management" (as described below in Part II, Section D). In the case of a sub-adviser, the adviser would only have to count the portion of the private fund assets for which it has advisory responsibility. An adviser would also be required to include any uncalled capital commitments in its amount of private fund assets and to determine the amount of its private fund assets quarterly, based on the fair value of the assets at the end of the quarter.

Assets Managed in the United States

Under the proposed rules, all of the private fund assets of an adviser whose principal office and place of business is in the United States would be considered "assets under management in the United States." This would also include assets of such adviser in offices located outside of the United States. A Non-U.S. Adviser, however, would only be required to count private fund assets it manages from a place of business in the United States toward the $150 million exemption threshold. Thus, the private fund exemption would appear to provide a fairly broad registration exemption for Non-U.S. Advisers, provided, however, that unlike the "foreign private adviser" exemption discussed below, a Non-U.S. Adviser relying on the private fund exemption would still be subject to certain SEC reporting requirements discussed below, which many Non-U.S. Advisers may deem burdensome.

Transition Provision if Assets Equal or Exceed $150 Million

The SEC would allow an adviser one calendar quarter (three months) to register with the SEC after becoming ineligible to rely on the private fund exemption due to an increase in the value of its private fund assets.

C. Exemption for Foreign Private Advisers

The Dodd-Frank Act also establishes a narrow "foreign private adviser" exemption. For purposes of this exemption, a foreign private adviser is any investment adviser who:

- has no place of business in the United States;

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[2] For this purpose, the SEC proposes to adopt the definition of U.S. person already contained in Regulation S, which includes (i) an individual that is a resident of the United States; (ii) legal partnerships and corporations that are organized or incorporated in the United States; (iii) trusts that have a trustee who is a resident of the United States; and (iv) discretionary accounts that have a fiduciary who is a resident of the United States. With respect to a discretionary account maintained outside of the United States for the benefit of U.S. persons, an adviser must treat such account as a U.S. person if the account is held for the benefit of a U.S. person by a non-U.S. fiduciary who is a related person of the adviser.

- has, in total, fewer than 15 clients and investors in the United States in private funds advised by the adviser;
- has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25 million, or such higher amount as the SEC may, by rule, deem appropriate in accordance with the purposes of the Advisers Act; and
- does not:
  - hold itself out generally to the U.S. public as an investment adviser;
  - act as an investment adviser to any registered investment company
  - elect to be treated as a business development company.

The SEC rule proposal clarifies and defines various statutory provisions set forth above.

<u>Clients</u>

In determining the number of its clients, the SEC would allow an adviser to rely on the safe harbor for counting clients currently in effect for the private adviser exemption (which was repealed and replaced by the foreign private adviser exemption). Under the proposed rule, an adviser would be permitted to treat the following as a single client for purposes of the exemption:

- A natural person and:
  - that person's minor children;
  - any relative, spouse, or relative of the spouse of that person who has the same principal residence;
  - all accounts of which that person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries; and
  - all trusts of which that person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries;
- A corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the organization's investment objectives; and
- Two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.

The SEC would also add a new requirement that an adviser is required to count clients that receive advice without paying compensation to the adviser.

<u>Private Fund Investor</u>

Under the new foreign private adviser exemption, an adviser cannot advise more than 14 clients or "investors in the United States in private funds." The SEC proposes to define a private fund investor as any person who would be included in determining (i) whether the limit of 100 beneficial owners of the outstanding securities of a private fund has been met for purposes of the exemption from registration under section 3(c)(1) of the Investment Company Act; or (ii) whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(1) of the Investment Company Act.

This proposed definition would prevent a foreign private adviser from circumventing the limitations in the foreign private adviser exemption by setting up intermediate accounts through which investors may access a private fund and not be counted for purposes of the exemption. Further, to avoid double counting of private fund investors, the SEC would allow an investment adviser to treat as a single client any person that is an investor in two or more private funds its advises.

The SEC would also include as investors beneficial owners (i) who are knowledgeable employees of a private fund and certain other persons related to such employees (collectively, "knowledgeable employees"); and (ii) of short-term paper issued by the private fund, even though such investors would not otherwise be counted as beneficial owners and/or qualified purchasers under section 3 of the Investment Company Act.

In the United States

The SEC also proposes to define what it means to be "in the United States" in order to clarify its meaning in several contexts within the foreign private adviser exemption. The SEC would adopt an established definition of the term by incorporating the definition of "U.S. person" in Regulation S.

