Recent Developments Affecting Investment Advisers

SEC and CFTC Jointly Propose Form PF to Implement Dodd-Frank Reporting Requirements for Advisers to Certain Private Funds; SEC Releases Study on Enhancing Investment Adviser Examinations

SUMMARY
This memo focuses on recent developments that affect investment advisers. Specifically, the SEC has recently proposed, jointly with the CFTC, certain rules and reporting requirements for registered investment advisers. The SEC has also released a study regarding registered adviser examinations. Further, although not covered in this memo, the SEC has released an additional study in which it examines harmonizing regulations governing conduct standards applicable to investment advisers and broker-dealers.1

REPORTING REQUIREMENTS FOR ADVISERS TO PRIVATE FUNDS
The SEC and CFTC have jointly proposed rules2 requiring registered investment advisers to private funds, as well as commodity pool operators and commodity trading advisors who are also registered advisers to private funds, to periodically report systemic risk information on new Form PF for use by the Financial Stability Oversight Council. Under the proposal, the character and detail of information a private fund adviser would be required to report on the proposed form would vary, based on both the size and the type of funds it advises. These reporting differences reflect the regulators’ belief that, overall, smaller3 funds present less risk to the stability of the financial system than larger funds, and private equity funds present less potential risk to U.S. financial stability than hedge funds and liquidity funds. Specifically:

- All private fund advisers, including commodity pool operators and commodity trading advisors that are also registered advisers to private funds, would be required to provide certain identifying information and basic aggregate and individual information for the private funds each advises.
Recent Developments Affecting Investment Advisers
February 3, 2011

Smaller private fund advisers (i.e., those with less than $1 billion in assets under management), would file this information, on proposed Form PF, on an annual basis in order to allow FSOC to monitor systemic trends in the fund industry. In addition, smaller private fund advisers to hedge funds would be required to disclose certain information on each advised hedge fund, including its strategy, counterparty exposure and trading and clearing practices in respect of the fund’s securities and derivatives.

Large Private Fund Advisers (i.e., those with at least $1 billion in assets under management) would have to file information on proposed Form PF quarterly, and would have to report more detailed financial information, tailored to each fund type, than smaller private fund advisers. In addition:

- Large hedge fund advisers, including commodity pool operators and commodity trading advisors that are investment advisers with at least $1 billion in assets under management in hedge funds, would report on additional items, including their aggregate funds’ exposures by asset class, geographical concentration and turnover, and, for each managed hedge fund with at least $500 million in assets, certain information concerning that fund’s investments, risk metrics, liquidity and leverage.

- Large liquidity fund advisers would provide certain information about each fund, including its assets, borrowings, and the extent to which each fund has a policy of complying with Investment Company Act Rule 2a-7, which regulates investments by registered money market funds.

- Large private equity fund advisers would report information focusing primarily on the leverage levels of their funds’ portfolio companies, their use of bridge financing and their funds’ investments in financial institutions.

The SEC and CFTC request comments on these proposals within 60 days after their publication in the Federal Register, which we expect to occur shortly.

ENHANCING INVESTMENT ADVISER EXAMINATIONS

The SEC Staff recently released a study for Congress, pursuant to Section 914 of Dodd-Frank, that focuses on the SEC’s historical role in examination of registered investment advisers, the prospective impact of Dodd-Frank on such examinations, and certain recommendations concerning these issues. Specifically, the Study:

- highlights that the frequency of examinations has declined over the past five years due to a combination of fewer SEC examiners and more registered advisers;

- projects that, although the number of investment advisers registered with the SEC is expected to decrease in the near term due to provisions of Dodd-Frank prohibiting certain mid-size advisers from registering with the SEC, over the next five to 10 years, the number of registered investment advisers is expected to increase sharply;

