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Dodd-Frank: *Impact on Asset Management*

Information for Investment Advisers, Broker-Dealers and Investment Funds

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Introduction

On July 21, 2010, President Obama signed into law The Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act makes significant changes to the existing financial services legal framework, affecting nearly every aspect of the industry. This summary highlights many of the provisions of the Dodd-Frank Act that matter most to the asset management industry—investments advisers, broker-dealers, registered investment companies, hedge funds, private equity funds and other alternative investment funds. Many of the issues discussed in this summary will remain in a constant state of flux and subject to extensive rulemaking efforts well past July 2011 when many rulemaking requirements were due. In reality, very few of the rulemaking efforts required by the Dodd-Frank Act have been completed and regulators have not met many of the Dodd-Frank deadlines. You can obtain additional information on various aspects of the Dodd-Frank Act on our website: http://www.chapman.com/publications.php.

If you have questions or comments about the issues discussed in this summary or any other aspects of the Dodd-Frank Act, please contact us. We look forward to being of service.

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Investment Adviser Registration

The Dodd-Frank Act makes significant changes to the existing investment adviser registration regime. These changes largely focus on registration of advisers to "private funds". "Private fund" is defined as an issuer that would be an investment company as defined in Section 3 of the Investment Company Act but for the exceptions in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Those sections apply to issuers that do not engage in a public offering of securities and either (1) have no more than 100 beneficial owners of securities or (2) the outstanding securities of which are owned exclusively by "qualified purchasers" as defined under the Investment Company Act.

What is an "investment adviser"?

Generally speaking, an "investment adviser" is any person who engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. Some entities get excluded from this definition, such as banks, some brokers-dealers and certain credit rating organizations.

The changes discussed in this section were originally scheduled to be effective July 21, 2011. Due to the significant quantity of Dodd-Frank Act rulemaking required of the SEC, the complex nature of much of the rulemaking and systems implementation issues related to adviser registration, necessary rulemaking in this area was not be completed in sufficient time to allow for full compliance with the new requirements by July 21, 2011. Accordingly, on April 8, 2011, the staff of the SEC's Division of Investment Management issued a letter stating the staff's expectation that the SEC would consider extending the date by which:

- "mid-sized advisers" must transition to state investment adviser registration and regulation, and
- "private advisers" (those with fewer than 15 clients) must register under the Advisers Act and come into compliance with the obligations of a registered adviser.

The staff's letter is available at http://www.sec.gov/rules/proposed/2010/ia-3110-letter-to-nasaa.pdf.

In conformance with the staff's letter, the SEC adopted final investment adviser rules on June 22, 2011 that provide that an adviser that is exempt from registration with the SEC and is not registered in reliance on Section 203(b)(3) of the Advisers Act, is exempt from registration with the SEC until March 30, 2012, provided that such adviser:

- during the course of the preceding twelve months had fewer than fifteen clients;
- neither holds itself out generally to the public as an investment adviser to any registered investment company or business development company.

This transitional exemption generally means that managers of hedge funds, private equity funds and other private funds do not have to register under the Advisers Act and comply with requirements applicable to registered advisers until March 30, 2012. Absent this transition rule, the Dodd-Frank Act would have required these advisers to register by July 21, 2011. (§419)

Elimination of Exemptions

Private Adviser Exemption (Fewer Than 15 Clients) Eliminated—Most hedge fund and private equity fund advisers will need to register with the SEC as investment advisers due to this change. Prior to the Dodd-Frank Act amendments, Section 203(b)(3) of the Advisers Act exempts from registration investment advisers who, during the last twelve months, had fewer than fifteen clients and who do not hold themselves out generally to the public as investment advisers or act as investment advisers to a registered investment company or a business development company. The Dodd-Frank Act eliminates this exemption which is frequently relied upon by private fund managers as well as certain advisers with a small number of client accounts. Certain family offices also relied on this exemption (or certain SEC exemptive relief) but many family offices will qualify for the "family office" exclusion from the "investment adviser" definition discussed below.

The SEC finalized rulemaking related to this issue on June 22, 2011. As described above, these rules provide that an adviser that is exempt from registration with the SEC and is not registered in reliance on Section 203(b)(3) of the Advisers Act, is exempt from registration with the SEC until March 30, 2012, provided that such adviser:

- during the course of the preceding twelve months had fewer than fifteen clients;
- neither holds itself out generally to the public as an investment adviser to any registered investment company or business development company.

This transitional exemption generally means that managers of hedge funds, private equity funds and other private funds do not have to register under the Advisers Act and comply with requirements applicable to registered advisers until March 30, 2012. For additional information about the SEC final rules on these issues, please see our client alert available at http://www.chapman.com/media/news/media.1038.pdf. (§403)

Private Fund Advisers Excluded From Intrastate Adviser Exemption—The Dodd-Frank Act makes the Advisers Act Section 203(b)(1) registration exemption inapplicable to investment advisers to private funds. That exemption relates to investment advisers whose clients are all residents of the state within which the investment adviser maintains its principal place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange. (§403)

New Exemptions

The Dodd-Frank Act adds several new registration exemptions for certain advisers. It is important to note that these provisions are exemptions *from registration with the SEC* for firms that fall within the statutory definition of "investment adviser". As a result, *advisers exempt from registration remain subject to the antifraud provisions of the Advisers Act* (Section 206 and certain rules thereunder). This is also generally the case for advisers not permitted to register with the SEC (discussed below). These registration exemptions should be distinguished from *exclusions* from the definition of "investment adviser" (e.g., the "family office" exclusion discussed below).

Foreign Private Advisers

The Dodd-Frank Act adds an exemption from registration for certain "foreign private advisers". A "foreign private adviser" is:

- any investment adviser who has no place of business in the U.S.,
- has fewer than 15 clients and investors in the U.S. in private funds advised by the adviser,
- has assets under management attributable to clients in the U.S. and U.S. investors in private funds of less than $25,000,000 (or such higher amount adopted by the SEC) and
- neither holds itself out generally to the public in the U.S. as an investment adviser nor acts as an adviser to a U.S. registered investment company or business development company.

On June 22, 2011, the SEC adopted rules addressing several issues arising under this new exemption. Among other things, these issues include how to determine:

- the number of advisory clients and investors in the U.S. in private funds (in certain cases, multiple persons or accounts can be treated as a single client);
- whether a client or fund investor is "in the U.S.";
- an adviser's "place of business"; and
- assets under management.

For additional details on the proposed rules, please see our client alert which is available at http://www.chapman.com/media/news/media.1038.pdf.

As a practical matter, many unregistered non-U.S. advisers will likely be required to register under the new rules because non-U.S. advisers will need to count assets attributable to U.S. investors in non-U.S. funds they manage for purposes of the $25,000,000 assets under management test. Non-U.S. advisers with relatively low assets under management for U.S. clients (but greater than $25 million) will need to carefully assess whether to sacrifice their U.S. clients rather than bear the burdens associated with U.S. investment adviser registration. Another consideration for non-U.S. advisers that have existing U.S.-registered affiliates will be whether to conduct all of their U.S. advisory business through the U.S. affiliate (or whether to organize such an affiliate). This would involve various considerations and changes related to advisory agreements, operations and personnel matters. (§403)

CFTC-Registered Commodity Trading Advisors that Advise Private Funds

The Advisers Act currently contains an exemption for any investment adviser that is registered with the CFTC as a commodity trading advisor whose business does not consist primarily of acting as an investment adviser (as defined under the Advisers Act) and that does not act as an investment adviser to a registered investment company or a business development company. The Dodd-Frank Act adds an exemption for any investment adviser that is registered with the CFTC as a commodity trading advisor and advises a private fund, provided that such an adviser must register with the SEC if the business of the adviser later becomes predominately the provision of *securities*-related advice. (§403)

Venture Capital Fund Advisers

The Dodd-Frank Act provides a new exemption from registration and reporting for investment advisers with respect to the provision of investment advice to a "venture capital fund or funds" with such term to be defined by the SEC. Venture capital fund advisers will remain subject to certain reporting and recordkeeping requirements to be separately determined by the SEC (see below).

The Dodd-Frank Act does not provide an exemption from registration for advisers with respect to the provision of investment advice relating to a "private equity fund or funds" as did prior versions of the legislation. However, a bill (HR 1082) has been introduced in the House of Representatives that would generally provide that no investment adviser shall be subject to the registration or reporting requirements of Advisers Act "with respect to the provision of investment advice relating to a private equity fund or funds, provided that each such fund has not borrowed and does not have outstanding a principal amount in excess of twice its invested capital commitments". The language of the bill differs somewhat from the language used in the venture capital fund adviser provision but would seem to be aimed at providing a similar exemption and allowing for similar reporting and recordkeeping requirements as proposed for exempt venture capital fund advisers (see below). Similar to the venture capital fund provision, the bill would require that the SEC define the term "private equity fund". The bill has been approved by the House Financial Services Committee and would need to be presented for a vote by the full House of Representatives.

On June 22, 2011, the SEC adopted new rules defining "venture capital fund" and providing for certain requirements regarding recordkeeping, reporting and examination of venture capital fund advisers. Proposed Advisers Act Rule 203(l)-1 defines a "venture capital fund" as a private fund that has the following characteristics:

- *Represents itself as pursuing a venture capital strategy*—The fund must represent itself to investors and potential investors as pursuing a venture capital strategy.
- *Invest primarily in qualifying investments and short term holdings*—Immediately after the acquisition of any asset, the fund must hold no more than 20% of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets that are not "qualifying investments" or "short-term holdings". "Qualifying investments" generally consist of any equity security issued by a "qualifying portfolio company" that is directly acquired by the fund and certain equity securities exchanged for the directly acquired securities. "Short-term holdings" include cash and cash equivalents and U.S. Treasuries with a remaining maturity of 60 days or less.

- *Very limited use of borrowing*—The 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, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days (excluding certain guarantees of qualifying portfolio company obligations).

- *No investor withdrawal rights*—The fund must only issue securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata.

- *Not a registered investment company*—The fund must not be registered under the Investment Company Act and may not have elected to be treated as a business development company under that Act.

For additional details on the final rules, including the definition of "qualifying portfolio company" and a discussion of SEC reporting requirements, please see our client alert which is available at http://www.chapman.com/media/news/media.1038.pdf. (§407)

Smaller Private Fund Advisers (U.S. AUM less than $150 million)

The Dodd-Frank Act requires the SEC to adopt a separate exemption from registration for investment advisers that act *solely* as advisers to private funds and that have assets under management in the U.S. of less than $150,000,000. Smaller hedge fund advisers that currently maintain a small number of separately managed accounts for individual clients will either need to face registration or consider asking those clients to invest in a fund rather than through an individual account. A question may also arise where the investments of a single client are held in the form of a "fund" (e.g., a limited partnership or LLC). This could be the case with a "parallel" fund or where a particular client has negotiated an individualized strategy but prefers to hold its investment in a separate vehicle. Questions could also arise where an adviser provides advice to trusts and similar estate planning vehicles that are technically "private funds" (these vehicles often rely on Section 3(c)(1) or 3(c)(7) even though they are not seen as "funds"). Advisers falling under this exemption will be subject to annual reporting and record keeping requirements as separately determined by the SEC (see below).

On June 22, 2011, the SEC adopted new Advisers Act Rule 203(m)-1 to provide a registration exemption for these advisers. The proposed SEC rule provides an exemption from Advisers Act registration for the following investment advisers:

- *U.S. Advisers*—an investment adviser with its principal office and place of business in the U.S. if the adviser: (1) acts solely as an adviser to one or more qualifying private funds; and (2) manages private fund assets of less than $150 million.

- *Non-U.S. Advisers*—an investment adviser with its principal office and place of business outside of the U.S. if: (1) the adviser has no client that is a U.S. person except for one or more qualifying private funds; and (2) all assets managed by the adviser from a place of business in the U.S. are solely attributable to private fund assets, the total value of which is less than $150 million.

For additional details on the final rules, including how to determine the location of an adviser's principal office and place of business, how to determine assets under management, the definition of "qualifying private fund" and a discussion of SEC reporting requirements, please see our client alert which is available at http://www.chapman.com/media/news/media.1038.pdf. (§408)

Advisers to Small Business Investment Companies

The Dodd-Frank Act adds an exemption as Advisers Act Section 203(b)(7) which exempts from registration any investment adviser (other than an entity that has elected to be regulated as a business development company pursuant to section 54 of the Investment Company Act) who solely advises (a) small business investment companies licensed under the Small Business Investment Act of 1958 (the "SBIA"), (b) entities that have received notice to proceed to qualify for a license as a small business investment company under the SBIA or (c) applicants that are affiliated with one or more licensed small business development company under the SBIA and have themselves applied for a license under the SBIA. (§404)

Family Offices Excluded From "Investment Adviser" Definition

To prevent typical family offices from being treated as investment advisers under the Advisers Act after the Dodd-Frank Act changes discussed above, the Dodd-Frank Act adds a new exclusion from the definition of "investment adviser" for family offices as defined by rule, regulation or order of the SEC. The Dodd-Frank Act also requires that any SEC "family office" definition must provide for an exemption that is consistent with the previous SEC family office exemptive orders and recognizes the range of organizational, management, and employment structures and arrangements employed by family offices. The Dodd-Frank Act also requires that the SEC definition grandfather certain family offices.

On June 22, 2011, the SEC adopted a new rule under the Advisers Act defining "family offices" for this purpose. The rule provides that a "family office" would not be considered to be an investment adviser for purpose of the Advisers Act. The rule defines a "family office" as a company that (a) has no clients other than family clients; (b) is wholly owned and controlled (directly or indirectly) by family members; and (c) does not hold itself out to the public as an investment adviser. The rule also provides that the "family office" definition includes a company's directors, partners, trustees, and employees acting within the scope of their position or employment and that comply with the requirements of the rule. The rule also includes grandfathering of certain family offices, however, these family offices may be remain subject to the antifraud provisions of the Advisers Act. For additional details, please see our related client alert which is available at: http://www.chapman.com/media/news/media.1038.pdf.

Notwithstanding the final SEC rule, a bill (HR 2225) has been introduced in the House of Representatives that would amend the Advisers Act to include a statutory definition of "family office". The language of the bill differs somewhat from the language used in the final SEC rule. If the bill proceeds, it would need to be considered by the House Financial Services Committee and, if approved, would subsequently be presented for a vote by the full House of Representatives. (§409)

Small and Mid-Sized Advisers Not Permitted to Register with SEC

Under pre-Dodd-Frank Act law, investment advisers with less than $25 million in assets under management ("AUM") are generally not permitted to register as investment advisers with the SEC as long as the adviser is regulated or required to be regulated as an investment adviser in the state in which it maintains its principal office and place of business. These advisers generally must register with one or more States. Under pre-Dodd-Frank SEC rules, advisers with between $25 and $30 million in AUM may generally register with the SEC or applicable States. Effective July 21, 2011, the Dodd-Frank Act effectively increased the AUM dollar amount threshold for SEC investment adviser registration to $100 million from the current $25 million. In doing so, however, the Dodd-Frank Act retains a $25 million threshold and generally creates two classes of advisers:

- *Small Advisers*—advisers with AUM of less than $25 million that are *regulated or required to be regulated* as investment advisers in the State in which the adviser maintains its principal office and place of business; and
- *Mid-Sized Advisers*—advisers with AUM of between $25 million and $100 million that are *required to be registered* as an investment adviser in the State in which the adviser maintains its principal office and place of business and, if registered, would be *subject to examination as an investment adviser by such State*.

