From: Robert Kiggins <rkiggins@MccarthyFingar.com>
Sent: Thursday, September 30, 2010 9:04 AM
To: secretary <secretary@CFTC.gov>
Subject: RE: Nationa lFutures Association Petition to Amend Commission Rule 4.5

Sorry. Please try http://hedgefundlaw.typepad.com/ny_metro_hedgefund_law_ne/

From: secretary [mailto:secretary@CFTC.gov]
Sent: Thursday, September 30, 2010 8:25 AM
To: Robert Kiggins
Subject: RE: Nationa lFutures Association Petition to Amend Commission Rule 4.5

Please resubmit your comment. The link you provided is bad. Thank you.

From: Robert Kiggins [mailto:rkiggins@MccarthyFingar.com]
Sent: Wednesday, September 29, 2010 5:11 PM
To: NFAamendrule4.5
Cc: Malachi Alston
Subject: Nationa lFutures Association Petition to Amend Commission Rule 4.5

See my comments at http://www.google.com/http://hedgefundlaw.typepad.com/ny_metro_hedgefund_law_ne/ in my article of today's date.

I find the position on hedging confusing for the reasons stated in my article.

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NY Metro Hedgefund Law & News

September 29, 2010

Registered Investment Companies engaging in Futures Transactions May Lose Blanket Exemption from Treatment as Commodities Pool Operators.

The National Futures Association ("NFA") has petitioned the Commodity Futures Trading Commission ("CFTC") to amend CFTC Rule 4.5, which provides an exclusion to the definition of "commodity pool operator" for certain eligible persons who would otherwise be considered as commodity pool operators. In that regard CFTC Rule 4.5 provides an exclusion from "commodity pool operator" treatment for investment companies registered under the Investment Company Act of 1940.

The exclusion is important because persons who are considered as "commodity pool operators" are required to register as such with the CFTC. Moreover, investment advisors to commodities pool operators are required to register as "commodity trading advisors" with the CFTC.

The NFA petition is now seeking to limit the scope of the CFTC Rule 4.5 exclusion for investment companies registered under the Investment Company Act of 1940. See Petition of the National Futures Association to Amend Rule 4.5, 75 Fed. Reg. 56997 (September 17, 2010).

Proposed Amendments

The NFA proposed amendments would impose the following restrictions on registered investment companies in order for them to be able to be qualify for the CFTC Rule 4.5 exclusion:

- Bona Fide Hedging Purposes, 5% Limit - Use of commodity futures or commodity options contracts will need to be solely for bona fide hedging purposes, provided that the aggregate initial margin and premiums for any non-hedging positions, which may only be held by the qualifying entity, will not exceed 5% of the liquidation value of that qualifying entity's portfolio.
- Market Restrictions - Such entity will not be marketed to the public as a commodity pool or otherwise as a vehicle for trading in or otherwise seeking investment exposure to, the commodity futures or commodity options markets.

Prior to 2003 rule changes, registered investment companies seeking exclusion under Rule 4.5 were subject to certain trading and marketing restrictions. The NFA proposed amendments are substantially similar to those previous restrictions, although the juxtapostion of a seeming total ban on non-hedged positions along with a seeming allowance of de minimis (5%) non-hedged positions is confusing.

Important Dates

Comments on the NFA petition to amend CFTC Rule 4.5 must be received on or before October 18, 2010.

*   *   *

Robert Kiggins, Esq. of McCarthy Fingar LLP, is author of the blog, and may be reached at (914) 385-1024 or rkiggins@mccarthyfingar.com.

Posted at 02:05 PM | Permalink | Comments (0) | TrackBack (0)

September 15, 2010

SEC Sweep of Funds of Funds and Advisers

A number of sources have reported on an ongoing SEC sweep of funds of funds and investment advisers making or recommending investments in underlying hedge and private equity funds to uncover conflicts of interest and lapses in oversight of client funds.