- proposes, as alternative means to alleviate the strain on SEC examination resources:
  - charging advisers user fees to cover the examination costs,
  - authorizing a new SRO to assist the SEC in adviser examinations, or
  - authorizing FINRA to conduct examinations for advisers involved in the securities industry who are already subject to its oversight.
PROPOSED RULES AND REPORTING FORM TO BE COMPLETED BY REGISTERED INVESTMENT ADVISERS TO PRIVATE FUNDS

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") directed the SEC to require private fund advisers to file reports with the SEC, which would be provided to the Financial Stability Oversight Council ("FSOC"), and instructed the SEC and CFTC jointly to issue rules, after consultation with FSOC, establishing the form and content of such reports. In particular, Section 404 of Dodd-Frank authorized the SEC to require registered advisers to private funds to maintain necessary and appropriate records and to file such records on a confidential basis with the SEC, and to conduct periodic inspections of the records of private funds maintained by registered advisers. Section 406 requires the SEC to issue in conjunction with the CFTC rules regarding the form and content of the reports to be filed by registered investment advisers and by commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") that are also registered investment advisers. The SEC and CFTC jointly proposed these rules after consulting with the U.K.'s Financial Services Authority ("FSA"), and the International Organization of Securities Commissions, along with other international regulators, reflecting their belief in the importance of international cooperation in order to facilitate efficient and effective oversight of globally active hedge funds. Proposed Form PF, to be filed by registered advisers to private funds, would require information about the operations of such funds and incorporates many of the same types of information gathered by the FSA in its semi-annual survey of hedge funds, in which participation is voluntary. The SEC and CFTC anticipate sharing information reported on Form PF with international regulators pursuant to information-sharing confidentiality agreements.

To implement the provisions of Dodd-Frank, the SEC has proposed Investment Advisers Act Rule 204(b)-1, which requires a registered investment adviser that advises one or more private funds to file Form PF with the SEC. Similarly, under proposed Commodity Exchange Act Rule 4.27(d), registered CPOs and CTAs that are dually registered as investment advisers with the SEC and advise a private fund, would be required to complete certain sections of Form PF, as substitute compliance for a portion of the CFTC's systemic reporting requirements. In contrast to Form ADV, which gathers and makes publically available basic information about investment advisers for the purposes of investor protection, Form PF is designed primarily as a confidential systemic risk disclosure tool to assist FSOC. Indeed, provisions of Dodd-Frank preclude the SEC and CFTC from being compelled to reveal the information except in very limited circumstances, such as to Congress pursuant to a confidentiality agreement. However, the SEC and CFTC contemplate using information from Form PF in their regulatory programs, including examinations and investigations, and in investor protection efforts, including enforcement actions.

The proposed rules apply only to advisers that are registered, or required to be registered, with the SEC (including any investment adviser that is also registered or required to be registered with the CFTC as a CPO or CTA), and advise one or more private funds. In general, private funds include hedge funds, private equity funds, liquidity funds, real estate funds and securitized asset funds. As defined in Form PF,
Recent Developments Affecting Investment Advisers
February 3, 2011

A private fund is an issuer that would be an investment company (as defined in the Investment Company Act (the “ICA”)) but for an exclusion under Section 3(c)(1) or 3(c)(7) of the ICA. Advisers solely to venture capital funds, and advisers solely to private funds that in the aggregate have less than $150 million in assets under management, which are both exempt from investment adviser registration under Dodd-Frank, would not be required to complete Form PF. However, they would be subject to separate information reporting requirements on Form ADV as “exempt reporting advisers” under proposed Rule 204-4 under the Investment Advisers Act.6

The SEC and CFTC are seeking comment on whether exempt investment advisers should be required to complete Form PF.

PRIVATE FUND CLASSIFICATIONS
Based on the view that a fund’s threat to financial stability varies based on size and type, Form PF requires different levels of information based on the classification and assets under management of the various private funds managed by the adviser. The proposed rules classify certain private funds as either (1) hedge funds, (2) liquidity funds or (3) private equity funds. Large Private Fund Advisers of hedge funds, liquidity funds or private equity funds (those holding at least $1 billion of assets under management) are required to disclose more information than smaller private fund advisers, and such information varies by the type of fund advised. (See Information Required on Form PF below.)