Place of Business

The SEC would define "place of business" for the purposes of the foreign private adviser exemption to mean any office where the adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities.

Assets under Management

The SEC would define assets under management with reference to the uniform method of calculating "regulatory assets under management" contained in Item 5 of Form ADV. This calculation method is further discussed in Part II, Section D below.

Part II: Rules Implementing Amendments to the Advisers Act

A. Eligibility to Register with the SEC: Mid-Sized Advisers

The Dodd-Frank Act creates a new group of investment advisers called "Mid-Sized Advisers" and prohibits such advisers from registering with the SEC if they are required to be registered and if so would be subject to examination in the state in which they maintain their principal office and place of business, and have between $25 and $100 million in assets under management. The Dodd-Frank Act shifts the primary responsibility for the regulatory oversight of Mid-Sized Advisers to the state securities authorities. In its proposed rules, the SEC attempted to clarify this prohibition, by interpreting what Congress intended "required to be registered" and "subject to examination" to mean under the Dodd-Frank Act.

What Does It Mean to be Required to be Registered?

The SEC construed "required to be registered" in this context to mean that a state has enacted an investment adviser statute and that the adviser is not relying on a state exemption to avoid registration. If a Mid-Sized Adviser is relying on an exemption from registration in such state, then the Mid-Sized Adviser must register with the SEC, unless another exemption from such registration is available. The SEC adopted this provision to prevent Mid-Sized Advisers from escaping oversight either by the SEC or any of the states by taking advantage of state registration exemptions. Also, this interpretation will require advisers with a principal place of business in Wyoming, which does not have an investment adviser statute, or in foreign countries, to register with the SEC. Note that the private fund exemption described above should be available to many Non-U.S. Advisers; however, such advisers would not likely be able to rely on other exemptions from registration otherwise available to U.S. advisers based on their being subject to state regulation.

When is an Adviser Subject to Examination?

Even if registered in the state in which it has its principal office and place of business, a Mid-Sized Adviser that would not be subject to examination as an investment adviser by the relevant state authority would be required to register with the SEC. Not all states conduct compliance examinations of its registered advisers. The SEC will not review each state's investment adviser examination program. Instead, the SEC will require each state to certify whether an investment adviser registered in the state would be subject to examination. Accordingly, a Mid-Sized Adviser having a principal office and place of business in a state that does not certify that it conducts investment adviser examinations will be required to register with the SEC. New York does not currently conduct regular examinations of New York state registered advisers, therefore, pending certification by the New York Attorney General it is not clear whether Mid-Sized Advisers in New York will be required to register with the SEC or with New York.

Transition to State Registration

Pursuant to its general exemptive authority, the SEC proposes to provide Mid-Sized Advisers with two "grace periods" to ensure a smooth transitional process to state registration. The first grace period would allow each investment adviser registered with the SEC on July 21, 2011, 30 days to determine whether it is eligible for SEC registration and to file an amended Form ADV. This 30 day period allows a Mid-Sized Adviser to calculate and report its "regulatory assets under management" (defined below) and in turn, to determine whether the adviser will need to withdraw its SEC registration. The second grace period would provide an additional 60 days from the end of the first grace period for an adviser to withdraw its SEC registration and transition to state registration (and obtain any required licenses for its representatives). An adviser's withdrawal from SEC registration must occur on or before October 19, 2011.

Assets Under Management

Generally, the amount of assets an adviser has under management will determine whether such adviser must register with the SEC or the states. 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 proposed rules would amend the instructions to Form ADV, which offer guidance to advisers in applying this definition. The SEC proposes to implement a uniform method of calculating assets under management. Specifically, the SEC would eliminate an adviser's ability to opt into or out of state or Federal regulation (e.g., by including or excluding a class of assets such as proprietary assets) and any corresponding regulatory requirements.

The SEC would revise Part 1A of Form ADV to refer to an adviser's "regulatory assets under management" in order to acknowledge the distinction from the amount of assets under management the adviser discloses to clients. Under the proposed rules, all advisers would be required to include in their regulatory assets under management (i) proprietary assets, (ii) assets managed without receiving compensation and (iii) assets of foreign clients. Currently an adviser may, but is not required to, exclude such types of assets in its calculation of assets under management. By requiring all advisers to report such assets, the SEC not only intends to provide for consistency in the calculations among advisers, but to prevent some advisers from excluding assets to remain below the new registration threshold.