Among other items, the SEC is seeking the names of hedge funds that were considered but rejected as well as the names of all third party consultants who were involved in the decisions to hire or reject a fund.

The SEC will also be examining the personal accounts of individual managers of funds of funds or investment advisers to see if any unfair advantage was taken of special knowledge they obtained in such positions such as front running or betting against client orders. The sweep letter also asks for dates and amounts of client withdrawals, details of any revenue sharing agreements, and trade blotters for both clients and managers.

Sources report that the initial SEC inquiry is to firms with $100MM to $15BB in assets under management.

* * *

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Posted at 08:12 AM | Permalink | Comments (0) | TrackBack (0)

September 10, 2010

Hedge Funds Post 0.55% Average Loss for Month of August

Hedge fund performance managed to outpace broader market indices, but nonetheless posted an average loss of 0.55% for the month of August, according to Hennessee Group LLC.

Market commentators noted that fund managers were hurt by the poor performance of the overall stock market. Over that same period, the Dow Jones Industrial Average ("DJIA") was down 4.31%, with the S&P 500 losing 4.7%.

July saw hedge funds post their only gain in the past four months, with the average fund up 1.9%. This followed losses the previous two months, with 1.35% and 3.01% declines in June and May, respectively, according to Hennessee Group.

Performance by Investment Strategy

Hedge Fund Research, another consulting firm reporting on hedge fund performance, provides the following strategy-specific data:

- Short-Bias - Short-bias funds performed well for the month of August, posting a gain of 3.0%.
- Macro Funds - Macro funds showed a gain of 2.16% for the month of August.
- Event-Driven - Funds specializing in event-driven strategies were nearly flat for the month of August.

It should be noted that according to Hedge Fund Research, the average fund posted a 0.17% gain in August, in contrast to the average loss of 0.55% for funds tracked by the Hennessee Group.

* * *

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Posted at 01:21 PM | Permalink | Comments (0) | TrackBack (0)

September 07, 2010

Securities Act of 1933: Regulation D "Safe Harbor" Provisions

Securities Act of 1933

The Securities Act of 1933 ("Securities Act"), as amended, is a federal law providing for the registration of securities with the Securities and Exchange Commission ("SEC"). While hedge fund interests do fit the definition of a "security" under the Securities Act, Regulation D "Safe Harbor" provisions govern the limited offer and sale of securities without registration. See Regulation D. Rule 506 is the most widely relied upon exemption under Regulation D, with qualifying funds permitted to raise an unlimited amount of capital. This article is designed to outline not only the Rule 506 exemption, but also Rule 504 and Rule 505 exemptions under the Regulation D Safe Harbor provisions.

Requirements for Meeting Regulation D

Rule 501 - Definitions and Terms Used in Regulation D

The most relevant portion of Rule 501 is the definition of an "accredited investor."

- **Accredited Investor** - Although there are several categories available to satisfy this standard, there are two generally relied upon approaches for individual investors. The more prominent is the 'net worth' standard of $1MM, exclusive of primary residence. As an alternative for individual investors there is the 'net income' test, requiring income in excess of $200,000 in each of the two most recent years or joint income with one's spouse in excess of $300,000 in each of those years and a reasonable expectation of reaching the same income level in the current year. For the institutional investor, the most common standard met is having total assets in excess of $5MM.

Rule 502 - General Conditions to Be Met

Rule 502 provides conditions for funds qualifying under the Regulation D Safe Harbor provisions. Issued securities must comply with certain integration rules, and limits on resale. A fund must also furnish certain information to any non-accredited investors in any offering.

Most notable among these conditions, Rule 502 contains public offering restrictions in accordance with rule 4(2) of the Securities Act.

- **No Public Offering of Securities** - Neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

  - Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
  - Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

There are certain exceptions for activities held outside of the United States, including journalist access to press conferences, meetings with an issuer or its selling representatives, and press-related materials.