1. Hedge Funds

Advisers to hedge funds would be required to disclose more information than those for other private funds because of the belief of the SEC and CFTC that hedge funds pose more systemic risk. The Release notes that hedge funds employ investment strategies that use derivatives, high levels of leverage, structured products and high volumes of trading to generate their returns. These strategies can lead to increased failure rates among these funds, which could then trickle through other parts of the economy, for example to financial institutions that have provided leverage. The Release also suggests that failing hedge funds may also liquidate their investments in fire sales, which could depress mark-to-market valuations of securities that are held widely, including by financial institutions, as well as other investors.

A “hedge fund” is defined in proposed Form PF as any private fund that (1) has a performance fee or allocation calculated by taking into account unrealized gains; (2) may borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net asset value (including any committed capital); or (3) may sell securities or other assets short. In addition, a commodity pool that meets the definition of a private fund would be treated as a hedge fund for purposes of Form PF. The Release acknowledges that there is no standard definition for a hedge fund but asserts that this definition is broadly based on the FSA survey definition and that, in any event, any fund that has a performance fee using market value (instead of only realized gains), relies on high leverage or employs short selling is an appropriate subject for a higher level of reporting.
The SEC and CFTC are requesting comment on the analysis of the potential systemic risk posed by hedge funds, as well as the definition of such funds and, specifically, on the bright-line definitional test for selling short and on the leverage threshold.

2. Liquidity Funds

A "liquidity fund" is defined as any private fund that seeks to generate income by investing in a portfolio of short-term obligations in order to maintain a stable net asset value per unit or minimize principal volatility for investors. This definition is intended to include potential substitutes for money market funds because the SEC and CFTC believe that these funds may be susceptible to runs, thus posing systemic risk that should be monitored by FSOC. Liquidity funds pose more potential problems than their money market counterparts because the latter, as registered investment companies, are subject to extensive regulation, including the asset diversification requirements of ICA Rule 2a-7. The liquidity fund information requirements in Form PF are intended to enhance FSOC’s understanding of the risks to stability that such funds pose.

The SEC recognizes that the definition of liquidity fund may capture, in particular, short-term bond funds and requests comment on the liquidity fund definition and if there is a way to include all money market substitutes but exclude short-term bond funds from the definition. It also requests comment on the ways in which such funds might cause systemic risk.

3. Private Equity Funds

A “private equity fund” is defined under proposed Form PF by exclusion as any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course. The Release notes, in particular, the buyout activities of private equity funds as providing potential systemic risk. Although acknowledging that advisers have suggested that certain features of private equity funds, such as reliance on long-term capital commitments from investors and lack of substantial debt at the fund level may mitigate certain problems, the SEC is concerned that leverage activities (especially the use of bridge loans) may cause failures at the fund to ripple through to financial institutions. Further, there is a concern that if private equity funds conduct leveraged buyouts of systemically important companies, those portfolio companies, because of the debt burdens they bear, could be subject to greater risk, something about which FSOC should be apprised.

The SEC requests comment on whether it has appropriately distinguished private equity funds from other private funds under the proposed definition. It also queries whether it has accurately assessed the systemic risk posed by such funds.
LARGE PRIVATE FUND ADVISERS

Large Private Fund Advisers, which are subject to heightened disclosure standards, are defined as those with (i) at least $1 billion in hedge fund assets under management at the close of business on any day during the reporting period; (ii) at least $1 billion in combined liquidity fund and registered money market assets under management at the close of business on any day during the reporting period; or (iii) at least $1 billion in private equity fund assets under management at the close of business on the last day of the quarterly reporting period, and would be considered “Large Private Fund Advisers” advising hedge funds, liquidity funds, and private equity funds, respectively. The Large Private Fund Adviser measure for liquidity funds combines both liquidity fund and registered money market assets because advisers’ liquidity and registered money market funds often pursue similar strategies and invest in the same securities, and thus are subject to many of the same risks.