Additionally, the SEC proposes to offer guidance to advisers to private funds for determining the amount of assets such advisers have under management. The SEC would require an adviser to include in its regulatory assets under management 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. Thus, this means that a manager of a private fund (e.g., a real estate fund) cannot exclude from the calculation of its regulatory assets under management the value of securities portfolios that have less than 50% of account assets comprised of securities, whereas such portfolios may be excluded from this calculation for other types of client accounts.

In calculating their regulatory assets, advisers would be required to use the fair value of their private fund assets to ensure consistency in the valuation of such assets. This assessment may prove difficult with illiquid assets or other assets whose fair value cannot be readily ascertained. In addition, the proposed rules would prohibit an adviser from subtracting outstanding indebtedness and other accrued but unpaid liabilities, which remain in a client's account and are managed by the adviser. For private funds, this would appear to require reporting of gross assets rather than the more common net asset value reporting made to investors.

A subadviser to a private fund would include only the value of the portfolio for which it provides subadvisory services in its calculation of regulatory assets under management. The SEC would also require advisers and subadvisers to private funds to include in their calculations the amount of any uncalled capital commitments made to a private equity fund.

Switching Between State and Federal Registration

Currently, Rule 203A-1 provides two mechanisms that prevent an adviser from having to frequently switch between registration based on fluctuations in assets under management. First, there is a $5 million buffer for advisers with assets under management between $25 and $30 million. This buffer allows an adviser to remain registered with the states if its assets under management exceed $25 million but fall below $30 million. Second, the rule permits an adviser to rely on the calculation of assets under management in its annual updating amendment so that there is no change to registration status based on fluctuations that occur during the course of the year. The SEC proposes to eliminate the $5 million buffer, but intends to retain an adviser's ability to rely on the annual updating amendment as the basis for its registration status.

Exceptions to the $100 Million Threshold for SEC Registration

The SEC has previously adopted several exemptions under Rule 203A-2 from the prohibition on registration. The SEC takes the position that this authority was unchanged by the Dodd-Frank Act and as such, these exemptions extend to Mid-Sized Advisers. The SEC proposes amendments to three of the exemptions contained within Rule 203A-2.

Nationally Recognized Statistical Rating Organizations ("NRSROs")

The SEC proposes to eliminate the exemption in Rule 203A-2(a) from the prohibition on SEC registration for NRSROs because Congress has provided for a separate regulatory regime for NRSROs under the Exchange Act.

Pension Consultants

The SEC proposes to amend the exemption available to pension consultants in Rule 203A-2(b) to increase the minimum value of plan assets from $50 million to $200 million. Those advisers currently relying on this exemption advising plan assets of less than $200 million may be required to register with the SEC or with one or more states.

Multi-State Advisers

The SEC proposes to amend the multi-state adviser exemption to align the rule with the Dodd-Frank Act. The proposed amendment would allow a Mid-Sized Adviser to register with the SEC if it would be required to register with 15 or more states (as opposed to the current threshold of 30).

Elimination of Safe Harbor

Currently, Rule 203A-4 provides a safe harbor from SEC registration for an investment adviser that is registered with the state securities authority of the state in which it has its principal office and place of business based on the adviser's reasonable belief that it is prohibited from registering with the SEC because it does not have sufficient assets under management. The SEC proposes to eliminate this safe harbor.

B. Expanded Reporting and Recordkeeping Requirements for Exempt Reporting Advisers

As described above, the Dodd-Frank Act provides special registration exemptions for advisers to venture capital funds and to private funds with less than $150 million in assets under management (collectively, "Exempt Reporting Advisers"). Advisers relying on these exemptions must nonetheless maintain such records, which the SEC has the authority to examine, and to submit such reports as the SEC determines necessary or appropriate in the public interest. The SEC intends to propose the precise nature of the recordkeeping requirements applicable to Exempt Reporting Advisers in a future rule release.

Reporting Required

The SEC proposes to require Exempt Reporting Advisers to file reports with the SEC on Form ADV and pay the corresponding filing fees. These reports will be publicly available on the SEC's website.

Information in Reports

The SEC proposes to modify Form ADV so that it can serve as a general form for both registered and Exempt Reporting Advisers. An Exempt Reporting Adviser would be required to identify the exemption(s) from registration on which it relies on Form ADV and to complete a limited subset of Form ADV items about the adviser and its business. Such advisers would not be required to complete all of the information that the SEC requires registered advisers to provide. The SEC proposes to require Exempt Reporting Advisers to complete the following items in Part 1A of Form ADV:

- 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); and
- Item 11 (Disclosure Information).