Rule 503 - Filing of Notice of Sales

Rule 503 governs the filing of Form D with the SEC. An issuer offering or selling securities in reliance on Rule 504, Rule 505 or Rule 506 shall file with the SEC five copies of a notice on Form D no later than 15 days after the first sale of securities. This is to filed electronically and needs to be updated annually as long as the securities offering in question is open to investors.

Rule 504 - Exemption for Limited Offerings and Sales of Securities Not Exceeding $1,000,000

Rule 504 provides an exemption to registration where no more than $1MM of securities are offered during any 12 month period. Securities Exchange Act of 1934 companies (those subject to the reporting requirements of section 13 or 15(d) thereof), investment companies, and certain development stage companies may not employ the Rule 504 exemption.

Note that under certain conditions, Rule 504 exempt companies may engage in general solicitation in connection with securities.

Rule 505 - Exemption for Limited Offers and Sales of Securities Not Exceeding $5,000,000

Rule 505 provides an exemption to registration where no more than $5MM of securities are offered during any 12 month period, and there is a limited number of non-accredited investors in any offering. Investment companies may not employ the Rule 505 exemption.

- **Limitation on Number of Purchasers** - Requires that there are no more than, or the issuer reasonably believes there are no

more than, 35 non-accredited investor purchasers of securities from the issuer in any offering under this exemption.

Rule 506 - Exemption for Limited Offers and Sales without Regard to Dollar Amount of Offering

Rule 506 provides an exemption where a fund meets conditions for both the nature of investors, and the number of non-accredited investors in any offering. Qualifying funds are permitted to raise an unlimited amount of capital.

- **Limitation on Number of Purchasers** - Requires that there are no more than, or the issuer reasonably believes that there are no more than, 35 non-accredited investor purchasers of securities from the issuer in any offering under this exemption.
- **Nature of Purchasers** - Each non-accredited investor, either alone or with his purchaser representative(s), must have such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.

Disqualification from Regulation D

Rule 507 - Disqualifying Provision Relating to Exemptions Under Rule 504, Rule 505 and Rule 506

Rule 507 provides that no exemption under Regulation D will be available if an issuer has been found to be in violation of Rule 503 Form D filing requirements.

Rule 508 - Insignificant Deviations from a Term, Condition or Requirement of Regulation D

Rule 508 describes conditions for certain insignificant violations *not* resulting in the loss of exemption under Regulation D. Note that violations of general solicitation rules, maximum dollar limits or number of purchasers will be deemed significant.

"Bad Actors" Provision

As set forth in the Dodd-Frank Bill, the SEC will promulgate rules that disqualify "bad actors" from relying on the Rule 506 exemption under Regulation D. Currently, these rules only apply to Rule 505 exemptions. The SEC will issue this set of rules by July 21, 2011.

The new provisions bar an individual that:

(1) is subject to a final order of an appropriate regulatory body that bars the person from association with an entity regulated by such authority, engaging in the business of securities, insurance, or banking, or engaging in savings association or credit union activities, or constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the 10-year period ending on the date of the filing of the offer or sale; or

(2) 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 Commission.

*

Regulation D provisions relate to transactions exempted from the registration requirements of section 5 of the Securities Act. Such transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws.

Nothing in these rules obviates the need to comply with any applicable state law relating to the offer and sale of securities. Regulation D is intended to be a basic element in a uniform system of Federal-State limited offering exemptions consistent with the provisions of sections 18 and 19(c) of the Act. In those states that have adopted Regulation D, or any version of Regulation D, special attention should be directed to the applicable state laws and regulations, including those relating to registration of person who receive remuneration in connection with the offer and sale of securities, to disqualification of issuers and other persons associated with offerings based on state administrative orders or judgments, and to requirements for filings of notices of sales.