The regulators expect that, although there will be only a relatively small group of Large Private Fund Advisers, that small group will hold most of the industry assets. Specifically, the SEC estimates that approximately 200 U.S.-based large hedge fund advisers manage approximately 80% of U.S. hedge fund industry assets, and that approximately 250 large private equity fund advisers manage approximately 85% of the committed capital to U.S. private equity funds. Form PF would require more information from these Large Private Fund Advisers than from smaller private advisers in order to gain more extensive systemic risk information from Large Private Fund Advisers, which hold most of the industry assets.

Large Private Fund Advisers would be required to file Form PF quarterly, and each such Large Private Fund Adviser would fill out a designated, separate section of Form PF with targeted questions for its fund type. In order to prevent advisers from structuring funds to avoid Large Private Fund Adviser status, for purposes of determining whether these thresholds are met, advisers would be required to aggregate the assets of managed accounts that pursue substantially the same investment strategy and invest in substantially the same positions as the private fund, and would also be required to aggregate the assets of that type of private fund advised by any of the adviser’s related persons.

The SEC and CFTC are requesting comments on whether the proposed asset thresholds and measuring periods for Large Private Fund Advisers are appropriate and whether smaller private fund advisers should also be required to complete the additional information that, under the current proposal, is limited to Large Private Fund Advisers.

FREQUENCY OF REPORTING AND ANTICIPATED IMPLEMENTATION DATES

Under the proposed rules, smaller private fund advisers would be required to file Form PF annually. Annual filings would be due no later than the last day on which the adviser may timely file its annual updating amendment to Form ADV (currently, 90 days after the end of the adviser’s fiscal year). A newly registered adviser’s initial filing would be required within 15 days following the end of its next occurring calendar quarter after registering with the SEC.
Recent Developments Affecting Investment Advisers  
February 3, 2011

Large Private Fund Advisers would be required to file Form PF no later than 15 days after the end of each calendar quarter. The SEC anticipates that the compliance date for Form PF filing would be December 15, 2011. Accordingly, it is anticipated that Large Private Fund Advisers would have to make their first Form PF filing by January 15, 2012. All other private fund advisers would be given 90 days from the end of their first fiscal year occurring on or after the compliance date of the proposed rule (currently scheduled for December 15, 2011) to file their first Form PF. Thus, smaller private fund advisers with a fiscal year ending December 31 would be required to complete their first Form PF filing by March 31, 2012.

The SEC and CFTC are requesting comments on whether Form PF should be required to be filed more or less frequently and whether the compliance dates provide sufficient time for advisers to prepare for filing.

**INFORMATION REQUIRED ON FORM PF**

All registered advisers to private funds will complete Sections 1a and 1b, and all hedge fund advisers will complete Section 1c. Large Private Fund Advisers to hedge funds, liquidity funds and private equity funds would also complete Sections 2, 3 and 4, respectively. Commodity pools that meet the definition of a private fund are categorized as hedge funds for purposes of Form PF. Accordingly, CPOs and CTAs that are also registered investment advisers would have to complete only Section 1 and, if applicable, Section 2 of the form.

1. **Section 1**

Sections 1a and 1b of the form, required to be completed by all registered advisers to private funds, request information concerning:

- basic identifying information of the adviser;
- basic aggregate information about the private funds managed by the adviser, such as the total and net assets of private funds under management and the amount of those assets attributable to certain types of funds;
- each fund’s gross and net assets, the aggregate notional value of its derivative positions, and monthly and quarterly performance information for each fund;
- a breakdown of the fund’s borrowing based on whether the creditor is a U.S. financial institution, foreign financial institution or non-financial institution, and the identity of, and amount owed to, each creditor owed 5% or more of the fund’s net asset value; and
- information about how concentrated the fund’s investor base is, including the number of beneficial owners of each fund’s equity and the percentage of equity held by the fund’s five largest equity holders.