Under the Dodd-Frank Act changes, these small and mid-sized advisers are generally not permitted to register with the SEC but will register with one or more States, subject to certain exceptions and exemptions. Investment advisers that are advisers to registered investment companies or to business development companies are excluded from this prohibition and must register with the SEC.

On June 22, 2011, the SEC adopted new rules that, among other things, include changes related to the changes in the foregoing statutory thresholds for SEC adviser registration, additional exclusions from the prohibition from registration for advisers not meeting statutory thresholds, and amendments to Form ADV related to these issues. For additional details regarding the new SEC rules, please see our client alert which is available at http://www.chapman.com/media/news/media.1038.pdf. After giving effect to these final SEC rules, the distinction between small advisers and mid-sized advisers does not matter for purposes of determining eligibility for State or SEC registration for advisers in most States. The distinction generally only matters for States that (1) require investment adviser registration but (2) do not have an investment adviser examination program. Based on current SEC guidance, this appears to be the case only in New York (some confusion initially existed with respect to Minnesota but the State has clarified that it does examine advisers). Wyoming is the sole State that does not require investment adviser registration or examination and all advisers that maintain their principal office and place of business in Wyoming will continue to be eligible for SEC registration. The Dodd-Frank Act also makes a distinction between small advisers and mid-sized advisers in that under the statutory changes mid-sized advisers that are required to register with 15 or more States as a result of the statutory prohibition are permitted to register with the SEC. Under pre-Dodd-Frank SEC rules, a small adviser that is required to register with 30 or more States is permitted to register with the SEC. However, the SEC is essentially eliminating this distinction in its new rules. As a result, advisers that maintain their principal office and place of business in States other than New York can generally treat the Dodd-Frank Act and related rules as raising the current $25 million threshold to $100 million and ignore the distinction between small and mid-sized advisers.

The new SEC rules also provide for the implementation of the new State/SEC threshold. Under the new rules, advisers registered with the SEC on January 1, 2012, must file an amendment to Form ADV no later than March 30, 2012. These amendments to Form ADV will be required to respond to new items in Form ADV and identify mid-sized advisers no longer eligible to remain registered with the SEC. Any adviser no longer eligible for SEC registration will have to withdraw its registration no later than June 28, 2012. Mid-sized advisers registered with the SEC as of July 21, 2011, must remain registered with the SEC (unless an exemption is available) until January 1, 2012. Effective July 21, 2011, advisers newly applying for registration with the SEC with between $25 and $100 million in AUM are prohibited from registering with the SEC and must register with the appropriate State securities authority.

The new rules also amend Advisers Act Rule 203A-1 to provide newly registering advisers with a choice between State and SEC registration when they have $100 million to $110 million in AUM. Once registered, advisers will not be required to withdraw registration unless they have less than $90 million in AUM. Thus, the SEC has created a buffer range from $90 million to $110 million in AUM to prevent advisers from having to switch between SEC and State registration. However, the final rules also eliminate the current $5 million buffer for small advisers with $25-$30 million in AUM. Under the new rules, if an adviser is registered with a State security authority, it must apply for registration with the SEC within 90 days of filing an annual Form ADV amendment reporting that it is eligible for SEC registration and not relying on an exemption from registration. If an adviser is registered with the SEC and files an annual Form ADV update reporting that it is not eligible for SEC registration (and is not relying on an exemption), it must withdraw from SEC registration within 180 days of its fiscal year end. During a period where an adviser is registered with both the SEC and one or more State securities authorities, the Advisers Act and applicable State law will apply to such adviser s advisory activities. (§410)

Recordkeeping and Reporting

SEC-Registered Private Fund Advisers

The SEC is permitted to require any SEC-registered investment adviser to maintain records and file reports relating to private funds managed by the adviser as the SEC determines (1) necessary *and* appropriate in the public interest *and* for the protection of investors, *or* (2) for the assessment of systemic risk by the Financial Stability Oversight Council. The SEC is permitted to provide these records and reports available to the Financial Stability Oversight Council. While the foregoing rulemaking authority is permissive rather than mandatory, the Dodd-Frank Act provides that these records and reports shall include a description of:

- the amount of assets under management and use of leverage;
- counterparty credit risk exposure;

- trading and investment positions;
- valuation policies and practices of the fund;
- types of assets held;
- side arrangements or side letters;
- trading practices; and
- such other information as the SEC, in consultation with the Financial Stability Oversight Council, determines is necessary *and* appropriate in the public interest *and* for the protection of investors *or* for the assessment of systemic risk. This information may include the establishment of different reporting requirements for different classes of fund advisers based on the type or size of private fund being advised.

On October 31, 2011, the SEC and CFTC adopted new reporting rules under the Advisers Act and Commodity Exchange Act. The new SEC rule requires investment advisers registered with the SEC that advise one or more private funds and have at least $150 million in private fund assets under management to file Form PF with the SEC. The new CFTC rule requires commodity pool operators and commodity trading advisors registered with the CFTC to satisfy certain CFTC filing requirements with respect to private funds by filing Form PF with the SEC, but only if those CPOs and CTAs are also registered with the SEC as investment advisers and are required to file Form PF under the Advisers Act. The new CFTC rule also allows such CPOs and CTAs to satisfy certain CFTC filing requirements with respect to commodity pools that are not private funds by filing Form PF with the SEC. Advisers must file Form PF electronically, on a confidential basis. The information contained in Form PF is designed, among other things, to assist the Financial Stability Oversight Council in its assessment of systemic risk in the U.S. financial system. Under the new reporting requirements, private fund advisers would be divided by size into two broad groups: large advisers and smaller advisers. Large private fund advisers would include any adviser with $1.5 billion or more in hedge fund assets under management, $1 billion in liquidity fund or registered money market fund assets under management, or $2 billion in private equity fund assets under management. Large private fund advisers would file Form PF on a quarterly basis and would provide more detailed information than smaller advisers. Smaller private fund advisers must file Form PF only once a year within 120 days of the end of the fiscal year, and report only basic information regarding the private funds they advise. There will be a two-stage phase-in period for compliance with Form PF filing requirements. Most private fund advisers will be required to begin filing Form PF following the end of their first fiscal year or fiscal quarter, as applicable, to end on or after December 15, 2012. Advisers with $5 billion or more in private fund assets must begin filing Form PF following the end of their first fiscal year or fiscal quarter, as applicable, to end on or after June 15, 2012. The adopting SEC/CFTC release is available at http://www.sec.gov/rules/final/2011/ia-3308.pdf.

The Dodd-Frank Act includes confidentiality protections related to certain information provided to the SEC. Certain of the Dodd-Frank Act confidentiality provisions came under attack after the SEC reportedly cited a provision (§929I) in an effort to avoid disclosing information related to the SEC's failure to detect the Madoff ponzi scheme. As a result, certain confidentiality provisions from Dodd-Frank Act §929I were amended in early October 2010. While other confidentiality protections remain, this may be an area that sees additional developments through SEC or Congressional action. (§404, §929I)

Advisers Registered with the SEC and CFTC

The Dodd-Frank Act requires the SEC and CFTC to promulgate rules by July 21, 2011 which establish the form and content of reports required to be filed with the SEC and CFTC for investment advisers that are required to register under both the Advisers Act and the Commodity Exchange Act. The October 31, 2011 joint SEC/CFTC action regarding Form PF described above is intended to satisfy this mandate. (§406)

Venture Capital Fund Advisers

While venture capital fund advisers will be exempt from SEC investment adviser registration, the SEC must adopt rules requiring these advisers to maintain such records and to file such reports as the SEC determines necessary *or* appropriate in the public interest *or* for the protection of investors. The SEC has adopted reporting obligations for these exempt advisers. Please see "SEC Private Fund Adviser Reporting—Registered and Exempt Advisers" below. (§407)

Smaller Private Fund Advisers

While private fund advisers with AUM in the U.S. of less than $150 million are exempt from SEC investment adviser registration, the SEC must adopt rules requiring these advisers to maintain such records and to file such reports as the SEC determines necessary *or* appropriate in the public interest *or* for the protection of investors. The SEC has adopted reporting obligations for these exempt advisers. Please see "SEC Private Fund Adviser Reporting—Registered and Exempt Advisers" below. (§408)

SEC Private Fund Adviser Reporting—Registered and Exempt Advisers

On June 22, 2011, the SEC adopted new rules that, among other things, make registered investment advisers and advisers relying on the venture capital fund and smaller private fund adviser exemptions discussed above ("exempt reporting advisers") subject to certain reporting requirements. As a result, exempt reporting advisers, although not registered, would be required to file a Form ADV and pay the relevant filing fee. Exempt reporting advisers would only be required to provide information relating to certain items in proposed Form ADV. The information required to be completed by exempt reporting advisers in Form ADV under the proposals includes:

- basic identifying information (Item 1);
- identification of exemptions from registration being relied upon (Item 2.B);
- identification about form of organization (Item 3)
- information regarding other business activities engaged in by the adviser (Item 6);
- financial industry affiliations and information regarding private funds managed by the adviser (Item 7);
- the adviser's control persons (Item 10); and
- disciplinary history for the adviser and its employees (Item 11).

The most controversial item above has been Item 7 which requires fund-by-fund reporting of information regarding each private fund managed by an adviser, including exempt reporting advisers. This information will be accessible to the public on the SEC's website. While the information may be of interest to regulators, much of the information will likely be of significant interest to an adviser's competitors, other market participants and the media. This information includes items such as:

- the name and place of formation of the fund;
- the name of the general partner, manager, trustee or directors of the fund;
- information regarding the Investment Company Act exemption relied upon;
- names of foreign regulatory authorities with which the fund is registered;
- details about master-feeder arrangements and funds-of-funds (defined as a fund investing 10% or more of its assets in other pooled vehicles of any type);
- whether the fund invests in funds registered under the Investment Company Act;
- whether the fund is a hedge fund, liquidity fund, private equity fund, real estate fund, securitized asset fund, venture capital fund or other private fund (these terms are defined in the instructions to Form ADV);
- the gross asset value of the fund (but not the *net* asset value, as originally proposed by the SEC);

- the current value of the fund's investments broken down by asset and liability class and by Level 1, 2 and 3 U.S. GAAP fair value hierarchy;
- the minimum investment, number of beneficial owners and percentage of fund owned by non-US persons (but not the percentage of fund owned by various categories of investor, as originally proposed by the SEC);
- identities of any other advisers or sub-advisers to the fund and whether the advisers clients are solicited to invest in the fund;
- whether the fund relies on Securities Act Regulation D and, if so, the fund's Form D file number;
- whether the fund's financial statements are audited and, if so, various information regarding the fund's auditor;
- identifying information about the fund's prime broker, custodian and administrator; and
- identifying information about each marketer of the fund (other than the adviser or its employees), including whether a website is used.

Of course, registered investment advisers would also be required to provide the foregoing information. For additional details regarding the new SEC rules, please see our client alert which is available at http://www.chapman.com/media/news/media.1038.pdf.

Examination

Private Fund Adviser Exam Cycles and Assessment of Systemic Risk

The Dodd-Frank Act requires that the SEC conduct periodic inspections of the records of private funds maintained by SEC-registered investment advisers in accordance with a schedule established by the SEC. This suggests that the SEC is required to establish a regular inspection cycle for registered private fund advisers. In recent years, the SEC has taken a risk-based approach to investment adviser inspection which generally means that larger advisers and certain advisers that warrant more frequent inspection have been examined more frequently than other advisers. According to certain reports, in recent years less than 10% of investment advisers have been examined by the SEC each year. The SEC is also permitted to conduct such additional, special, and other examinations of private fund advisers as the SEC may prescribe as necessary and appropriate in the public interest and for the protection of investors, or *for the assessment of systemic risk*. The concept of conducting examinations for the assessment of systemic risk is a new exam concept introduced by the Dodd-Frank Act. (§404)

Private Fund Records Subject to SEC Adviser Examinations

The Dodd-Frank Act provides that the records and reports of any private fund managed by an SEC-registered investment adviser are deemed to be the records and reports of the investment adviser. Accordingly, private fund records are subject to review by the SEC in an examination of the adviser. (§404)

Advisers to Mid-Sized Private Funds

The SEC is required to adopt examination procedures with respect to the investment advisers of "mid-sized" private funds which reflect the level of systemic risk posed by such funds. The Dodd-Frank Act does not define "mid-sized" funds. As a result, the SEC is presumably required to implement exam procedures that make some distinction between advisers to large private funds and advisers to smaller private funds with discretion left to the SEC to determine the appropriate distinctions both in terms of procedures and size of funds.

Study on Investment Adviser Exams and SRO

The SEC is required to review and analyze the need for enhanced examination and enforcement resources for investment advisers. This study must examine:

- the number and frequency of examinations of investment advisers by the SEC over the 5 years preceding July 21, 2010;
- the extent to which having Congress authorize the SEC to designate one or more self-regulatory organizations to augment the Commission's efforts in overseeing investment advisers would improve the frequency of examinations of investment advisers; and
- current and potential approaches to examining the investment advisory activities of dually-registered broker-dealers and investment advisers or affiliated broker-dealers and investment advisers.

The SEC issued its report on the results of the study on January 17, 2011. The report outlines the findings of the study including the SEC staff opinion that the SEC will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency. The report notes that the SEC's examination program requires a source of funding that is adequate to permit the SEC to meet new challenges and prevent examination resources from being outstripped by growth in the number of registered investment adviser. The study includes the staff's recommendation that Congress consider three possible approaches to address the capacity constraints concerning adviser examinations:

- Congress could authorize the SEC to impose "user fees" on SEC-registered advisers that could be retained by the SEC to fund the investment adviser examination program.
- Congress could authorize one or more SROs to examine, subject to SEC supervision, all SEC-registered investment advisers with statutorily mandated membership in such SROs for investment advisers.
- FINRA could be authorized to examine firms registered both as broker-dealers and investment advisers for compliance with the Advisers Act.