It is important to note that hedge funds are subject to all federal securities laws, and while this article discusses a particular set of registration exemptions to the Securities Act of 1933 under Regulation D, there are several other important federal laws for sponsors and managers to keep in mind:

- Securities Exchange Act of 1934
- Investment Advisers Act of 1940

- Investment Company Act of 1940
- Commodities Exchange Act

* * *

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Posted at 02:08 PM | Permalink | Comments (0) | TrackBack (0)

September 03, 2010

Dodd Frank Act - Primer on the Volcker Rule

Under the so-called Volcker Rule (the "Rule") of the Dodd Frank Act a banking entity except as permitted by other parts of the Rule is prohibited from:

1. engaging in proprietary trading, and
2. from aquiring or retaining any interest in or sponsorship of a hedge fund or private equity fund.

The permitted activities are:

1. investment in US government and agency obligations, certain obligations of US government related issuers such as Fannie Mae and Freddie Mac, and US state and local obligations
2. underwriting and market making activities to the extent they are not designed to exceed reasonably expected near term demands of clients, customers or counterparties
3. hedging activities designed to reduce risk to the banking entity
4. the purchase, sale, acquisition, or disposition of securities or other instruments on behalf of customers
5. investments in one or more small business investment companies as defined in the Small Business Investment Company Act of 1958, investments designed to promote the public welfare, and investments that are qualified rehabilitation expenditures with regard to a qualified rehabilitated building or certified historic structure
6. insurance company investments for its general account permitted by insurance company investment laws, subject to certain insurance, banking, and financial oversight
7. organization and offering of a private equity or hedge fund to which the banking entity provides bona fide trust, fiduciary services, or investment advisory services - subject to numerous additional conditions
8. certain proprietary trading activity conducted solely outside the US
9. certain hedge fund and private equity fund activity conducted solely outside the US

There are a number of limitations on the foregoing exceptions. The most important pertains to Item 7 and limits the banking entity, subject to a number of other limitations, to making (i) an investment for up to a 3% interest in a proprietary private equity or hedge fund and (ii) an amount up to 3% of the banking entity's Tier I capital in all such funds. However, a banking entity is permitted to provide temporary seed capital of up to 100% of a new fund for up to one year.

There are also restrictions on the types of transactions which a banking entity which is the manager, investment adviser, or sponsor to a hedge fund or private equity fund may enter into with the fund. There is an explicit permission to provide prime brokerage services - again subject to numerous requirements.

* * *

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September 02, 2010

Sponsors and Managers: Beware Benefit Plan Investors in Your Fund(s)

The assets of a hedge fund in which benefit plan investors have invested will not be considered "plan assets" if the equity participation in the fund by "benefit plan investors" is not "significant" (the "25% Limit"). If a hedge fund does not comply with the 25% Limit, and the hedge fund does not meet one of the other exceptions under the Plan Asset Regulations, then the assets of the hedge fund will be deemed "plan assets" for purposes of ERISA and Section 4975 of the Code, with adverse consequences.

Investments in hedge funds by pension plans governed by the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), or the "prohibited transaction" rules of Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code"), raise special issues for the managers of those funds. Depending upon the structure and operation of a hedge fund, its assets may be considered "plan assets" for purposes of ERISA and Section 4975 of the Code. For the reasons discussed below, hedge fund managers typically seek to structure their funds so that their assets are not characterized as "plan assets" for purposes of ERISA and the Code. This article outlines the requirements of, and legal and practical issues raised by, compliance with the "25% Limit" - the approach that hedge fund managers commonly use so that their funds' assets are not considered "plan assets" for purposes of ERISA and Section 4975 of the Code.