Section 1c of the form would solicit information only about hedge funds managed by the adviser, including their investment strategies, percentage of assets managed through computer-driven algorithms, significant counterparty exposures (and the identity of such counterparties), and trading and clearing practices for securities and derivatives.
2. Section 2

Section 2 would be completed only by advisers to hedge funds with at least $1 billion in assets under management. Section 2a would focus on information in the aggregate about the managed hedge funds, including:

- the market value of assets invested (on a short and long basis) in different types of securities and commodities, and the duration of fixed income portfolio holdings (including asset backed securities) to indicate the assets’ interest rate sensitivity; and
- the turnover rate of the adviser’s aggregate portfolios during the reporting period to provide an indication of the adviser’s frequency of trading, and a geographic breakdown of investments held by the hedge funds.

Section 2b of Form PF would require large hedge fund advisers (advisers with at least $1 billion in hedge fund assets under management) to report additional information concerning each “qualifying hedge fund” they advise, which is a hedge fund that has a net asset value of at least $500 million at the close of any business day during the reporting quarter. In order to prevent advisers from structuring their funds to avoid reporting under this subsection, advisers would have to aggregate any parallel managed accounts, parallel funds and funds of the same master-feeder structure, and treat any funds managed by a related person as if it were managed by the filing adviser, for purposes of this $500 million threshold.

Under Section 2b, the adviser would report, for each qualifying hedge fund, information concerning:

- the same information as that requested in section 2a regarding exposure to different types of assets;
- the fund’s concentration of positions, its portfolio liquidity and, if regularly calculated, its value at risk metric for each month of the reporting period;
- its collateral practices with significant counterparties, and the identity of, and clearing relationships with, the three central clearing counterparties to which the fund has the greatest net counterparty credit exposure;
- the impact on the fund’s portfolio from specified changes to certain identified market factors, if regularly considered in the fund’s risk management, broken down by the long and short components of the qualifying hedge fund’s portfolio;
- certain financing information, such as a monthly breakdown of its secured and unsecured borrowing and its derivatives exposures, and information about the value of the collateral and letters of credit supporting its secured borrowing and derivatives exposures and the types of creditors; and
- information about its investor composition and liquidity.

3. Section 3

Section 3 of Form PF would require advisers of liquidity funds managing at least $1 billion in combined liquidity fund and registered money market fund assets at the close of business on any day of the reporting period to report for each liquidity fund they manage:

- whether, as a matter of policy, the fund complies with certain provisions of rule 2a-7 under the ICA;
Recent Developments Affecting Investment Advisers
February 3, 2011

-9-

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- whether the fund uses the amortized cost method and/or the penny rounding method of pricing in computing its net asset value per share;
- the fund’s net asset value, net asset value per share, market-based net asset value per share, weighted average maturity, weighted average life, 7-day gross yield, amount of daily and weekly liquid assets, and amount of assets with a maturity greater than 397 days, for each month of the reporting period;
- the amount of its assets invested in different types of instruments, broken down by the maturity of those instruments, as well as information for each open position of the fund that represents 5 percent or more of the fund’s net asset value;
- any secured or unsecured borrowing of the liquidity fund, broken down by creditor type and the maturity profile of that borrowing, and whether the fund has in place a committed liquidity facility; and
- certain information regarding the concentration of the fund’s investor base, gating and redemption policies, and investor liquidity.