In addition, Exempt Reporting Advisers would have to complete corresponding sections of Schedules A, B, C and D to Form ADV. Exempt Reporting Advisers must file an initial report on Form ADV by August 20, 2011. Unlike registered advisers, Exempt Reporting Advisers would not be required to prepare Part 2 of Form ADV, which requires a narrative brochure summarizing an adviser's qualifications, investment strategies and business practices.

The reporting requirements for Exempt Reporting Advisers (especially those applicable to private fund managers with less than $150 million in assets under management) is somewhat controversial to the extent that it places an undue burden on smaller advisers that are less able to absorb the increased compliance costs associated with SEC reporting and recordkeeping. This burden may be even more acute for those fund managers with between $150 million to a few hundred million in assets under management who are subjected to the full panoply of SEC compliance requirements under the proposed rules to the same extent as multi-billion dollar fund managers.

Updating Requirements

Exempt Reporting Advisers would be required to update this disclosure at least annually, within 90 days of the end of the adviser's fiscal year. Certain items, such as an adviser's identification and disciplinary information, would be required to be updated promptly if it becomes inaccurate between the required updates.

C. SEC's Proposed Revisions to Form ADV

To enhance its oversight of investment advisers, the SEC proposes to amend Part I of Form ADV to require advisers to provide additional information about three areas of their operations: (i) the private funds they advise, (ii) their advisory businesses, including data about their employees and their advisory activities, and (iii) their non-advisory activities and financial industry affiliations.

New Section 7.B.1 of Form ADV

Information About the Private Fund and its Investors

The SEC proposes to require advisers to provide greater information about the private funds they advise in response to Item 7.B and Schedule D. Both registered and Exempt Reporting Advisers would be required to complete this Item. Currently, Item 7 of Form ADV requires a registered adviser to complete a separate Schedule D for any "investment-related limited partnership" that the registered adviser or a related person of the registered adviser advises. By incorporating the new term "private fund" as defined under the Advisers Act into Item 7, the SEC would require advisers to report on all pooled investment vehicles whether or not such vehicles are organized as limited partnerships.

The SEC proposes to amend Section 7.B of Schedule D by adding a new Section 7.B.1, which would add several new items of information to be reported to the SEC by private fund advisers. Part A of new Section 7.B.1 would require an adviser to report identifying information on a separate Schedule D for each private fund it advises. Specifically, an adviser would be required to disclose the name of each private fund, but would be permitted to preserve anonymity of a private fund client by reporting the client's name in code. However, the SEC proposes to permit an adviser with a principal office and place of business outside the United States to omit a Schedule D for a private fund that is not organized in the United States and that is not offered to, or owned by, United States persons.

Additionally, Part A would require an adviser to identify the state or country where each private fund is organized and to state how the fund is organized (e.g., as a master or a feeder fund). The adviser would also have to identify the name of the private fund's general partner, manager, trustees, directors or persons occupying similar positions. This particular item would also ask an adviser to report the regulatory status of a private fund, including the exemption from registration under the Investment Company Act on which it relies. To avoid duplicative reporting, the SEC would allow subadvisers to exclude private funds for which another adviser files a Schedule D and would permit an adviser sponsoring a master-feeder arrangement to submit only one Schedule D covering the master fund and all of the feeder funds. Part A would further require an adviser to list whether it is a subadviser to a private fund and to identify by name and SEC file number any other advisers to the fund.

The SEC is also proposing several questions in Part A that would allow the SEC to better understand a private fund's investment activities. In particular, the SEC would ask an adviser to report the size of a private fund, including both its gross and net assets, and the extent of leverage it employs. The SEC would require an adviser to select the type of investment strategy employed by the adviser from among seven broad categories and to break down the assets and liabilities held by the fund by class and categorization in the fair value hierarchy established under GAAP.

Beyond a private fund's investment activities, the SEC would require an adviser to report information about a private fund's investors. The SEC would ask about both the number and the types of investors in the fund, as well as the minimum amounts required to be invested. Finally, Part A would require an adviser to provide information about characteristics of the fund that may cause the fund manager to have conflicts of interest with the fund's investors which may implicate the adviser's fiduciary duties. Specifically, the SEC would ask an adviser to disclose whether its clients are solicited to invest in the private fund and to disclose approximately what percentage of its clients are invested in the private fund.

<u>Information About Service Providers</u>

In Part B of Form ADV, the SEC would require an adviser to report information concerning five types of service providers for each private fund: auditors, prime brokers, custodians, administrators, and marketers. In particular, the SEC would require that an adviser identify its service providers, provide their location, and state whether they are related persons. Moreover, for each service provider, an adviser would be required to describe the services it provides and to include certain identifying information, such as registration status.