The Department of Labor's ("DOL") plan asset regulations (the "Plan Asset Regulations") define what constitutes "plan assets." The Plan Asset Regulations provide as a general rule that, when an employee benefit plan governed by ERISA or Section 4975 of the Code (a "Plan") invests in an entity, the Plan's assets include the Plan's investment but do not, solely by reason of such investment in the entity, include any of the underlying assets of the entity. However, as in the case of a hedge fund, where the Plan's investment is an equity interest that is not a publicly offered security or a security issued by a company that is registered under the 1940 Act, the Plan's assets include both the equity interest and an undivided interest in each of the underlying assets of the hedge fund unless one of the exceptions in the Plan Asset Regulations is satisfied. The exception most commonly used by hedge funds provides that assets of a hedge fund in which a Plan has invested will not be considered "plan assets" if the equity participation in the fund by "benefit plan investors" is not "significant", defined to mean not over 25%.

If a hedge fund does not comply with the 25% Limit, and the hedge fund does not meet one of the other exceptions under the Plan Asset Regulations, then the assets of the hedge fund will be deemed "plan assets" for purposes of ERISA and Section 4975 of the Code. The consequences of this would include:

• the hedge fund's manager would be a fiduciary of each Plan investor governed by ERISA, and the manager's activities would be subject to the general fiduciary requirements of Section 404 of ERISA;

• all of the hedge fund's activities would be subject to the prohibited transaction rules of Section 406 of ERISA and Section 4975 of the Code. Among other things, transactions with affiliates would be restricted, and performance fees charged by the hedge fund manager would need to be structured to ensure compliance with applicable DOL guidelines; and

• in many instances, failure to comply with the 25% Limit would result in a withdrawal or redemption of the capital committed by Plans, which may have a material adverse impact on a hedge fund's operations.

The Plan Asset Regulations define a "benefit plan investor" broadly as:

• any employee benefit plan, whether or not subject to ERISA and whether or not covering U.S. employees (including governmental plans, church plans and non-U.S. plans);

• any plan described in Section 4975(e)(1) of the Code, including individual retirement accounts and Keogh plans; and any entity whose underlying assets include "plan assets" by reason of an employee benefit plan's investment in the entity (*e.g.*, insurance company separate accounts or collective investment vehicles, including other hedge funds, that do not comply with the 25% Limit). Thus, the term "benefit plan investor" includes plans that are not themselves subject to ERISA.

* * *

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August 11, 2010

Hedge Funds Post 1.9% Average Gain for Month of July

Hedge fund performance failed to keep pace with broader market indices, but did post an average gain of 1.9% for the month of July, according to Hennessee Group LLC. Over that same period, the Dow Jones Industrial Average ("DJIA") was up 7.1%, with the S&P 500 gaining 6.8%.

Market commentators contributed the relative underperformance to fund managers trimming their positions after seeing losses the previous two months, with 1.35% and 3.01% declines in June and May, respectively, according to Hennessee Group.

Including July performance, Hennessee Group reports hedge funds are up 1.87% for the year, with the DJIA gaining .03%, and the S&P 500 dropping 1.33% for that same period.

Performance by Investment Strategy

Hedge Fund Research, another consulting firm reporting on hedge fund performance, provides the following strategy-specific data:

- Equity-Based - Equity-based hedge funds led the group, gaining 2.88% for the month of July.
- Short-Selling - Contrasting the gains by equity-based funds, short-selling funds struggled for the month of July, posting a decline of 6.30%.
- Event-Driven - Funds specializing in event-driven strategies posted a gain of 2.19% for the month of July.

* * *

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Posted at 08:34 AM | Permalink | Comments (0) | TrackBack (0)

August 05, 2010

New York State Investment Adviser Registration

Under Section 359-eee of Article 23A of the New York General Business Law (often called the "Martin Act") and related regulations, an investment adviser which is not registered with the Securities and Exchange Commission ("SEC") but which has 6 or more New York resident advisory clients (excluding certain institutional clients) must register at the state level as an investment adviser in New York through the Investment Adviser Regulatory Depository System ("IARD"). An adviser registering with New York (or any other state) can go to the IARD State Entitlement Packet which (as of the posting of this article) contains information on how to complete a state IARD filing.