4. Section 4

Section 4 of Form PF would apply to private fund advisers managing at least $1 billion in private equity fund assets as of the close of business of the reporting period. It would require certain information about each private equity fund managed by such advisers, including:

- the outstanding balance of its borrowings and guarantees;
- the weighted average debt-to-equity ratio of controlled portfolio companies in which the fund invests, and the range of that debt-to-equity ratio among such portfolio companies;
- the maturity profile of its portfolio companies’ debt, the portion of that debt that is payment-in-kind or zero coupon, and whether the fund or any of its portfolio companies experienced an event of default on any of its debt during the reporting period;
- the identity of the institutions providing bridge financing to the adviser’s portfolio companies and the amount of that financing;
- a breakdown of the fund’s investments by industry and by geography; and
- if the fund invests in any financial industry portfolio company, it would have to provide its name, its debt-to-equity ratio, and the percentage of the portfolio company beneficially owned by the fund.

The SEC and CFTC request comment on the various sections of Form PF and whether they serve their intended purposes.

FILING FEES AND FORMAT

Under proposed rule 204(b)-1(b), Form PF would have to be filed through an electronic system designated by the SEC. The SEC is considering using the current Investment Adviser Registration Depository platform, which might allow interconnectivity of Form ADV and Form PF filings. Form PF filers would be required to pay filing fees reflecting the reasonable costs of the filing system. The SEC anticipates that Large Private Fund Advisers’ filing fees would be higher than other advisers’ fees.

Though they have not yet determined the specific fees to be paid (only that advisers will pay fees and that Large Private Fund Advisers will be charged higher filing fees), the SEC and CFTC request comment on
whether smaller and/or Large Private Fund Advisers should be charged differently from what is currently anticipated.

STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS

Section 914 of Dodd-Frank directed the SEC to conduct a study reviewing and analyzing the need for enhanced examination and enforcement resources for investment advisers (the “Study”). That section provided that the Study examine: (1) the number and frequency of examinations of investment advisers by the SEC over the past five years, (2) the extent to which appointing a self-regulatory organization to assist in overseeing investment advisers would improve the frequency of examinations, and (3) current and potential approaches to examining the investment advisory activities of dually registered broker-dealers and investment advisers and investment advisers affiliated with broker-dealers.

On January 14, 2011, the Staff of the Division of Investment Management of the SEC (the “Staff”) released the Study, in which it addresses Congress’s directives and makes certain recommendations. Specifically, the Study focused on the SEC’s historical role in adviser examinations, the prospective impact of Dodd-Frank on such examinations, and certain recommendations and considerations concerning these issues.

THE SEC’S HISTORICAL ROLE IN INVESTMENT ADVISER EXAMINATIONS

The SEC, through its Office of Compliance Inspections and Examinations (“OCIE”), conducts examinations of registered investment advisers’ books, records and activities. The Staff notes that the examinations are intended (1) to improve compliance, (2) to prevent fraud, (3) to monitor risk, and (4) to inform regulatory policy.

OCIE’s investment adviser examination program employs a risk-based approach, identifying higher-risk advisers for examination and focusing its resources on higher-risk activities at selected advisers. Specifically, it conducts three types of examinations. One type of examination targets higher-risk investment advisers and concentrates on areas including conflicts of interest, portfolio management, advertising and asset verification. The second examination type is based around leads received from tips, complaints and referrals. The third examination type is of limited scope and conducted for special purposes, including risk-targeted sweeps designed to focus on specific areas of concern within the industry, and risk assessment reviews which are meant to provide OCIE with a risk profile of an investment adviser. Staffing at each examination, including the number of examiners and their training levels, vary depending on the type of examination and complexity of the adviser’s operations. Similarly, the length of each examination, which ranges from a few days to several months, depends on the complexity of the examination.