For example:

(i) for an auditor, the adviser would be required to state whether the auditor was independent, registered with the Public Company Accounting Oversight Board and subject to the PCAOB's regular inspection, and whether audited statements are distributed to fund investors;

(ii) for a prime broker, the adviser would be required to state whether it is SEC-registered and whether it acts as custodian for the private fund;

(iii) for a custodian, the adviser would be required to state whether it is a related person of the adviser;

(iv) for an administrator, the adviser would be required to state whether it prepares and sends to investors account statements 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; and

(v) for a marketer, the adviser would be required to state whether it is a related person of the adviser, its SEC file number (if any), and the address of any website it uses to market the fund.

Advisory Business and Employees

Item 5 of Part 1A of Form ADV requires an adviser to provide basic information regarding the business of the adviser, particularly its scope, the nature of the services it provides and the types of clients to whom it provides those services. The SEC proposes to modify these reporting requirements to require an adviser to specify the number of employees it has that are registered as investment adviser representatives or insurance agents. The SEC also proposes to require an adviser to specify the types of clients it services, e.g. high net worth individuals or investment companies, and the types of advisory activities in which it engages, such as financial planning or portfolio management.

Other Business Activities and Financial Industry Affiliations

Items 6 and 7 require advisers, including Exempt Reporting Advisers, to report those financial services the adviser and its affiliates are actively engaged in providing. The SEC proposes to expand the list of services from which an adviser may choose to reflect new SEC-registrants under the Dodd-Frank Act, including registered security-based swap dealers.

Participation in Client Transactions

Item 8 requires an adviser to report information about its transactions, if any, with clients. The SEC proposes to require an adviser to disclose whether a broker or dealer that the adviser selects for client transactions is also a related person of the adviser. In turn, the SEC would also require an adviser to indicate whether it or its related person receives direct or indirect compensation for client referrals. This item would require disclosure of relationships with affiliated third party fund marketing firms.

<u>Certain Compensation Arrangements</u>

Against the backdrop of the Dodd-Frank Act's provisions relating to excessive incentive-based compensation, the SEC proposes to require each adviser to indicate in Item 1 whether or not the adviser had $1 billion or more in assets as of the last day of the adviser's most recent fiscal year.

D. Pay to Play Rule

Rule 206(4)-5 under the Advisers Act, which is commonly referred to as the Pay to Play Rule, generally prohibits registered and certain unregistered advisers that solicit business from public pension plans from engaging directly or indirectly in certain pay to play practices that are identified in the rule. The SEC proposes to amend the scope of this rule to include Exempt Reporting Advisers and foreign private advisers. The proposed rules also amend provisions related to prohibitions against an adviser making payments to persons who solicit government employees.

<u>Part III: SEC and CFTC Propose Private Fund Systemic Risk Reporting Rule</u>

The SEC and CFTC recently proposed new rules under the Advisers Act and the Commodity Exchange Act, respectively, that would require investment advisers registered with the SEC that advise one or more private funds to file Form PF with the SEC. The proposed CFTC rule would permit commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") registered with the CFTC to satisfy certain proposed CFTC filing requirements by filing Form PF with the SEC, but only if those CPOs and CTAs are also registered with the SEC as an investment adviser and advise one or more private funds.

Under the proposed rules, private fund advisers would be divided by size into two groups: large private fund advisers and small private fund advisers. In turn, the amount of information reported and the frequency of reporting would depend on the group to which an adviser belongs. A large private fund adviser would include any adviser with $1 billion or more in hedge fund, liquidity fund (i.e., an unregistered money market fund), or private equity fund assets under management. All other private fund advisers would be regarded as small private fund advisers and would not be subject to the heightened reporting requirements. A large private fund adviser would be required to file Form PF quarterly, while small private fund advisers would only be required to file annually.

A more detailed explanation of this rule proposal and its implications for SEC-registered investment advisers that advise one or more private funds will be forthcoming in a future Dodd-Frank Newsletter.

We will keep you updated on this and other Dodd-Frank rulemaking developments. If adopted, the proposed rules, together with the recently enacted amendments to Part II of Form ADV, would subject both existing registrants and new private fund manager registrants to substantially increased SEC reporting requirements. If you have any questions about this Dodd-Frank Newsletter, please contact Irwin Latner at (212) 592-1558 or ilatner@herrick.com, Patrick Sweeney at (212) 592-1547 or

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