For additional details regarding the SEC's report, please see our client alert which is available at http://www.chapman.com/media/news/media.956.pdf. (§914)

Closure on SEC Examinations

The Exchange Act now provides that no later than 180 days after the date on which SEC staff completes the on-site portion of a compliance examination or inspection or receives all records requested from the entity being examined or inspected (whichever is later), the SEC staff must provide the entity being examined or inspected with written notification indicating either that the examination or inspection has concluded, has concluded without findings, or that the staff requests the entity undertake corrective action. This requirement also includes an exception that could allow additional time for certain complex examinations or inspections and for situations where SEC staff requests for corrective action that cannot be completed within the required deadline. (§929U)

Enforcement

Expansion of Aiding and Abetting Liability Provisions

Prior to the Dodd-Frank Act, the SEC could only charge aiding and abetting violations under the Exchange Act and the Advisers Act. The Dodd-Frank Act now permits the SEC to charge aiding and abetting violations under the Securities Act and the Investment Company Act as well. It also authorizes the SEC to seek a penalty for aiding and abetting violations under the Advisers Act (rather than only injunctive relief). In addition, the Dodd-Frank Act amends these Acts (including the Exchange Act) to expand the state of mind element necessary for aiding and abetting violations of the securities laws. The prior standard required that an aider or abettor "knowingly" provide substantial assistance to another person's violations. The Dodd-Frank Act provides for liability for those who aid and abet violations knowingly or *recklessly*. These changes will make it easier for the SEC to bring aiding and abetting charges.

On June 6, 2011, the Northern District Court for California refused to retroactively apply Section 929M(2)(b) of the Dodd-Frank Act that authorizes the SEC to sue for aiding and abetting a primary violation of the Advisers Act. The SEC had alleged that the defendants made misleading statements concerning a mutual fund. The Court partially granted a motion to dismiss by the defendants, holding that nothing in the Dodd-Frank Act suggests that it was meant to apply retroactively. Since the events at issue occurred prior to the enactment of the Dodd-Frank Act, the Court dismissed the related charges based on Section 929M(2)(b). The Court's opinion is available at this link. (§929M, §929N, §929O)

Study on Aiding and Abetting Liability in Private Actions

The Comptroller General is required to conduct a study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws. To the extent feasible, this study must include (1) a review of the role of secondary actors in companies issuance of securities; (2) the courts interpretation of the scope of liability for secondary actors under Federal securities laws after January 14, 2008; and (3) the types of lawsuits decided under the Private Securities Litigation Act of 1995. The Comptroller General must submit a report to Congress on the findings of the study by July 21, 2011.

In a June 13, 2011 decision that could have implications with respect to these issues, *Janus Capital Group v. First Derivative Traders*, the United States Supreme Court ruled that an investment adviser to a mutual fund may not be held directly liable for misstatements in the fund s prospectus in a private action under Rule 10b-5 under the Exchange Act. Among other things, Rule 10b-5 prohibits making any untrue statement of material fact in connection with the purchase or sale of securities. In the 5-4 decision, the Court held that because the false statements included in the prospectus were made by the fund itself and not by the fund s investment adviser, the adviser cannot be held directly liable in a private action under Rule 10b-5. The Court's decision in this case will likely have an impact on the Comptroller General study and the report required to be submitted to Congress because the study is expressly required to address court interpretations of the scope of liability for secondary actors under Federal securities laws after January 14, 2008. In addition, the case could become an issue for consideration by Congress following delivery of the Comptroller General's report. For additional information regarding this case, see our client alert available at http://www.chapman.com/media/news/media.1026.pdf. (§929Z)

Collateral Bars

The SEC is now authorized to suspend or bar a regulated person who violates securities laws in one part of the financial services industry from associating with a regulated entity in another part of the industry. For example, if an individual associated with a broker-dealer is the subject of an enforcement action, the SEC may now suspend or bar that person not only from associating with a broker-dealer, but also from associating with an investment adviser, municipal securities dealer, municipal advisor, transfer agent or nationally recognized statistical rating organization (NRSRO).

Prior to enactment of the Dodd-Frank Act, there was no associational bar or similar provision with respect to municipal advisors, nor was there a formal associational bar with respect to NRSROs. However, before enactment of the Dodd-Frank Act there existed a statutory provision for revoking the registration of an NRSRO if any person associated with it was found to have willfully violated any provision of the Securities Act of 1933 and if it was necessary for the protection of investors and in the public interest. As a result, in two cases the same administrative law judge found that the respondent had no reasonable expectation of, and no vested right in, association with an NRSRO, if such an association would subject the NRSRO to revocation of registration because, although this provision is not formally an associational bar, for practical purposes it amounts to one, and it is unlikely any NRSRO would ever have hired the respondent or otherwise associated with the respondent.

In the first instances of the SEC staff seeking to use this power, the SEC staff sought to bar certain individuals found to have been involved in various securities law violations from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, and NRSRO (and from participating in an offering of penny stock in certain cases). A significant aspect of these actions is that the misconduct in these cases occurred *prior to enactment of the Dodd-Frank Act*. Prior to enactment of the Dodd-Frank Act, there was no associational bar or similar provision with respect to municipal advisors, nor was there a formal associational bar with respect to NRSROs. In two separate cases involving the same administrative law judge, the judge found that because such bars did not exist at the time of the related misconduct, the new bars attach new legal consequences to the conduct and were impermissibly retroactive. As a result, the individuals in these cases were ordered barred from association with any broker, dealer, investment adviser, municipal securities dealer, and transfer agent (and from participating in an offering of penny stock in one case) but were *not* barred from association with municipal advisors or NRSROs (see http://www.sec.gov/litigation/aljdec/2011/id419bpm.pdf and http://www.sec.gov/litigation/aljdec/2011/id431bpm.pdf). However, in a later decision, a different administrative law judge allowed all collateral bars sought by the SEC where the respondent did not challenge the sanction sought by the SEC staff, including as to municipal advisors and NRSROs, but there was little discussion of the issue in the opinion (see http://www.sec.gov/litigation/aljdec/2011/id432rgm.pdf). Having said that, the same judge did *not* allow the municipal advisors and NRSROs collateral bars in three subsequent cases (see http://www.sec.gov/alj/aljdec/2011/id446rgm.pdf, http://www.sec.gov/alj/aljdec/2011/id443rgm.pdf and http://www.sec.gov/alj/aljdec/2011/id442rgm.pdf). Finally, in four other cases, a third administrative law judge allowed all collateral bars sought by the SEC, including NRSROs but not including municipal advisors (see http://www.sec.gov/alj/aljdec/2011/id441ce.pdf, http://www.sec.gov/alj/aljdec/2011/id435ce.pdf, http://www.sec.gov/litigation/admin/2011/34-65422.pdf and http://www.sec.gov/litigation/admin/2011/34-65423.pdf). The judge in these cases noted that before enactment of the Dodd-Frank Act there existed a statutory provision for revoking the registration of an NRSRO if any person associated with it was found to have willfully violated any provision of the Securities Act of 1933 and if it was necessary for the protection of investors and in the public interest. As a result, in these cases the administrative law judge found that the respondent had no reasonable expectation of, and no vested right in, association with an NRSRO, if such an association would subject the NRSRO to revocation of registration because, although this provision is not formally an associational bar, for practical purposes it amounts to one, and it is unlikely any NRSRO would ever have hired the respondent or otherwise associated with the respondent. As a side note, the same judge was involved with a fifth case where neither the municipal advisor nor NRSRO bars were allowed but the NRSRO was disallowed on grounds not related to the Dodd-Frank Act (see http://www.sec.gov/litigation/admin/2011/34-65593.pdf). (§925)

SEC Authority to Impose Penalties in Administrative Proceedings

Prior to the Dodd-Frank Act, the SEC could only impose a civil penalty in an administrative proceeding against an individual associated with an entity subject to SEC jurisdiction, such as a broker-dealer or investment adviser. This required the SEC to bring an action in federal district court to seek a civil penalty against a person not associated with a regulated entity. The Dodd-Frank Act now allows the SEC to seek a civil penalty against any person in an administrative proceeding before an administrative law judge rather than in federal court. It also increases the penalty amounts the SEC can seek in administrative proceedings. These changes will likely increase the number of administrative enforcement actions filed by the SEC, but will also provide defendants the opportunity to resolve cases through administrative action rather than a potentially more significant federal district court action. (§929P)

Closure on SEC Investigations After Receiving a Wells Notice

The Exchange Act now provides that no later than 180 days after the date on which the SEC staff provide a Wells Notice to any person, the SEC staff must either file an action against that person or provide notice to the Director of the SEC Division of Enforcement of its intent to not file an action. This requirement includes exceptions that could allow additional time for certain complex enforcement investigations.

In an early case involving the new Exchange Act provision, a party filed a motion to dismiss an SEC action claiming that the SEC failed to institute cease-and-desist proceedings on a timely basis within the 180 day time frame. In this case the SEC instituted cease-and-desist proceedings 187 days after providing the party with a written Wells Notice. The administrative law judge denied the motion. Although the actual actions of the SEC staff are somewhat unclear, the ruling appears to be based on an apparent finding that (i) Division staff submitted a request for an extension to the 180-day time limit under the Exchange Act provision; (ii) the Division Director's staff provided the SEC Chairman with notice that the Division Director intended to extend the initial 180-day deadline; and (iii) the Division Director approved the extension (see http://www.sec.gov/alj/aljorders/2011/ap684bpm.pdf and http://www.sec.gov/litigation/opinions/2011/ia-3311.pdf). (§929U)

Harmonization of Investment Adviser and Broker-Dealer Enforcement

The Dodd-Frank Act requires "harmonization" of enforcement by the SEC with respect to violations of the standard of conduct applicable to broker-dealers when providing personalized investment advice about securities to retail customers and with respect to violations of the standard of conduct applicable to investment advisers. The Dodd-Frank Act requires the SEC to seek to prosecute and sanction violators of the standard of conduct applicable to a broker-dealer providing personalized investment advice about securities to a retail customer to same extent as the SEC prosecutes and sanctions violators of the standard of conduct applicable to an investment adviser under the Advisers Act (and vice versa). Note that this provision applies only to the SEC and not FINRA and most broker-dealer suitability actions are brought by FINRA rather than the SEC. (§913)

Fiduciary Duty—Investment Advisers and Broker-Dealers

The Dodd-Frank Act requires the SEC to conduct studies and evaluations of the effectiveness of existing legal and regulatory requirements applicable to broker-dealers, investment advisers and associated persons who provide personalized investment advice and recommendations about securities to retail customers. The Act also amends Section 15 of the Exchange Act and Section 211 of the Advisers Act to expressly permit the SEC to adopt rules that provide a standard of conduct for broker-dealers and investment advisers when they provide personalized investment advice to retail customers. The Dodd-Frank Act defines "retail customer" for these purposes as a natural person (or such person's legal representative) who receives personalized investment advice about securities from a broker-dealer or investment adviser and uses that advice primarily for personal, family or household purposes. On July 27, 2010, the SEC published a request for public comment related to these issues. The SEC release is available at http://www.sec.gov/rules/other/2010/34-62577.pdf. If the SEC proposes a fiduciary standard rule in the future, the SEC will publish that proposal and industry participants will also be able to submit comments on these issues and the specific proposal at that time.

Background

While investment advisers are generally considered to owe fiduciary duties to their advisory clients, broker-dealers have generally not been considered "fiduciaries" with respect to brokerage clients. The SEC has generally held the position that investment advisers have a fundamental obligation to act in the best interests of their advisory clients and to provide investment advice in a client's best interests, among other things. On the other hand, broker-dealers not acting in an investment adviser capacity generally have more limited obligations with respect to brokerage clients. For example, a broker-dealer generally has a duty of fair dealing, duty of best execution, suitability requirements and certain disclosure requirements. The basic broker-dealer suitability obligation generally requires that a broker-dealer, in recommending to a customer the purchase, sale or exchange of any security, must have reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of any facts disclosed by the customer as to other security holdings and the customer's financial situation and needs. This requirement has been construed to impose a duty of inquiry on broker-dealers to obtain relevant information from customers relating to their financial situations and to keep such information current, however, contrary to the fiduciary obligations of an investment adviser, the broker-dealer suitability obligation generally applies only to solicited transactions and is not an ongoing obligation that applies after the recommendation of the purchase or sale transaction for a particular security. Broker-dealers are also often excluded from the definition of "investment adviser" under the Advisers Act if performance of investment advisory services is solely incidental to the conduct of business as a broker-dealer and the broker-dealer receives no special compensation for such services. Accordingly, the current broker-dealer standards of conduct with respect to brokerage clients differ significantly from the fiduciary duties typically owed by investment advisers to advisory clients.

Rulemaking Authority

The Dodd-Frank Act amends Section 15 of the Exchange Act to expressly provide that the SEC may adopt rules to provide that when a broker-dealer provides personalized investment advice about securities to a retail customer (and such other customers as the SEC may determine), the standard of conduct for such broker-dealer with respect to the customer shall be the same as the standard of conduct applicable to an investment adviser under amended Section 211 of the Advisers Act (described below). The receipt of compensation based on commission or other standard compensation for the sale of securities may not, in and of itself, be considered a violation of such standard applied to a broker-dealer. Notably, the amendment also specifies that nothing in amended Section 15 will require a broker-dealer or registered representative to have a continuing duty of care or loyalty to a customer after providing personalized investment advice about securities. Amended Section 15 also provides that where a broker-dealer sells only proprietary products or another limited range of products, the SEC may adopt rules that require that the broker-dealer provide notice to each retail customer and obtain the consent or acknowledgment of the customer, provided that the sale of only proprietary or other limited range of products by a broker-dealer will not, in and of itself, be considered a violation of any standard of conduct adopted under amended Section 15.

The Dodd-Frank Act also amends Section 211 of the Advisers Act to expressly permit the SEC to adopt rules that would provide that the standard of care applicable to broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers (and such other customers as the SEC may determine) shall be to act in the best interest of the customer without regard to the financial or other interest of the broker-dealer or investment adviser providing the advice. Amended Section 211 also requires that in accordance with such rules any material conflicts of interest must be disclosed and may be consented to by the customer. The amended provision also requires that such rules provide that such standard of conduct be no less stringent than the standard applicable to investment advisers under Section 206(1) and (2) of the Advisers Act when providing personalized investment advice about securities, provided that the SEC may not ascribe a meaning to the term “customer” that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser. Similar to amended Section 15 of the Exchange Act, amended Section 211 provides that the receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard applied to a broker-dealer or investment adviser.

The Dodd-Frank Act *permits*, but does not *require*, the SEC to adopt rules setting forth the standard of care applicable to broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. However, SEC Chairman Mary Shapiro and certain other SEC Commissioners have stated their support for such standards on several occasions. There also appears to be industry support for a “harmonized” fiduciary duty standard for investment advisers and broker-dealers, *provided that the standard is “business model neutral”*. The concept of a “business model neutral” standard means that any standard adopted should allow both broker-dealers and investment advisers to continue to provide the same level and types of services and products as they currently provide to customers.

Disclosure of Terms of Customer Relationships and Conflicts of Interest

The SEC is also required to (a) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers-dealers and investment advisers, including any material conflicts of interest; and (b) examine and, where appropriate, adopt rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for broker-dealers and investment advisers that the SEC deems contrary to the public interest and the protection of investors.