By contrast, the Investment Advisers Act of 1940 ("Advisers Act") is a federal securities law that regulates and provides for the federal level registration of investment advisers. Where registration under the Advisers Act is appropriate (*for when Advisers Act registration may be appropriate see the end of this article below the * * * mark*) , an investment adviser will register electronically as such with the SEC through IARD. An SEC registered investment adviser with 6 or more New York resident advisory clients (again excluding certain institutional clients) will, in addition to registering with the SEC, also be required to "notice file" with New York through IARD.

Note however: that notice filing as an investment adviser with New York is not the same thing at all as registration as an investment adviser with New York. In the former case, the adviser is primarily SEC regulated and, in the latter case, the adviser is regulated by the Investor Protection Bureau of the Office of the Attorney General of the State of New York.

For more information on New York law and NY registration: see Investor Protection Bureau Investment Advisers Page.

Some Pertinent New York Investment Adviser Regulations

Investment Adviser Definition

An investment adviser is defined as follows:

"Investment adviser shall mean any person who, for compensation, engages in the business of advising members of the public, either directly or through publications or writings within or from the State of New York, as to the value of securities or as to the advisability of investing in, purchasing, or selling or holding securities, or who, for compensation and as a part of a regular business issues or promulgates analyses or reports concerning securities to members of the public within or from the State of New York [NY Inv. Adv. Reg. 11.12(f)]"

There exists a registration exemption for investment advisers operating below a defined limit on number of in-state clients as follows:

"A person who sells investment advisory services to less than six (6) persons in this state exclusive of financial institutions and institutional buyers [NY Inv. Adv. Reg. 11.13(a)(5)]. "

While an investment adviser may register or notice file (further described above) with less than six New York clients, it is not required to do so.

New York Registration

Proper registration of an investment adviser in New York State is accomplished by satisfying the following requirements:

- **Filing of Form ADV** - Form ADV, Part 1 will need to be filed with New York through the IARD system. Form ADV, Part 2 and Schedule F, which cannot be filed through IARD, must be filed with the state, together will an income statement and balance sheet that is either audited or certified by management [11.4(a), 11.14(b)].
Form ADV, Part 2 filings are not yet accepted by IARD. Until IARD, in accordance with the Dodd-Frank Bill, provides for the online filing of Part 2 of Form ADV, the NY Department of Law requires the filing of Part 2 of Form ADV in paper form [11.5(a)(1)]
- **Annual Renewal** - The application for annual renewal as an investment adviser shall be filed with IARD. The application for annual renewal registration shall include the required fee and any other information the Department of Law may reasonably require [11.4(d)].
- **Updates and Amendments** - An investment adviser must file with IARD, in accordance with the instructions in the Form ADV, any amendments to the investment adviser's Form ADV [11.4(f)(1)].
- **Investment Adviser Examination Requirements** - An investment adviser, subject to certain waivers, must take and receive a passing grade within two (2) years prior to the date of filing registration information on (1) the

Uniform Investment Adviser Law Examination (Series 65 examination), or (2) the General Securities Representative Examination (Series 7 examination) and the Uniform Combined State Law Examination (Series 66 examination) [11.6].

- **Filing Fees** - The fees for initial and annual renewal registrations filed directly with the Department of Law or its designee are $200 [11.8(a)].
- **Record Keeping Requirements** - Certain books and records, such as annual financial statements and client files, must be maintained and preserved in an easily accessible place for a period of not less than five (5) years from the last transaction or publication, with the first two (2) years being an appropriate office of the investment adviser [11.9].
- **Filing of Investment Advisory Literature and Advertisements** - An investment adviser must file certain advisory literature and advertising material [11.10].

Investment Adviser FAQ

The Investor Protection Bureau provides a list of frequently asked questions, as additional reference when registering as an investment adviser with New York State.

