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# Changes in Store for Registered Investment Advisers under Financial Reform

Mid-sized registered investment advisers (with between $30m and $100m in assets under management) may be forced to give up their SEC licenses and switch to registration with their home states and, possibly, other states under the new financial reform legislation.

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Most of the public focus has been on the new registration requirement for private fund managers that have previously operated under an exemption. The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted this month, also includes significant changes for many RIAs.

The amendments to the Investment Advisers Act of 1940 ("IAA") will take effect in July 2011. Most provisions of the new law will need new SEC regulations for clarification or implementation. The SEC has a huge amount on its plate, so it is unlikely that they'll issue real direction for some months. This presents an opportunity for advisers to make their views heard during the rulemaking process.

The following is a summary of the changes Dodd-Frank makes to the registration and compliance requirements for registered investment advisers.

### Mid-sized SEC registrants may be required to shift to state registration

Currently, an adviser that is required to be registered under both the IAA and applicable state law is (i) prohibited from registering with the SEC if its AUM are less than $25m and (ii) subject only to SEC registration if its AUM are at least $30m.

The Dodd-Frank Act increases the threshold under which SEC registration is prohibited to $100m, with an exception for an adviser that would need to register with 15 or more states as a result of this provision.[1]

1 The existing provision for SEC registration of advisers to registered investment companies is undisturbed.

Advisers in this category would have to shift their licenses over to the states.

- An adviser with AUM over $25m that is located in a state (such as New York) that does not provide for examinations of investment advisers may elect to register with the SEC or its home state.

It is possible that the SEC will grandfather current SEC registrants – a point on which industry input will be valuable. If not, the deadline for moving to state registration will likely be in July 2011.

### Some consequences of shifting to state registration

An RIA that has to switch from SEC to state registration will face new circumstances beyond just getting to know a different regulator.

1. The adviser may need to register in other states where it has six or more clients, in addition to its home state.[2]
2. Advisory personnel, including supervisors and solicitors, whose clients are primarily high net worth or institutional will lose their current federal preemption from "investment adviser representative" registration and will need to file Form U-4 and register with their home state.
   - Individual registration usually requires passing an examination, although state regulators may waive this for transitioning personnel

2 One needs to look at applicable SEC and state rules on how to count "clients." Many states also exclude various types of "institutional" clients from the determination.

with substantial industry experience. (This is a point that should be made to your home state regulator.)

3. A quirk in the Act would apparently prohibit a transferred RIA from serving as an "investment manager" for ERISA assets.[3] Hopefully, this can be resolved by action of the Department of Labor so that any such firm is not forced to give up existing business.

## New exemption from SEC registration for private fund managers with less than $150m AUM in U.S.

An adviser whose sole clients are "private funds" (e.g., limited partnerships that are exempt from investment company registration) will be exempt from SEC registration if its total AUM "in the United States" is less than $150m.[4]

- Note that (as now) a fund manager may have to register with one or more states, absent an applicable exemption, even though it is exempt from SEC registration.

Advisers relying on this new exemption must comply with new recordkeeping and reporting requirements to be adopted by the SEC. They will apparently also be subject to SEC examination.

- An open question is whether these new SEC recordkeeping and reporting requirements will apply to an adviser that is covered by this exemption but required to register with its home state.

## Recordkeeping and examination requirements for SEC-registered advisers

The Act gives the SEC broad power to require SEC-registered advisers to maintain and produce extensive records on private funds they manage.

- The SEC may distinguish between different types or sizes of fund, depending on its perception of the risks that each present.

## Potential regulation of client agreements and disclosures

Dodd-Frank includes authorization for the SEC to:

- prohibit, or impose limits on, advisers' use of mandatory predispute arbitration clauses in client agreements
- require "simple and clear disclosures to investors regarding the terms of their relationships with . . . investment advisers, including any material conflicts of interest" and
- issue rules "prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for . . . investment advisers that [it] deems contrary to the public interest and the protection of investors."

These statutory provisions apply to "any investment adviser," not just those registered with the SEC. They may or may not apply to investors in private funds. Their full impact will not be known until the SEC adopts implementing rules.

## "Family Offices" to be unregulated

Family offices will be excluded from being considered "investment advisers" (not just exempt from registration) under the IAA. The SEC is directed to define "family office" consistent with its current approach to exempting such operations. This has relied on criteria such as the following:

- the family office is wholly owned by the respective family
- the office has no retail (non-family) investors and does not hold itself out to the public as an investment adviser
- the office's advisory role is a limited portion of the services it offers to the family
- the fees the office charges the family are only to cover expenses and not make a profit

This will eliminate the need for family offices to obtain their own individual exemptions, so long as they fit within the new exclusion. However, it should be noted that any family office must still find its own exemption under applicable state law; otherwise, it will be required to register at the state level.

## "Accredited Investor" and "Qualified Client" criteria to be adjusted

Investors in private funds typically need to meet certain income or net worth tests in order to invest.

1. Effective upon enactment of the Act (expected in July 2011), the net worth standard for determining "accredited investor" status of an individual, which is usually a minimum condition for investing in a private fund, must exclude the value of his or her primary residence.

   Also, $1 million, which is the current individual net worth requirement for accredited investor status would be subject to adjustment (for inflation and investor protection considerations generally) by the SEC beginning in 2015.

2. RIAs may not charge a fee based on account performance (including a carried interest) to any client or investor not meeting certain financial criteria. Currently, such "qualified clients" must have either $750,000 under management with the adviser or a net worth (with spouse) of at least $1.5m, or be a "qualified investor" (having investable assets of at least $5m).

   Dodd-Frank requires the SEC to adjust the net worth test for inflation beginning in July 2011 and every five years thereafter.

These changes may reduce somewhat the pool of eligible investors for private funds.

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3 An adviser with AUM under $30m that is now state-registered could continue to be an ERISA fiduciary under the current rules.

4 The SEC generally considers advisory business conducted by affiliated companies under common management to be integrated for purposes of IAA coverage, so one probably cannot avoid registration and compliance for fund management by segregating it from other advisory business.

## Actions to take now

Because the shape and burden of Dodd-Frank's requirements depend so much on SEC rule-making, investment advisers may wish to try to influence the rule-making process. This includes working through industry groups and commenting on the proposed rules when they are published. In any event, RIAs should begin planning for the compliance changes involved.

Our lawyers can help you formulate comments to the SEC and plan for the new compliance regime. If you would like further information, please contact the Edwards Angell Palmer & Dodge LLP lawyer responsible for your matters or one of the lawyers listed below.

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