Required SEC Study

The Dodd-Frank Act requires the SEC to evaluate the effectiveness of existing standards of care for broker-dealers, investment advisers and associated persons who provide personalized investment advice and recommendations about securities to retail customers and whether there are legal or regulatory gaps, shortcomings or overlaps in existing standards of care that should be addressed by rule or statute.

On January 21, 2011, the SEC delivered its report to Congress describing its findings and making certain recommendations. The report indicates that the SEC staff’s recommendations are guided by an effort to establish a standard to provide for the integrity of advice given to retail investors and to recommend a harmonized regulatory regime for investment advisers and broker-dealers when providing the same or substantially similar services, to better protect retail investors.

The staff recommends that the SEC adopt what they refer to as a "uniform fiduciary standard" by promulgating rules providing that when brokers, dealers and investment advisers provide personalized investment advice about securities to a retail customer, the standard of conduct required be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing advice. In making this recommendation, the staff notes that the Dodd-Frank Act explicitly provides that the receipt of commission-based compensation for the sale of securities does not, in and of itself, violate the uniform fiduciary standard of conduct applied to a broker dealer. The staff also notes that the Dodd-Frank Act provides that the uniform fiduciary standard does not necessarily require broker-dealers to have a continuing duty of care or loyalty to a retail customer after providing personalized investment advice. The staff of the SEC recommends that in implementing this uniform fiduciary standard the SEC should:

- exercise rulemaking authority to implement the uniform fiduciary standard which should provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice;
- engage in rulemaking and/or issue interpretive guidance addressing the duties of loyalty and care with existing guidance and precedent under the Advisers Act continuing to apply;
- obligate both investment advisers and broker-dealers to eliminate certain conflicts of interest and provide for uniform, simple and clear disclosures for conflicts of interest that are not prohibited;
- address through interpretive guidance and/or rulemaking how broker-dealers should fulfill the uniform fiduciary standards when engaging in principal trading;
- consider specifying uniform standards for the duty of care owed to retail investors which could include, for example, specifying what basis a broker-dealer or investment adviser should have in making a recommendation to an investor;
- engage in rulemaking and/or issue interpretive guidance to explain what it means to provide "personalized investment advice about securities"; and
- consider additional investor education outreach as an important complement to the uniform fiduciary standard. The staff also recommends that the SEC adopt the uniform fiduciary standard with effective oversight to provide additional protection to retail investors.

The report also recommends further harmonization of certain regulations applicable to broker dealers and investment advisers to provide retail investors with the similar protections when they are receiving similar services. Areas where the report suggests that the SEC should focus on review and consideration of more harmonized regulation include:

- Substantive advertising and customer communication rules and guidance for broker-dealers and investment advisers regarding the review and content of advertisements;
- Regulatory requirements to address the status and disclosure requirements of finders and solicitors by broker-dealers and investment adviser to help retail customers better understand the conflicts associated with finders' and solicitors' receipt of compensation;
- Supervisory requirements for investment advisers and broker-dealers with a focus on whether harmonization would facilitate the examination and oversight of these entities;
- Disclosure requirements in Form ADV and Form BD and consideration of whether investment advisers should be subject to a substantive review prior to registration;
- Whether investment advisers should be subject to federal continuing education and licensing requirements; and
- Whether the Advisers Act books and records requirements should be modified consistent with the standard applicable to broker-dealers.

The Dodd-Frank Act also requires that the study consider potential impact of (a) eliminating the broker-dealer exclusion from the definition of “investment adviser” in the Advisers Act and (b) applying the duty of care and other requirements of the Advisers Act to broker-dealers. The SEC staff expresses its belief in its report that these alternatives would not provide the SEC with a flexible, practical approach to addressing what standard should apply to broker-dealers and investment advisers when they are performing the same functions for retail investors.

Commissioners Casey and Paredes issued a separate statement to identify what they viewed as significant shortcomings in the study and to express their view that certain areas should be explored in greater detail with further analysis. They further express their view that since there is no statutory deadline for any follow-on rulemaking, any rulemaking prior to further research and analysis would be ill-conceived and possibly harmful. The report is available at http://sec.gov/news/studies/2011/913studyfinal.pdf. (§913)

Derivatives

Changes Relevant to Asset Management

The Dodd-Frank Act brings four broad changes to the over-the-counter derivatives market as it relates to the asset management industry. First, Dodd-Frank grants new authority to the SEC and CFTC to regulate the OTC derivatives market that departs from the prior framework of limited regulation in this area that arose out of the Commodity Futures Modernization Act of 2000. Second, Dodd-Frank introduces new statutory anti-manipulation provisions covering OTC derivatives and grants the SEC and CFTC new authority to adopt rules in this area. Third, in the future many derivatives transactions will trade through clearinghouses and exchanges. Fourth, some large investment advisers and private fund managers may be considered “major swap participants” and be subject to significant new regulatory obligations. While broker-dealers and others that are significant participants in the OTC derivatives area will have greater interest in the Dodd-Frank OTC derivatives changes, these four areas should be the most significant considerations for investment advisers and investment funds. With a certain exceptions, the SEC and CFTC were required to complete rulemaking related to these changes by July 15, 2011. These provisions primarily appear throughout Titles VII and VIII of the Dodd-Frank Act.

Regulators did not meet many of the deadlines for Dodd-Frank rulemaking in the derivatives area. The primary derivatives-related provisions of the Dodd-Frank Act (Title VII) were generally scheduled to become effective on July 16, 2011 (unless a provision requires rulemaking in which case such provisions become effective not less than 60 days after publication of a final rule). Because a substantial number of Title VII provisions still required rulemaking as of July 16, 2011, the CFTC and SEC each took action to address issues related to the July 16 deadline. The CFTC and SEC actions are discussed briefly below and you may obtain additional information in our client alert available at http://www.chapman.com/media/news/media.1029.pdf.

On July 14, 2011, the CFTC issued an order to temporarily exempt swap market participants from certain provisions of Title VII of the Dodd-Frank Act. The CFTC order recognized the need to further define the terms “swap”, “swap dealer”, “major swap participant”, and “eligible contract participant” and delayed the effectiveness of Title VII provisions that use those terms until the earlier of December 31, 2011, or the date that the CFTC completed final rules to define them. The CFTC order also temporarily exempted certain transactions in exempt or excluded commodities until the earlier of December 31, 2011, or the repeal or replacement of certain of CFTC regulations promulgated in connection with such exemption. The CFTC has published a list of the affected Dodd-Frank provisions on its website. The final CFTC order is available at http://cftc.gov/LawRegulation/FederalRegister/FinalRules/2011-18248a. On July 14, 2011, the CFTC staff issued a no-action letter that supplements the foregoing proposed CFTC exemptive relief. Specifically, the no-action letter would address certain matters related to swap dealers, major swap participants and derivatives clearing organizations. The final no-action letter is available at http://cftc.gov/LawRegulation/CFTCStaffLetters/11-04. After it became apparent that the necessary regulations would not be adopted by December 31, 2011, the CFTC subsequently issued a second order and no-action letter extending the latest expiration date of the temporary relief to July 16, 2012. The order is available at http://cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister122011.pdf and the no-action letter is available at http://cftc.gov/ucm/groups/public/@newsroom/documents/file/noactionletter071612.pdf.

On June 15, 2011, the SEC provided guidance and temporary exemptive relief to address the July 16 deadline. The SEC guidance makes clear that substantially all of Title VII s requirements applicable to security-based swaps will not go into effect on July 16. The SEC also granted temporary relief to market participants from compliance with most of the new Exchange Act requirements that would otherwise apply on July 16. In addition, to enhance the legal certainty provided to market participants, the SEC s action provides temporary relief from Section 29(b) of the Exchange Act which generally provides that contracts made in violation of any provision of the Exchange Act shall be void as to the rights of any person who is in violation of the provision.

On July 1, 2011, the SEC approved an order granting temporary relief and interpretive guidance to make clear that a substantial number of the requirements of the Exchange Act applicable to securities will not apply to security-based swaps when the revised definition of "security" goes into effect on July 16, 2011. Federal securities laws prohibiting fraud and manipulation will continue to apply to security-based swaps on and after July 16, 2011. To enhance legal certainty for market participants, the SEC also provided temporary relief from provisions of U.S. securities laws that allow the voiding of contracts made in violation of those laws. The SEC order is available at http://www.sec.gov/rules/exorders/2011/34-64795.pdf. The SEC also approved an interim final rule providing exemptions from the Securities Act, Trust Indenture Act and other provisions of the federal securities laws to allow certain security-based swaps to continue to trade and be cleared as they have prior to the Dodd-Frank Act changes. That interim relief will extend until the SEC adopts rules further defining "security-based swap" and "eligible contract participant." The related SEC release is available at http://www.sec.gov/rules/interim/2011/33-9231.pdf.

Prior to the CFTC and SEC actions, a bill (HR 1573) was also introduced in the House of Representatives to delay the implementation of Title VII of the Dodd-Frank Act, as well as the effective dates of CFTC and SEC rules to implement it, until December 31, 2012. The bill maintains the current timeframe for the CFTC and SEC to issue final rules regarding regulatory definitions, maintains the current timeframe for rules requiring record retention and regulatory reporting, and also requires additional public forums to take input from stakeholders before the Dodd-Frank rules can be made final. The bill has been approved by the House Financial Services Committee on a straight party line vote and would subsequently need to be presented for a vote by the full House of Representatives. Even if the bill is passed by the full House, many believe that it would likely face opposition from the Senate and the President.

SEC/CFTC Dual Regulatory Oversight

The Dodd-Frank Act is the first attempt to bring comprehensive regulation to the OTC derivatives market in the U.S. since the Commodity Futures Modernization Act of 2000 generally placed these markets outside the regulatory authority of the SEC and CFTC. The SEC and CFTC will have dual regulatory oversight over derivatives. The SEC will oversee regulation of "security-based swaps" and the CFTC will oversee "swaps" (though the prudential regulators, such as the Federal Reserve Board, also have an important role in setting capital and margin for swap entities that are banks). The SEC and CFTC will have joint regulatory authority over "mixed swaps" that have characteristics of both "swaps" and "security-based swaps" and these mixed swaps will generally be treated as "security-based swaps". Participants in both swap and security-based swap markets will therefore be subject to regulation by both the SEC and the CFTC (this is similar in some respects to current dually-registered broker-dealer/futures commission merchants).

For this purpose, a "swap" is broadly defined to include most OTC derivatives other than "security-based swaps." Accordingly, for this purpose a "swap" is not limited to contracts normally called "swaps" in common industry jargon. However, this "swap" definition generally excludes futures contracts and forward contracts that are likely to be settled by physical delivery and also excludes options on individual securities or any group or index of securities and certain other limited exceptions. A "security-based swap" generally includes a derivative based on (i) a narrow-based security index; (ii) a single security or loan; or (iii) the occurrence, nonoccurrence, or the extent of the occurrence of an event relating to an issuer of a security, or the issuers of securities, in a narrow-based security index. Security-based swaps are included within the definition of "security" under the Exchange Act and the Securities Act.

On April 27, 2011, the SEC and CFTC jointly proposed rules and proposed interpretive guidance to, among other things, further define the terms “swap,” “security-based swap” and “security-based swap agreement”. The proposed guidance provides that the determination of whether an instrument is a swap or security-based swap is to be made at the inception of the instrument and that the characterization would remain throughout the life of the instrument unless the instrument is modified. The proposal includes a rule establishing a process that would allow market participants or either the SEC or CFTC to request a determination from the SEC and CFTC of whether a product is a swap, security-based swap, or a mixed swap. For details on the proposed rules and interpretive guidance, please see our client alert which is available at http://www.chapman.com/media/news/media.1013.pdf. For related information on a Treasury proposal to issue a determination that would exempt both foreign exchange swaps and foreign exchange forwards from the definition of ‘‘swap’’ in accordance with the relevant provisions of the Commodity Exchange Act, please see http://www.gpo.gov/fdsys/pkg/FR-2011-05-05/pdf/2011-10927.pdf.

Anti-Manipulation Prohibitions

The Dodd-Frank Act expands the anti-manipulation provisions of Section 9 of the Exchange Act and Section 6 of the Commodity Exchange Act and authorizes the SEC and CFTC to adopt rules to prevent fraud, manipulation, and deception in connection with any security-based swap, swap, or a contract of sale of any commodity or for future delivery on or subject to the rules of any CFTC-registered entity. These provisions are largely based on existing Exchange Act Section 10(b) and the SEC and CFTC have indicated that they will likely interpret these provisions in a broad manner as has been the case with Section 10(b). The SEC and CFTC both proposed rules under these provisions and the proposed rules were largely based on existing Exchange Act Rule 10b-5. The rules include new Exchange Act Rule 9j-1 and new CFTC Regulations 180.1 and 180.2. These antifraud provisions generally apply to all market participants and would encompass issuers, broker-dealers, swap dealers, major swap participants, persons associated with a security-based swap dealer or major security-based swap participant, swap counterparties, and any customers, clients or other persons that use or employ or effect transactions in swaps, including for purposes of hedging or mitigating commercial risk or exposure. In addition, the anti-manipulation provisions cover manipulative conduct with respect not only to a derivative directly but also manipulative conduct with respect to the underlying reference asset. The CFTC adopted final rules on July 7, 2011, with an effective date of August 15, 2011. However, the SEC has not yet adopted a final rule and the SEC’s public Dodd-Frank calendar indicates that such action is not contemplated to occur until January-June 2012.

The SEC rule proposal is available at http://www.sec.gov/rules/proposed/2010/34-63236.pdf. The CFTC adopting release is available at http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2011-17549a and the rule proposal is available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-27541a.pdf (the final CFTC rules are virtually identical to the proposed rules).

Clearing, Exchange Trading and Related Issues

The Act provides that the SEC or CFTC have the authority to require that swaps and security-based swaps clear through a derivatives clearing organization or clearing agency. Swaps and security-based swaps that are subject to clearing requirements generally must also be traded through a board of trade designated as a contract market, an exchange, a swap execution facility or a security-based swap execution facility. The SEC or CFTC will designate certain swaps for clearing based upon notional exposures, trading liquidity, adequate pricing data, the effect on the mitigation of systemic risk, the effect on competition, among other factors. Clearinghouses and exchanges are not required to accept swaps for clearing that the regulators designate for clearing (based on, for example, illiquidity or difficulty in pricing). If no clearinghouse accepts a swap designated for clearing by a regulator, the SEC or CFTC may take whatever action it determines necessary and in the public interest, which may include adequate margin or capital.

While these requirements might not have a significant direct impact to many investment advisers or investment funds, advisers should monitor developments in this area to determine whether these issues impact their business indirectly. For example, the SEC, CFTC and banking regulators will set capital and margin requirements for swap dealer and major swap participants. The higher capital and margin requirements will likely be reflected in the cost to and margin required of counterparties. The capital and margin requirements related to uncleared swaps will likely be higher than in connection with cleared swaps. Uncleared swaps also may generally be less liquid than cleared swaps.