The number and frequency of examinations are, to a large extent, a function of the number of registered investment advisers and the number of staff at OCIE. From October 1, 2004 through September 30,
Recent Developments Affecting Investment Advisers
February 3, 2011

2010, the number of registered investment advisers increased from 8,581 advisers to 11,888, and assets managed by such advisers increased from $24.1 trillion to $38.3 trillion. Over that same time period, OCIE staff dedicated to examining investment advisers decreased from 477 to 460. (The Study observes that the SEC has significantly fewer examiners relative to the number of entities it regulates in comparison to federal bank regulators, and that this gap has widened over the past seven years.) Thus, over that period, the ratio of registered investment advisers to OCIE staff increased from 18.0 to 25.8. During the same time, there was a 29.8% decrease in the number of examinations of registered investment advisers. As a result of these changes, the percentage of registered investment advisers examined each year fell from 18% in 2004 to 9% in 2010. At the 2010 rate of examination, on average, a registered investment adviser could expect to be examined less than once every 11 years. In addition to the shortage of staffing and increase in number of advisers, OCIE has been using more intensive examination methods overall, and has conducted more examinations of higher-risk advisers, which generally require more resources and take longer than low-risk adviser examinations, thus contributing to the overall decline in number of examinations.

The Staff acknowledged in the Study that an important factor in the adequacy of the examination program is the efficiency with which OCIE staff conduct the examinations. OCIE undertook a self-assessment in March 2010, analyzing the strategy, structure, personnel, process and technology of its examination program, and has since implemented reforms to improve the efficiency of its program.

PROSPECTIVE IMPACT OF DODD-FRANK ON ADVISER EXAMINATIONS

While the Study predicts an increase in examinations in the near term, the frequency of examinations in the longer term is less certain. Dodd-Frank should effect a short term reduction in the number of registered investment advisers because of its prohibition against mid-size managers, those holding between $25 million and $100 million in assets under management, from registering as investment advisers with the SEC. The Study estimates that there will be 3,350 fewer registered investment advisers in the near term, a 28.2% decrease from the 11,888 registered advisers as of September 30, 2010. It projects, however, that the number of SEC-registered investment advisers and their respective assets under management will increase over the long term due to general economic conditions. The Staff notes that, at an assumed annual growth rate for advisers and assets of 5%, the number of registered advisers would grow from 8,358 advisers to 10,897 advisers in five years, and the amount of assets they manage would grow from $38.5 trillion to $49.1 trillion. In 10 years, there would be 13,908 registered advisers managing approximately $62.7 trillion of client assets. Dodd-Frank authorizes annual increases to the SEC budget over the next five years, but the amount that the SEC actually receives will depend upon Congressional appropriations, and the amount that OCIE receives will depend upon the SEC’s internal allocation of resources.

Because of the anticipated reduction of registered investment advisers in the near term, the Study anticipates that the ratio of registered investment advisers to OCIE staff will decline to 18.6 on July 21,
Recent Developments Affecting Investment Advisers
February 3, 2011

2011, from 25.8 on September 30, 2010. Thus, in the near term, the Staff expects the frequency of examinations to increase, although any increase may be tempered by the need to reallocate OCIE staff to new examination programs required by Dodd-Frank, such as programs related to clearing agencies and credit-rating agencies.

The Study cautions that the projected long-term increase in registered investment advisers, along with the SEC’s new examination obligations under Dodd-Frank, will strain its resources available to examine investment advisers. The Study stresses that periodically reallocating investment adviser regulatory responsibilities between the federal government and the states is not a proper long-term solution to the fundamental capacity problem because state funding to support the examinations cannot be assured. The Staff does believe, however, that stable funding could address these challenges.

OPTIONS AND RECOMMENDATIONS
The Study discusses three options for Congress to consider in order to strengthen the SEC’s investment adviser examination program. The first option proposed is to impose user fees on registered investment advisers and to use such fees solely to fund the examination program. User fees are an important funding source for many other federal agencies, and the SEC already relies on user fees to support the IARD, the electronic registration system for investment advisers. The fees could be set at a level to achieve the proper frequency of examinations to engender greater deterrence of wrongdoing, such deterrence, the SEC believes, being at least partially the function of each investment adviser’s perception of the probability of being examined. Fees would also provide a steady, long-term and reliable form of funding for the program. Due to the stability of such fees, OCIE would be able to engage in better training of its staff and invest in better technology, resulting in more efficient examinations.