* * *

With the passage of the Dodd-Frank Bill last month, it appears that certain advisers previously allowed to register with the SEC, i.e. those with assets under management ("AUM") above $25 MM, but less than $100 MM, may effective July 21, 2011 (one year after the Bill was signed into law) instead be required to register with one or more states. If an investment adviser at this AUM level ($25MM to $100MM) has its principal place of business in a state and is subject to being inspected or reviewed by the state's securities authorities, it will, if it is a new investment adviser not previously SEC registered, be required to register as an adviser within such state. Put differently: as of July 21, 2011, in most cases, only investment advisers with $100MM AUM will be allowed to be SEC registered and, advisers below that level, will seemingly be required to register at the state level. Depending on the adviser's business mix this could require registration in up to 14 states for advisers who were previously registered at the federal level with the SEC.

I say "seemingly" and "could" in the foregoing two sentences, as it remains unclear whether the Dodd-Frank Bill will require federal level SEC deregistration for those previously permitted to register with the SEC as an investment adviser, or by when such federal level SEC deregistration would need to take place.

Transitional periods, like the present one, in which new laws are phased in and old ones are phased out are in almost constant flux, and consequently the exact methodology for securities law filings changes frequently. Also the interplay of federal and state laws as it affects investment advisers is complex. Finally, more complications are introduced as we are living in an period in which digital on line registration and filing requirements are replacing old paper registration filing requirements on a more or less *ad hoc* basis.

Given the complexity of the whole subject of investment adviser registration and filings, professional help including a so-called "Blue Sky" survey of applicable state securities laws is advised. Finally, as is always the case with this blog, nothing in this article should be relied upon as specific legal advice. Each case is different and non-apparent factual variations can change legal outcomes as to investment adviser registration and filing requirements.

* * *

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Posted at 02:38 PM | Permalink | Comments (0) | TrackBack (0)

July 28, 2010

AUM Effect on Whether as Investment Adviser is SEC or State Registered

Here is a summary of the updated SEC ADV registration requirements with respect to adviser assets under management (AUM):

Under $25 MM

States remain responsible for registration requirements at this AUM level. An adviser at this AUM level will not be permitted to register with the SEC unless its state does not regulate investment advisers.

$25 to $100 MM

The Dodd-Frank Bill establishes a new category for advisers at this AUM level. If an adviser has its principal place of business and is subject to being inspected or reviewed by the state's securities authorities, it will be subject to registration in such state. If the adviser's state does not promulgate such requirements, it will be required to register with the SEC.

However, an adviser that would otherwise fit this newly created category will be given the option of SEC registration if it would otherwise be required to register with 15 or more states.

$100 MM

Advisers with $100 MM or greater AUM will be required to register with the SEC, unless otherwise exempt under the Advisers Act.

* * *

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July 23, 2010

SEC Adopts Rule Changes to Form ADV, Part 2

The Securities and Exchange Commission has voted unanimously to adopt changes to the principal disclosure document that SEC-registered investment advisers must provide to their clients and prospective clients.

Form ADV, Part 2, commonly referred to as the 'brochure,' includes an investment adviser's qualifications, investment strategies, and business practices.

Amendments

The amendments to form ADV, Part 2 address the following issues:

Narrative Format and Updating Requirements

An investment adviser is required to prepare a narrative, plain English, brochure, presented in a consistent, uniform manner, with particular focus on conflicts of interest the firm and its personnel face, the effects of those conflicts on firm services, and steps the adviser takes to address the conflicts.

An investment adviser must deliver the brochure to a client before or at the time the adviser enters into an advisory contract with the client. In addition, an adviser must provide each client with an annual summary of material changes to the brochure and either deliver a complete updated brochure or offer to provide the client with the updated brochure.