For details on SEC rulemaking and interpretive efforts related to derivatives matters under Dodd-Frank, please see http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml#derivatives. For details on CFTC rulemaking and interpretive efforts under Dodd-Frank, please see http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/index.htm.

Swap Dealers and Major Swap Participants

The Dodd-Frank Act subjects "swap dealers," "securities-based swap dealer," "major swap participants" and "major security-based swap participants" to new regulation by the CFTC and SEC. Among other things, entities in these categories will be required to register with the SEC or CFTC and be subject to recordkeeping and reporting requirements, margin and capital requirements and business conduct guidelines. A swap dealer is generally a person or entity that holds itself out as a dealer in swaps, makes a market in a swap, regularly enters into swaps with counterparties for its own account in the ordinary course of business, or engages in any activity that causes the person or entity to be commonly known as a dealer or market maker in swaps. A major swap participant is generally any person or entity:

- that maintains a *substantial position* in swaps for any of the major swap categories as determined by the SEC or CFTC (excluding positions held for *hedging or mitigating commercial risk* and positions maintained by certain retirement plans held for purposes of hedging or mitigating risk directly associated with such plans);
- whose outstanding swaps create *substantial counterparty exposure* that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or
- that (1) is a *financial entity* that is *highly leveraged* relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate federal banking agency, and (2) maintains a substantial position in outstanding swaps in any major swap category as determined by the SEC or CFTC.

Both a swap dealer and a major swap participant can be so designated for a specific type of swap rather than for all swaps. This means, for example, that an entity might be a major swap participant for some types of swaps, but not others. It would appear unlikely that an adviser of a private investment fund would fit these definitions by virtue of providing investment advice to the fund regarding swap transactions. Advisers should, however, assess whether private funds or other vehicles that they manage might meet these definitions and become subject to the related regulation.

In early December 2010, the SEC and CFTC issued joint proposed rules and interpretative guidance to further define the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant." The joint SEC/CFTC release does not provide a rigid or formulaic definition for the terms "swap dealer" and "security-based swap dealer" but rather provides interpretive guidance intended to assist in what will be a facts-and-circumstances assessment for market participants. As required by the Dodd-Frank Act, the proposal includes rules setting forth a de minimis exception excluding a person that meets the following conditions from the dealer definitions:

- The aggregate effective notional amount, measured on a gross basis, of the swaps or security-based swaps that the person enters into over the prior 12 months in connection with dealing activities must not exceed $100 million;
- The aggregate effective notional amount of such swaps or security-based swaps with "special entities" (as defined in Commodity Exchange Act and Securities Exchange Act of 1934 to include certain governmental and other entities) over the prior 12 months must not exceed $25 million.
- The person must not enter into swaps or security-based swaps as a dealer with more than 15 counterparties, other than swap or security-based swap dealers, over the prior 12 months.

- The person must not enter into more than 20 swaps or security-based swaps as a dealer over the prior 12 months.

The joint SEC/CFTC release also provides guidance regarding the major swap participant/major security-based swap participant definitions, including rules defining the italicized terms shown above. These terms include “substantial position,” “hedging or mitigating commercial risk,” “substantial counterparty exposure,” “financial entity” and “highly leveraged.” The joint SEC/CFTC release is available at http://www.sec.gov/rules/proposed/2010/34-63452.pdf.

A bill (HR 1610) has been introduced in the House of Representatives that would limit the scope of the “major swap participant” definition and clarify the margin requirement for end-users of swaps. The bill will now need to be considered by the House Financial Services Committee, and, if approved, would subsequently need to be presented for a vote by the full House of Representatives. A similar bill (S 947) has also been introduced in the Senate and has been referred to the Senate Committee on Banking, Housing, and Urban Affairs.

Commodity Pools Operators and Commodity Trading Advisors

Dodd-Frank Act Impact

As noted in other parts of this summary, the Dodd-Frank Act brings broad changes to various regulatory aspects of the over-the-counter derivatives markets and commodities markets. Among these changes are amendments to the Commodity Exchange Act related to the addition of the defined term “commodity pool” and changes to the existing definitions of “commodity pool operator” (CPO) and “commodity trading advisor” (CTA). This section discusses certain key issues that relate to CPOs and CTAs, as well as firms that are currently exempt from registration as CPOs or CTAs.

Prior to the Dodd-Frank Act changes, an operator of a U.S. pooled vehicle that traded only over-the-counter derivatives, but not exchange-traded futures contracts or options on futures contracts, generally would not be required to register as a CPO or rely on an exemption from CPO registration. This was also generally the case for advisers to such vehicles with respect to CTA registration or exemptions. As a result of Dodd-Frank Act changes, as well as CFTC proposed rule amendments, in the future many operators and advisers of these pooled vehicles will be required to register with the CFTC as CPOs and/or CTAs. In addition, an adviser to managed accounts (but not pools) that invest in over-the-counter derivatives might be required to register as a CTA (where the adviser would not be required to do so under pre-Dodd-Frank requirements). Firms required to register as CPOs or CTAs are also generally required to become members of the National Futures Association, the self-regulatory organization of the futures industry.

In part, the changes facing CPOs and CTAs (or firms currently exempt from registration as CPOs or CTAs) arise as a result of Dodd-Frank changes to the Commodity Exchange Act definitions described above. Under these changes, a pooled investment vehicle that directly or indirectly uses swaps generally falls within the new definition of “commodity pool” (and the operator and adviser to such a pool generally fall within the amended CPO and CTA definitions). As a result, after the Dodd-Frank Act changes, the Commodity Exchange Act will generally require the operator of such a pool to register as a CPO and the adviser to register as a CTA, each subject to certain exemptions. Further, the Dodd-Frank Act amends the CTA definition to contemplate providing advice regarding swaps. This means that certain advisers may need to review whether they will fall within the amended CTA and potentially be required to register as a CTA if they advise only non-pool accounts that use swaps. These Dodd-Frank Act changes generally become effective July 16, 2011 (and do not depend on CFTC rulemaking).

As described above in the “Derivatives” section, the CFTC and SEC have each taken action to address issues related to the July 16 deadline. Included among these actions are CFTC orders that delay the requirement (a) to register as a CPO for any person who operates collective investment vehicles whose only commodity interests are in “swaps” and (b) to register as a CTA for persons whose only advice regarding commodity interests involves “swaps”. The delay is effective until the earlier of July 16, 2012, or the effective date of final regulations further defining “swap”. For additional information on this CFTC action, see our client alert available at http://www.chapman.com/media/news/media.1035.pdf.

Discretionary CFTC Proposals In Consideration of Dodd-Frank Act

On January 26, 2011 the CFTC proposed to amend several existing rules and issue one new rule in consideration of the Dodd-Frank Act that would rescind or significantly limit exemptions from CPO or CTA registration currently used by many investment managers or on which managers trading swaps intended to rely when the Dodd-Frank Act changes become effective. The Dodd-Frank Act does not specifically address these exemptions, however, the CFTC has proposed these changes in order to ensure that it can adequately oversee the commodities and derivatives markets and assess market risk associated with pooled investment vehicles under its jurisdiction. The CFTC also wants its registration and reporting regime for pooled investment vehicles and their operators and/or advisors to align with the registration and reporting regimes of other regulators, such as that of the SEC for investment advisers described earlier in this summary.

In particular, the proposed CFTC changes would eliminate the CPO registration exemptions currently included in CFTC Rule 4.13(a)(3) and 4.13(a)(4). CFTC Rule 4.13(a)(3) currently provides an exemption from CPO registration with respect to certain privately-offered funds (such as 3(c)(1) and 3(c)(7) funds) that are offered only to "qualified eligible persons" (as defined under CFTC rules), accredited investors, or knowledgeable employees, and that limit the aggregate initial margin and premiums attributable to commodity interests to no more than 5% of the fund's liquidation value. CFTC Rule 4.13(a)(4) provides an exemption from CPO registration with respect to certain privately-offered funds (such as 3(c)(7) funds) that are offered solely to "qualified eligible persons". Elimination of these exemptions would have an effect similar to the changes related to registration of investment advisers to private funds under the Advisers Act described in the first section of this publication. Most notably, elimination of these exemptions would have the effect of requiring many hedge fund managers to register as CPOs. Investment advisers that currently operate under an exemption from CTA registration based on the fact that they provide advice only to pools that are exempt under Rules 4.13(a)(3) and 4.13(a)(4) would also be required to register as CTAs if the proposal is adopted and another exemption is not available.

The CFTC proposal also narrows the CFTC Rule 4.5 exclusion from the definition of CPO for investment companies registered under the Investment Company Act. CFTC Rule 4.5 currently provides an exclusion from the definition of CPO for persons operating otherwise regulated entities, such as sponsors and advisers of investment companies registered under the Investment Company Act. Prior to amendments made in 2003, Rule 4.5 required that the use of commodity futures by a qualifying fund for non bona fide hedging purposes be limited to 5% of the liquidation value of the fund's portfolio and that the fund not be marketed as a commodity pool to the public. The CFTC proposal would generally add these requirements back to the rule as they relate to investment companies registered under the Investment Company. As a result, an operator of a registered investment company would no longer be able to rely on Rule 4.5 to avoid registration as a CPO if the investment company invests more than a small amount of its assets for non-hedging purposes in commodities.

The CFTC proposal would also eliminate relief from the certification requirement for annual reports of pools operated pursuant to CFTC Rule 4.7 and require the annual confirmation of exemptive notices filed pursuant to CFTC Rules 4.5, 4.13 and 4.14. The proposed changes also include a new CFTC Rule 4.27 which provides for additional reporting requirements for certain CPOs and CTAs via Forms CPO-PQR and CTA-PR.

For additional information regarding these CFTC proposals, please see our client alert available at http://www.chapman.com/media/news/media.974.pdf. The CFTC proposal is available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-1685a.pdf. (Title VII)

Systemic Risk Regulation

The Dodd-Frank Act creates the Financial Stability Oversight Council to provide comprehensive monitoring to identify risks to the stability of the U.S. financial system. The Council is charged with identifying threats to the financial stability of the U.S., promoting market discipline, and responding to emerging risks to the stability of the U.S. financial system. (§§111-112)

Nonbank Financial Companies That Threaten Financial Stability

A nonbank financial company (i.e., a nonbank company predominantly engaged in financial activities) will be subject to Federal Reserve supervision (at "enhanced" levels with "enhanced standards") if 2/3 of the members of the Financial Stability Oversight Council determine the nonbank financial company (NBFC) threatens financial stability (because of its activities or if it came under "financial stress"). While the Federal Reserve must issue regulations further specifying when a company is "predominantly engaged in financial activities," the basic test is whether at least 85% of its revenues derive from financial activities or 85% of its assets are related to financial activities. Financial activities, as defined in the Bank Holding Company Act (BHCA), include all banking, insurance, and securities related activities. The Council also has the ability to designate for Federal Reserve supervision a company that it determines is operating to evade the 85% revenue or asset test. For foreign companies operating in the U.S., their U.S. operations could be designated for such enhanced supervision and standards. Insurance companies, savings and loan holding companies, industrial loan companies, broker-dealers, investment advisers, large mutual funds, and other financial companies could be covered by such a Council designation. A key issue to watch will be how the Council acts in this entirely new field to see how expansively it views systemic risk.

On February 7, 2011, the Federal Reserve issued a proposed rule that would establish criteria for determining whether a company is "predominantly engaged in financial activities". The proposed rule provides that a company is predominantly engaged in financial activities if:

- The consolidated annual gross financial revenues of the company in *either* of its two most recently completed fiscal years represent 85% or more of the company's consolidated annual gross revenues in that fiscal year; *or*
- The consolidated total financial assets of the company as of the end of *either* of its two most recently completed fiscal years represent 85% or more of the company's consolidated total assets as of the end of that fiscal year.

As a result, in order to avoid being considered to be predominantly engaged in financial activities, a company's level of financial revenues or assets would need to be below the 85% threshold in *both* of its two most recent fiscal years. The proposed rule defines the "consolidated annual gross financial revenues" of a company as that portion of the company's consolidated annual gross revenues derived, directly or indirectly, by the company or any of its subsidiaries from (i) activities that are financial in nature under section 4(k) of the Bank Holding Company Act; or (ii) the ownership, control, or activities of an insured depository institution. Similarly, the proposed rule defines the ''consolidated total financial assets'' of a company as that portion of the company's consolidated total assets related to (i) activities that are financial in nature under section 4(k) of the Bank Holding Company Act, or (ii) the ownership, control, or activities of an insured depository institution. The rule proposal also lists activities that are considered to be "financial in nature" for these purposes. The rule proposal would also allow the Federal Reserve Board based on all facts and circumstances to determine that a company is predominantly engaged in financial activities by applying the 85% test itself at any point in time. This provision is designed to give the Federal Reserve Board flexibility to act quickly and designate a company as a nonbank financial company during the course of the year if changes in the activities or financial condition of a company would affect the systemic risk designation of the company. For additional details on the rule proposal, please see the Federal Reserve notice of proposed rulemaking which is available at http://www.federalreserve.gov/newsevents/press/bcreg/20110208a.htm.

Nonbank Financial Companies Designated for Federal Reserve Supervision

If the Council designates a nonbank financial company to be supervised by the Federal Reserve, the company will need to register with the Federal Reserve and will be subject to enhanced supervision and prudential standards determined by the Federal Reserve based on recommendations of the Council. These standards could include, among other things, risk-based capital requirements, leverage limits, liquidity requirements, resolution plan and credit exposure report requirements, concentration limits, a contingent capital requirement, enhanced public disclosures, short-term debt limits, and overall risk management requirements. Supervised nonbank financial companies will be subject to examinations, reporting and enforcement by the Federal Reserve.

On January 26, 2011, the Council issued proposed rules setting forth the standards and procedures governing Council determinations whether to require that a nonbank financial company be supervised by the Federal Reserve and be subject to prudential standards because the company could pose a threat to the financial stability of the U.S. The proposed rule would have established a framework to be used by the Council in assessing the systemic threat of a company that is organized around six broad categories:

- size;
- lack of substitutes for the financial services and products the company provides;
- interconnectedness with other financial firms;
- leverage;
- liquidity risk and maturity mismatch; and
- existing regulatory scrutiny.

The Council would also consider any other risk-related factors deemed appropriate either by regulation or on a case-by-case basis. The Council would evaluate companies in each of the six categories using quantitative metrics where possible but the Council expects to use its judgment, informed by data on the six categories, to determine whether a firm should be designated as systemically important and supervised by the Federal Reserve. This approach incorporated both quantitative measures and qualitative judgments. For additional details, please see the rule proposal at http://www.treasury.gov/initiatives/Documents/Nonbank%20NPR%20final%2001%2013%2011%20formatted%20for%20FR.pdf.