The second option discussed in the Study is to authorize a Self Regulatory Organization (an “SRO”), or multiple SROs, for registered investment advisers. The SRO would be a privately funded entity with specific market expertise that, subject to SEC oversight, would have the authority to adopt rules, examine member firms for compliance with such rules, and enforce compliance with those rules, similar to how the Financial Industry Regulatory Agency (“FINRA”) regulates the securities industry. Thus, while the SEC would still have to oversee the SRO and possibly conduct examinations of the SRO, the SRO would be able to conduct more frequent examinations of registered investment advisers. In order for this approach to be viable, however, membership in the SRO would be mandatory for all registered advisers. The Study acknowledges that there would be many issues raised by the SRO structure that would have to be resolved, including whether to authorize more than one SRO, the corporate governance structure of each SRO, the membership requirements for the SRO and the funding of the SRO. The Study also notes that user fees may be a less expensive option than creating an SRO and can avoid additional disadvantages of an SRO, such as the additional management costs required to oversee an SRO and the possible differences in interpretation of applicable law that may arise between the SEC and the SRO it oversees.
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The third option discussed in the Study is to seek an amendment to the Exchange Act that would expressly permit FINRA to examine all of its members that are also registered as investment advisers for compliance with the Advisers Act. Although most registered investment advisers are not members of FINRA, almost all of the largest broker-dealers are also registered as investment advisers. These dual registrants have a substantial amount of retail advisory clients and employ many investment adviser representatives. Allowing FINRA to examine dual registrants would allow OCIE to use its existing resources to focus solely on investment advisers that are not members of FINRA. Moreover, aside from the efficiency gained by having one regulator conducting both the securities and investment adviser examinations for the dual registrants, this proposal would permit FINRA to obtain a more holistic view of the dual registrants’ overall activities, which should result in a more effective and cost-efficient examination.

At the end of the Study, the Staff concludes that it will not have sufficient capacity in either the near term or long term to conduct effective examinations of registered investment advisers with adequate frequency. Therefore, it recommends that Congress consider the three options discussed above in order to strengthen the examination program.

* * *

ENDNOTES


3 Consistent with the Release, the term “smaller” is used to refer to any private fund advisers that are not Large Private Fund Advisers.

4 Specifically, they would complete Section 1 and, if relevant, Section 2 of proposed Form PF. For details of the information required by each section of proposed Form PF, see “Information Required on Form PF.”

5 Consistent with its use in the Release, we use the term “private fund adviser” in this memo to mean any investment adviser that (i) is registered or required to register with the SEC (including any investment adviser that is also registered or required to register with the CFTC as a CPO or CTA) and (ii) advises one or more private funds.


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“Real Estate Fund” is defined as any private fund that is not a hedge fund, that does not provide investors with redemption rights in the ordinary course and that invests primarily in real estate and real estate-related assets.

“Securitized Asset Fund” is defined as any private fund that is not a hedge fund and that issues asset-backed securities and whose investors are primarily debt holders.

“Venture Capital Fund” is defined as any private fund meeting the definition of venture capital fund in rule 203(l)-1 of the Advisers Act.

Proposed Form PF defines “borrowings” as “[s]ecured borrowings and unsecured borrowings, collectively.” “Secured borrowing” is defined as “[o]bligations for borrowed money in respect of which the borrower has posted collateral or other credit support” and includes reverse repos. “Unsecured borrowing” is defined as [o]bligations for borrowed money in respect of which the borrower has not posted collateral or other credit support.”

Although “owed” is not defined in the form, the instruction in proposed Form PF requests, in part, the adviser to “[i]dentify each creditor, if any, to which the reporting fund owed an amount in respect of borrowings . . .” (emphasis omitted).

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