Expanded Content

The new brochure addresses the following topics:

- **Advisory Business** - An investment adviser must describe its advisory business, including the types of advisory services offered, state whether it holds itself out as specializing in a particular type of advisory service, and disclose the amount of client assets that it manages.
- **Fees and Compensation** - An investment adviser must describe how it is compensated for its advisory services, provide a fee schedule, and disclose whether fees are negotiable. The investment adviser must also describe the types of other fees or expenses, such as brokerage fees, custody fees, and fund expenses that clients may pay in connection with the services provided.
- **Performance-Based Fees and Side-by-Side Management** - An investment adviser that accepts performance-based fees, or that supervises an individual who accepts such fees, is required to disclose this fact. If the investment adviser also manages accounts that are not charged a performance fee, the adviser must explain the conflicts of interest that arise from the simultaneous management of these accounts and must describe how it addresses those conflicts.
- **Methods of Analysis, Investment strategies, and Risk of Loss** - An investment adviser must describe its methods of analysis and investment strategies and explain that investing in securities involves risk of loss. Investment advisers who use a particular method of analysis or strategy or who recommend a particular type of security are required to explain the material risks involved and discuss the risks in detail, if those risks are unusual.
- **Disciplinary Information** - An investment adviser is required to disclose in its brochure material facts about any legal or disciplinary event that is material to a client's evaluation of the advisory business or to the integrity of its management personnel. An investment adviser must deliver promptly to clients updated information when there is new disclosure of a disciplinary event or a material change to an existing disciplinary event.
- **Code of Ethics, Participation or Interest in Client Transactions, and Personal Trading** - An investment adviser is required to describe briefly its code of ethics and state that a copy is available upon request. The adviser must also disclose whether it or an affiliate recommends to clients, or buys or sells for client accounts, securities in which the adviser or an affiliate has a material financial interest and, if so, the conflicts of interest associated with that practice. The adviser also must disclose whether it or an affiliate invests (or is allowed to invest) in the same securities that it recommends to clients or in related securities, such as options or other derivatives, and must explain the conflicts involved and how it addresses those conflicts. In addition, an investment adviser that trades in the recommended securities at or around the same time as the client has to explain the specific conflicts inherent in that practice and how it addresses them.
- **Brokerage Practices** - An investment adviser is required to describe the factors considered in selecting or recommending broker-dealers for client transactions and determining the reasonableness of brokers' compensation. Investment advisers also must disclose soft dollar practices (research or other products or services, other than execution, provided by brokers or a third party to the investment adviser in connection with client transactions); client referrals (using client brokerage to compensate brokers for client referrals); directed brokerage (asking or permitting clients to send trades to a specific broker for execution); and trade aggregation (bundling trades to obtain volume discounts on execution costs). Investment advisers must explain how they address the various conflicts of interest associated with these practices.

Supplements

An adviser is required to deliver "brochure supplements" to new and prospective clients, providing them with information about the specific individuals who will provide services to the clients. The supplement will contain brief résumé-like disclosure about the educational background, business experience, other business activities, and disciplinary history of the individual. It will also include contact information for the individual's supervisor.

Electronic Filing

Advisers are now required to electronically file Form ADV, Part 2. The filings will be publicly available on the SEC's website.

Compliance Dates

The amended rules and forms will be effective 60 days after publication in the Federal Register.

Most investment advisers will begin distributing and publicly posting new brochures in the first quarter of 2011.*

In accordance with the Form ADV, Part 2 Amendments, managers should prepare for the adoption of these rule changes, and

in this evolving regulatory landscape move forward with particular concentration on transparency, documentation of compliance and communication with investors.

Form ADV is divided into two parts, and is required to register as an investment adviser with the SEC. This article, and the amendments described herein, relate solely to Form ADV, Part 2. Form ADV, Part 1 requires the disclosure of information that is mostly within the purview of the SEC or state securities authorities, as opposed to investors. Specifically, Form ADV, Part 1 covers aspects of an investor adviser's business, such as name, number of employees, form of organization, and nature of business, as well as disciplinary history within the last ten years.

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