The original January 2011 proposal generated substantial criticism. As a result, on October 11, 2011, the Council issued a second notice of proposed rulemaking modifying the previous proposal. One of the greatest criticisms of the January 2011 proposal was that it relied almost exclusively on qualitative factors and analysis and that the proposal lacked detail and quantitative metrics for evaluation of companies. The October 2011 proposal modifies and enhances the previous proposal and guidance by (1) proposing a three-stage evaluation process to identify with increasing scrutiny the companies which pose the greatest threat to U.S. financial stability, culminating in the Council's designation of those companies, (2) certain uniform quantitative metrics to be used in the three-stage process, and (3) significant explanatory guidance included as an appendix. For additional details, please see the rule proposal at http://www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designation%20NPR%20-%20Final%20with%20web%20disclaimer.pdf.

The Council expects to begin assessing the systemic importance of nonbank financial companies under the proposed framework shortly after adopting a final rule. Subsequently, and on a regular basis, the Council expects to screen nonbank financial companies to identify companies whose material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities, could pose a threat to the financial stability of the U.S. In addition, under the Dodd-Frank Act, the Council must review each designation of a nonbank financial company at least once a year. (primarily §102, §§112-116, §121, §§161-166)

Volcker Rule

The original "Volcker Rule" covers three separate issues. First, subject to some exceptions, the prohibits a bank holding company and its affiliates from engaging in "proprietary trading." Second, subject to some exceptions, it prohibits such companies from owning an interest in or "sponsoring" a hedge fund or private equity fund. These two provisions are contained in Section 619 of the Dodd-Frank Act and are generally now referred to as the Volcker Rule. These are the two issues of primary interest to the asset management industry and we discuss these provisions below. (The third element of the original Volcker Rule, as announced by President Obama in January 2010, is a prohibition on a company holding more than 10% of the liabilities of financial companies in the U.S. and is not discussed here.)

Proprietary Trading

The prohibition on proprietary trading applies to any bank, any thrift, any bank holding company (including the US operations of a foreign bank) ("BHC"), any savings and loan holding company ("SLHC"), and all of their affiliates. This means the prohibition covers broker-dealer and fund manager affiliates of banks (and all other affiliates of banks). Section 619 defines all these companies as "banking entities." The Dodd-Frank Act defines proprietary trading as any transaction a banking entity enters into as principal for its "trading account" to buy (or otherwise acquire) or sell (or otherwise dispose of) a security, a derivative, or a future delivery contract for a commodity. Section 619 also covers an option on any of these items and any other "security or financial instrument" regulators determine should be covered. Under this definition of proprietary trading, the ban clearly covers trading of traditional securities, futures contracts, and OTC derivatives. The regulations that must be issued before the ban becomes effective will likely provide more information on the scope of the ban.

It is unclear what "principal trading" activities in such contracts that are covered by the ban. Section 619 states that a "trading account" is any account used for acquiring or taking positions in the types of financial contracts covered by the prohibition "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)." "Trading account" also includes any account the regulators determine should be covered. Again, the regulations that must be issued before the ban becomes effective will likely give more guidance on what constitutes a trading account.

Two types of exceptions to the general ban exist. One type of exception permits "proprietary trading" in certain securities, derivatives, or futures contracts. Thus, banking entities can engage in proprietary trading of certain government related obligations. They can also make investments in small business investment companies, "public welfare" investments authorized for national banks, and investments that qualify as qualified rehabilitation expenditures related to qualified rehabilitated buildings or historic structures. The second type of exception is for "proprietary trading" that reflects an approved purpose. This includes trading (1) for the account of a customer; (2) that represents risk-mitigating hedging related to actual holdings if designed to reduce risk; and (3) that is "in connection with underwriting or market-making activities" so long as such activity is designed "not to exceed the reasonably expected near term demands of clients, customers, or counterparties." In addition, insurance companies are not banned from making investments for their general account (directly or through affiliates) if the investment is permitted by state insurance law unless the federal banking regulators find it conflicts with the safety of a BHC or SLHC. These exceptions will also likely be clarified by the regulations that must be issued before the ban becomes effective. The SEC, the CFTC, and the federal banking regulator for a banking entity (acting together) can also permit a banking entity to engage in such other trading activity as they determine "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States."

Hedge Fund or Private Equity Fund Ownership or Sponsorship

This prohibition applies to the same "banking entities" as the proprietary trading ban. This prohibition prohibits banking entities from acquiring or retaining any equity, partnership or other ownership interest in, or sponsoring, any hedge fund or private equity fund. For this purpose hedge fund and private equity fund include any company that would be an investment company under the Investment Company Act but for Sections 3(c)(1) or 3(c)(7) of that Act or any similar fund as determined by the federal banking regulators, the SEC or the CFTC. Because many types of companies, such as asset backed commercial paper conduits, rely on these exemptions, it is unclear whether the ban will ultimately cover all companies that rely on the 3(c)(1) or 3(c)(7) exemption. Notwithstanding the general prohibition, subject to certain requirements and limitations, an exception exists for “organizing and offering” a hedge fund or private equity fund, including serving as its general partner, managing member or trustee, or selecting or controlling a majority of the fund’s directors, trustees or management.

Notwithstanding the general investment prohibition, banking entities will be permitted to make or retain an investment in a hedge fund or private equity fund that it organizes and offers (no third party funds), provided: (i) the aggregate interest of the banking entity and its affiliates does not exceed 3% of that particular fund’s total ownership interests and (ii) the aggregate interest of the banking entity and its affiliates in all hedge funds and private equity funds does not exceed 3% of the banking entity’s Tier 1 Capital.

In addition, banking entities will be permitted to make any investment (i.e., up to 100%) in a hedge fund or private equity fund that it organizes and offers (no third party funds), for the purpose of establishing the fund and providing it with sufficient capital to attract unaffiliated investors. The banking entity must actively seek unaffiliated investors to reduce or dilute its interest and such interest must comply with the aforementioned de minimis exception within a year of the fund’s launch (with the possibility of obtaining an extension of up to two additional years).

A foreign Banking Entity that is not directly or indirectly controlled by a U.S. Banking Entity will be permitted to sponsor and/or invest, without being subject to any of the foregoing restrictions, in any offshore private equity or hedge fund that: (i) is not marketed or sold to US residents and (ii) generally conducts no business in the US, other than as incidental to its non-US activities.

Systemically Important Nonbank Financial Companies

The foregoing bans do not apply to nonbank financial services companies supervised by the Federal Reserve but regulators are instructed to establish limits on and capital requirements for these activities conducted by nonbank financial companies supervised by the Federal Reserve.

Financial Stability Oversight Council Study

The Dodd-Frank Act requires the Financial Stability Oversight Council to conduct a study and make recommendations on implementing the provisions of the Volcker Rule. On January 18, 2011, the Council issued its report which is available at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf. In its report, the Council recommends that the Office of the Comptroller of the Currency, the Federal Insurance Deposit Corporation, the Board of Governors of the Federal Reserve System, the SEC and the CFTC consider taking the following actions to identify and eliminate prohibited proprietary trading activities and investments in or sponsorships of hedge funds and hedge funds by private banking entities:

- Require banking entities to sell or wind down all impermissible proprietary trading desks;
- Require banking entities to implement a robust compliance regime, including public attestation by the CEO of the regime’s effectiveness;
- Require banking entities to perform quantitative analysis to detect potentially impermissible proprietary trading without provisions for safe harbors;
- Perform supervisory review of trading activity to distinguish permitted activities from impermissible proprietary trading;
- Require banking entities to implement a mechanism that identifies to governmental agencies which trades are customer-initiated;
- Require divesture of impermissible proprietary trading positions and impose penalties when warranted;

- Prohibit banking entities from investing in or sponsoring any hedge fund or private equity fund, except to bona fide trust, fiduciary or investment advisory customers;
- Prohibit banking entities from engaging in transactions that would allow them to “bail out” a hedge fund or private equity fund;
- Identify “similar funds” that should be brought within the scope of the Volcker Rule prohibitions in order to prevent evasion of the intent of the rule; and
- Require banking entities to publicly disclose permitted exposure to hedge funds and private equity funds.

The Office of the Comptroller of the Currency, the Federal Insurance Deposit Corporation, the Board of Governors of the Federal Reserve System, the SEC and the CFTC were required to consult with one another and to adopt rules to implement the Volcker Rule by October 18, 2011. In adopting those regulations, these agencies are required to consider the above recommendations of the Financial Stability Oversight Council.

In October 2011, federal regulators proposed these implementing regulations related to the Volcker Rule. The proposal is available at http://www.gpo.gov/fdsys/pkg/FR-2011-11-07/pdf/2011-27184.pdf.

Effective Dates and Implementation

Both of the proprietary trading and hedge fund/private equity fund prohibitions become effective after two years, or, if earlier, one year after implementing regulations are issued. As described above, the CFTC, SEC, and appropriate banking regulators proposed those regulations in October 2011. Along with the implementing regulations, the same regulators are instructed to issue additional capital requirements and other restrictions “as appropriate” for banking entity interests in or sponsorships of hedge funds or private equity funds. These capital requirements and other restrictions, if any, would apply during the transition period for disposing of existing interests and, perhaps, for at least some future activities covered by exceptions.

Although the substantive Volcker Rule regulations will be determined through the interagency rulemaking effort, the Dodd-Frank Act charges the Federal Reserve Board with adopting rules that provide a period of time for a supervised entity to bring its activities, investments, and relationships into compliance with the Volcker Rule and the implementing regulations. This time period is intended to give markets and firms an opportunity to adjust to the requirements of the Volcker Rule. On February 9, 2011, the Federal Reserve Board adopted a final rule to implement the conformance period during which supervised entities must bring their activities and investments into compliance with the Volcker Rule prohibitions and restrictions on proprietary trading and relationships with hedge funds and private equity funds. The notice regarding the final rule is available at http://edocket.access.gpo.gov/2011/pdf/2011-3199.pdf. The conformance rule reflects a narrow view by the Federal Reserve of the availability of extension periods for compliance with the Volcker Rule requirements, however, it remains to be seen whether the Federal Reserve will take a restrictive approach in ruling on any individual extension applications. The final conformance rule does not address definitional or other aspects of the Volcker Rule that will be addressed in the interagency rulemaking process implementing the substantive provisions of the Volcker Rule. The Federal Reserve expects to review the conformance rule after completion of the interagency rulemaking process to determine whether modifications are necessary. (§619)

Investor Qualification Standards

Accredited Investor Definition

The SEC is required to adjust the net worth standard applicable to natural persons in the definition of “accredited investor” used in Regulation D and Rule 215 under the Securities Act. Under the current versions of Rule 501(a) of Regulation D and Rule 215, “accredited investor” is defined to include, among other things, any natural person:

- whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000; and
- who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

The Dodd-Frank Act requires that the SEC adopt rules to revise this definition as it relates to natural persons to exclude the value of a person's primary residence in meeting the $1 million net worth threshold. The income requirement of the second provision remains unchanged by the Dodd-Frank Act. Although the Dodd-Frank Act leaves the task of setting a final net worth standard to the SEC, the primary residence exclusion was effective immediately upon enactment of the Dodd-Frank Act. The Dodd-Frank Act does not define the term "value," nor does it address the treatment of mortgage and other indebtedness secured by an investor's primary residence for purposes of the net worth calculation. However, according to SEC staff guidance, pending rulemaking on this issue, the amount of indebtedness secured by an investor's primary residence may also be excluded from the net worth calculation in an amount up to the fair market value of the residence. Indebtedness secured by the residence in excess of the value of the residence should be considered a liability and deducted from the investor's net worth for this purpose. The Dodd-Frank Act also provides that any net worth threshold set by SEC must be at least $1 million until July 21, 2014. Because the primary residence exclusion was effective immediately upon enactment of the Dodd-Frank Act, issuers relying on the definition of "accredited investor" in Regulation D or in Rule 215 should already have considered whether they need to revise their disclosure and subscription documents to the extent necessary to reflect this change.

On December 21, 2011, the SEC adopted amendments to the net worth standard of the "accredited investor" definition in Rule 215(e) and 501(a)(5) under the Securities Act. In both cases, the net worth standard is as follows: "Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000." As a general matter, for purposes of calculating net worth:

- the person's primary residence may not be included as an asset;
- indebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, is not included as a liability (except that if the amount of such indebtedness outstanding at the time of sale of securities exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability) and
- indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities is included as a liability.

Accordingly, the amendments clarify that the net worth of an investor is calculated by excluding the investor's net equity in their primary residence. Any indebtedness associated with an individual's primary residence is included as part of the general net worth calculation. The amendments effectively exclude the value of the primary residence from net worth without reducing the net worth by more than the amount that the residence contributed to the net worth calculation. The amendments also address the treatment of incremental debt secured by a primary residence that is incurred in the 60 days before a sale of securities to an investor in an effort to prevent investors from artificially inflating their net worth by effectively converting their home equity (which is excluded from the net worth) into cash or other assets that would be included in net worth. Finally, the amendments include a grandfathering provision that permits the application of the former accredited investor net worth test in certain limited circumstances related to rights to purchase securities held by a person on July 20, 2010. For additional details on the amendments, please see our client alert which is available at http://www.chapman.com/media/news/media.1129.pdf. (§413)

Accredited Investor Study

The Comptroller General is required to conduct a study on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for "accredited investor" status and eligibility to invest in private funds. The Comptroller General must submit a report on the results of the study to the

Senate Banking, Housing, and Urban Affairs Committee and the House Financial Services Committee by July 21, 2013. (§415)

Qualified Clients

The Dodd-Frank Act adjusts the “qualified client” standard under Advisers Act Rule 205-3 as it relates to that rule’s exemption from the Section 205 prohibition on adviser compensation tied to capital gains upon, or the capital appreciation of, advisory client assets (i.e., performance-based compensation). This provision requires that any rule adopted by the SEC with respect to Advisers Act Section 205 that uses a dollar amount test must adjust for the effects of inflation beginning not later than July 21, 2011 and every five years thereafter with such adjustments being rounded to the nearest multiple of $100,000. Advisers Act Rule 205-3 currently uses a $750,000 assets under management test and a $1.5 million net worth test for purposes of determining an investor’s status as a “qualified client”. Because Rule 205-3 also includes “qualified purchasers” as defined under the Investment Company Act within the definition of “qualified client”, the rule also indirectly uses dollar amount tests of $5 million and $25 million of “investments” as defined under the Investment Company Act and applicable rules. It is unclear whether this provision extends to those indirect dollar amounts.

On May 10, 2011, the SEC provided notice that it intends to issue an order revising the dollar amount tests of Advisers Act Rule 205-3 to account for the effects of inflation. The SEC issued its order on July 12, 2011. In particular, the order changes the $750,000 assets under management test to $1 million and changing the net worth test to $2 million. These changes are effective September 19, 2011. *Registered investment advisers that impose performance fees, including firms that receive incentive allocations or carried interest allocations with respect to private funds, should review advisory agreements and private fund subscription documents to consider whether revisions need to be made to comply with this SEC order.* The SEC is order is available at http://www.sec.gov/rules/other/2011/ia-3236.pdf. The SEC also proposed amendments to Rule 205-3 to provide that the SEC will subsequently issue orders making future inflation adjustments every five years. The rule amendments would also change Rule 205-3 to exclude the value of a person’s primary residence from the determination of whether a person meets the net worth standard required to qualify as a “qualified client.” The proposal also includes transition provisions to take into account performance fee arrangements that were permissible when they were entered into, so that new dollar amount thresholds do not require investment advisers to renegotiate the terms of arrangements that were permissible when the parties entered into them. For additional details on the proposed amendments, please see our client alert which is available at http://www.chapman.com/media/news/media.1009.pdf. (§418)

Disqualification of “Bad Actors” from Regulation D Offerings

The SEC is required to adopt rules that provide for the disqualification of offerings and sales of securities made under Rule 506 of Regulation D for certain “bad actors.” In particular, the SEC must adopt disqualifications that:

- are substantially similar to the provisions of Rule 262 under the Securities Act (which provides certain disqualifications for Regulation A securities offerings for persons subject to certain orders, convictions, judgments, suspensions or expulsions); and
- disqualify any offering or sale of securities by a person that:
    - is subject to a final order of any state securities, bank or insurance regulatory authority, an appropriate federal banking agency, or the National Credit Union Administration, that (a) bars the person from (i) association with an entity regulated by such authority; (ii) engaging in the business of securities, insurance, or banking; or (iii) engaging in savings association or credit union activities; or (b) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the preceding 10-year period; or
    - has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC.

The SEC was required to adopt these new rules by July 21, 2011.

On May 25, 2011, the SEC proposed amendments to Securities Act Rules 501 and 506 under Regulation D, as well as to Form D, to implement the foregoing Dodd-Frank Act requirements. Under the proposed amendments, no exemption under Rule 506 would be available for a sale of securities if a covered person:

- Has been convicted within ten years (or five years, in the case of issuers, their predecessors and affiliated issuers) of certain felonies or misdemeanors involving SEC filings or securities transactions businesses;
- Is subject to any court order, judgment or decree entered within five years that restrains or enjoins the person from engaging or continuing to engage in any conduct or practice involving SEC filings or securities transactions businesses;
- Is subject to a final order of a state securities, banking or insurance authority, a federal banking agency; or the National Credit Union Administration that (a) bars the person from association with certain regulated entities or from engaging in certain securities, banking, insurance and similar activities or (b) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years;
- Is subject to an order of the SEC entered pursuant to Section 15(b) or 15B(c) of the Exchange Act or Section 203(e) or (f) of the Advisers Act that (a) suspends or revokes the person's registration as a broker-dealer, municipal securities dealer or investment adviser, (b) places limitations on the activities, functions or operations of the person, or (c) bars the person from being associated with any entity or from participating in the offering of any penny stock;
- Is suspended or expelled from membership in, or association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade;
- Has filed (as a registrant or issuer) a registration statement or Regulation A offering statement filed with the SEC (or was an underwriter in such an offering) that, within five years, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; or
- Is subject to a U.S. Postal Service false representation order entered within five years or is subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the U.S. Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

The persons covered by the foregoing would include: the issuer; any predecessor of the issuer; any affiliated issuer; any director, officer, general partner or managing member of the issuer; any beneficial owner of 10% or more of any class of the issuer's equity securities; any promoter connected with the issuer in any capacity at the time of such sale; any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; and any general partner, director, officer or managing member of any such solicitor. For additional information about the proposal, please see our client alert which is available at http://www.chapman.com/media/news/media.1016.pdf. The SEC release is available at http://www.sec.gov/rules/proposed/2011/33-9211.pdf. (§926)

Short Sales

Study on Short Selling

The newly-created SEC Division of Risk, Strategy, and Financial Innovation is required to conduct a study on the state of short selling on national securities exchanges and in the over-the-counter markets, with particular attention to the impact of recent rule changes and the incidence of the failure to deliver shares sold short; or delivery of shares on the fourth day following the short sale transaction (late delivery of shares). The SEC must submit a report on the results of the study, *including recommendations for market improvements*, to the Senate Banking, Housing, and Urban Affairs Committee and the House Financial Services Committee by July 21, 2012. (§417)

Real-Time Short Position Reporting

The SEC Division of Risk, Strategy, and Financial Innovation is also required to conduct a study on the feasibility, benefits, and costs of requiring publicly reporting real-time short sale positions of publicly listed securities, or, in the alternative, reporting such short positions in real-time only to the SEC and FINRA. This study must also consider the feasibility, benefits, and costs of conducting a voluntary pilot program in which public companies agree to have all trades in their shares marked “short”, “market maker short”’, “buy”, “buy-to-cover”, or “long”, and reported in real-time through the Consolidated Tape. The SEC must submit a report on the results of the study to the Senate Banking, Housing, and Urban Affairs Committee and the House Financial Services Committee by July 21, 2011.

The SEC requested comment on this study on May 3, 2011. This request did not specifically solicit comments with respect to the study on short selling discussed in the preceding section. For additional details, please see our client alert which is available at http://www.chapman.com/media/news/media.1006.pdf. (§417)

Customer Notice and Elections Regarding Short Sales

Section 15(d) of the Exchange Act now requires that broker-dealers notify customers that they may elect not to allow their fully-paid for securities to be used in connection with short sales. In addition, if a broker-dealer uses a customer’s securities in connection with short sales, the broker-dealer must notify the customer that the broker-dealer may receive compensation in connection with lending the securities. The SEC is permitted to adopt rules that prescribe the form, content, time and manner of delivery of this notice. (§929X)

Short Sale Disclosure

Section 13(f) of the Exchange Act now requires the SEC to prescribe rules providing for the public disclosure of the name of the issuer and the title, class, CUSIP number, aggregate amount of the number of short sales of each security, and any additional information determined by the SEC following the end of each reporting period, which must occur at least every month. There is no time requirement for the SEC to adopt these rules.

The SEC referenced this required rulemaking in its request for comment on the real-time short position study described above and also sought comment on general short disclosure in that request but has not adopted rules under this requirement at the time of this publication. For additional details, please see our client alert which is available at http://www.chapman.com/media/news/media.1006.pdf. (§929X)

Enforcement Authority to Prevent Manipulative Short Selling

Section 9 of the Exchange Act now provides that it is unlawful for any person, directly or indirectly, to effect a manipulative short sale of any security. The SEC is required to issue such rules as are necessary or appropriate to ensure that the appropriate enforcement options and remedies are available for violations of this prohibition in the public interest or for the protection of investors. (§929X)

Broker Voting of Proxies

The Dodd-Frank Act amends the Exchange Act to require a national securities exchange to adopt rules prohibiting a broker-dealer from voting securities registered under Section 12 of the Exchange Act, unless the beneficial owners of the securities have instructed the broker-dealer to vote the proxy in accordance with the voting instructions of the beneficial owner. Shareholder votes subject to this prohibition include votes that relate to the election of a member of the board of directors, executive compensation or any other significant matter as determined by the SEC. Votes for uncontested board seats of registered investment companies are excluded from this requirement. On September 9, 2010, the SEC approved

NYSE rules that prohibit NYSE member organizations from voting uninstructed shares if the matter voted on relates to executive compensation. The related SEC release is available at http://www.sec.gov/rules/sro/nyse/2010/34-62874.pdf. The SEC has also approved similar rule changes for various other exchanges. (§957)

Investment Adviser Custody

Adviser Custody Rule

New Advisers Act Section 223 requires SEC-registered investment advisers to take such steps to safeguard client assets over which such adviser has custody as prescribed by SEC rules, including, without limitation, verification of such assets by an independent public accountant. This change does not appear to impact the existing Advisers Act custody rule (Rule 206(4)-2), which the SEC last amended effective early 2010. (§411)

Adviser Custody Study

The Comptroller General is required to conduct a study of the compliance costs of, and related matters associated with, the current books and record rule (Rule 204-2) and the custody rule (Rule 206(4)-2) under the Advisers Act regarding custody of funds or securities of clients by investment advisers. The Comptroller General must submit a report on the results of the study to the Senate Banking, Housing, and Urban Affairs Committee and the House Financial Services Committee by July 21, 2013. (§412)

Availability of Custody Records of Investment Adviser Clients and Registered Investment Companies

The Advisers Act and Investment Company Act are revised to require each person having custody or use of assets of an investment adviser client or of an investment company registered under the Investment Company Act to maintain and preserve all records that relate to the custody or use by such person of such assets as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors. These records will be subject to reasonable periodic, special, or other examinations as determined by the SEC and to other information and document requests by the SEC. This allows the SEC to more easily verify client assets with custodians in exams and is apparently intended to cure an obstacle faced by the SEC in seeking information from banks and other entities not subject to SEC jurisdiction. (§929Q)

PCAOB Authority Over Broker-Dealer Audits

The Dodd-Frank Act expands the Public Company Accounting Oversight Board's authority to oversee auditors of broker-dealers. Under the Sarbanes-Oxley Act, auditors of broker-dealers were required to register with the PCAOB. The Dodd-Frank Act provides the PCAOB with standard-setting, inspection and disciplinary authority regarding broker-dealer audits.

In September 2010, the SEC has announced that it was considering a rulemaking project to update the audit and related attestation requirements under the federal securities laws for broker-dealers, particularly in light of the Dodd-Frank Act. Pending any SEC and PCAOB rulemaking in this area, the SEC provided transitional guidance with respect to its existing rules regarding non-issuer broker-dealers. Specifically, the SEC has stated that references in SEC rules and staff guidance and in the federal securities laws to Generally Accepted Auditing Standards ("GAAS") or to specific standards under GAAS, as they relate to non-issuer broker-dealers, should continue to be understood to mean auditing standards generally accepted in the United States of America, plus any applicable rules of the SEC. The SEC release on these issues is available at http://www.sec.gov/rules/interp/2010/34-62991.pdf. Subsequently, on June 15, 2011, the SEC proposed amendments to Exchange Act Rule 17a-5, the broker-dealer financial reporting rule. The proposed amendments update the requirements of broker-dealers to file annual financial reports, would require certain broker-dealers to provide the SEC and other examiners with access to independent public accountants, and would enhance the SEC s ability to oversee broker-dealers custody practices by filing a new quarterly Form Custody. For additional details, please see our client alert available at http://www.chapman.com/media/news/media.1027.pdf.

The PCAOB staff is evaluating potential revisions to the PCAOB's auditing and attestation standards for audits of broker-dealers and is monitoring relevant SEC rulemaking actions. General PCAOB information related to broker-dealers and broker-dealer auditors is available at http://pcaobus.org/Information/Pages/BrokerDealers.aspx.

On December 14, 2010, the PCAOB proposed for public comment a rule that would establish an interim inspection program while the PCAOB considers the scope and elements of a permanent program. On June 14, 2011, the PCAOB adopted a temporary rule for an interim inspection program. The SEC approved the temporary rule on August 18, 2011. The temporary rule allows the PCAOB to begin basic inspection work on selected audits of broker-dealers. The PCAOB also expects that information gathered through the interim inspection program will be useful in making judgments about the scope of a permanent inspection program for auditors of broker-dealers, including consideration of potential costs and regulatory burdens that would be imposed on different categories of registered public accounting firms and classes of broker-dealers. The PCAOB intends to consider whether there should be exemptions from the permanent program. The PCAOB expects to be able to gather the information necessary to inform its consideration of a permanent program without having to inspect most auditors of broker-dealers under the interim program. The interim program will continue until replaced by a permanent program. The PCAOB anticipates proposing rules for a permanent program, including any exemptions that the PCAOB may determine to be appropriate, in 2013. Additional information is available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket032.aspx.

On July 12, 2011, the PCAOB proposed two attestation standards related to an auditor's examination of compliance reports and review of exemption reports of broker-dealers. The PCAOB also proposed a new standard on auditing supplemental information accompanying audited financial statements that broker-dealers and issuers file with the SEC, such as supporting schedules. The proposed examination standard and review standard would apply to compliance reports and exemption reports of brokers and dealers in the event the SEC adopts its proposed amendments to the broker-dealer financial reporting rule under Exchange Act Rule 17a-5. Additional information is available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket035.aspx and http://pcaobus.org/Rules/Rulemaking/Pages/Docket036.aspx.

The Sarbanes-Oxley Act required that public companies and other issuers pay annually a portion of an Accounting Support Fee that funds most PCAOB operations. Dodd-Frank required that the PCAOB equitably allocate those operating expenses between issuers and broker-dealers. On December 14, 2010, the PCAOB proposed a rule that would provide that broker-dealers be assessed a share of the Accounting Support Fee in proportion to their "tentative net capital," as defined by SEC rules. The PCAOB adopted this rule on June 14, 2011. Under the PCAOB funding rule, approximately 86% of the 4,600 broker-dealers registered with FINRA would pay no fee because their tentative net capital is less than $5 million. The SEC approved these rules on August 18, 2011. The PCAOB expects that the initial allocation, assessment, and collection of the accounting support fee for brokers and dealers will take place during the fall of 2011. Additional information is available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket033.aspx. (§982)

Municipal Securities Adviser Regulation

The Dodd-Frank Act amends section 15B of the Exchange Act to require the registration of municipal advisors with the SEC and provide for their regulation by the Municipal Securities Rulemaking Board (MSRB). In general terms, municipal advisors include:

- financial advisors to states and local governments and obligated persons with respect to the issuance of municipal securities or the investment of bond proceeds
- swap advisors to municipal issuers and conduit borrowers, and

- third-party solicitors of business (in connection with municipal securities products) for brokers, dealers, municipal securities dealers, other municipal advisors, or investment advisers.

The Dodd-Frank Act also includes a specific antifraud prohibition and imposes a fiduciary duty on municipal advisors. The new registration requirement became effective on October 1, 2010. The SEC has adopted temporary rules requiring municipal advisors to register with the SEC and proposed permanent rules for the registration of municipal advisors on December 20, 2010. The temporary rules originally expired on December 31, 2011 but on December 21, 2011 the SEC extended the effectiveness of the temporary rules until September 30, 2012. The extension release is available at http://sec.gov/rules/interim/2011/34-66020.pdf. The permanent rule proposal is available at http://www.sec.gov/rules/proposed/2010/34-63576.pdf. Municipal advisors can access and complete the new registration form (Form MA-T) and obtain other information at: http://www.sec.gov/info/municipal/form_ma-t.htm.

The MSRB has proposed a variety of rules related to municipal advisors on issues including assessments, gifts, fair dealing, political contributions and “pay to play” issues, fiduciary duties and supervision. However, given substantial concern regarding the timing of a permanent municipal advisor definition and registration matters, the MSRB has withdrawn a variety proposed rules on matters affecting municipal advisors until the SEC adopts permanent rules regarding municipal advisor registration. See http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-51.aspx. (§975)

SIPC Issues

The Dodd-Frank Act amends the Securities Investor Protection Act of 1970 by increasing the amount of cash protection for each customer to $250,000 and by providing that this amount can adjust for inflation in the future. The Dodd-Frank Act also increases the minimum assessment paid by SIPC members to 0.02% of the member’s gross revenues from the securities business. Persons that misrepresent SIPC membership or protection can be fined or imprisoned. The SEC approved a related SIPC by-law change on January 10, 2011 (see http://www.sec.gov/rules/other/2011/sipa-170.pdf). (§929H and §929V)

Other New SEC Rulemaking Authority

Mandatory Arbitration in Broker-Dealer and Investment Advisory Agreements

The SEC is now expressly permitted to adopt rules prohibiting, or imposing conditions or limitations on the use of, mandatory arbitration clauses in broker-dealer and investment adviser client agreements if the SEC finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors. The scope of any such rules is limited to arbitration clauses regarding disputes arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization. (§921)

Incentive-Based Compensation

The SEC and other federal regulators are required to adopt rules or issue guidelines requiring registered investment advisers and broker-dealers (among others) to disclose the structures of all incentive-based compensation arrangements to determine whether the compensation structure (1) provides an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or (2) could lead to material financial loss to the investment adviser or broker-dealer. This provision may not require the reporting of the actual compensation of particular individuals. The SEC also must issue rules prohibiting incentive-based compensation that encourages inappropriate risks by providing excessive compensation or that could lead to material financial loss as described above. Investment advisers and broker-dealers with assets (not assets under management) of less than $1 billion will be exempt from such requirements. Regulators must adopt these rules or guidelines by March 21, 2011.

Regulators missed the March 21, 2011 deadline. On March 29, 2011, regulators issued proposed rules governing incentive-based compensation practices at certain financial institutions, including broker-dealers and investment advisers with more than $1 billion in total consolidated assets (not assets under management). For purposes of these rules "investment adviser" includes any firm that falls within the definition of "investment adviser" under the Advisers Act, even if the firm is not required to register under that Act. Additional requirements would apply to "larger covered financial institutions" with total consolidated assets of $50 billion or more. In general terms the proposed rules would:

- prohibit incentive-based compensation arrangements that encourage inappropriate risks,
- require the institutions to implement related policies and procedures, and
- require covered financial institutions to make annual non-public reports to their primary regulators describing their incentive-based compensation arrangements.

The proposed rules define "incentive-based compensation" as any variable compensation that serves as an incentive for performance, regardless of the form of payment (i.e., cash, equity, or other property). Only the incentive-based compensation paid to "covered persons" (any executive officer, employee, director, or principal shareholder of a covered financial institution) would be subject to the requirements of the rules. The SEC estimates that approximately 132 broker-dealers and approximately 68 investment advisers would be affected by the proposed rules, with 18 broker-dealers and 7 registered investment advisers falling within the requirements applicable to larger covered financial institutions. For details on the SEC's approval of the proposed regulations, please see our related client alert which is available at http://www.chapman.com/media/news/media.978.pdf. A copy of the final proposal is available at http://www.sec.gov/rules/proposed/2011/34-64140.pdf. (§956)

Pre-Sale Disclosure of Investment Product or Service Features

Section 15 of the Exchange Act now expressly provides that the SEC may issue rules requiring that broker-dealers provide certain documents or information to retail investors before the purchase of an investment product or service by the retail investor. In developing any such rules, the SEC must consider whether the rules will promote investor protection, efficiency, competition, and capital formation. Any documents or information that the SEC requires broker-dealers to deliver must be in a summary format and contain clear and concise information about (i) investment objectives, strategies, costs, and risks, and (ii) any compensation or other financial incentive received by a broker-dealer or other intermediary in connection with the purchase of retail investment products. The SEC previously proposed point of sale disclosure requirements and confirmation requirements for transactions in mutual funds, college savings plans, and certain other securities in 2004 and reopened the proposal for additional comments in 2005, however, the SEC has not taken final action on these proposals.

On May 3, 2011, the SEC published a FINRA proposal to adopt new FINRA Rule 2341 (Investment Company Securities). In light of concerns raised by commenters, FINRA withdrew this proposal on August 1, 2011. Proposed FINRA Rule 2341 was largely the same as current NASD Rule 2830 but would also have included several significant changes to the current rule. The most significant change would have required broker-dealers to make specific disclosures related to certain cash compensation received from investment companies and their affiliates. These new requirements would have focused on cash compensation paid in addition to the sales charges and service fees disclosed in a fund's prospectus fee table, such as revenue-sharing and "shelf space" payments. Although this rulemaking was not expressly related to the Dodd-Frank Act, it would have changed the focus on disclosure of certain broker-dealer compensation to pre-sale disclosure given by selling broker-dealers rather than registration statement disclosure from mutual funds and other investment companies. For additional information on the rule proposal, see our client alert available at http://www.chapman.com/media/news/media.1011.pdf. FINRA's withdrawal of the proposed rule is available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p124082.pdf. (§919)

Definition of "Client" of an Investment Adviser

The Dodd-Frank Act amends Section 211 of the Advisers Act to limit the SEC s ability to define the term "client" as it relates to investment advisers. The SEC is prohibited from defining "client" for purposes of Sections 206(1) and (2) of the Advisers Act to include investors in a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser. Those sections make it unlawful for any investment adviser (*including an unregistered adviser*) to employ any device, scheme, or artifice to defraud any client or prospective client and to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. The prohibition does not relate to Advisers Act Section 206(4), which separately makes it unlawful for any investment adviser to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative (whether or not involving "clients"). The Dodd-Frank Act appears to effectively permit the SEC to define "client" to include investors in a private fund for all other purposes under the Advisers Act (effectively overruling portions of the 2006 decision of the U.S. Court of Appeals in *Phillip Goldstein, et al. v. SEC*). (§406)

Missing Security Holders

The SEC is required to revise Exchange Act Rule 17Ad-17 to require broker-dealers to exercise reasonable care to find missing security holders. The SEC is also required to adopt rules requiring broker-dealers (and other paying agents) to provide a written notification to each missing security holder that the missing security holder has been sent a check that has not yet been negotiated. The written notification may be sent along with a check or other mailing subsequently sent to the missing security holder but must be provided no later than 7 months after the sending of the non-negotiated check. The SEC rules must also include a provision clarifying that these requirements will have no effect on State escheatment laws. These rules must be adopted by July 21, 2011.

On March 18, 2011, the SEC proposed amendments to Exchange Act Rule 17Ad-17 to implement the statutory requirements. The SEC proposal is available at http://www.sec.gov/rules/proposed/2011/34-64099.pdf. (§929W)

Other Studies

Private Funds SRO

The Comptroller General is required to conduct a study of the feasibility of forming a self-regulatory organization to oversee private funds. The Comptroller General must submit a report on the results of the study to the Senate Banking, Housing, and Urban Affairs Committee and the House Financial Services Committee. On July 11, 2011, the Government Accountability Office published a report on the results of the required study. Despite the fact that the Dodd-Frank Act requires a study of an SRO to oversee *private funds* rather than to oversee *investment advisers* to private funds, the GAO report focuses on an SRO for private fund *advisers* and this focus was discussed with Congressional staffs in advance of the report. The study found that the general consensus among industry participants and regulators was that forming a private fund adviser SRO could be done but that the formation of a private fund adviser SRO would require legislation and would not be without challenges, including raising the necessary start-up capital and reaching agreements on its fee and governance structures. The study found that creating a private fund adviser SRO could supplement the SEC's oversight of investment advisers and help address the SEC's capacity challenges but that such an SRO would oversee only a fraction of all registered investment advisers. As a result, the SEC would need to maintain the staff and resources necessary to examine the majority of investment advisers that do not advise private funds and to oversee the private fund adviser SRO, among other things. The study also found that by fragmenting regulation between advisers that advise private funds and those that do not, a private fund adviser SRO could lead to regulatory gaps, duplication, and inconsistencies. A copy of the report is available at http://www.gao.gov/new.items/d11623.pdf. (§416)

Investor Financial Literacy

The SEC must conduct a study to identify:

- the existing level of financial literacy among retail investors, including subgroups of investors identified by the SEC;
- methods to improve the timing, content, and format of disclosures to investors with respect to financial intermediaries, investment products, and investment services;

- the most useful and understandable relevant information that retail investors need to make informed financial decisions before engaging a financial intermediary or purchasing an investment product or service that is typically sold to retail investors;
- methods to increase the transparency of expenses and conflicts of interests in transactions involving investment services and products;
- the most effective existing private and public efforts to educate investors; and
- in consultation with the Financial Literacy and Education Commission, a strategy to increase the financial literacy of investors in order to bring about a positive change in investor behavior.

The SEC must submit a report on the results of the study to the Senate Banking, Housing, and Urban Affairs Committee and the House Financial Services Committee by July 21, 2012.

The SEC requested comment on this study on April 19, 2011, to help ensure that the study includes all relevant programs, as well as to better understand the details and effectiveness of existing investor education programs. The SEC request is available at http://www.sec.gov/rules/other/2011/34-64306.pdf. (§917)

Mutual Fund Advertising

The Comptroller General is required to conduct a study on mutual fund advertising to identify:

- existing and proposed regulatory requirements for open-end investment company advertisements;
- current marketing practices for the sale of open-end investment company shares, including the use of past performance data, funds that have merged, and incubator funds;
- the impact of such advertising on consumers; and
- recommendations to improve investor protections in mutual fund advertising and additional information necessary to ensure that investors can make informed financial decisions when purchasing shares.

The Comptroller General must submit a report on the results of the study to the Senate Banking, Housing, and Urban Affairs Committee and the House Financial Services Committee. On July 26, 2011, the Government Accountability Office published a report on the results of the study. The study found that while some studies have suggested that advertisements that emphasize a fund's past performance can influence investors to make inappropriate investments, the evidence that investors are harmed by these advertisements is mixed and the extent to which investors rely on performance advertisements is unclear. Industry surveys show that investors are increasingly relying on information from financial advisors and other sources and use a variety of information, not just performance information, when making investment decisions. The study also found that advertising focusing on performance is generally not common, with GAO estimating that only 9% of materials reviewed by the GAO emphasized a fund's performance and 35% contained some type of performance information. The study further found that FINRA review of public advertisements also helps limit the potential for investors to be misled by fund advertising but that fund company representatives expressed concerns that FINRA does not always effectively communicate changes in advertising rule interpretations that arise when the regulatory staff identify concerns about new material being used by fund companies. The study found that this can result in certain firms being disadvantaged compared to other firms that continue to use materials that were reviewed by FINRA prior to new interpretations. To help ensure investors are better protected from misleading advertisements, the report recommends that the SEC take steps to ensure FINRA develops sufficient mechanisms to notify all fund companies about changes in rule interpretations for fund advertising. Both SEC and FINRA agreed with the recommendation. A copy of the report is available at http://www.gao.gov/new.items/d11697.pdf. (§918)

Conflicts of Interest Within Financial Firms

The Comptroller General is required to conduct a study (1) to identify and examine potential conflicts of interest that exist between the staffs of the investment banking and equity and fixed income securities analyst functions within the same firm, and (2) to make recommendations to Congress designed to protect investors in light of such conflicts. The study must consider:

- the potential for investor harm resulting from conflicts, including consideration of the forms of misconduct engaged in by the several securities firms and individuals that entered into the Global Analyst Research Settlements in 2003;
- the nature and benefits of the undertakings to which those firms agreed in enforcement proceedings, including firewalls between research and investment banking, separate reporting lines, dedicated legal and compliance staffs, allocation of budget, physical separation, compensation, employee performance evaluations, coverage decisions, limitations on soliciting investment banking business, disclosures, transparency, and other measures;
- whether any such undertakings should be codified and applied permanently to securities firms, or whether the SEC should adopt rules applying any such undertakings to securities firms; and
- whether to recommend regulatory or legislative measures designed to mitigate possible adverse consequences to investors arising from the conflicts of interest or to enhance investor protection or confidence in the integrity of the securities markets.

The Comptroller General must submit a report on the results of the study to the Senate Banking, Housing, and Urban Affairs Committee and the House Financial Services Committee by January 21, 2012. (§919A)

Investor Access to Information about Advisers and Broker-Dealers

The SEC must complete a study, including recommendations, of ways to improve the access of investors to registration information (including disciplinary actions, regulatory, judicial, and arbitration proceedings, and other information) about registered and previously registered investment advisers, associated persons of investment advisers, brokers-dealers and their associated persons on the existing CRD and IARD systems. The study must also identify additional information that should be made publicly available. The study must include an analysis of the advantages and disadvantages of further centralizing access to the information contained in the existing systems, including identification of data pertinent to investors, and must include the identification of the method and format for displaying and publishing such data to enhance accessibility by and utility to investors. The SEC announced publication of this study on January 27, 2011. The primary recommendation of this study is to enable investors to simultaneously search both the databases for information about broker-dealers and investment advisers simultaneously using either FINRA's BrokerCheck website or the Investment Adviser Public Disclosure (IAPD) website and receive unified search results. The report recommends that the search functions for BrokerCheck and IAPD be expanded to permit searches for broker-dealers, investment advisers, registered representatives, and investment adviser representatives based on ZIP code or other indicator of location. The report also recommends that BrokerCheck and IAPD be enhanced by adding educational content such as links and definitional material. A copy of the report is available at http://www.sec.gov/news/studies/2011/919bstudy.pdf. The SEC must now implement any recommendations of the study not later than July 27, 2012. (§919B)

Financial Planner Regulation

The Comptroller General is required by the Dodd-Frank Act to conduct a study to evaluate the effectiveness of current regulations applicable individuals who hold themselves out as "financial planners," the current oversight structure and regulations for financial planners; and legal or regulatory gaps in the regulation of financial planners and other individuals who provide or offer to provide financial planning services. On January 18, 2011, the Government Accountability Office published a report on the results of the study. The study found that while there is no specific, direct regulation of "financial planners" *per se* at the federal or state level, various laws and regulations apply to most of the services they provide. Financial planners are primarily regulated as investment advisers by the SEC and the states and are subject to laws and regulations governing broker-dealers and insurance agents when they act in those capacities. Federal and state agencies also have regulations on marketing and the use of titles and designations that can apply to financial planners. The U.S. Government Accountability Office issued the following primary recommendations in its report:

- That the National Association of Insurance Commissioners assess consumers' understanding of the standards of care associated with the sale of insurance products;
- That the SEC assess investors' understanding of financial planners' titles and designations; and
- That the SEC collaborate with the states to better understand problems associated specifically with the financial planning activities of investment advisers.

A copy of the report is available at http://www.gao.gov/new.items/d11235.pdf. (§919C)

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